

RED HAT INC
Form 10-Q
July 10, 2009
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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 May 31, 2009

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

(State or other jurisdiction of incorporation or organization)

06-1364380

(I.R.S. Employer Identification No.)

1801 Varsity Drive, Raleigh, North Carolina 27606

(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 or a non-accelerated filer or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in 12b-2 of the Exchange Act.

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

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

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

As of June 30, 2009, there were 188,007,091 shares of common stock outstanding.

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

	May 31, 2009 (Unaudited)	February 28, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 510,616	\$ 515,548
Investments in debt and equity securities, short-term	206,891	147,178
Accounts receivable, net of allowances for doubtful accounts of \$2,758 and \$2,387, respectively	106,639	128,669
Prepaid expenses and other current assets	95,387	99,437
Total current assets	919,533	890,832
Property and equipment, net of accumulated depreciation and amortization of \$96,923 and \$91,140, respectively	69,619	67,913
Goodwill	438,901	438,109
Identifiable intangibles, net	119,638	122,177
Investments in debt securities, long-term	167,028	183,363
Other assets, net	51,104	51,242
Total assets	\$ 1,765,823	\$ 1,753,636
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 13,089	\$ 9,576
Accrued expenses	52,104	54,123
Deferred revenue	402,764	382,050
Other current obligations	878	900
Total current liabilities	468,835	446,649
Deferred lease credits	4,319	4,470
Long-term deferred revenue	164,576	161,032
Other long-term obligations	34,573	35,432
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, \$0.0001 per share par value, 300,000,000 shares authorized, 208,435,308 and 207,794,700 shares issued, and 187,937,113 and 189,998,611 shares outstanding at May 31, 2009 and February 28, 2009, respectively	21	21
Additional paid-in capital	1,295,305	1,281,469
Retained earnings	69,033	50,519
Treasury stock at cost, 20,498,267 and 17,796,089 shares at May 31, 2009 and February 28, 2009, respectively	(283,054)	(236,283)
Accumulated other comprehensive income	12,215	10,327
Total stockholders' equity	1,093,520	1,106,053
Total liabilities and stockholders' equity	\$ 1,765,823	\$ 1,753,636

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	
	May 31,	May 31,
	2009	2008
Revenue:		
Subscriptions	\$ 148,790	\$ 130,694
Training and services	25,598	25,941
Total subscription and training and services revenue	174,388	156,635
Cost of subscription and training and services revenue:		
Cost of subscriptions	10,050	8,957
Cost of training and services	16,418	17,472
Total cost of subscription and training and services revenue	26,468	26,429
Gross profit	147,920	130,206
Operating expense:		
Sales and marketing	63,977	59,271
Research and development	35,102	28,911
General and administrative	23,785	22,114
Total operating expense	122,864	110,296
Income from operations	25,056	19,910
Other income, net	3,480	10,020
Interest expense	(53)	(1,586)
Income before provision for income taxes	28,483	28,344
Provision for income taxes	9,969	11,054
Net income	\$ 18,514	\$ 17,290
Basic net income per common share	\$ 0.10	\$ 0.09
Diluted net income per common share	\$ 0.10	\$ 0.08
Weighted average shares outstanding		
Basic	188,916	190,779
Diluted	194,382	218,853

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	
	May 31, 2009	May 31, 2008
Cash flows from operating activities:		
Net income	\$ 18,514	\$ 17,290
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,810	9,097
Share-based compensation expense	10,676	10,561
Deferred income taxes	6,428	8,767
Excess tax benefits from share-based payment arrangements	(14,200)	(8,967)
Other	(124)	561
Changes in operating assets and liabilities net of effects of acquisitions:		
Accounts receivable	26,278	19,320
Prepaid expenses and other current assets	644	(5,003)
Accounts payable	2,997	(5,570)
Accrued expenses	(3,029)	1,986
Deferred revenue	2,361	15,454
Other assets, net	(152)	(134)
Net cash provided by operating activities	61,203	63,362
Cash flows from investing activities:		
Purchase of investment in debt securities available for sale	(157,034)	(305,646)
Proceeds from sales and maturities of investment in debt securities available for sale	122,449	216,534
Proceeds from sales of investment in equity securities available for sale	221	
Acquisitions of businesses, net of cash acquired		(43,750)
Purchase of developed software and other intangible assets	(989)	(1,615)
Purchase of property and equipment	(6,028)	(9,522)
Net cash used in investing activities	(41,381)	(143,999)
Cash flows from financing activities:		
Excess tax benefits from share-based payment arrangements	14,200	8,967
Proceeds from exercise of common stock options	4,400	11,447
Payments related to net settlement of employee share-based awards	(1,798)	
Purchase of treasury stock	(46,771)	(9,147)
Structured stock repurchase		1,989
Proceeds from other borrowings		66
Payments on other borrowings	(900)	(23)
Net cash provided by (used in) financing activities	(30,869)	13,299
Effect of foreign currency exchange rates on cash and cash equivalents	6,115	158
Net decrease in cash and cash equivalents	(4,932)	(67,180)
Cash and cash equivalents at beginning of period	515,548	677,720

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Cash and cash equivalents at end of period	\$ 510,616	\$ 610,540
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The accompanying notes are an integral part of these consolidated financial statements.

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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 global leader in providing open source software solutions to the enterprise. The Company is also the market leader in providing enterprise-ready open source operating system platforms. The Company applies its technology leadership to create its: enterprise operating platform, Red Hat Enterprise Linux; enterprise middleware platform, JBoss Enterprise Middleware; virtualization solutions and other infrastructure technology solutions, based on open source technology. The Company's enterprise solutions are intended to meet the functionality requirements and performance demands of the enterprise and third-party computer hardware and software applications that are critical to the enterprise. The Company provides these solutions through integrated management services, Red Hat Network, RHN Satellite, JBoss Operations Network and JBoss Customer Support Portal, which allow various Red Hat enterprise technologies to be updated and configured and the performance of these and other technologies to be monitored in an automated fashion. These solutions reflect the Company's continuing commitment to provide an enterprise-wide infrastructure platform and developer solutions based on open source technology. The Company derives its revenue and generates its cash from customers primarily from two sources: (i) subscriptions for its enterprise technologies and (ii) training and services revenue, as further described below in NOTE 2, Summary of Significant Accounting Policies.

NOTE 2 Summary of Significant Accounting Policies

Unaudited Interim Financial Information

The unaudited interim consolidated financial statements as of and for the three months ended May 31, 2009 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary to present fairly the consolidated balance sheets, consolidated operating results and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months ended May 31, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2010. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC's rules and regulations for interim reporting. For further information, see the Company's Consolidated Financial Statements, including notes thereto, included in the Company's Annual Report on Form 10-K for the fiscal year ended February 28, 2009.

Principles of Consolidation

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

Use of Estimates

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Revenue Recognition

The Company establishes persuasive evidence of a sales arrangement for each type of revenue transaction based on either a signed contract with the end customer, a click-through contract on the Company's website whereby the customer agrees to the Company's standard subscription terms, signed or click-through distribution contracts with original equipment manufacturers (OEMs) and other resellers, or, in the case of individual training seats, through receipt of payment which indicates acceptance of the Company's training agreement terms.

Subscription Revenue

Subscription revenue is comprised of direct and indirect sales of Red Hat enterprise technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is recognized as revenue ratably over the life of the subscription. Red Hat enterprise technologies are generally offered with either one or three-year base subscription periods; the majority of the Company's subscriptions have one-year terms. Under these subscription agreements, renewal rates are generally specified for one or three-year renewal terms. The base subscription generally entitles the end user to the technology itself and post-contract customer support (PCS) generally consisting of a specified level of customer support and security errata, bug fixes, functionality enhancements to the technology and upgrades to new versions of the technologies, each on a when-and-if available basis, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company's sales-force as well as web store sales, and (2) indirect, which includes distributors, resellers and OEMs. The Company recognizes revenue from the sale of Red Hat enterprise technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement.

Subscription arrangements with large enterprise customers often have contracts with multiple elements (e.g., software technology, maintenance, training, consulting and other services). The Company allocates revenue to each element of the arrangement based on vendor-specific objective evidence of each element's fair value when the Company can demonstrate sufficient evidence of the fair value of at least those elements that are undelivered. The fair value of each element in multiple element arrangements is created by either (i) providing the customer with the ability during the term of the arrangement to renew that element at the same rate paid for the element included in the initial term of the agreement or (ii) selling the services on a stand-alone basis.

Training and Services Revenue

Training and services revenue is comprised of revenue for consulting, engineering and customer training and education services. Consulting services consist of time-based arrangements, and revenue is recognized as these services are performed. Engineering services represent revenue earned under fixed fee arrangements with the Company's OEM partners and other customers to provide for significant modification and customization of the Company's Red Hat enterprise technologies. The Company recognizes revenue for these fixed fee engineering services using the percentage of completion basis of accounting, provided the Company has the ability to make reliable estimates of progress towards completion, the fee for such services is fixed or determinable and collection of the resulting receivable is probable. Under the percentage of completion method, earnings under the contract are recognized based on the progress toward completion as estimated using the ratio of labor hours incurred to total expected project hours. Changes in estimates are recognized in the period in which they are known. Revenue for customer training and education services is recognized on the dates the services are complete.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Deferred Commissions

Deferred commissions are the incremental costs that are directly associated with non-cancelable subscription contracts with customers and consist of sales commissions paid to the Company's sales force. The commissions are deferred and amortized over a period that approximates the period of the subscription term. The commission payments are paid in full subsequent to the month in which the customer's service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancelable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not fully pay for their subscription agreements. Amortization of deferred commissions is included in sales and marketing expense in the accompanying Consolidated Statements of Operations. Deferred commissions are included in prepaid expenses and other current assets on the accompanying Consolidated Balance Sheets.

Impairment of Goodwill and Other Long-Lived Assets

The Company tests goodwill for impairment annually and whenever events or circumstances indicate an impairment may exist. Accounting principles generally accepted in the U.S. require goodwill be tested at least annually using a two-step process that begins with identifying potential impairment. Potential impairment is identified if the fair value of the reporting unit to which goodwill applies is less than the recognized or book value of the related reporting entity, including such goodwill. Where the book value of a reporting entity, including related goodwill, is greater than the reporting entity's fair value, the second step of the goodwill impairment test is performed to measure the amount of impairment loss, if any. For the three months ended May 31, 2009 and May 31, 2008, the Company did not identify any potential impairment related to its goodwill.

The Company evaluates the recoverability of its property and equipment and other assets whenever events or changes in circumstances indicate an impairment may have occurred. An impairment loss is recognized when the net book value of such assets exceeds the estimated future undiscounted cash flows attributable to the assets or the business to which the assets relate. Impairment losses, if any, are measured as the amount by which the carrying value exceeds the fair value of the assets. For the three months ended May 31, 2009 and May 31, 2008, no potential impairment losses related to the Company's long-lived assets were identified.

Cash and Cash Equivalents

The Company considers liquid investments purchased with a maturity period of three months or less at the date of purchase to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

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

Table of Contents**RED HAT, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(Unaudited)***Investments in Debt and Equity Securities*

The Company's investments at May 31, 2009 and February 28, 2009 are in debt and equity securities which are classified as available for sale and carried at market value as described below. Investments in debt securities are classified as either a cash equivalent, current asset (Investments in debt and equity securities, short-term) or long-term asset (Investments in debt securities, long-term) based on the maturity date. Investments with a maturity date of one year or less from the balance sheet date are classified as a current asset and those with a maturity date of greater than one year are classified as a long-term asset. The weighted average maturity period of the Company's investment in debt securities was 0.4 years at May 31, 2009 and February 28, 2009.

The Company's investments are considered available for sale as these securities are available for sale at any time in response to needs for liquidity, changes in the availability of and the yield on alternative instruments or changes in funding sources or terms. The following table summarizes the Company's average total return and resulting unrealized gain or loss related to these investments which is recorded as other comprehensive income, a separate component of stockholders' equity (in thousands):

	Three Months Ended May 31, 2009	Three Months Ended May 31, 2008
<i>Debt securities:</i>		
Unrealized gains (losses) on available-for-sale debt securities during the period	\$ 2,556	\$ (4,848)
Average rate of total return on investment in debt securities portfolio	1.8%	3.4%
<i>Equity securities:</i>		