RED HAT INC
Form 10-K
April 24, 2019
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended February 28, 2019

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 of Incorporation)	**(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)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $0.0001 par value	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

The aggregate market value of the common equity held by non-affiliates of the registrant as of August 31, 2018 was approximately $23.1 billion based on the closing price of $147.73 of our common stock as reported by the New York Stock Exchange on August 31, 2018. For purposes of the immediately preceding sentence, the term "affiliate" consists of each director, executive officer and greater than 10% stockholder of the registrant. There were 177,755,763 shares of common stock outstanding as of April 22, 2019.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Red Hat, Inc.'s Definitive Proxy Statement to be filed with the Securities and Exchange Commission and delivered to stockholders in connection with its annual meeting of stockholders to be held on August 15, 2019 are incorporated by reference into Part III of this Form 10-K. With the exception of the portions of the Proxy Statement expressly incorporated into this Annual Report on Form 10-K by reference, such document shall not be deemed filed as part of this Annual Report on Form 10-K.

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CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

Certain statements contained in this report and the documents incorporated by reference in this report, including in Management's Discussion and Analysis of Financial Condition and Results of Operations, constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements provide current expectations of future events based on certain assumptions, and any statement that is not strictly a historical statement could be deemed to be a forward-looking statement (for example, statements regarding current or future financial performance; management's plans and objectives for future operations; product plans and performance; management's expectations regarding market risk and market penetration; management's assessment of market factors; strategies, objectives and plans of Red Hat, Inc. together with its subsidiaries ("Red Hat") and its partners; and the consummation of the proposed acquisition of Red Hat by International Business Machines Corporation). Words such as "anticipate," "believe," "estimate," "expect," "intend," "outlook," "plan," "project," "will," and similar expressions, may also identify such forward-looking statements. Red Hat may also make forward-looking statements in other filings made with the Securities and Exchange Commission ("SEC"), press releases, materials delivered to stockholders and oral statements made by management. Investors are cautioned that these forward-looking statements are inherently uncertain, are not guarantees of Red Hat's future performance and are subject to a number of risks and uncertainties that could cause Red Hat's actual results to differ materially from those found in the forward-looking statements and from historical trends. These risks and uncertainties include the risks and cautionary statements detailed in Part I, 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 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.

PART I

ITEM 1.BUSINESS

OVERVIEW

Red Hat 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 and storage technologies.

Our business model

Development. We employ an open source development model. The open source development model allows us to use the collective input, resources and knowledge of a global community of contributors who collaborate to develop, maintain and enhance software. This collaboration is possible because the human-readable source code for that software is publicly available and licenses permit modification.

Licensing. We typically distribute our software offerings under open source licenses that permit access to the software's human-readable source code.

Subscriptions. We provide our software offerings primarily under annual or multi-year subscriptions as well as on-demand through our certified cloud and service providers ("CCSPs").

Our offerings

Our offerings are designed to provide customers with high-performing, scalable, flexible, reliable and secure technologies that meet the information technology ("IT") needs of enterprises and service providers. Customers can develop and deploy applications using on-premise (physical or virtual environments or private clouds) or off-premise (public cloud) IT resources to create an environment that is designed to enhance efficiency while providing increased security. Our offerings are designed to perform consistently across physical, virtual and hybrid cloud (a combination of one or more public and private clouds) environments to offer our customers greater agility and flexibility for application development and deployment.

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Our offerings include:

Infrastructure-related Offerings

- Red Hat Enterprise Linux—an operating system platform that runs applications on a broad range of hardware and can be deployed in physical, virtual and hybrid cloud environments.
- Red Hat Satellite—a system management offering that is designed to make Red Hat infrastructure easier to deploy, scale and manage across physical, virtual and hybrid cloud environments.
- Red Hat Virtualization—software that allows customers to use and manage a common hardware infrastructure to run multiple operating systems and applications.

Application Development-related and Other Emerging Technology Offerings

- Red Hat Middleware—a suite of offerings used to develop, deploy and manage applications; integrate applications, data and devices; and automate business processes across hybrid cloud environments.
- Other Emerging Technologies—software that enables customers to build and manage hybrid IT computing environments. Our emerging technology offerings include Red Hat OpenShift, Red Hat Cloud Infrastructure, Red Hat OpenStack Platform, Red Hat Ansible Automation, Red Hat CloudForms and Red Hat Storage technologies.

We also offer a wide range of services that are designed to help customers derive additional value from Red Hat technologies. Our consulting services assist customers to enable infrastructure, application development, integration, middleware, cloud, container, automation and storage solutions. Our support services provide customers with technical support to assist with implementing, configuring and using Red Hat technologies. Our training services provide customers and partners with skilled Red Hat certified professionals.

Red Hat, Inc. was incorporated in Connecticut in March 1993 as ACC Corp., Inc., which subsequently changed its name to Red Hat Software, Inc. Red Hat Software, Inc. reincorporated in Delaware in September 1998 and changed its name to Red Hat, Inc. in June 1999. Except as otherwise indicated, all references in this report to “we,” “us,” “our,” the “Company,” the “registrant” or “Red Hat” refer to Red Hat, Inc. and its subsidiaries. Our fiscal year ends on the last day of February, and we identify our fiscal years by the calendar years in which they end. For example, we refer to the fiscal year ended February 28, 2019 as “fiscal 2019.”

PROPOSED ACQUISITION BY INTERNATIONAL BUSINESS MACHINES CORPORATION

On October 28, 2018, we entered into an Agreement and Plan of Merger (the “Merger Agreement”) with International Business Machines Corporation, a New York corporation (“IBM”), and Socrates Acquisition Corp., a Delaware corporation and a wholly-owned subsidiary of IBM (“Sub”), pursuant to which, among other things, Sub will merge with and into us, with Red Hat surviving as a wholly-owned subsidiary of IBM (the “Merger”). Our Board of Directors and the Board of Directors of IBM each approved the Merger and the Merger Agreement, and our stockholders approved the adoption of the Merger Agreement at a special meeting of stockholders on January 16, 2019. The transaction is expected to close in the latter half of 2019, subject to certain conditions, including receipt of regulatory approvals. Until the closing, we will continue to operate as an independent company.

At the effective time of the Merger (the “Effective Time”), subject to the terms and conditions of the Merger Agreement, each share of our common stock, par value $0.0001 per share, issued and outstanding immediately prior to the Effective Time (other than (i) canceled shares, (ii) dissenting shares, and (iii) subsidiary converted shares) shall be converted into the right to receive $190.00 in cash without interest. See NOTE 1—Company and Merger Agreement to our Consolidated Financial Statements for further discussion of the Merger Agreement.

The foregoing description of the Merger Agreement is qualified in its entirety by reference to the full text of the Merger Agreement, which has been filed as Exhibit 2.1 to the Current Report on Form 8-K that we filed with the SEC on October 29, 2018.

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OUR BUSINESS

We use the open source software development and licensing model to provide our offerings to customers primarily on a subscription basis. Subscriptions for our offerings are marketed and sold to customers directly and through business partners.

Development and licensing of Red Hat's open source offerings

The open source software development model allows us to use the collective input, resources and knowledge of a global community of contributors who collaborate to develop, maintain and enhance software. We believe this model offers advantages to Red Hat because we are able to develop our offerings by integrating information, knowledge and testing from this global community. We develop our offerings by working with open source development communities, often in a leadership role. Red Hat sponsors a number of open source projects, including the CentOS project, the Ceph community project, the Fedora Project, GlusterFS, the JBoss community projects and OpenShift Origin. We are also an active contributor in other open source projects such as Apache Camel, Kubernetes, the Linux kernel, the Open Container Initiative, the OpenDaylight Project, Open Platform for NFV and OpenStack. Our participation helps us to benefit from the efforts of these communities, which we believe enhances acceptance and support of our offerings and technologies. Additionally, the open and transparent nature of these communities provides our customers and potential customers, who may also be part of these open source communities, with access and insights into, and the ability to influence, the future direction of our offerings.

Under the open source licensing model, a software developer distributes the software under an open source license, such as the GNU General Public License ("GPL"), GNU Lesser General Public License or Apache License. Open source licenses provide relatively broad rights for recipients of the software to use, copy, modify and redistribute the software. These rights afford significant latitude for recipients to inspect, suggest changes to, customize or enhance the software.

The open source model provides an inherent level of transparency and choice that contrasts with the proprietary software model. Under the proprietary software model, a software vendor generally develops the software itself or acquires components from other vendors, without the input from a wider community of participants. The vendor generally licenses to the user only the machine-readable binary (or object) code version of the software, with no or limited rights to copy, modify or redistribute the software, and does not make the underlying source code available to the user or other developers. Moreover, peer review and collaborative enhancements are more difficult because of the lack of access to the source code.

The scale and efficiency of open source software development has greatly increased through the availability of collaborative technologies and cloud-based tools, such as email lists, websites and code repositories. These technologies have enabled a global community of developers to collaborate on more complex open source projects, many of which are commercially funded.

We believe that open source software is a viable and arguably superior alternative to traditional proprietary software. Open source software, as compared to proprietary software, offers a number of benefits to customers, including:

- enabling a customer's in-house development team to collaborate and innovate with a global community of independent developers and testers;
- providing a customer's in-house development team access to both binary and source code, and broader rights to copy, modify and redistribute the software;
- offering a customer greater flexibility through open rather than proprietary protocols and formats;
- enabling ongoing, quicker access to improvements and fixes; and
- allowing a customer to inspect and help diagnose problems more easily and customize the software to suit its particular needs.

Subscription business model

We provide our software offerings to our customers primarily under annual or multi-year subscriptions as well as on-demand through CCSPs. Our subscription business model is designed to provide customers with a comprehensive technology solution for the duration of their subscription. A subscription generally entitles a customer to, among other things, a specified level of support, as well as security updates, fixes, functionality enhancements, upgrades to the technologies, each if and when available, and compatibility with an ecosystem of certified hardware and software. A subscription also includes access to the Red Hat Customer Portal, which provides customers with services such as our knowledge base, product usage documentation and account management tools. We offer customers subscription options that provide varying levels of customer support. In addition, our customers are eligible to participate in Red Hat's Open Source Assurance program, which provides certain protections in the event of an intellectual property infringement claim made against a customer and based on our software offerings.

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Our subscription business model contrasts with the typical proprietary software license model from a revenue recognition perspective. Under a proprietary software license model, the vendor typically recognizes license revenue in the period that the software is initially licensed. In contrast, under our subscription model, we generally defer revenue when we bill the customer and recognize revenue over the life of the subscription term.

Distribution of Red Hat offerings

We make Red Hat offerings available directly to customers and indirectly through various channels of distribution. Our direct sales channels include our sales force and our web store. Our indirect sales channels include CCSPs (such as public cloud providers and managed service providers), distributors, embedded technology partners, independent software vendors ("ISVs"), systems integrators ("SIs") and value added resellers ("VARs"). In addition, hardware original equipment manufacturers ("OEMs") pre-load and support Red Hat offerings on their hardware products and sell their hardware together with Red Hat offerings as part of pre-configured solutions.

With the support and tools we make available, many of these companies have engineered and certified that their technologies run on or with Red Hat offerings, and, in some cases, independent hardware vendors ("IHVs") and ISVs have built their products and solutions using our offerings. Our offerings can also be used on an on demand basis through our CCSPs, allowing our customers to utilize their subscriptions with increased flexibility. We believe widespread support from these companies helps to increase the level of market acceptance and adoption of our offerings.

Support by leading technology providers

To facilitate the widespread deployment of Red Hat offerings, we have focused on gaining broad support for our offerings from technology providers that are critical to enterprises. For example, leading ISVs with applications that run on, or with, our technologies include Affirmed Networks, Inc., Cerner Corporation, Cloudera, Inc., Dynatrace LLC, Dell Inc. ("Dell"), F5 Networks, Inc. ("F5 Networks"), Hewlett Packard Enterprise Company ("HPE"), IBM, Mavenir Systems, Inc., Microsoft Corporation ("Microsoft"), NetApp, Inc. ("NetApp"), Oracle Corporation ("Oracle"), SAP SE ("SAP"), SAS Institute Inc., Swift Technologies Inc., Veritas Technologies LLC and VMware, Inc. ("VMware"). In addition, we have certification and pre-load arrangements with leading hardware vendors including Cisco Systems, Inc. ("Cisco"), Dell, Fujitsu Limited ("Fujitsu"), HPE, Hitachi, Ltd., IBM, Lenovo Group Ltd. ("Lenovo") and NEC Corporation. We also have certification agreements with leading networking, storage and telecommunication companies including Big Switch Networks, Inc., Cisco, Dell, Ericsson Inc., F5 Networks, HPE, Huawei Technologies Co., Ltd., Juniper Networks, Inc. and Nokia Corporation. We have strategic relationships with leading semiconductor and technology companies, such as Advanced Micro Devices, Inc., ARM Holdings plc, Intel Corporation, IBM and NVIDIA Corporation. We have strategic relationships with leading cloud computing platforms, such as Alibaba Cloud Computing, Amazon Web Services, Inc. ("AWS"), Fujitsu, Google Inc. ("Google"), IBM and Microsoft. We also have relationships with a number of global SIs such as Accenture plc, Atos SE, DXC Technology Company, Infosys Limited, IBM, Tata Consultancy Services Limited, Tech Mahindra Limited and Wipro Limited.

Factors influencing our success

We believe our success is influenced by:

- our ability to utilize the innovation derived from software developed by an open source community and make it consumable for enterprise customers;
- the extent to which we can expand the breadth and depth of our offerings;
- strategic business combinations and acquisitions of technical talent and technologies;
- 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;
- the extent to which adoption of our emerging technology offerings and software development processes such as CI/CD (continuous integration and continuous deployment) and DevOps increases;
- our involvement and leadership in key open source communities and projects, which enable us to develop, enhance and maintain our offerings;
- our corporate culture, which we believe fosters innovation, creativity and collaboration;
- our ability to generate increasing revenue directly and through partners and other strategic relationships, including CCSPs, distributors, embedded technology partners, IHVs, ISVs, OEMs, SIs and VARs;

- our ability to generate new and recurring revenue for our offerings;

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- the widespread and increasing deployment of open source technologies globally;
- 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;
- our ability to provide customers with consulting and training services that generate additional subscription revenue; and
- 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.

Subscription revenue by product group

Subscription revenue for our Infrastructure-related offerings (Red Hat Enterprise Linux, Red Hat Satellite, Red Hat Virtualization and related offerings) as a percentage of our total revenue were 63.4%, 66.8% and 70.3% for fiscal 2019, fiscal 2018 and fiscal 2017, respectively. Subscription revenue for our Application Development-related offerings (Red Hat Middleware) and other emerging technology offerings (Red Hat OpenShift, Red Hat Cloud Infrastructure, Red Hat OpenStack Platform, Red Hat Ansible Automation, Red Hat CloudForms and Red Hat Storage technologies) as a percentage of our total revenue were 24.3%, 21.4% and 18.2% for fiscal 2019, fiscal 2018 and fiscal 2017, respectively. For additional financial information about our products and services, see NOTE 22—Segment Reporting to our Consolidated Financial Statements.

Customers

We sell our offerings to enterprises in a variety of industries, including financial services, government, healthcare, retail, technology and media, telecommunications and transportation. For fiscal 2019, fiscal 2018 and fiscal 2017, the U.S. government and its agencies represented in the aggregate approximately 10% of our total revenue.

Backlog

We define total backlog as (i) total deferred revenue, which has been billed, plus (ii) the value of non-cancellable subscription agreements not yet billed or reflected in our financial statements and the value of service agreements not yet billed or reflected in our financial statements that we believe to be firm (“off-balance sheet backlog”). Total backlog at February 28, 2019 included deferred revenue classified as a current liability of $2.16 billion and long-term deferred revenue of $821.2 million. The value of off-balance sheet backlog was in excess of $1.0 billion, and the portion of such value at February 28, 2019 that we expect to be billed during the fiscal year ending February 29, 2020 is in excess of $490 million. At February 28, 2018, total backlog included deferred revenue classified as a current liability of $1.85 billion and long-term deferred revenue of $741.5 million and the value of off-balance sheet backlog at February 28, 2018 was in excess of $775 million.

We report our off-balance sheet backlog as a conservative approximation, often describing the amount as “in excess of,” primarily because the value of underlying contracts is derived from data not yet subjected to the complete application of our revenue recognition policies. For example, the value of the service agreements included as a part of off-balance sheet backlog is less than the stated value of such agreements because in certain instances customers are not contractually required to purchase the stated value of such services (e.g., when the services are to be billed on a time and materials basis and the service agreement’s stated value is merely an estimate of the aggregate value of the services to be provided). Historically, the impact on off-balance sheet backlog resulting from the difference in the amount of services billed and the service agreements’ stated value has not been material. We endeavor to derive the value of our off-balance sheet backlog in a consistent manner year over year and, therefore, believe the amounts are comparable.

Seasonality

Our fourth fiscal quarter has historically been our strongest quarter for billing both new business and renewals. For a more detailed discussion, see Part II, Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations.”

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BUSINESS STRATEGY

Our goal is to be the default choice for next-generation IT, partnering with our customers through an open, hybrid cloud portfolio including hybrid cloud infrastructure, cloud-native development and management and automation. Key elements of our strategy to achieve this goal include:

Driving the widespread adoption of our offerings

We seek to drive further adoption of our offerings through:

- continuing to evolve our technology portfolio through ongoing innovation;
- supporting new and emerging technologies such as OpenShift, OpenStack and Ansible;
- leveraging new delivery models, such as on demand consumption;
- encouraging modern software development processes, such as CI/CD (continuous integration and continuous deployment) and DevOps; and
- using a consultative selling approach, with a focus on solving customer problems.

Additionally, we believe the demand for portability, management and consistency in hybrid cloud environments can provide us with a greater ability to penetrate existing and generate new customer and partner opportunities. We also seek to drive further adoption of our offerings by diversifying our customer base, including focusing on international growth.

Investing in the development of open source technologies and promoting the use of our technologies by software developers globally

We intend to continue to invest significant resources in the development of open source technologies, capitalizing on our substantial experience working with open source development projects and in communities with customers, contributors and partners to create better open source technologies. We expect this continued investment to take the form of expenditures on internal development efforts, as well as continued funding of third-party open source projects and the expansion of our developer offerings. We also believe that by expanding and empowering the developers that use our technologies, we can enhance our technical leadership position and drive additional growth.

Pursuing strategic acquisitions and alliances

We expect to continue to pursue a selective acquisition strategy as opportunities arise to complement and expand our technology offerings and service capabilities. In fiscal 2019, we completed the acquisition of Y.G. Noobaa Ltd., an early stage company developing software for managing data storage services.

We also intend to create and extend our strategic alliances where it is beneficial to our business. To facilitate the widespread deployment of Red Hat offerings, we intend to continue to grow our CCSPs, distributors, embedded technology partners, IHVs, ISVs, OEMs, VARs and other channel partner networks on a global basis. In addition, we are enhancing our relationships with SIs in order to expand our reach to customers that traditionally rely on SIs for advice and recommendations regarding their technology purchases.

Promoting a range of services to help our customers derive additional value

We seek to increase revenue by providing additional consulting and other targeted services. We also enable our partners to provide services that promote growth in our subscription revenue. These services are designed to help customers derive additional value from Red Hat offerings.

PRODUCTS AND SERVICES

Our offerings are designed to provide customers with high-performing, scalable, flexible, reliable and secure technologies that meet customers' IT needs in physical, virtual and hybrid cloud environments. Through our offerings, our customers and partners are able to take advantage of the quality and value of open source software that we help to develop, aggregate, integrate, test, certify, deliver, maintain, enhance and support. Customers can also take advantage of the flexibility of our software offerings to build a variety of deployment models on which to run their applications. Our service offerings include consulting, support and training.

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Infrastructure-related offerings

Red Hat Enterprise Linux technologies. Red Hat Enterprise Linux is an operating system built with open source software components, including the Linux kernel, and is designed expressly for enterprise computing to run applications on a broad range of hardware in physical, virtual and hybrid cloud environments. A worldwide community of developers collaborates to improve Linux software components, and we believe we are able to integrate the best of those improvements into our stable, yet innovative and high-performing Red Hat Enterprise Linux platform. Moreover, Red Hat Enterprise Linux enjoys the support of major CCSPs, IHVs, ISVs, OEMs and other technology partners, increasing the interest of developers in adding further enhancements to the Linux kernel and other open source software components. Additionally, Red Hat and selected OEM partners offer comprehensive technical support, with up to 24x7, one-hour response.

Red Hat Enterprise Linux is also available in multiple variants that allow customers to obtain a version of Red Had Enterprise Linux specifically for their use cases, applications and hardware architectures. These variants include Red Hat Enterprise Linux Server for High-Performance Computing, Red Hat Enterprise Linux for Real Time and Red Hat Enterprise Linux for SAP Solutions. Offerings for supported architectures include Red Hat Enterprise Linux Server (x86-64), Red Hat Enterprise Linux for IBM z Systems, Red Hat Enterprise Linux for Power Little Endian and Red Hat Enterprise Linux Server for ARM.

In addition, Red Hat offers a portfolio of add-ons that extends the features of Red Hat Enterprise Linux. These add-ons, which are designed to tailor a customer’s computing environment to suit specific requirements, include:

- High Availability—provides failover services between nodes within a cluster intended to make applications more resistant to downtime.
- Resilient Storage—enables a shared storage or clustered file system to access the same storage device over a network.
- Smart Management—includes management and provisioning modules that allow a customer to provision, patch, configure and control Red Hat Enterprise Linux development, test and production systems.
- Smart Virtualization—includes the Red Hat Virtualization offering, which provides virtualization functionality and management tools for both server and desktop deployments.
- Extended Lifecycle Support—provides software maintenance and support after Red Hat’s published end of life date for certain versions of Red Hat Enterprise Linux.
- Extended Update Support—extends the software maintenance and support period of certain eligible Red Hat Enterprise Linux subscriptions for up to 24 months to give customers more flexibility with their resource and deployment cycles.
- Red Hat Insights—provides a hosted service that is designed to help customers proactively identify and resolve technical and security issues in their Red Hat Enterprise Linux and Red Hat Cloud Infrastructure environments.

We believe that these add-ons provide customers with increased features, flexibility and choice.

Red Hat Satellite. Red Hat Satellite is a system management offering that is designed to make Red Hat infrastructure easier to deploy, scale and manage across physical, virtual and hybrid cloud environments. Red Hat Satellite provides broad capabilities for systems provisioning, configuration management, content management and subscription management.

Red Hat Virtualization. Red Hat Virtualization includes standalone virtualization functionality and management tools for both server and desktop deployments. Red Hat Virtualization combines the Kernel-based Virtual Machine (KVM) hypervisor included in the Linux kernel with the oVirt open source virtualization management system to offer customers a platform for large-scale virtualization initiatives and cloud deployments. Red Hat Virtualization is designed to support virtual machines running Red Hat Enterprise Linux and its wide ecosystem of certified hardware systems and software applications, as well as the Microsoft Windows operating systems and application servers supported under Microsoft Windows Server Virtualization Validation Program (SVVP).

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Application Development-related and other emerging technology offerings

Red Hat Middleware. Red Hat Middleware is a suite of offerings for developing, deploying and managing applications; integrating applications, data and devices; and automating business processes across hybrid cloud environments. Red Hat Middleware offerings can also be deployed on Red Hat OpenShift to provide middleware functionality as a service. Red Hat Middleware integrates, tests and refines enterprise-ready features from JBoss and other community projects into supported, stable, enterprise-class middleware platforms.

Red Hat Middleware offerings consist of a number of deployment platforms and tools, including:

- Red Hat JBoss Enterprise Application Platform—provides an environment for building, hosting and deploying applications and services. It includes features such as clustering, caching, messaging, transaction and a full web services stack.
- Red Hat JBoss Web Server—provides an enterprise-class web server solution for large-scale websites and lightweight web applications that utilize Apache Tomcat and Apache Web Server.
- Red Hat Data Grid—provides a scalable, distributed in-memory data grid that permits cost-effective scaling of big data tiers.
- Red Hat Fuse and Red Hat AMQ—provides customers messaging and integration tools for distributed applications.
- Red Hat 3scale API Management—provides centralized API management features through a distributed, cloud hosted layer.
- Red Hat Data Virtualization—provides a solution for integration of distributed data sources.
- Red Hat Decision Manager—provides a platform for business rules management, business resource optimization and complex event processing.
- Red Hat Process Automation Manager—provides a platform for developing applications that automate business decisions and process.
- Red Hat Developer Studio—provides an integrated development environment for developing, testing and deploying rich web applications, enterprise applications and service-oriented architecture services.
- Red Hat JBoss Operations Network—provides built-in management and monitoring capabilities to administer JBoss application environments.

Emerging Technology Offerings. Red Hat's emerging technologies are software offerings that enables customers to build and manage hybrid IT computing environments.

- Red Hat OpenShift—a container-based cloud application platform (also called "platform as a service" or "PaaS") that allows developers to develop, host and scale applications in a cloud environment. It automates the hosting, configuration, deployment and administration of application stacks in an elastic cloud environment utilizing Linux containers. OpenShift gives application developers self-service access so they can more easily deploy applications on demand. Customers can use OpenShift Container Platform in a private cloud environment and in certain public cloud environments, OpenShift Online in a public cloud environment for month to month use, or OpenShift Dedicated in a public cloud environment using their own OpenShift instance managed by Red Hat. Customers can also use Red Hat Middleware services for OpenShift to enable enterprise application development, deployment and integration capability with OpenShift.
- Red Hat Cloud Infrastructure—an offering that combines and integrates Red Hat Satellite, Red Hat Virtualization, Red Hat CloudForms, Red Hat OpenStack Platform and Red Hat Insights. Red Hat Cloud Infrastructure allows users to build and manage a private or hybrid infrastructure as a service cloud.
- Red Hat OpenStack Platform—an infrastructure as a service offering that provides an enterprise-ready cloud foundation built on OpenStack technologies optimized for and integrated with Red Hat Enterprise Linux and Red Hat Virtualization.

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- Red Hat Ansible Automation—offerings that are designed to automate application and IT environment lifecycles. Our Red Hat Ansible Automation offerings include Red Hat Ansible Tower, an IT automation platform that is designed to provide simplified provisioning, configuration management and application deployment as well as management of a broad range of IT automation activities across hybrid cloud environments, Red Hat Ansible Engine, a support offering for users of the Ansible technology, and Red Hat Ansible Network Automation, a network automation platform the enables users to operationalize the automation of network infrastructures.
- Red Hat CloudForms—a hybrid cloud management solution that allows users to deploy, monitor and manage services across private clouds as well as virtualized and container-based infrastructures.
- Red Hat Storage technologies that enable customers to build storage platforms at large-scale using commodity hardware. Red Hat Gluster Storage enables distributed file storage across hybrid cloud environments. Red Hat Ceph Storage offers a block and object storage platform for enterprises deploying on public or private clouds. Users of enterprise OpenStack deployments and container application platforms can use Red Hat Storage technologies for their storage needs.

Additional Red Hat offerings. Red Hat offerings also include other technologies, such as a realtime operating system, high-performance distributed computing, directory services and user authentication. These offerings broaden customer choice and are components of our open source architecture for the enterprise.

Red Hat consulting, support and training services

Red Hat offers a range of services that are designed to help our customers derive additional value from Red Hat offerings.

Consulting. We offer the services of experienced consultants and architects focused on our offerings to assist with the technology and strategic infrastructure, application development and modernization needs of our customers. Our consulting services include assessments, proofs of concept, implementations, upgrade planning, platform migrations, solution integration, technology adoption journeys and application development.

Support. Our Red Hat subscriptions generally include varying levels of technical support to assist customers with implementing, configuring and using Red Hat technologies. In addition, Red Hat's Customer Portal provides an online method for customers to obtain certified software, access a knowledge base and software update alerts and advisories, as well as interact with our technical support engineers. We also offer technical account management services for customers that require a more personalized support relationship. The technical account management services are designed to offer a highly skilled, proactive support engineer who understands a customer's IT infrastructure and serves as a primary point of contact for technical support that is tailored to the customer's business. Our customer success management services are designed to help our customers achieve success with our solutions and maximize the value our customers get from their Red Hat subscriptions.

Training. Our training services consist of an array of interactive, virtual and video courses and certification exams designed to meet the diverse needs of our customers and business partners. We deliver courses and exams worldwide in on-site, classroom and online settings. Courses span topics such as system administration, deployment, management and security, Dev/Ops and enterprise application development and integration. Certifications include Red Hat Certified System Administrator, Red Hat Certified Engineer, Red Hat Certified Enterprise Application Developer, Red Hat Certified Architect and Red Hat Certified Specialist with a variety of focus areas. We also offer training through our Red Hat Learning Subscription, which is a tiered, subscription-based offering that includes access to all of our online courses and labs and can be delivered on demand at each user's own pace. We offer Basic, Standard and Developer tiers as part of our Red Hat Learning Subscription.

By providing consulting and support services that help to enable infrastructure, application integration and middleware solutions in hybrid cloud environments, we facilitate further adoption and use of our technologies in the enterprise. In addition, our training services provide customers and partners with skilled Red Hat certified professionals who often serve as internal open source advocates, increasing opportunities for successful adoption and use of our technologies. Our service capabilities promote and reinforce the use of open source technologies as well as our Red Hat brands.

COMPETITION

The rapidly evolving and intensely competitive enterprise software industry is characterized by new and evolving industry standards, disruptive technology developments and frequent new product introductions by both new and established IT companies. We compete with a number of large and well-established companies that have significantly greater financial resources, larger development staffs and more extensive marketing and distribution capabilities. We also compete with emerging start-up companies that may be able to innovate and provide products and services faster than we can. No assurance can be given that our efforts to compete effectively will be sufficient.

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We believe that the major factors affecting the competitive landscape for our offerings include:

- the name and reputation of the vendor or competitive offering;
- the product price, performance, reliability, security and functionality;
- the partnerships of the vendor with major industry hardware and/or software providers;
- the channel strength and number of channel partners of the vendor;
- the financial and value relationship of subscription services;
- the availability of third-party enterprise applications that are compatible with the technology;
- the speed with which customers transition to cloud computing environments and the type of cloud computing environments utilized (public, private or hybrid);
- the breadth of hardware and software ecosystem compatibility, including the ability to move IT workloads among various cloud offerings;
- the number of cloud service providers;
- the management framework for administering the software technologies;
- the quality of consulting and support services;
- the number of customer and company reference accounts;
- the ability to attract and retain qualified technical and other employees;
- the ability to influence enterprise software developers to write more applications that are compatible with our technologies;
- the ability of the vendor to quickly diagnose software issues and provide patches and other solutions; and
- the strength of the vendor's relationships and reputation in the open source community.

With respect to our operating system offerings, our competitors include Microsoft, which offers a hardware-independent, multi-user operating system that has a larger, more diverse ecosystem of third-party enterprise applications than the Red Hat Enterprise Linux ecosystem. Moreover, we also compete with HPE, IBM, Oracle and Unisys Corporation, each of which offers a UNIX operating system. Many of these competitors bundle competitive operating systems with their hardware and additional software offerings, thereby making it more difficult for us to penetrate their customer bases. With respect to Linux operating systems, our competitors include AWS, with its Amazon Linux 2, EQT Partners, with its SUSE Linux Enterprise Server, and Oracle, with its Oracle Linux product. We also compete with freely available Linux distributions, such as CentOS, Debian, Fedora, openSUSE and Ubuntu.

With respect to our virtualization offerings, our competitors include Microsoft, Oracle and VMware. Microsoft and VMware offer virtualization technologies that are certified and supported with Red Hat Enterprise Linux operating system offerings, and Microsoft supports its server operating systems and application servers running on our virtualization offerings.

With respect to our middleware offerings, our competitors include AWS, IBM, Microsoft, MuleSoft, Inc., Oracle, Pegasystems Inc., Pivotal Software, Inc. ("Pivotal") and TIBCO Software Inc. Most of these vendors offer the majority of their middleware products under a typical proprietary software license model. IBM and Oracle often bundle hardware and software for their customers, making it more difficult for us to penetrate their customer bases. We also compete with freely available middleware distributions, such as Apache Tomcat and Wildfly. Our middleware offerings support Java EE, through our JBoss Enterprise Application Platform offerings, an open source implementation of the Java EE platform, and Java SE, in our support for OpenJDK, the open source reference implementation of the Java SE platform.

With respect to our emerging technology offerings, we compete with companies that provide tools for enterprises to create private or hybrid cloud environments, such as Docker Inc., Microsoft, Mirantis Inc. ("Mirantis"), Oracle, Pivotal and VMware, companies that provide platform as a service offerings, such as IBM, Oracle and Pivotal, and companies that provide public clouds with, and that allow users to consume, computing resources as a service without the need to purchase equipment or software, such as AWS, Google and Microsoft.

With respect to our service offerings, we face competition in the markets for services related to the development, deployment and integration of enterprise technologies. Our competitors in these markets include Mirantis and Pivotal, as well as other technology consulting and training companies.

Due to the nature of open source technology, the open source software model is not characterized by the traditional barriers to entry that are found in the proprietary software model. For example, the financial and legal barriers to creating a new Linux distribution are relatively low because the software components typically included in Linux distributions are publicly available under open source licenses that permit copying, modification and redistribution. Anyone can use, copy, modify and redistribute Red Hat Enterprise Linux, Red Hat Middleware and our other open source offerings. However, they are not permitted to refer to these products as "Red Hat" or "Red Hat JBoss" products unless they have a formal business relationship with us that allows for such references. In addition, the primary means by which customers can receive Red Hat software, as well as security updates, fixes, functionality enhancements and upgrades to the technologies, each if and when available, is to purchase and maintain a current subscription directly from us or our partners with whom we have agreements. Our customers agree that during their support relationship with Red Hat, they will purchase a support subscription for each unit of Red Hat software they deploy.

SOFTWARE ENGINEERING AND DEVELOPMENT

We have invested, and intend to continue to invest, significant resources in research and development. We expended $668.5 million, $578.3 million and $480.7 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively, in research and development costs. We focus and modify our research and development efforts based on our business strategy, the needs of our customers and changes in the marketplace. Our development efforts focus on adding new or improved functionality desired by customers to our portfolio of offerings and supporting the expansion of our third-party hardware and software ecosystems. However, any upgrades and enhancements are offered on an if-and-when-available basis. Red Hat is also investing in developing new software offerings and enabling new forms of development that are aimed at customers who seek hybrid, private and public cloud computing solutions.

We recognize the importance of open source software development to the enterprise and seek to have a leadership role in the open source ecosystem by supporting our community engagements. Our software engineers collaborate with open source software development teams working through open source projects, such as Apache Camel, the CentOS project, the Ceph community project, the Fedora Project, GlusterFS, the JBoss community projects, Kubernetes, the Linux kernel, the Open Container Initiative, the OpenDaylight Project, Open Platform for NFV, OpenShift Origin and OpenStack. This involvement enables us to remain abreast of, and in some instances lead, certain technical advances, plans for development of new features and timing of releases, as well as other information related to the management of open source projects.

Our software engineers make development contributions to many components comprising Red Hat software offerings and provide leadership within the various open source communities across many of our core components. Our software engineers also perform extensive testing of Red Hat technologies. We use various industry recognized methods of quality assurance testing to seek to ensure that our technologies are ready for use by our customers when delivered. We also work closely with leading hardware and software vendors to seek to ensure that their hardware and applications will operate effectively with Red Hat platforms.

INTELLECTUAL PROPERTY

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

We pursue registration of some of our trademarks in the U.S. and in other countries. We have registered the "Red Hat" and "JBoss" trademarks and the Red Hat Shadowman logo in countries in North America, South America, Europe, Asia and Africa as well as in Australia.

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Despite our efforts to protect our trademark rights, unauthorized third parties have, in the past, attempted and, in the future, may attempt, to misappropriate our trademark rights. We cannot be certain that we will succeed in preventing such misappropriation of our trade names and trademarks. The laws of some foreign countries do not protect or deter misappropriation of our trademark rights to the same extent as do the laws of the U.S. In addition, while we engage in certain enforcement activity, policing unauthorized use of our trademark rights is difficult, expensive and time-consuming, and our efforts may be inadequate. The loss of any material trademark or trade name could have a material adverse effect on our business, operating results and financial condition.

Red Hat also seeks patent protection for some of the innovative ideas of our software developers and other employees. Some of these inventions are applicable to our current technologies, while others provide protection to new and other technologies. Moreover, our principal objectives in seeking patent protection are to provide a measure of deterrence against the potential patent infringement claims of third parties and to a more limited extent to help ensure that new technologies and innovations covered by our patents remain open. As part of Red Hat's commitment to the open source community, we provide our Patent Promise, an undertaking, subject to certain limitations, not to enforce our patent rights against users of open source software covered by certain open source licenses. This permits the development and distribution of open source applications by third parties that could otherwise infringe on our patents. For these reasons, it is unlikely that our patents will, of themselves, provide us substantial revenue.

Third parties have, in the past, asserted and, in the future, may assert, infringement claims against us, which may result in costly litigation or require us to obtain a license to third-party intellectual property rights. See Part I, Item 3, "Legal Proceedings." There can be no assurance that such licenses will be available on reasonable terms or at all, which could have a material adverse effect on our business, operating results and financial condition. Red Hat regularly commits to its subscription customers that if portions of our offerings are found to infringe third-party intellectual property rights we will, at our expense and option: obtain the right for the customer to continue to use the technology consistent with their subscription agreement with us; modify the technology so that its use is non-infringing; or replace the infringing component with a non-infringing component, and defend them against specified infringement claims. Although we cannot predict whether we will need to satisfy these commitments and we often have limitations on these commitments, satisfying these commitments could be costly, be time-consuming, divert the attention of technical and management personnel, and adversely affect our business, financial condition, operating results and cash flows.

We also generally enter into confidentiality and nondisclosure agreements with our employees and consultants and seek to control access to and distribution of our confidential documentation and other proprietary information.

EMPLOYEES

As of February 28, 2019, Red Hat had approximately 13,360 employees.

EXECUTIVE OFFICERS OF THE REGISTRANT

Our Executive Officers as of April 22, 2019 were as follows:

Name	Age	Position
DeLisa K. Alexander	53	Executive Vice President and Chief People Officer
Paul J. Cormier	62	Executive Vice President and President, Products and Technologies
Michael R. Cunningham	58	Executive Vice President and General Counsel
Michael A. Kelly	47	Chief Information Officer
Arun Oberoi	64	Executive Vice President, Global Sales and Services
Eric R. Shander	50	Executive Vice President and Chief Financial Officer
James M. Whitehurst	51	President and Chief Executive Officer

DeLisa K. Alexander. Ms. Alexander has served as Executive Vice President and Chief People Officer since March 2011, Senior Vice President, People and Brand, from November 2007 until March 2011 and as Vice President, People, from July 2006 until November 2007. From August 2001 until July 2006, Ms. Alexander served in a number of legal capacities for Red Hat, including most recently as Assistant General Counsel and Assistant Secretary of the Company. Prior to joining Red Hat, Ms. Alexander was associated with the Kilpatrick Stockton LLP law firm (now Kilpatrick Townsend & Stockton LLP) where she focused on mergers, acquisitions, venture capital and intellectual property licensing.

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Paul J. Cormier. Mr. Cormier has served as President, Products and Technologies since April 2008 and as Executive Vice President since May 2001. From March 1999 to May 2001, Mr. Cormier served as Senior Vice President, Research and Development at BindView Development Corporation, a network management software company. From June 1998 to March 1999, Mr. Cormier served as Chief Technology Officer for Netect Internet Software Company, a network security vendor. From January 1996 to June 1998, Mr. Cormier first served as Director of Engineering, Internet Security and Collaboration Products and then as Senior Director of Software Product Development, Internet Security Products, for AltaVista Internet Software, a web portal and internet services company.

Michael R. Cunningham. Mr. Cunningham joined Red Hat as Senior Vice President and General Counsel in June 2004 and has served as Executive Vice President and General Counsel since May 2007. From October 2002 to February 2003 (following the acquisition by IBM, a provider of information technology products and services, of the management consulting business of PricewaterhouseCoopers LLP), Mr. Cunningham served as an Associate General Counsel at IBM with legal responsibilities for the Business Consulting Services division in the regions of Europe, the Middle East and Africa. From November 1994 until October 2002, Mr. Cunningham served in a number of legal capacities for PricewaterhouseCoopers LLP, including as a Partner and Associate General Counsel.

Michael A. Kelly. Mr. Kelly has served as Chief Information Officer since August 2016. Prior to joining Red Hat, Mr. Kelly served in several senior leadership roles at McKesson Corporation, a provider of pharmaceuticals and medical supplies, including as Senior Vice President of IT Shared Services and Chief Information Officer, McKesson U.S. Pharmaceuticals, from October 2012 to August 2016 and Senior Vice President, Enterprise Application Services from May 2011 to October 2012. Mr. Kelly also served as Chief Information and Chief Technology Officer of McKesson Specialty Health, a division of McKesson Corporation, from October 2007 to May 2011 and as Chief Information Officer of Oncology Therapeutics Network from October 2005 until it was acquired by McKesson Corporation in October 2007.

Arun Oberoi. Mr. Oberoi joined the Company as Executive Vice President, Global Sales and Services in May 2012. From December 2010 to January 2012, Mr. Oberoi served as President and CEO of Viridity Software, Inc., a data center infrastructure management company. From March 2008 to June 2010, Mr. Oberoi was CEO of Aveksa, Inc., an access governance and management software company. From January 2004 to February 2006, Mr. Oberoi was Executive Vice President of Worldwide Sales and Services at Micromuse, Inc., a provider of network and service management solutions. Micromuse was acquired by IBM in February 2006, where Mr. Oberoi subsequently served as Vice President within IBM Tivoli until March 2008. Prior to Micromuse, Mr. Oberoi held various executive leadership roles at Hewlett-Packard.

Eric R. Shander. Mr. Shander has served as Executive Vice President and Chief Financial Officer since April 2017. He joined Red Hat as Vice President, Finance and Accounting in November 2015 and has served as principal accounting officer since March 2016 and principal financial officer since January 2017. Prior to joining Red Hat, Mr. Shander served at IBM as VP/Global Services Automation & Competitiveness from January 2015 to November 2015, as VP/Americas Strategic IT Outsourcing Delivery from May 2011 to December 2014 and as VP/Global Finance & Accounting Solutions & Delivery from September 2008 to April 2011. Mr. Shander served as VP/Chief Accountant at Lenovo from April 2005 to August 2008.

James M. Whitehurst. Mr. Whitehurst has served as the President and Chief Executive Officer of Red Hat and as a member of the Board of Directors since January 2008. Prior to joining Red Hat, Mr. Whitehurst served at Delta Air Lines, Inc. as Chief Operating Officer from July 2005 to August 2007, as Senior Vice President and Chief Network and Planning Officer from May 2004 to July 2005 and as Senior Vice President—Finance, Treasury & Business Development from January 2002 to May 2004. Prior to joining Delta, he was a partner and managing director at The Boston Consulting Group.

AVAILABLE INFORMATION

We maintain a website at www.redhat.com. We make available, free of charge on our website, our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Securities Exchange Act”), as soon as reasonably practicable after we electronically file those reports with, or furnish them to, the SEC. All SEC filings are also available free of charge at the SEC’s website at www.sec.gov. We also similarly make available, free of charge on our website, the reports filed with the SEC by our executive officers, directors and 10% stockholders pursuant to Section 16 under the Securities Exchange Act as soon as reasonably practicable after copies of those filings are provided to us by those persons. We are not including the information contained at www.redhat.com, or at any other Internet address, as part of, or incorporating it by reference into, this Annual Report on Form 10-K.

ITEM 1A. RISK FACTORS

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

RISKS RELATED TO THE MERGER

The announcement and pendency of our agreement to be acquired by International Business Machines Corporation may have an adverse effect on our business, financial condition, operating results and cash flows.

On October 28, 2018, we entered into an Agreement and Plan of Merger (the "Merger Agreement") with International Business Machines Corporation, a New York corporation ("IBM"), and Socrates Acquisition Corp., a Delaware corporation and a wholly-owned subsidiary of IBM ("Sub"), pursuant to which, among other things, Sub will merge with and into us, with Red Hat surviving as a wholly-owned subsidiary of IBM (the "Merger"). Upon the terms and subject to the conditions set forth in the Merger Agreement, at the effective time of the Merger (the "Effective Time"), each share of our common stock issued and outstanding immediately prior to the Effective Time will be cancelled and automatically converted into the right to receive $190.00 in cash, without interest and subject to any applicable withholding taxes.

Uncertainty about the effect of the proposed Merger on our employees, partners, customers and other third parties may disrupt our sales and marketing or other key business activities and may have a material adverse effect on our business, financial condition, operating results and cash flows. Current and prospective employees may experience uncertainty about their roles following the Merger and this may have an effect on our corporate culture. There can be no assurance we will be able to attract and retain key talent, including senior leaders, to the same extent that we have previously been able to attract and retain employees. Any loss or distraction of such employees could have a material adverse effect on our business, financial condition and operating results. In addition, we have diverted, and will continue to divert, significant management and other internal resources towards the completion of the Merger and planning for integration, which could materially adversely affect our business, financial condition, operating results and cash flows. Parties with which we have business relationships may experience uncertainty as to the future of such relationships and may delay or defer certain business decisions, seek alternative relationships with third parties or seek to alter their present business relationships with us. Parties with whom we otherwise may have sought to establish business relationships may seek alternative relationships with third parties.

The Merger Agreement generally requires us to operate our business in the ordinary course pending consummation of the proposed Merger and restricts us, without IBM's consent, from taking certain specified actions until the Merger is completed. These restrictions may affect our ability to execute our business strategies, to respond effectively to competitive pressures and industry developments, and to attain our financial and other goals and may otherwise harm our business, financial condition, operating results and cash flows.

The failure to complete the Merger with IBM in a timely manner or at all could negatively impact the market price of our common stock as well as adversely affect our business, financial condition, operating results and cash flows.

Completion of the Merger with IBM is subject to several conditions beyond our control that may prevent, delay or otherwise adversely affect its completion in a material way, including the expiration or termination of applicable waiting periods under antitrust and competition laws and similar competition approvals or consents that must be obtained from regulatory entities. The Merger cannot be completed until the conditions to closing are satisfied or (if permissible under applicable law) waived. We cannot guarantee that the closing conditions set forth in the Merger Agreement will be satisfied or, even if satisfied, that no event of termination will take place. In the event that the Merger is not completed for any reason, the holders of our common stock will not receive any payment for their shares of common stock in connection with the proposed Merger. Instead, we will remain an independent public company and the holders of our common stock will continue to own their shares of common stock.

If the Merger or a similar transaction is not completed, the share price of our common stock may drop to the extent that the current market price of our common stock reflects an assumption that a transaction will be completed. In addition, under circumstances specified in the Merger Agreement, we may be required to pay a termination fee of

$975.0 million in the event the Merger is not consummated. Further, a failure to complete the Merger may result in negative publicity, negative impressions of us in the financial markets and investment community and negative responses from customers, partners and other third parties. Any disruption to our business resulting from the announcement and pendency of the Merger and from intensifying competition from our competitors, including any adverse changes in our relationships with our employees, partners, customers and other third parties, could continue or accelerate in the event of a failure to complete the Merger. There can be no assurance that our business, financial condition, operating results and cash flows will not be adversely affected, as compared to our condition prior to the announcement of the Merger, if the Merger is not consummated.

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Regulatory approvals may not be received, may take longer than expected or may impose conditions that are not presently anticipated or that cannot be met.

Before the Merger may be completed, various approvals, authorizations and declarations of non-objection must be obtained from certain regulatory and governmental authorities. Subject to the terms and conditions of the Merger Agreement, each party has agreed to use their reasonable best efforts to take all actions and to do, or cause to be done, all things reasonably necessary, proper or advisable under applicable laws to consummate the Merger and the other transactions contemplated by the Merger Agreement as soon as practicable and no later than the termination date of the Merger Agreement, including obtaining any requisite approvals, subject to certain specified limitations under the Merger Agreement. These approvals include approval under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and the Council Regulation 139/2004 of the European Union.

These regulatory and governmental entities may impose conditions on the granting of such approvals and if such regulatory and governmental entities seek to impose such conditions, lengthy negotiations may ensue among such regulatory or governmental entities, IBM and us. Such conditions and the process of obtaining regulatory approvals could have the effect of delaying completion of the Merger and such conditions may not be satisfied for an extended period of time.

We cannot assure you that these regulatory clearances and approvals will be obtained in a timely manner or obtained at all, or that the granting of these regulatory clearances and approvals will not involve the imposition of regulatory remedies on the completion of the Merger, including requiring changes to the terms of the Merger Agreement. These conditions or changes could result in the conditions to the closing of the Merger not being satisfied. Our stockholders approved the adoption of the Merger Agreement at a special meeting of stockholders on January 16, 2019 prior to receipt of all of the required regulatory approvals. We and IBM may subsequently agree to regulatory remedies without further seeking stockholder approval, except as required by applicable law, even if such regulatory remedies could have an adverse effect on us, IBM or the combined company.

The Merger Agreement contains provisions that could discourage or deter a potential competing acquirer that might be willing to pay more to effect an alternative transaction with us.

Under the Merger Agreement, we are generally not permitted to solicit or discuss takeover proposals with third parties, subject to certain exceptions. Further, subject to limited exceptions, the Merger Agreement contains restrictions on our ability to pursue other alternatives to the Merger and, in specified circumstances, could require us to pay IBM a termination fee of $975.0 million. Such restrictions may discourage or deter a third party that may be willing to pay more than IBM for our common stock from considering or proposing an alternative transaction with us. Notwithstanding the foregoing, in no event will the termination fee be paid to IBM more than once. In addition, the adoption of the Merger Agreement by our stockholders eliminated our right to terminate the Merger Agreement in response to a superior proposal. Additional information regarding these restrictions is provided in the definitive proxy statement on Schedule 14A (the “Proxy Statement”) that we filed with the Securities and Exchange Commission (“SEC”) on December 12, 2018.

We have been and may be subject to litigation challenging the Merger, which may require significant management time and attention and significant legal expenses and may result in unfavorable outcomes, which could delay or prevent the Merger from being completed or have a material adverse effect on our business, financial condition, results of operations and cash flows.

Three putative class action complaints were filed on behalf of Company stockholders in the United States District Court for the District of Delaware against Red Hat and its Board of Directors (the “Actions”). The complaints alleged that the Proxy Statement filed in connection with the Merger Agreement omitted material information in violation of Sections 14(a) and 20(a) of the Securities Exchange Act, rendering the Proxy Statement false and misleading. Among other remedies, the complaints sought to enjoin the special meeting of our stockholders and the closing of the Merger, as well as damages, costs and attorneys’ fees.

On January 4, 2019, the parties reached an agreement whereby the Actions were dismissed as moot in exchange for supplemental disclosures filed by the Company. Those supplemental disclosures were filed by the Company as definitive additional proxy soliciting material on Schedule 14A with the SEC on January 4, 2019. The Actions were dismissed on January 8, 2019 and January 9, 2019. Plaintiffs in the Actions have reserved the right to seek an award of attorneys' fees for causing the filing of the supplemental disclosures.

In addition, while the Actions have been dismissed, it is possible that additional lawsuits related to the Merger may be filed in the future against the Company, in which case we could be materially and adversely affected by such additional litigation.

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The completion of the transaction contemplated by the Merger Agreement may trigger change in control or other similar provisions in certain agreements to which we are a party.

If we are unable to negotiate waivers of change in control or other similar provisions in certain agreements to which we are a party, the counterparties may exercise their rights and remedies under the agreements, potentially terminating the agreements or seeking monetary damages. Even if we are able to negotiate waivers, the counterparties may require a fee for such waivers or seek to renegotiate the agreements on terms less favorable to us.

We will incur substantial transaction fees and costs in connection with the Merger.

We have and expect to continue to incur significant costs, expenses and fees for professional services and other transaction costs in connection with the Merger. A material portion of these expenses are payable by us whether or not the Merger is completed. Further, while we have assumed that a certain amount of transaction expenses will be incurred, factors beyond our control could affect the total amount or the timing of these expenses. Many of the expenses that will be incurred, by their nature, are difficult to estimate accurately. These expenses may exceed the costs historically borne by us. These costs could adversely affect our business, financial condition, operating results and cash flows.

RISKS RELATED TO BUSINESS UNCERTAINTY

We face intense competition.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We have expanded our operations significantly in recent years. For example, our total revenue increased from $2.92 billion for the fiscal year ended February 28, 2018 to $3.36 billion for the fiscal year ended February 28, 2019 ("fiscal 2019"). Moreover, the total number of our employees increased from approximately 11,870 as of February 28, 2018 to approximately 13,360 as of February 28, 2019. In addition, we continue to explore ways to extend our offerings and geographic reach. Our growth has placed and will likely continue to place a strain on our management systems, information systems, resources and internal controls. Our ability to successfully provide our offerings and implement our business plan requires adequate information systems and resources, internal controls and oversight from our senior management. As we expand in international markets, these challenges increase as a result of the need to support a growing business in an environment of multiple languages, cultures, customs, legal systems, dispute resolution systems, regulatory systems and commercial practices. As we grow, (i) we may not be able to adequately screen and hire or adequately train, supervise, manage or develop sufficient personnel, and (ii) we may not be able to develop or effectively manage our controls, oversight functions or information systems. If we are unable to effectively manage our growth, our business, financial condition, operating results and cash flows could be adversely affected.

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

As part of our business strategy, we have in the past entered into business combinations and acquisitions, and we may continue to do so in the future, subject to the restrictions under the Merger Agreement. Under the terms of the Merger Agreement, without the consent of IBM, we may not acquire businesses outside of the ordinary course of business above specified thresholds or that could reasonably be expected to increase the risk of not obtaining, or the risk of materially impeding or delaying the obtaining of, any regulatory approvals with respect to the Merger. These types of transactions can increase the expense of running our business and present significant challenges and risks, including:

- integrating the acquired business' accounting, financial reporting, management, information and information security, human resource and other administrative systems to permit effective management and reporting, and the lack of control if such integration is delayed or not implemented;
- incorporating and further developing acquired products or technology into our offerings and maintaining quality standards consistent with our brands;
- effectively evaluating talent at an acquired business or identifying cultural challenges associated with integrating employees from the acquired business into our organization;
- losing key employees of the acquired business;

- achieving the expected benefits of the transaction, which may include generating greater market acceptance of our offerings and technologies, increasing our revenue or integrating the assets acquired into one or more of our current offerings;

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

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

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

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

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

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

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

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

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

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

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

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

We may not be able to continue to attract and retain capable management.
Our future success depends on the continued services and effectiveness of a number of key management personnel. The loss of these individuals, particularly to a competitor, some of which may be in a position to offer greater compensation, could adversely affect our business or stock price.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our business model may encounter customer resistance.

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

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

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

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

The competitive position of our offerings is dependent on their compatibility with products and services of third-party enterprise hardware and software companies. To the extent that a hardware or software vendor might have or develop products and services that compete with ours, the vendor may have an incentive to seek to limit the performance, functionality or compatibility of our offerings when used with one or more of the vendor's offerings. In addition, these vendors may fail to support or issue statements of compatibility or certification of our offerings when used with their offerings. We intend to encourage the development of additional applications that operate on both current and new versions of our offerings by, among other means, attracting third-party developers to our offerings, providing open source tools to create these applications and maintaining our existing developer relationships through marketing and technical support. We intend to encourage the compatibility of our software with various third-party hardware and software offerings by maintaining and expanding our relationships, both business and technical, with relevant independent hardware and software vendors. If we are not successful in achieving these goals, however, our offerings may not be competitive and our business, financial condition, operating results and cash flows may be adversely affected.

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

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

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

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

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

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

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

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

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

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

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

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

RISKS RELATED TO LEGAL UNCERTAINTY

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

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

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

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

In the past, our technologies have been subject to intellectual property infringement claims. Some of these claims have been brought by entities that do not design, manufacture, or distribute products or services or that acquire intellectual property such as patents for the sole purpose of monetizing their acquired intellectual property through asserting claims of infringement. As these entities do not have operating businesses of their own and therefore have limited risk of counterclaims for damages or injunctive relief, it may be difficult to deter them from bringing intellectual property infringement claims. We expect to face the possibility of more intellectual property infringement claims as our prominence increases, business activities expand, market share and revenue grow, the number of products and competitors in our industry grows and the functionality of products in different portions of the industry overlap. We may not be able to accurately assess the risk related to these suits, and we may be unable to accurately assess our level of exposure.

Defending patent and other intellectual property claims, even claims without significant merit, can be time-consuming and costly and can divert the attention of technical and management personnel. We may receive unfavorable preliminary or interim rulings in the course of litigation, and there can be no assurances that favorable final outcomes will be obtained in all cases. We may decide to settle certain lawsuits and disputes on terms that are disadvantageous to us. Similarly, if any litigation to which we are a party is resolved adversely, we may be subject to an unfavorable judgment that may not be reversed upon appeal. The terms of such a settlement or judgment may require us to cease offering certain of our technologies or pay substantial amounts to the other party. In addition, we may have to seek a license to continue offering technologies found to be in violation of a third party’s rights, which may not be available on reasonable terms, or at all, and may significantly increase our operating costs and expenses and which could have a material adverse effect on our business, financial condition and operating results. As a result, we may also be required to develop alternative non-infringing technology or practices or discontinue the practices. The development of alternative non-infringing technology or practices could require significant effort and expense or may not be feasible. An unfavorable legal decision regarding the intellectual property in and to our technology and other offerings could adversely affect our business, financial condition, operating results and cash flows. See Part I, Item 3, “Legal Proceedings” for additional information.

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

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

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

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

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

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

A number of our offerings, including Red Hat Enterprise Linux, have been developed and licensed under the GNU General Public License and similar open source licenses. These licenses state that any program licensed under them may be liberally copied, modified and distributed. It is possible that a court would hold these licenses to be unenforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Additionally, if any of the open source components of our offerings may not be liberally copied, modified or distributed, then our ability to distribute or develop all or a portion of our offerings could be adversely impacted. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may become incompatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from distributing the software code subject to the modified license.

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

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

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

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

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

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

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

Lawsuits or legal proceedings may be commenced against us. These disputes and proceedings may involve significant expense and divert the attention of management and other employees. If we do not prevail in these matters, we could be required to pay substantial damages or settlement costs, which could adversely affect our business, financial condition, operating results and cash flows. See Part I, Item 3, "Legal Proceedings" for additional information.

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

Our business is subject to a variety of federal, state and international laws and regulations that apply to the collection, use, retention, protection, disclosure, transfer and processing of personal data. These data privacy- and protection-related laws and regulations are evolving, with new or modified laws and regulations proposed and implemented frequently and existing laws and regulations subject to new or different interpretations. For example, the European Union's General Data Protection Regulation took effect in May 2018, establishing new requirements applicable to the handling and processing of personal data and providing for greater penalties for noncompliance. Any failure by us to comply with data privacy- and protection-related laws and regulations could result in enforcement actions, significant penalties or other legal actions against us or our customers or suppliers. An actual or alleged failure to comply, which could result in negative publicity, reduce demand for our offerings, increase the cost of compliance, require changes in business practices that result in reduced revenue, restrict our ability to provide our offerings in certain locations, result in our customers' inability to use our offerings and prohibit data transfers or result in other claims, liabilities or sanctions, including fines, could have an adverse effect on our business, financial condition, operating results and cash flows.

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

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

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

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

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

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

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RISKS RELATED TO FINANCIAL UNCERTAINTY

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

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

Our fourth fiscal quarter has historically been our strongest quarter for sales. This pattern has become more pronounced as the number of customers with renewal dates occurring in the last half of our fiscal year has continued to increase. Additionally, a significant portion of our quarterly sales typically occur during the last weeks of the quarter and our operating results may be adversely impacted if we do not have sufficient time to bill and collect from our customers in the same quarter or fiscal year. Some of our customers may wait until the end of the quarter to negotiate their contracts in the hope of obtaining more favorable terms, which can also impede our ability to execute these contracts within the same quarter. Moreover, as an increasing number of customers enter into larger, multi-year transactions with us, such transactions tend to have longer sales cycles and can involve customers choosing to pay annually, which may impact our quarterly financial results. If, among other considerations, our future financial performance falls below the expectations of securities analysts or investors or we are unable to increase or maintain profitability, the market price of our common stock may decline.

We may not be able to meet the financial and operational challenges that we will encounter as our international operations, which represented approximately 45.3% of our total revenue for fiscal 2019, continue to expand.

Our international operations accounted for approximately 45.3% of total revenue for fiscal 2019. As we expand our international operations, we may have difficulty managing and administering a globally dispersed business and we may need to expend additional funds to, among other activities, reorganize our sales force and technical support services team, outsource or supplement general and administrative functions, staff key management positions, obtain additional information technology infrastructure and successfully localize offerings for a significant number of international markets, which may adversely affect our operating results. Additional challenges associated with the conduct of our business globally that may adversely affect our operating results include:

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

- public health risks and natural disasters, particularly in areas in which we have significant operations;

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- limitations on the repatriation and investment of funds and foreign currency exchange restrictions; and
- changes in import/export duties, quotas or other trade barriers that could affect the competitive pricing of our offerings and reduce our market share in some countries.

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

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

During fiscal 2019, a substantial portion of our subscription revenue was derived from our Red Hat Enterprise Linux offerings. Although we are continuing to develop other offerings, we expect that revenue from Red Hat Enterprise Linux will constitute a majority of our revenue for the foreseeable future. Declines and variability in demand for Red Hat Enterprise Linux could occur as a result of:

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

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

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

A portion of our business is conducted in currencies other than the U.S. dollar. Changes in exchange rates among other currencies and the U.S. dollar may affect our revenue, operating expenses and operating margins, which are reported in U.S. dollars. We cannot predict the impact of future exchange rate fluctuations. For example, the income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies.

As we expand international operations, our exposure to exchange rate fluctuations may increase. We may use financial instruments, primarily forward purchase contracts, to economically hedge currency commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations. If these hedging activities are not successful or we change or reduce these hedging activities in the future, we may experience significant unexpected expenses from fluctuations in exchange rates. For information regarding our hedging activity, see Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk.”

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

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

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We may be subject to greater tax liabilities.

We are subject to income tax and other taxes in the U.S. and in numerous foreign jurisdictions. Our domestic and foreign tax liabilities are dependent on the jurisdictions in which profits are determined to be earned and taxed. Additionally, the amount of taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we operate. Changes in tax laws, or in judicial or administrative interpretations of tax laws, could have an adverse effect on our business, financial condition, operating results and cash flows. Significant judgment, knowledge and experience are required in determining our worldwide provision for income taxes. Our future effective tax rate is impacted by a number of factors including our interpretation of the Tax Cuts and Jobs Act (the "Tax Act") enacted into law on December 22, 2017 and the regulations, some of which are pending, and other interpretive guidance relative to the Tax Act, changes in the valuation of our deferred tax assets and liabilities, increases in expenses not deductible for tax, including impairment of goodwill in connection with acquisitions, and changes in available tax credits. We anticipate that the U.S. Department of the Treasury, the Internal Revenue Service and other standard-setting bodies will continue to issue regulations and interpretive guidance on how the provisions of the Tax Act will be applied or otherwise administered, and additional regulations or interpretive guidance may be issued in the future that is different from our current interpretation and could be made retroactive.

In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly and increasingly subject to audits by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any potential litigation related to such audits could be materially different from our historical income tax provisions and accruals. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes more difficult. The results of an audit or litigation could adversely affect our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions that are not permanently reinvested may result in increased state taxes and/or additional foreign withholding taxes. In addition, the Tax Act significantly impacts how U.S. multinational corporations are taxed on foreign earnings. Numerous countries are evaluating their existing tax laws due in part to recommendations made by the Organization for Economic Co-operation and Development's ("OECD's") Base Erosion and Profit Shifting ("BEPS") project and in response to the changes in U.S. tax laws. Although we cannot predict whether or in what form any legislation based on such proposals may be adopted by the countries in which we do business, future tax reform based on such proposals may increase the amount of taxes we pay and adversely affect our operating results and cash flows. Moreover, the European Commission and some foreign jurisdictions have introduced proposals to impose a separate tax on specified digital service activity. It is unclear how or if such proposals, if enacted, would impact us.

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

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

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

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

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

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

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

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

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the U.S. These principles are subject to interpretation by the SEC and various bodies formed to create and interpret appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a significant effect on our reported results, as well as our processes and related controls, and may retroactively affect previously reported results.

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

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

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

Future fluctuations and uncertainty in economic and market conditions could adversely affect the market value of our investments, and we could record additional impairment charges and lose some or all of the principal value of investments in our portfolio. A total loss of an investment or a significant decline in the value of our investment portfolio could adversely affect our financial condition and operating results. For information regarding the sensitivity of and risks associated with the market value of portfolio investments and interest rates, see Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk.”

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

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

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

RISKS RELATED TO THE CONVERTIBLE NOTES

The convertible notes mature on October 1, 2019, and the use of our cash to repay the convertible notes, satisfy our conversion obligations under the convertible notes, or repurchase the convertible notes following a fundamental change will reduce our liquidity and capital resources.

In October 2014, we issued $805.0 million of 0.25% Convertible Senior Notes due 2019 (the "convertible notes"). As of February 28, 2019, there was $306.6 million aggregate principal amount of convertible notes outstanding. The convertible notes will mature on October 1, 2019, unless previously purchased or converted. On October 1, 2019, the outstanding aggregate principal amount of the convertible notes and all accrued and unpaid interest on such notes will become due and payable. Holders that elect to convert their convertible notes prior to maturity will receive a cash payment in the amount of $1,000 for each $1,000 in principal amount of convertible notes converted, which may also adversely affect our liquidity, plus shares of our common stock in an amount equal to the excess conversion value above $1,000, if any. In addition, if the Merger is completed prior to maturity of the convertible notes, we would be required to make an offer to repurchase the convertible notes for cash in an amount equal to 100% of their principal amount plus accrued and unpaid interest to but excluding the date of repurchase. Any of these cash payments could adversely affect our liquidity and capital resources.

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

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

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

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

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

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

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

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

The option counterparties are financial institutions or affiliates of financial institutions, and we will be subject to the risk that these option counterparties may default under the convertible note hedge transactions. Our exposure to the credit risk of the option counterparties will not be secured by any collateral. If one or more of the option counterparties to one or more of our convertible note hedge transactions becomes subject to insolvency proceedings, we will become an unsecured creditor in those proceedings with a claim equal to our exposure at the time under those transactions. Our exposure will depend on many factors but, generally, the increase in our exposure will be correlated to the increase in the market price of our common stock and in the volatility of the market price of our common stock. In addition, upon a default by one of the option counterparties, we may suffer dilution with respect to our common stock as well as adverse financial consequences. We can provide no assurances as to the financial stability or viability of any of the option counterparties.

RISKS RELATED TO OWNERSHIP OF OUR COMMON STOCK

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

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

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

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

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We may issue additional shares of our common stock in certain limited circumstances and thereby adversely affect the market price of our common stock.

Pursuant to the terms of the Merger Agreement, from October 28, 2018 until the Effective Time, we generally may not issue, deliver, sell, pledge or otherwise encumber any shares of our common stock, other voting equity interests or certain equity equivalents, or securities convertible into, or exchangeable or exercisable for, or any options, warrants, calls or rights to acquire, any such stock interest or equity equivalent other than the issuance of shares upon the exercise of options, settlement of other equity awards, exercise of the rights under the employee stock purchase plan, and in relation to notices of conversion regarding the convertible notes and pursuant to warrant transactions.

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

We do not currently expect to pay dividends on our common stock.

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. Under the terms of the Merger Agreement, from October 28, 2018 until the Effective Time, we may not declare, set aside or pay any dividends on, or make any other distributions in respect of, any of our capital stock or other equity or voting interests without IBM’s prior written consent. In addition, our ability to pay cash dividends on our common stock may be prohibited or limited by the terms of any future debt financing arrangement.

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

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

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

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

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

Further, as a Delaware corporation, we are also subject to certain Delaware law anti-takeover provisions. Under Delaware law, a corporation may not engage in a business combination with any holder of 15% or more of its capital stock unless the holder has held the stock for three years or, among other things, the Board of Directors has approved the transaction. Our Board of Directors could rely on Delaware law to prevent or delay an acquisition of us. Additionally, certain provisions of the convertible notes could make it more difficult or more expensive for a third party to acquire us or could also have the effect of delaying or reducing the likelihood of a change in control of us even if such acquisition or change of control may be favorable to our stockholders.

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ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our headquarters is currently located in a subleased facility at 100 East Davie Street, Raleigh, North Carolina. The building includes approximately 380,000 square feet of office and retail space and an integrated parking deck. We entered into an agreement to sublease this building on December 27, 2011, and the sublease will expire on August 23, 2035. The rental payments under the sublease are approximately $4.6 million annually until December 31, 2020 and approximately $3.8 million annually thereafter until the end of the sublease. We are also responsible for payment of taxes and all operating expenses relating to the subleased building (other than certain expenses relating to the operation of the integrated parking deck and the retail portions of the building, which are the responsibility of the tenants of those portions of the building). Over the term of the sublease agreement, we also receive certain rent credits and improvement allowances.

Including our headquarters, we have leased office facilities in over 40 countries and more than 105 office locations. Significant locations in North America include Ann Arbor, Michigan; Atlanta, Georgia; Boston, Massachusetts; Chicago, Illinois; Durham, North Carolina; Huntsville, Alabama; Mahwah, New Jersey; McLean, Virginia; Minneapolis, Minnesota; Montreal, Canada; New York, New York; Plano, Texas; San Francisco, California; Sunnyvale, California; Toronto, Canada and Westford, Massachusetts. Significant locations in Latin America include Bogota, Colombia; Buenos Aires, Argentina; Mexico City, Mexico; Santiago, Chile and Sao Paulo, Brazil. Significant locations in EMEA include Amsterdam, Netherlands; Barcelona, Spain; Brno, Czech Republic; Cork, Ireland; Dubai, United Arab Emirates; Farnborough, United Kingdom; Frankfurt, Germany; London, United Kingdom; Madrid, Spain; Milan, Italy; Munich, Germany; Paris, France; Ra’anana, Israel; Rome, Italy; Stockholm, Sweden; Stuttgart, Germany and Waterford, Ireland. Significant locations in Asia Pacific include Beijing, China; Bengaluru, India; Brisbane, Australia; Canberra, Australia; Hong Kong; Kuala Lumpur, Malaysia; Melbourne, Australia; Mumbai, India; New Delhi, India; Pune, India; Seoul, South Korea; Shenzhen, China; Singapore; Sydney, Australia and Tokyo, Japan. We believe that in all material respects our properties have been satisfactorily maintained, are in good condition and are suitable for our operations.

ITEM 3. 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.

In addition, three putative class action complaints were filed against Red Hat and its Board of Directors relating to the Merger with IBM. We received the following complaints, each filed in the United States District Court for the District of Delaware: Charles Orgel, individually and on behalf of all others similarly situated v. Red Hat, Inc., et al. (filed December 18, 2018), Michael Kent, individually and on behalf of all others similarly situated v. Red Hat, Inc., et al. (filed December 19, 2018) and Christopher Nunn Bishop, individually and on behalf of all others similarly situated v. Red Hat, Inc., et al. (filed December 21, 2018) (together, the “Actions”). The complaints in the Actions alleged that the definitive proxy statement on Schedule 14A (the “Proxy Statement”) that was filed with the SEC on December 12, 2018 omitted purportedly material information in violation of Sections 14(a) and 20(a) of the Securities Exchange Act, rendering the Proxy Statement false and misleading.

On January 4, 2019, the parties reached an agreement whereby the Actions were dismissed as moot in exchange for supplemental disclosures filed by the Company. Those supplemental disclosures were filed by the Company as definitive additional proxy soliciting material on Schedule 14A with the SEC on January 4, 2019. The Actions were dismissed on January 8, 2019 and January 9, 2019. Plaintiffs in the Actions have reserved the right to seek an award of attorneys’ fees for causing the filing of the supplemental disclosures.

ITEM 4. MINE SAFETY DISCLOSURES

This Item is not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our common stock trades on the New York Stock Exchange under the symbol "RHT."

Holders

As of April 22, 2019, we estimate that there were 1,044 registered stockholders of record of our common stock.

Dividends

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. Under the terms of the Merger Agreement, from October 28, 2018 until the Effective Time, we may not declare, set aside or pay any dividends on, or make any other distributions in respect of, any of our capital stock or other equity or voting interests without IBM's prior written consent.

Stock Performance Graph

The following graph shows a comparison of cumulative total return (equal to dividends plus stock appreciation) during the period from February 28, 2014 through February 28, 2019 for:

- Red Hat, Inc.;
- a new peer group consisting of Adobe Inc. ("Adobe"), Akamai Technologies, Inc. ("Akamai"), ANSYS, Inc. ("ANSYS"), Autodesk, Inc. ("Autodesk"), Cadence Design Systems, Inc. ("Cadence Design Systems), Citrix System, Inc. ("Citrix"), Intuit Inc. ("Intuit"), Jack Henry & Associates, Inc. ("Jack Henry"), NetApp, Open Text Corporation ("Open Text"), PTC Inc. ("PTC"), salesforce.com, inc. ("salesforce"), ServiceNow, Inc., Symantec Corporation ("Symantec"), Synopsys, Inc. ("Synopsys"), Verisign, Inc. ("Verisign"), VMware and Workday, Inc. (the "New Peer Group");
- a prior peer group consisting of Adobe, Akamai, ANSYS, Autodesk, Cadence Design Systems, Citrix, Intuit, Jack Henry, NetApp, Nuance Communications, Inc., Open Text, PTC, salesforce, Symantec, Synopsys, Verint Systems Inc., Verisign and VMware (the "Prior Peer Group"); and
- the S&P 500 Index.

We are required to provide a line-graph presentation comparing cumulative, five-year stockholder returns on an indexed basis with a broad equity market index and either a published industry index or an index of peer companies selected by Red Hat. The change in peer group was made to be consistent with changes made to the composition of companies considered to be peers for purposes of benchmarking executive compensation during fiscal 2019.

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COMPARISON OF FIVE-YEAR CUMULATIVE TOTAL RETURN AMONG RED HAT, STOCK PERFORMANCE PEER GROUP AND S&P 500 INDEX

	2/28/2014	2/27/2015	2/29/2016	2/28/2017	2/28/2018	2/28/2019
RED HAT, INC.	$100.00	$117.17	$110.78	$140.38	$249.87	$309.54
NEW PEER GROUP	$100.00	$107.10	$95.83	$135.32	$193.87	$261.22
PRIOR PEER GROUP	$100.00	$109.24	$100.22	$139.43	$194.96	$257.88
S&P 500 INDEX	$100.00	$115.51	$108.36	$135.42	$158.57	$166.00

Notes:

- Assumes initial investment of $100.00 on February 28, 2014. Total return includes reinvestment of dividends.
- If the annual interval, based on the fiscal year-end, ends on a day that is not a trading day, the preceding trading day is used.
- The information included under the heading “Stock Performance Graph” in Item 5 of this Annual Report on Form 10-K is “furnished” and not “filed” and shall not be deemed to be “soliciting material” or subject to Regulation 14A, shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act or otherwise subject to the limitations of that section, and shall not be deemed incorporated by reference in any filing of the Company under the Securities Act of 1933 (the “Securities Act”), as amended, or the Securities Exchange Act, whether made before or after the date of this report and irrespective of any general incorporation by reference language in any such filing.
- The stock price performance shown in the graph is not necessarily indicative of future price performance.

Unregistered Sales of Equity Securities

During the three months ended February 28, 2019, the Company issued 1,753,478 shares of its unregistered common stock upon settlement of conversions of an aggregate of $223.3 million in principal amount of the convertible notes. These shares of the Company’s common stock were issued in reliance on the exemption from registration provided by Section 3(a)(9) of the Securities Act.

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Issuer Purchases of Equity Securities

The table below sets forth information regarding the Company's purchases of its common stock during its fourth fiscal quarter ended February 28, 2019:

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased (1)(2)	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (3)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (3)
December 1, 2018—December 31, 2018	123,111	$ 73.40	—	$ 737.2 million
January 1, 2019—January 31, 2019	1,338,957	$ 75.22	—	$ 737.2 million
February 1, 2019—February 28, 2019	313,697	$ 73.41	—	$ 737.2 million
Total	1,775,765		—	

(1) During the three months ended February 28, 2019, the Company withheld an aggregate of 23,750 shares of its common stock (with a weighted average share price of $175.45) from employees to satisfy minimum tax withholding obligations relating to the vesting of restricted share awards. These shares were not withheld pursuant to the programs described in Note (3) below.

(2) In connection with the convertible note conversions settled during the three months ended February 28, 2019, the Company exercised a portion of the options that are part of the convertible note hedge transactions and acquired 1,752,015 shares of its common stock. The counterparties to the convertible note hedge transactions may be deemed to be an "affiliate purchaser" and may have purchased the shares of the Company's common stock deliverable to the Company upon the exercise of the options.

(3) On June 21, 2018, the Company announced that its Board authorized 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, which replaced a previous repurchase program, commenced on July 1, 2018, and will expire on the earlier of (i) June 30, 2020 or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. Pursuant to the Merger Agreement, we do not anticipate additional repurchases of the Company's common stock prior to the consummation of the Merger with IBM.

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ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial data for each of the Company's fiscal years in the five-year period ended February 28, 2019. The selected balance sheet data as of February 28, 2019 and February 28, 2018 and the selected statement of operations data for the fiscal years ended February 28, 2019, February 28, 2018, and February 28, 2017 are derived from our Consolidated Financial Statements contained in this Annual Report on Form 10-K and should be read in conjunction with the Consolidated Financial Statements, related notes and other financial information included herein. The selected statement of operations data for the fiscal years ended February 29, 2016 and February 28, 2015 is derived from our Consolidated Financial Statements contained in the Annual Report on Form 10-K for the fiscal year ended February 29, 2016, and the selected balance sheet data as of February 28, 2017 and February 29, 2016 is presented including the effects of retrospective application of relevant adopted Accounting Standards Updates.

	Fiscal Years Ended				
	February 28, 2019	February 28, 2018	February 28, 2017	February 29, 2016	February 28, 2015
	(in thousands, except per share data)				
SELECTED STATEMENT OF OPERATIONS DATA					
Revenue:					
Subscriptions	$2,949,059	$2,574,178	$2,135,780	$1,803,449	$1,561,234
Training and services	413,010	346,283	276,023	248,781	228,255
Total subscription and training and services revenue	$3,362,069	$2,920,461	$2,411,803	$2,052,230	$1,789,489
Gross profit	$2,863,818	$2,488,664	$2,057,425	$1,742,601	$1,516,290
Income from operations [(1)]	$512,232	$475,732	$334,075	$288,048	$249,994
Interest income	$30,531	$18,493	$13,921	$11,673	$8,336
Interest expense	$19,838	$24,569	$23,822	$23,121	$9,394
Other (expense) income, net	$(4,870)	$8,335	$(2,164)	$(1,735)	$6,562
Provision for income taxes [(1)] [(2)]	$84,067	$216,140	$66,620	$75,500	$75,297
Net income [(1)]	$433,988	$261,851	$255,390	$199,365	$180,201
Net income per share:					
Basic [(1)]	$2.46	$1.48	$1.42	$1.09	$0.97
Diluted [(1)]	$2.33	$1.42	$1.40	$1.07	$0.95
Weighted average shares outstanding:					
Basic	176,773	177,150	179,642	182,817	186,529
Diluted	186,321	184,602	182,961	186,119	189,246

	As of				
	February 28, 2019	February 28, 2018	February 28, 2017	February 29, 2016	February 28, 2015
	(in thousands)				
SELECTED BALANCE SHEET DATA					
Total cash, cash equivalents, restricted cash and available-for-sale investment securities	$2,424,969	$2,472,932	$2,133,231	$1,995,390	$1,808,743
Working capital [(1)]	$741,082	$836,590	$428,943	$316,757	$549,410
Total assets [(1)]	$5,588,289	$5,474,493	$4,540,062	$4,158,278	$3,784,569
Total deferred revenue (current and long-term)	$2,982,424	$2,595,172	$2,069,956	$1,722,544	$1,482,328
Convertible notes (current and long-term)	$301,367	$768,000	$745,633	$723,942	$702,939
Stockholders' equity[(1)]	$1,613,932	$1,478,124	$1,252,166	$1,337,591	$1,288,338

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(1) As adjusted to reflect the impact of the retrospective application of ASC 606, *Revenue from Contracts with Customers*. See NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements for detailed information on adoption of ASC 606.

(2) Provision for income taxes for the fiscal years ended February 28, 2019 and February 28, 2018 included a charge of $18.0 million and $122.7 million, respectively, related to the Tax Act. See NOTE 11—Income Taxes to our Consolidated Financial Statements.

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ITEM 7. 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 and storage technologies.

On October 28, 2018, we entered into an Agreement and Plan of Merger (the "Merger Agreement") with International Business Machines Corporation, a New York corporation ("IBM"), and Socrates Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of IBM ("Sub"), pursuant to which IBM has agreed to acquire us (the "Merger") for $190.00 per share in an all-cash transaction valued at approximately $34.62 billion. Our Board of Directors and the Board of Directors of IBM each approved the Merger, and our stockholders approved the adoption of the Merger Agreement at a special meeting of stockholders on January 16, 2019. The transaction is expected to close in the latter half of 2019, subject to certain conditions, including receipt of regulatory approvals. We have incurred merger-related costs of $33.7 million, which are included in General and administrative expenses in our Consolidated Statement of Operations for the fiscal year ended February 28, 2019. See NOTE 1—Company and Merger Agreement to our Consolidated Financial Statements in Part II, Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K.

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

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

We derive our revenue and generate cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat technologies. Our revenue is affected by, among other factors, corporate, government and consumer spending levels. In evaluating the performance of our business, we consider a number of factors, including total revenue, deferred revenue, operating income, operating margin and cash flows from operations. The arrangements with our customers that produce this revenue and cash are explained in further detail in this Part II, Item 7 under "Critical Accounting Estimates" and in NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements. We adopted ASC 606, *Revenue from Contracts with Customers*, effective March 1, 2018, using the full retrospective transition method. All amounts and disclosures set forth in this Annual Report on Form 10-K have been updated to comply with the new standard and such information is designated "as adjusted."

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

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In fiscal 2020, we expect to focus on, among other things: (i) driving the widespread adoption of our offerings, (ii) investing in the development of open source technologies and promoting the use of our technologies by software developers globally, (iii) pursuing strategic acquisitions and alliances, and (iv) promoting a range of services to help our customers derive additional value.

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 II, Item 7, we disclose non-GAAP amounts and growth rates that exclude the impact of foreign currency exchange rate fluctuations for fiscal 2019 in an effort to provide a comparable framework for assessing how our business performed when compared to fiscal 2018. To compute the non-GAAP impact of foreign currency exchange rate fluctuations, we translate amounts from our non-U.S. operations for fiscal 2019 using the average foreign currency exchange rate for the twelve months ended February 28, 2018.

Revenue

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 fiscal 2019 versus fiscal 2018 are as follows (in thousands):

	Fiscal Years Ended		
	February 28, 2019	February 28, 2018	Year-Over-Year Growth Rate
Infrastructure-related subscription revenue, as reported	$2,132,635	$1,950,396	9.3%
Adjustment for foreign currency exchange rates	6,826	—	
Infrastructure-related subscription revenue, excluding foreign currency impact	2,139,461	1,950,396	9.7%
Application Development-related and other emerging technology subscription revenue, as reported	816,424	623,782	30.9%
Adjustment for foreign currency exchange rates	5,779	—	
Application Development-related and other emerging technology subscription revenue, excluding foreign currency impact	822,203	623,782	31.8%
Total subscription revenue, as reported	2,949,059	2,574,178	14.6%
Adjustment for foreign currency exchange rates	12,605	—	
Total subscription revenue, excluding foreign currency impact	2,961,664	2,574,178	15.1%
Total training and services revenue, as reported	413,010	346,283	19.3%
Adjustment for foreign currency exchange rates	7,013	—	
Total training and services revenue, excluding foreign currency impact	420,023	346,283	21.3%
Total revenue, as reported	3,362,069	2,920,461	15.1%
Adjustment for foreign currency exchange rates	19,618	—	
Total revenue, excluding foreign currency impact	$3,381,687	$2,920,461	15.8%

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Subscription revenue

Our enterprise technologies are delivered primarily under subscription agreements. These agreements typically have a one- or three-year subscription period. A subscription generally entitles a customer to, among other things, a specified level of support, as well as security updates, fixes, functionality enhancements, upgrades to the technologies, each if and when available, and compatibility with an ecosystem of certified hardware and software. Subscription revenue increased sequentially for each quarter of fiscal 2019, fiscal 2018 and fiscal 2017 and was driven primarily by the increased use of our offerings by customers and our expansion of sales channels and geographic footprint during these periods.

Subscription revenue increased 14.6%, or $374.9 million, for fiscal 2019 compared to fiscal 2018. Excluding the impact of foreign currency exchange rate fluctuations, subscription revenue increased by 15.1% for fiscal 2019. The increase in subscription revenue is driven primarily by additional subscriptions related to our Red Hat Enterprise Linux, Red Hat Middleware and certain emerging technology offerings: Ansible, OpenShift and OpenStack. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government and telecommunications to our open source solutions from proprietary technologies. We believe revenue growth for subscriptions related to our Red Hat Enterprise Linux offerings has moderated primarily due to certain deals renewing in prior years with terms that extend beyond fiscal 2019. Additionally, we believe revenue growth in our Middleware portfolio has moderated as customers shift their workloads from traditional Java deployments to containerized environments with middleware-as-a-service on OpenShift. We believe this transition will impact the revenue growth of the Middleware portfolio into fiscal 2020.

Training and services revenue

Training and services revenue increased 19.3%, or $66.7 million, for fiscal 2019 as compared to fiscal 2018. Excluding the impact of foreign currency exchange rate fluctuations, training and services revenue increased by 21.3%. The increase is driven primarily by customer interest in new products and increased demand for consulting projects supporting Ansible and OpenShift solutions.

Deferred revenue, billings proxy, seasonality and backlog

Deferred revenue

Our deferred revenue, current and long-term, balance at February 28, 2019 was $2.98 billion. Total deferred revenue increased 14.9%, or $387.3 million at February 28, 2019 from $2.60 billion at February 28, 2018. Excluding the impact of foreign currency exchange rate fluctuations, total deferred revenue increased by 17.9%, or $463.8 million, from February 28, 2018 to February 28, 2019, which is the change in deferred revenue reported in our Consolidated Statements of Cash Flows.

Below is a summary of our deferred revenue, as reported and excluding the impact of foreign currency exchange rate fluctuations, for February 28, 2019 and February 28, 2018 (in thousands):

	February 28, 2019	February 28, 2018	Year-Over-Year Growth Rate
Current deferred revenue, as reported	$2,161,206	$1,853,719	16.6%
Adjustment for foreign currency exchange rates	48,325	—	
Current deferred revenue, excluding foreign currency impact	$2,209,531	$1,853,719	19.2%
Long-term deferred revenue, as reported	$821,218	$741,453	10.8%
Adjustment for foreign currency exchange rates	28,205	—	
Long-term deferred revenue, excluding foreign currency impact	$849,423	$741,453	14.6%
Total deferred revenue, as reported	$2,982,424	$2,595,172	14.9%
Adjustment for foreign currency exchange rates	76,530	—	
Total deferred revenue, excluding foreign currency impact	$3,058,954	$2,595,172	17.9%

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Billings proxy

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

Below is a summary of our billings proxy for fiscal 2019 and fiscal 2018 (in thousands):

	Fiscal Years Ended		
	February 28, 2019	February 28, 2018	Year-Over-Year Growth Rate
Revenue, as reported	$3,362,069	$2,920,461	15.1%
Change in deferred revenue, as reported on Statements of Cash Flows	463,782	432,182	
Billings proxy	3,825,851	3,352,643	14.1%
Adjustment to revenue for foreign currency exchange rates	19,618	—	
Billings proxy, excluding foreign currency impact	$3,845,469	$3,352,643	14.7%

Seasonality

Our fourth fiscal quarter has historically been our strongest quarter for new billings and renewals. This pattern has become more pronounced over time as the number of customers with renewal dates occurring in the last half of our fiscal year has continued to increase. Furthermore, our quarterly sales cycles are frequently weighted toward the end of the quarter, with an increased volume of sales completed in the last weeks of each quarter. The year-over-year compounding effect of this seasonality in billing patterns and overall new business and renewal activity causes the value of invoices making up our billings that we generate in the last half of our fiscal year to continually increase in proportion to the value of our invoices making up our billings in the first half of our fiscal year.

Below is a summary of our billings (approximated as described above by adding revenue for the period with the change in deferred revenue as reported in our Consolidated Statements of Cash Flows for the same period) by quarter for fiscal 2019, fiscal 2018, fiscal 2017, fiscal 2016 and fiscal 2015 (in thousands):

	First quarter		Second quarter		Third quarter		Fourth quarter	
Fiscal Years Ended	Billings proxy	% of fiscal year total	Billings proxy	% of fiscal year total	Billings proxy	% of fiscal year total	Billings proxy	% of fiscal year total
February 28, 2019	$708,938	18.5%	$788,961	20.6%	$999,906	26.1%	$1,328,046	34.7%
February 28, 2018	$631,079	18.8%	$682,780	20.4%	$805,253	24.0%	$1,233,531	36.8%
February 28, 2017	$521,806	18.9%	$572,851	20.8%	$679,441	24.6%	$986,239	35.7%
February 29, 2016	$449,439	19.4%	$479,131	20.7%	$620,244	26.8%	$763,911	33.0%
February 28, 2015	$404,005	19.5%	$439,690	21.2%	$539,807	26.1%	$688,680	33.2%

Backlog

Our total backlog as of February 28, 2019 was approximately $4.1 billion and includes amounts already billed to customers and recognized as current and long-term deferred revenue in our Consolidated Balance Sheet of $2.16 billion and $821.2 million, respectively, plus the value of non-cancellable subscription agreements not yet billed or reflected in our financial statements and the value of services agreements not yet billed or reflected in our financial statements that we believe to be firm ("off-balance sheet backlog"), which was in excess of $1.0 billion. Our total backlog as of February 28, 2018 was approximately $3.4 billion, including current and long-term deferred revenue of $1.85 billion and $741.5 million, respectively, plus off-balance sheet backlog in excess of $775 million. The increase in total backlog from approximately $3.4 billion as of February 28, 2018 to approximately $4.1 billion as of February 28, 2019 demonstrates increased customer commitment to our open source technologies.

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We report our off-balance sheet backlog as a conservative approximation, often describing the amount as "in excess of," primarily because the value of underlying contracts was derived from data not yet subjected to the complete application of our revenue recognition policies. For example, the value of the service agreements included as a part of off-balance sheet backlog is less than the stated value of such agreements because in certain instances customers are not contractually required to purchase the stated value of such services (e.g., when the services are to be billed on a time and materials basis and the service agreement's stated value is merely an estimate of the aggregate value of the services to be provided). Historically, the impact on off-balance sheet backlog resulting from the difference in the amount of services billed and the service agreements' stated value has not been material. We endeavor to derive the value of our off-balance sheet backlog in a consistent manner year over year and, therefore, believe the amounts are comparable.

Revenue by geography

In fiscal 2019, approximately 45.3%, or $1.52 billion, of our revenue was generated outside the U.S. compared to approximately 43.6%, or $1.27 billion, for fiscal 2018. Excluding the impact of foreign currency exchange rate fluctuations, our revenue generated outside the U.S. would have been 45.7%, or $1.54 billion, of our total revenue in fiscal 2019. Our international operations are expected to grow as our international sales force and channels become more mature and as we enter new locations outside the U.S. or expand our presence in existing international locations. As of February 28, 2019, we had offices in more than 105 locations throughout the world.

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

	Americas		EMEA		Asia Pacific		Consolidated	
Fiscal Years Ended	**Revenue**	**YoY Growth %**	**Revenue**	**YoY Growth %**	**Revenue**	**YoY Growth %**	**Revenue**	**YoY Growth %**
February 28, 2019, as reported	$2,092,329	12.6%	$786,503	19.7%	$483,237	19.2%	$3,362,069	15.1%
Adjustment for foreign currency exchange rates	19,093		(5,429)		5,954		19,618	
February 28, 2019, excluding foreign currency impact	$2,111,422	13.6%	$781,074	18.8%	$489,191	20.7%	$3,381,687	15.8%
February 28, 2018, as reported	$1,858,004	19.5%	$657,197	27.5%	$405,260	18.9%	$2,920,461	21.1%

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

Gross profit margin

Gross profit margin remained constant at 85.2% for fiscal 2019 and fiscal 2018 and decreased from 85.3% for fiscal 2017. The decrease from fiscal 2017 was primarily driven by a higher mix of training and services revenue relative to subscription revenue. Training and services revenue as a percentage of total revenue was 12.3%, 11.9% and 11.4% for fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

Gross profit margin by geography

Gross profit margins by our geographic regions were as follows:

Fiscal Years Ended	**Americas**	**EMEA**	**Asia Pacific**	**Consolidated (1)**
February 28, 2019	85.8 %	87.4%	82.9 %	85.2 %
February 28, 2018	85.9 %	87.4%	82.9 %	85.2 %
February 28, 2017	86.3 %	86.7%	83.7 %	85.3 %

(1) Consolidated gross profit includes corporate (non-allocated) share-based compensation expense for fiscal 2019, fiscal 2018 and fiscal 2017 of $19.8 million, $16.9 million and $16.6 million, respectively. Share-based compensation expense was not allocated to geographic segments. For additional information, see NOTE 19—Share-based Awards to our Consolidated Financial Statements.

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

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

Income from operations

Operating income was 15.2%, 16.3% and 13.9% of total revenue for fiscal 2019, fiscal 2018 and fiscal 2017, respectively. Operating expenses as a percent of revenue increased to 69.9% for fiscal 2019 from 68.9% for fiscal 2018 due primarily to investments and enhancements in our sales and marketing and research and development functions in addition to merger-related costs. In comparison, operating expenses as a percent of revenue decreased in fiscal 2018 to 68.9% from 71.5% for fiscal 2017 due to improved sales productivity as well as efficiencies in our marketing and general administrative support areas of the business.

Income from operations by geography

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

Fiscal Years Ended	Americas	EMEA	Asia Pacific	Consolidated (1)
February 28, 2019	18.0 %	24.8 %	31.0 %	15.2 %
February 28, 2018 (2)	21.3 %	23.7 %	28.9 %	16.3 %
February 28, 2017 (2)	20.5 %	21.0 %	29.3 %	13.9 %

(1) Consolidated operating income includes corporate (non-allocated) share-based compensation expense for fiscal 2019, fiscal 2018 and fiscal 2017 of $209.1 million, $192.2 million and $192.5 million, respectively. Share-based compensation expense was not allocated to geographic segments. For additional information, see NOTE 19—Share-based Awards to our Consolidated Financial Statements.

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

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

Cash, cash equivalents, restricted cash and short-term and long-term available-for-sale investments in debt and equity securities balances at February 28, 2019 totaled $2.42 billion. Cash generated from operating activities for fiscal 2019 totaled $1.01 billion, which represents a 9.7% increase in operating cash flow as compared to fiscal 2018. This increase is due to higher operating income, billings and collections.

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

Foreign currency exchange rates' impact on results of operations

Approximately 45.3% of our revenue for fiscal 2019 came from sales outside the U.S. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions results in increased revenue and operating expenses from operations for our non-U.S. operations. Similarly, our revenue and operating expenses will decrease for our non-U.S. operations if the U.S. dollar strengthens against foreign currencies.

Using the average foreign currency exchange rates from fiscal 2018, our revenue from non-U.S. operations for fiscal 2019 would have been higher than we reported by approximately $19.6 million and operating expenses from non-U.S. operations for fiscal 2019 would have been higher than we reported by approximately $22.9 million, which would have resulted in income from operations being lower by $3.3 million.

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Business combinations

Noobaa

On November 27, 2018, we acquired all of the shares of Y.G. Noobaa Ltd. (“Noobaa”), an early stage company developing software for managing data storage services, for approximately $11.8 million. The technologies of Noobaa complement and enhance our portfolio of hybrid cloud technologies, including Red Hat OpenShift Container Platform, Red Hat OpenShift Container Storage and Red Hat Ceph Storage. Together, these technologies are designed to provide users with a set of powerful, consistent and cohesive capabilities for managing application, compute, storage and data resources across public and private infrastructures.

CoreOS

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

Permabit

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

Codenvy

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

3scale

On June 24, 2016, we completed our acquisition of all of the shares of 3scale, Inc. (“3scale”) for approximately $29.1 million. 3scale is a provider of application programming interface (“API”) management technology. By adding 3scale to our existing portfolio, including Red Hat Middleware and Red Hat OpenShift, we strengthened our enablement of the API economy with simplified cloud integration and microservices-based architectures.

Transaction costs

We incurred transaction costs, including legal and accounting fees, relating to these acquisitions, which have been expensed as incurred and included in General and administrative expense in our Consolidated Statements of Operations. For fiscal 2019, transaction costs relating to the Noobaa acquisition totaled approximately $0.2 million; for fiscal 2018, transaction costs relating to the CoreOS, Permabit and Codenvy acquisitions totaled approximately $2.0 million; and for fiscal 2017, transaction costs relating to the 3scale acquisition totaled approximately $1.8 million.

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CRITICAL ACCOUNTING ESTIMATES

We prepare our consolidated financial statements in accordance with U.S. GAAP. Our significant accounting policies are disclosed in NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements and describe our methods for applying U.S. GAAP in areas such as revenue recognition, deferred selling costs, fair value measurements, and foreign currency translation among other areas deemed significant. In applying certain significant accounting policies, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities, revenue and expenses, as well as related disclosure of contingent assets and liabilities. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition, results of operations or cash flows could be adversely affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting estimates, which we discuss further below. Critical accounting estimates are applied in the following areas:

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

Revenue recognition

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

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

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

Goodwill and other long-lived assets

We make judgments about the recoverability of goodwill, identifiable intangible assets and other long-lived assets, including capitalized software purchased or developed for internal use. The assumptions and estimates used to determine recoverability of goodwill, identifiable intangible assets and other long-lived assets are complex and subjective. They can be affected by various factors, including external factors, such as industry and economic trends, and internal factors, such as changes in our business strategy and our internal, multi-year forecasts for our subscription and services offerings, which often include emerging technologies. Changes in any of these various factors could materially impact our financial condition and results of operations.

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Share-based compensation

We are required to make estimates and assumptions with regards to the number of share-based awards that we expect will ultimately vest and the amount of tax benefits we expect will ultimately be realized, among other things.

Share-based awards expected to vest

With respect to performance-based awards that we grant to certain executive officers and senior management, we estimate the number of shares expected to vest based primarily on our most current reported financial results relative to a defined peer group's most recent reported financial results. Because past or current financial trends may not be predictive of future financial performance, our estimate of the number of shares expected to vest may differ materially from the number of shares that actually vest. The maximum number of potential performance-based shares available to vest as of February 28, 2019 totaled 1.3 million, of which approximately 0.9 million shares are expected to vest with associated compensation expense of $31.7 million. If all of the potential performance-based shares were to vest, we would be required to recognize additional expense of approximately $17.0 million. See NOTE 19—Share-based Awards to our Consolidated Financial Statements for further discussion related to awards outstanding and expected to vest.

Income tax benefits related to share-based awards

We recognize share-based compensation expense based on an award's grant date fair value over the performance period and/or requisite service period. Because we do not know the actual amount of tax benefits an award will generate until such award is exercised (or vested), we assume that the amount ultimately recognized for tax purposes will be the same amount we recognized in our operating results, that is for "book" purposes. Consequently, our deferred tax asset related to share-based compensation expense, which totaled $24.5 million as of February 28, 2019, is based on each qualifying award's grant date fair value rather than the award's to-be-determined exercise date intrinsic value (or vesting date fair value).

Historically, the difference between the grant date fair value and the exercise date intrinsic value has been significant. As a result of such differences, for fiscal 2019, fiscal 2018 and fiscal 2017, we realized net excess tax benefits related to share-based awards totaling $17.4 million, $27.0 million and $15.8 million, respectively.

If the share price for our common stock were to depreciate for a sustained period of time, we could be required to recognize a tax benefit shortfall. Such shortfalls could have a material adverse effect on our cash flows and financial results. For further discussion, see NOTE 2—Summary of Significant Accounting Policies, NOTE 11—Income Taxes and NOTE 19—Share-based Awards to our Consolidated Financial Statements.

Income taxes

As described in NOTE 2—Summary of Significant Accounting Policies to our Consolidated Financial Statements, we account for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

We continue to assess the realizability of our deferred tax assets, which primarily consist of share-based compensation expense deductions (described above), tax credit carryforwards and deferred revenue. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. As of February 28, 2019, deferred tax assets totaled $183.0 million, of which $3.3 million was offset by a valuation allowance. For further discussion regarding deferred income taxes, see NOTE 2—Summary of Significant Accounting Policies and NOTE 11—Income Taxes to our Consolidated Financial Statements.

Because tax laws are complex and subject to different interpretations, significant judgment is required. As a result, we make certain estimates and assumptions in (i) calculating our income tax expense, deferred tax assets and deferred tax liabilities, (ii) determining any valuation allowance recorded against deferred tax assets and (iii) evaluating the amount of unrecognized tax benefits, as well as the interest and penalties related to such uncertain tax positions. Our estimates and assumptions may differ significantly from tax benefits ultimately realized. For further discussion regarding uncertain tax positions, see NOTE 11—Income Taxes to our Consolidated Financial Statements.

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Loss contingencies

We are subject to the possibility of various losses arising in the course of conducting our business, including losses related to legal proceedings and claims brought against us. We consider the likelihood of loss or impairment of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of loss, in determining loss contingencies. An estimated loss contingency is accrued when it is probable that an asset has been impaired or a liability has been incurred and the amount of loss can be reasonably estimated.

Significant judgment is required in evaluating both the likelihood and the estimated amount of a potential loss. Until the final resolution of a matter, there may be an exposure to loss in excess of the amount recorded, and such amount could be material. Should any of our estimates or assumptions change or prove to have been incorrect, it could materially adversely impact on our business, financial condition, operating results or cash flows.

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RESULTS OF OPERATIONS

Fiscal years ended February 28, 2019 and February 28, 2018

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

	Fiscal Years Ended February 28, 2019	February 28, 2018 (1)	$ Change	% Change
Revenue:				
Subscriptions	$2,949,059	$2,574,178	$374,881	14.6 %
Training and services	413,010	346,283	66,727	19.3
Total revenue	3,362,069	2,920,461	441,608	15.1 %
Cost of revenue:				
Subscriptions	213,843	185,339	28,504	15.4
As a % of subscription revenue	7.3 %	7.2 %		
Training and services	284,408	246,458	37,950	15.4
As a % of training and services revenue	68.9 %	71.2 %		
Total cost of revenue	498,251	431,797	66,454	15.4 %
As a % of total revenue	14.8 %	14.8 %		
Gross profit	2,863,818	2,488,664	375,154	15.1 %
Operating expense:				
Sales and marketing	1,378,278	1,195,286	182,992	15.3
Research and development	668,542	578,330	90,212	15.6
General and administrative	304,766	239,316	65,450	27.3
Total operating expense	2,351,586	2,012,932	338,654	16.8 %
Income from operations	512,232	475,732	36,500	7.7
Interest income	30,531	18,493	12,038	65.1
Interest expense	19,838	24,569	(4,731)	(19.3)
Other (expense) income, net	(4,870)	8,335	(13,205)	(158.4)
Income before provision for income taxes	518,055	477,991	40,064	8.4 %
Provision for income taxes (2)	84,067	216,140	(132,073)	(61.1)
Net income	$433,988	$261,851	$172,137	65.7 %
Gross profit margin—subscriptions	92.7 %	92.8 %		
Gross profit margin—training and services	31.1 %	28.8 %		
Gross profit margin	85.2 %	85.2 %		
As a % of total revenue:				
Subscription revenue	87.7 %	88.1 %		
Training and services revenue	12.3 %	11.9 %		
Sales and marketing expense	41.0 %	40.9 %		
Research and development expense	19.9 %	19.8 %		
General and administrative expense	9.1 %	8.2 %		
Total operating expenses	69.9 %	68.9 %		
Income from operations	15.2 %	16.3 %		
Income before provision for income taxes	15.4 %	16.4 %		
Net income	12.9 %	9.0 %		
Effective income tax rate (2)	16.2 %	45.2 %		

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

(2) See NOTE 11—Income Taxes to our Consolidated Financial Statements for further discussion.

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Revenue

Subscription revenue

Subscription revenue, which is primarily comprised of direct and indirect sales of Red Hat offerings, increased by 14.6%, or $374.9 million, to $2.95 billion for fiscal 2019 from $2.57 billion for fiscal 2018.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 9.3%, or $182.2 million, to $2.13 billion for fiscal 2019 from $1.95 billion for fiscal 2018. The increase in subscription revenue is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of customers to our open source Linux platform from proprietary operating systems.

Revenue derived from the sale of subscriptions supporting our Application Development-related and other emerging technology offerings increased by 30.9%, or $192.6 million, to $816.4 million for fiscal 2019 from $623.8 million for fiscal 2018. The increase is primarily driven by additional subscriptions for Red Hat Middleware and certain emerging technology offerings: Ansible, OpenShift and OpenStack. We expect the growth rate of revenue derived from our Application Development-related and other emerging technology offerings to exceed the growth rate of revenue derived from our Infrastructure-related offerings as our Application Development-related and other emerging technology offerings continue to gain broader market acceptance in the enterprise IT environment.

Training and services revenue

Training revenue includes fees paid by our customers for delivery of educational materials and instruction. Services revenue includes fees received from customers for consulting services regarding our offerings, deployment of Red Hat technologies and for delivery of added functionality to Red Hat technologies for our major customers and OEM partners. Total training and services revenue increased by 19.3%, or $66.7 million, to $413.0 million for fiscal 2019 from $346.3 million for fiscal 2018. Training revenue increased by 15.1%, or $12.1 million, as a result of increased revenue generated from our Red Hat Learning Subscription ("RHLS") offerings and increased consumption of training courses or units related to our emerging technology offerings. Services revenue increased by 20.5%, or $54.6 million, as a result of an increase in consulting engagements driven by increased demand for our open source cloud enabling solutions such as Ansible and OpenShift. We expect services revenue to continue growing, though at a slower pace than subscription revenue, as we continue to expand our reach by enabling our channel partners to provide consulting services on our behalf. Combined training and services revenue as a percentage of total revenue was 12.3% and 11.9% for fiscal 2019 and fiscal 2018, respectively.

Cost of revenue

Cost of subscription revenue

The cost of subscription revenue primarily consists of expenses we incur to support, distribute, and package Red Hat offerings. These costs include labor-related costs to provide technical support, security updates and fixes, as well as costs for fulfillment. Cost of subscription revenue increased by 15.4%, or $28.5 million, to $213.8 million for fiscal 2019 from $185.3 million for fiscal 2018. The overall increase is primarily due to employee compensation expense, which increased $15.4 million, due to the expansion of our technical staff in order to meet the demands of our growing subscriber base for support, security updates and fixes, especially with respect to the increase in demand for our emerging technology offerings. The remaining expense increase is primarily related to $15.7 million higher expense associated with facility and technology infrastructure enhancements. As the number of open source technology subscriptions continues to increase, we expect associated support costs will continue to increase, although we anticipate this will occur at an overall slower rate than that of subscription revenue growth due to economies of scale. Gross profit margin on subscriptions decreased to 92.7% for fiscal 2019 from 92.8% for fiscal 2018.

Cost of training and services revenue

Cost of training and services revenue is mainly comprised of personnel and third-party consulting costs for the design, development and delivery of custom engineering, training courses and professional services provided to various types of customers. Cost of training and services revenue increased by 15.4%, or $38.0 million, to $284.4 million for fiscal 2019 from $246.5 million for fiscal 2018. The increase in cost to deliver training and services includes $24.8 million increased employee compensation expenses and increased outside contractor fees of $9.0 million. The increase in employee compensation expense and outside contractor fees is due to the expansion of our professional consulting teams needed to meet the growing demand for services related to our emerging technology offerings. The remaining increase in cost to deliver training and services includes $4.5 million travel-related expenses. Total costs to deliver training and services as a percentage of training and services revenue decreased to 68.9% for fiscal 2019 from 71.2% for fiscal 2018.

Gross profit margin

Gross profit margin remained constant at 85.2% for fiscal 2019 and fiscal 2018. Training and services revenue as a percentage of total revenue was 12.3% for fiscal 2019 as compared to 11.9% for fiscal 2018.

Operating expenses

Sales and marketing

Sales and marketing expense consists primarily of salaries and other related costs for sales and marketing personnel, sales commissions, travel, public relations and marketing materials and trade shows. Sales and marketing expense increased by 15.3%, or $183.0 million, to $1.38 billion for fiscal 2019 from $1.20 billion for fiscal 2018. This increase was primarily due to a $137.2 million increase in selling costs, which includes $108.7 million, $15.9 million and $7.7 million of additional employee compensation-, event- and travel-related, and facilities-related expenses, respectively, the majority of which is attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew by 15.4%, or $45.8 million for fiscal 2019 as compared to fiscal 2018 and includes incremental employee compensation expense, marketing program costs, facility costs and outside contractor costs of $26.7 million, $9.4 million, $3.8 million and $3.0 million, respectively. As a result of investments made to expand the breadth of our global sales coverage and depth of our product sales coverage, sales and marketing expense increased as a percentage of revenue to 41.0% for fiscal 2019 from 40.9% for fiscal 2018.

Research and development

Research and development expense consists primarily of personnel and related costs for development of software technologies and systems management offerings. Research and development expense increased by 15.6%, or $90.2 million, to $668.5 million for fiscal 2019 from $578.3 million for fiscal 2018. The increase in research and development costs primarily resulted from the expansion of our engineering group through both direct hires and business acquisitions as we continue investing in Application Development-related and other emerging technologies. Employee compensation expense increased by $77.1 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased by $10.4 million. Research and development expense was 19.9% of total revenue for fiscal 2019 compared to 19.8% for fiscal 2018.

General and administrative

General and administrative expense consists primarily of personnel and related costs for general corporate functions, including information systems, finance, accounting, legal, human resources and facilities expense. General and administrative expense increased by 27.3%, or $65.5 million, to $304.8 million for fiscal 2019 from $239.3 million for fiscal 2018. The increase in general and administrative expense primarily resulted from merger-related costs of $33.7 million related to the pending Merger with IBM, increased employee compensation expenses of $17.7 million and $18.5 million higher expense associated with facility and technology infrastructure enhancements, partially offset by a decrease of $9.4 million in outside contractor costs. General and administrative expense as a percentage of revenue was 9.1% and 8.2% for fiscal 2019 and fiscal 2018, respectively.

Interest income

Interest income increased by 65.1%, or $12.0 million, for fiscal 2019 as compared fiscal 2018. The increase in interest income for fiscal 2019 is attributable to higher yields earned on cash and investment balances.

Interest expense

Interest expense decreased by $4.7 million for fiscal 2019 as compared to fiscal 2018. Interest expense is primarily attributable to the interest on the Company’s 0.25% Convertible Senior Notes due 2019 (the “convertible notes”). See NOTE 12—Convertible Notes to our Consolidated Financial Statements for further discussion.

Other (expense) income, net

Other (expense) income, net is primarily due to net losses recognized from the settlement of foreign currency transactions during fiscal 2019, partially offset by realized gains of $1.3 million on the sale of certain strategic equity investments.

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Income taxes

The effective tax rate for fiscal 2019 of 16.2% differed from the U.S. federal statutory rate of 21.0% primarily due to excess tax benefits from share-based compensation, research tax credits and the impact from the Tax Cuts and Jobs Act (the “Tax Act”), which was enacted in December 2017. The effective tax rate for fiscal 2018 of 45.2% differed from the U.S. federal statutory rate of 32.7% primarily due to the impact from the Tax Act, 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 fiscal 2019 and fiscal 2018 included a one-time tax charge of $18.0 million and $122.7 million, respectively, related to the Tax Act. Further included in tax expense for fiscal 2019 and fiscal 2018 was a net discrete tax benefit of $17.4 million and $27.0 million, respectively, primarily related to net excess tax (charges) benefits from share-based compensation. For further discussion regarding our income taxes, see NOTE 11—Income Taxes to our Consolidated Financial Statements.

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Fiscal years ended February 28, 2018 and February 28, 2017

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

	Fiscal Years Ended			
	February 28, 2018 (1)	February 28, 2017 (1)	$ Change	% Change
Revenue:				
Subscriptions	$2,574,178	$2,135,780	$438,398	20.5 %
Training and services	346,283	276,023	70,260	25.5
Total revenue	2,920,461	2,411,803	508,658	21.1 %
Cost of revenue:				
Subscriptions	185,339	158,977	26,362	16.6
As a % of subscription revenue	7.2 %	7.4 %		
Training and services	246,458	195,401	51,057	26.1
As a % of training and services revenue	71.2 %	70.8 %		
Total cost of revenue	431,797	354,378	77,419	21.8 %
As a % of total revenue	14.8 %	14.7 %		
Gross profit	2,488,664	2,057,425	431,239	21.0 %
Operating expense:				
Sales and marketing	1,195,286	1,034,191	161,095	15.6
Research and development	578,330	480,668	97,662	20.3
General and administrative	239,316	208,491	30,825	14.8
Total operating expense	2,012,932	1,723,350	289,582	16.8 %
Income from operations	475,732	334,075	141,657	42.4
Interest income	18,493	13,921	4,572	32.8
Interest expense	24,569	23,822	747	3.1
Other income (expense), net	8,335	(2,164)	10,499	(485.2)
Income before provision for income taxes	477,991	322,010	155,981	48.4 %
Provision for income taxes (2)	216,140	66,620	149,520	224.4
Net income	$261,851	$255,390	$6,461	2.5 %
Gross profit margin—subscriptions	92.8 %	92.6 %		
Gross profit margin—training and services	28.8 %	29.2 %		
Gross profit margin	85.2 %	85.3 %		
As a % of total revenue:				
Subscription revenue	88.1 %	88.6 %		
Training and services revenue	11.9 %	11.4 %		
Sales and marketing expense	40.9 %	42.9 %		
Research and development expense	19.8 %	19.9 %		
General and administrative expense	8.2 %	8.6 %		
Total operating expenses	68.9 %	71.5 %		
Income from operations	16.3 %	13.9 %		
Income before provision for income taxes	16.4 %	13.4 %		
Net income	9.0 %	10.6 %		
Effective income tax rate (2)	45.2 %	20.7 %		

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

(2) See NOTE 11—Income Taxes to our Consolidated Financial Statements for further discussion.

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Revenue

Subscription revenue

Subscription revenue increased by 20.5%, or $438.4 million, to $2.57 billion for fiscal 2018 from $2.14 billion for fiscal 2017.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 15.0%, or $254.0 million, to $1.95 billion for fiscal 2018 from $1.70 billion for fiscal 2017 and is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of customers to our open source Linux platform from proprietary operating systems.

Revenue derived from the sale of subscriptions supporting our Application Development-related and other emerging technology offerings increased by 42.0%, or $184.4 million, to $623.8 million for fiscal 2018 from $439.3 million for fiscal 2017. The increase is primarily due to additional subscriptions for Red Hat Middleware offerings and certain emerging technology offerings: Ansible, OpenShift and OpenStack.

Training and services revenue

Total training and services revenue increased by 25.5%, or $70.3 million, to $346.3 million for fiscal 2018 from $276.0 million for fiscal 2017. Training revenue increased 18.4%, or $12.5 million, primarily as a result of increased revenue generated from our RHLS offerings and increased consumption of training related to our emerging technology offerings. Our services revenue increased by 27.8%, or $57.7 million, as a result of an increase in consulting engagements driven by increased demand for our open source cloud enabling solutions such as Ansible and OpenShift. Combined training and services revenue as a percentage of total revenue was 11.9% and 11.4% for fiscal 2018 and fiscal 2017, respectively.

Cost of revenue

Cost of subscription revenue

Cost of subscription revenue increased by 16.6%, or $26.4 million, to $185.3 million for fiscal 2018 from $159.0 million for fiscal 2017. Employee-related expenses increased $20.9 million for fiscal 2018 as compared to fiscal 2017, due to the expansion of our technical staff in order to meet the demands of our growing subscriber base for support, security updates and fixes, especially with respect to the increase in demand for our emerging technology offerings. The remaining expense increase is related to $5.3 million higher expense associated with facility and technology infrastructure enhancements. Gross profit margin on subscriptions was 92.8% and 92.6% for fiscal 2018 and fiscal 2017, respectively.

Cost of training and services revenue

Cost of training and services revenue increased by 26.1%, or $51.1 million, to $246.5 million for fiscal 2018 from $195.4 million for fiscal 2017. Costs of training and services revenue increased by 26.1%, or $51.1 million, to $246.5 million for fiscal 2018. The increase in costs to deliver training and services includes $24.5 million increased employee compensation expenses and increased outside contractor fees of $20.0 million. The increase in employee compensation expense and outside contractor fees is due to the expansion of our professional consulting teams needed to meet the growing demand for services related to our emerging technology offerings. The remaining increase in cost to deliver training and services includes $3.2 million travel-related expenses and $2.6 million expense associated with facilities and technology infrastructure. Total costs to deliver training and services as a percentage of training and services revenue increased to 71.2% for fiscal 2018 from 70.8% for fiscal 2017.

Gross profit

Gross profit margin decreased to 85.2% for fiscal 2018 from 85.3% for fiscal 2017. This decrease was driven by a higher mix of training and services revenue relative to subscription revenue. Training and services revenue as a percentage of total revenue was 11.9% for fiscal 2018 as compared to 11.4% for fiscal 2017.

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Operating expenses

Sales and marketing

Sales and marketing expense increased by 15.6%, or $161.1 million, to $1.20 billion for fiscal 2018 from $1.03 billion for fiscal 2017. Selling costs increased by 14.3%, or $112.2 million, for fiscal 2018 as compared to fiscal 2017 and include $82.1 million, $14.4 million and $8.7 million of additional employee-, facilities- and travel-related expenses, respectively, the majority of which is attributable to the expansion of our sales force from the prior year. The remaining increase relates to marketing costs, which grew by 19.7%, or $48.9 million, for fiscal 2018 as compared to fiscal 2017 and includes incremental employee compensation expense and marketing program costs of $28.1 million and $14.1 million, respectively. Sales and marketing expense as a percentage of revenue decreased to 40.9% for fiscal 2018 from 42.9% for fiscal 2017.

Research and development

Research and development expense increased by 20.3%, or $97.7 million, to $578.3 million for fiscal 2018 from $480.7 million for fiscal 2017. Employee compensation increased by $74.9 million primarily from the expansion of our engineering group through both direct hires and business acquisitions as we continued investing in Application-Development-related and other emerging technologies. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased by $16.2 million. Research and development expense was 19.8% and 19.9% of total revenue for fiscal 2018 and fiscal 2017, respectively.

General and administrative

General and administrative expense increased by 14.8%, or $30.8 million, to $239.3 million for fiscal 2018 from $208.5 million for fiscal 2017. The increase in general and administrative expenses primarily resulted from increased employee compensation expenses of $13.5 million and $15.1 million higher expense associated with facility and technology enhancements. General and administrative expense decreased as a percentage of revenue to 8.2% for fiscal 2018 from 8.6% for fiscal 2017.

Interest income

Interest income increased by 32.8%, or $4.6 million, to $18.5 million for fiscal 2018 from $13.9 million for fiscal 2017. The increase is attributable to higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $0.7 million to $24.6 million for fiscal 2018 as compared to $23.8 million for fiscal 2017. The increase in interest expense is attributable to our convertible notes.

Other income (expense), net

Other income (expense), net is primarily due to realized gains of $13.4 million on the sale of certain strategic equity investments during fiscal 2018, partially offset by net losses recognized from the settlement of foreign currency transactions.

Income taxes

The effective tax rate for fiscal 2018 of 45.2% differed from the U.S. federal statutory rate of 32.7% primarily due to the impact from the Tax Act, excess tax benefits from share-based compensation, foreign income taxed at lower rates, research tax credits and the domestic production activities deduction. The effective tax rate for fiscal 2017 differed from the U.S. federal statutory rate of 35% primarily due to the impact from the excess tax benefits from share-based compensation, foreign income taxed at lower rates and research tax credits. Tax expense for fiscal 2018 included a one-time tax charge of $122.7 million related to the Tax Act. Further included in tax expense for fiscal 2018 and fiscal 2017 was a net discrete tax benefit of $27.0 million and $15.8 million, respectively, primarily related to net excess tax benefits from share-based compensation.

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LIQUIDITY AND CAPITAL RESOURCES

We derive our liquidity and operating capital primarily from cash flows from operations. Historically, we also received cash from the sale of equity securities, including private sales of preferred stock and the sale of common stock in our initial and follow-on public offerings, and the issuance of convertible notes, including our issuance of convertible notes described in detail in NOTE 12—Convertible Notes to our Consolidated Financial Statements. At February 28, 2019, we had total cash and investments of $2.42 billion, which was comprised of $1.88 billion in cash and cash equivalents, $293.4 million of short-term investments and $248.5 million of long-term fixed-income investments. This compares to total cash and investments of $2.47 billion at February 28, 2018.

On October 28, 2018, we entered into the Merger Agreement with IBM and Sub, pursuant to which IBM has agreed to acquire us for $190.00 per share in an all-cash transaction valued at approximately $34.62 billion. We have agreed to various customary covenants and agreements, including, among others, agreements to conduct our business in the ordinary course during the period between the execution of the Merger Agreement and the Effective Time. In addition, without the consent of IBM, we may not take, authorize, agree or commit to do certain actions outside of the ordinary course of business, including acquiring businesses or incurring capital expenditures above specified thresholds, issuing additional debt facilities, and repurchasing outstanding shares of our common stock. We do not believe these restrictions will prevent us from meeting convertible note obligations, ongoing costs of operations, working capital needs, or capital expenditure requirements for the next 12 months.

The Merger Agreement contains certain termination rights for IBM and us. Upon termination of the Merger Agreement under specified circumstances, we may be required to pay IBM a termination fee of $975.0 million.

Convertible note conversions

For at least 20 trading days during the 30 consecutive trading days ending on the last trading day of the fiscal quarters ended August 31, 2017 through February 28, 2019, our common stock traded at a price exceeding 130% of the conversion price of the convertible notes. Accordingly, the convertible notes remained convertible at the holders' option until March 29, 2019. Effective 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. To the extent we receive notices of conversion on or after April 1, 2019, the principal amount of the convertible notes will be settled in cash. Total settled conversions through February 28, 2019 amounted to $498.4 million aggregate principal amount of the convertible notes. We expect to settle conversions of $116.2 million in principal amount of the convertible notes in the first quarter of fiscal 2020 by paying cash for the principal amount and issuing shares of common stock for the excess conversion value. We continue to receive conversion requests and as of April 22, 2019, such incremental requests totaled $3.5 million in principal amount of the convertible notes, of which $3.0 million is scheduled to settle on June 3, 2019, and the remainder at the maturity date of the convertible notes. The aggregate principal amount of the convertible notes remaining is expected to be $186.9 million after the expected conversion settlements as discussed above and the incremental conversion requests received as of April 22, 2019.

Fiscal year ended February 28, 2019

Cash flows—overview

At February 28, 2019, cash and cash equivalents totaled $1.88 billion, an increase of $159.0 million as compared to February 28, 2018. The increase in cash and cash equivalents for fiscal 2019 is primarily the result of cash provided by operations, which generated $1.01 billion, and net sales and maturities of available-for-sale debt securities of $193.4 million, partially offset by repayments of convertible notes of $438.4 million, the repurchase of 2,786,879 shares of our common stock for $412.8 million and payments made in return for shares of our common stock received from employees to satisfy employees' minimum tax withholding obligations related to share awards vesting of $131.9 million. Net cash provided by operating activities and net cash used in investing activities and financing activities is further described below.

Cash flows from operations

Cash provided by operations of $1.01 billion during fiscal 2019 includes net income of $434.0 million, adjustments to exclude the impact of non-cash income and expenses, which totaled a $265.8 million net source of cash, and changes in operating assets and liabilities, which totaled a $313.0 million net source of cash. Non-cash income and expenses include the portion of repayments of convertible notes that are attributable to debt discount, which totaled $60.0

million, classified as operating cash flows due to our adoption of ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments*. Cash provided by changes in operating assets and liabilities for fiscal 2019 was primarily the result of an increase in our deferred revenue, which generated operating cash flow of $463.8 million. The increase in deferred revenue was due to growth in billings as we generally bill our customers in advance of subscription periods.

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Cash flows from investing

Cash provided by investing activities of $110.0 million for fiscal 2019 includes net sales and maturities of available-for-sale debt securities of $193.4 million offset by investments in property and equipment of $61.3 million, which primarily relate to information technology infrastructure and leasehold improvements, the acquisition of Noobaa for $11.6 million, net of working capital and purchase price adjustments, and investments in intangible assets, primarily patents, which totaled $10.5 million.

Cash flows from financing

Cash used in financing activities of $919.9 million for fiscal 2019 includes repayments of convertible notes of $438.4 million, $412.8 million to repurchase 2,786,879 shares of our common stock and $131.9 million of payments made in return for shares of our common stock received from employees to satisfy employees' minimum tax withholding obligations related to employee share awards vesting during fiscal 2019. Partially offsetting these uses of cash were proceeds of $62.1 million from our employee stock purchase plan.

Fiscal year ended February 28, 2018

Cash flows—overview

At February 28, 2018, cash and cash equivalents totaled $1.72 billion, an increase of $633.3 million as compared to February 28, 2017. The increase in cash and cash equivalents for fiscal 2018 is the result of cash provided by operating activities, which totaled $923.1 million, and net sales and maturities of available-for-sale debt securities of $325.9 million. Partially offsetting cash provided by operating activities was cash used for business acquisitions of $315.1 million and the repurchase of 2,318,584 shares of our common stock for $237.0 million. Net cash generated by operating activities and net cash used for investing activities and financing activities is further described below.

Cash flows from operations

Cash provided by operations of $923.1 million during fiscal 2018 includes net income of $261.9 million, adjustments to exclude the impact of non-cash income and expenses, which totaled a $290.0 million net source of cash, and changes in operating assets and liabilities, which totaled a $371.3 million net source of cash. Cash provided by changes in operating assets and liabilities for fiscal 2018 was primarily the result of an increase in our deferred revenue, which generated operating cash flow of $432.2 million. The increase in deferred revenue was due to growth in billings as we generally bill our customers in advance of subscription periods.

Cash flows from investing

Cash used in investing activities of $76.9 million for fiscal 2018 includes acquisitions of CoreOS, Permabit and Codenvy for $315.1 million, net of $6.9 million cash acquired, and investments in property and equipment of $85.0 million, which primarily relate to information technology infrastructure and leasehold improvements. Partially offsetting these uses of cash were proceeds from net sales and maturities of available-for-sale debt securities of $325.9 million.

Cash flows from financing

Cash used in financing activities of $273.1 million for fiscal 2018 includes $237.0 million to repurchase 2,318,584 shares of our common stock and payments made in return for shares of our common stock received from employees to satisfy employees' minimum tax withholding obligations related to employee share awards vesting during fiscal 2018 of $89.5 million. Partially offsetting financing activities using cash were proceeds from our employee stock purchase plan, which totaled $50.1 million.

Investments in debt securities

Our investments in debt securities are comprised primarily of available-for-sale fixed-income investments recorded at their fair values, of which $293.4 million are classified as short-term and $248.5 million are classified as long-term in the Consolidated Balance Sheet at February 28, 2019. The vast majority of our investments were priced with the assistance of pricing vendors. These pricing vendors use the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs. In the event observable inputs are not available, we assess other factors to determine the securities' fair values, including broker quotes or model valuations. Independent price verifications of all of our holdings are performed by the pricing vendors, which we review. In the event a price fails a pre-established tolerance check, it is researched so that we can assess the cause of the variance to determine what we believe is the appropriate fair value.

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We presently do not intend to liquidate our short- and long-term investments in debt securities prior to their scheduled maturity dates. However, in the event that we liquidate these investments prior to their scheduled maturities and there are adverse changes in market interest rates or the overall economic environment, we could be required to recognize a realized loss on those investments when we liquidate these investments. At February 28, 2019 and February 28, 2018, net accumulated unrealized net losses on our available-for-sale debt securities totaled $2.4 million and $5.3 million, respectively.

Capital requirements

Our capital requirements during fiscal 2020 will depend on numerous factors, including the amount of resources we devote to:

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

We have utilized, and will continue from time to time to utilize, cash and investments to fund, among other potential uses, purchases of our common stock, purchases of fixed assets, purchases of intangible assets (primarily patents), and mergers and acquisitions. Given our historically strong operating cash flow and the $2.42 billion of cash and investments held at February 28, 2019, we believe our cash balances totaling $1.88 billion, together with our ability to generate additional cash from operations, should be sufficient to satisfy our cash requirements for the next twelve months and for the foreseeable future. However, we may take advantage of favorable capital market conditions that may arise from time to time to raise additional capital.

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

As of February 28, 2019, $1.26 billion of our total cash and investments were held outside the U.S. Our intent has been to reinvest the earnings of foreign subsidiaries indefinitely outside the U.S. to fund both organic growth and acquisitions. The Tax Act includes a provision to move the U.S. to a territorial tax system by imposing a transition tax on historic foreign earnings whether or not such earnings are repatriated to the U.S. In light of the new territorial tax system, we no longer consider earnings from certain foreign subsidiaries to be indefinitely reinvested. As of February 28, 2019, cumulative undistributed foreign earnings totaled $397.5 million, of which $86.6 million is considered indefinitely reinvested. For further discussion, see NOTE 11—Income Taxes to our Consolidated Financial Statements.

Off-balance sheet arrangements

As of February 28, 2019 and February 28, 2018, we have no off-balance sheet financing arrangements and do not utilize any “structured debt,” “special purpose” or similar unconsolidated entities for liquidity or financing purposes.

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Contractual obligations

The following table summarizes our principal contractual obligations at February 28, 2019 (in thousands):

	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease obligations	$291,980	$60,722	$92,233	$59,495	$79,530
Capital lease obligations	288	282	6	—	—
Convertible notes 0.25% coupon obligations	640	640	—	—	—
Convertible notes principal	306,552	306,552	—	—	—
Total	$599,460	$368,196	$92,239	$59,495	$79,530

Obligations under contracts that we may cancel without significant penalty are not included in the table above. In addition, because we are unable to reasonably estimate the timing of settlements and any future payments related to uncertain tax positions, such liabilities are not included in the above table. However, as of February 28, 2019, we have recognized a total of $179.9 million related to such liabilities, which are included in Other long-term obligations in our Consolidated Balance Sheet.

RECENT ACCOUNTING PRONOUNCEMENTS

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

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest rate risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of short- and long-term investments in a variety of available-for-sale fixed- and floating-rate debt securities, including both government and corporate obligations and money market funds. Investments in both fixed-rate and floating-rate interest earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair value adversely impacted due to a rise in prevailing interest rates, while floating-rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income related to these securities may fall short of expectations due to changes in interest rates, or we may suffer losses in principal if forced to sell securities that have declined in market value due to changes in interest rates or perceived credit risk related to the securities' issuers. A hypothetical one-half percentage point change in interest rates, assuming a parallel shift of all interest rates, would result in an approximate $0.4 million change in annual interest income derived from investments in our portfolio as of February 28, 2019. For further discussion related to our investments as of February 28, 2019 and February 28, 2018, see NOTE 2—Summary of Significant Accounting Policies and NOTE 21**—**Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Investment risk

The fair value of our available-for-sale investment portfolio is subject to interest rate risk. Based on a sensitivity analysis performed on this investment portfolio, a hypothetical one percentage point increase in prevailing interest rates would result in an approximate $4.3 million decrease in the fair value of our available-for-sale investment securities as of February 28, 2019. For further discussion related to our investments as of February 28, 2019 and February 28, 2018, see NOTE 2—Summary of Significant Accounting Policies and NOTE 21—Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Credit risk

Investments in debt and equity securities

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

Accounts receivable

As of February 28, 2019 we had one customer whose accounts receivable balance individually represented 10% of total accounts receivable. As of February 28, 2018, no individual customer accounted for 10% or more of our total accounts receivable.

Foreign currency risk

Approximately 45.3% of our revenue for fiscal 2019 was produced by sales outside the U.S. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decrease if the U.S. dollar strengthens against foreign currencies. We have operations in Argentina and our functional currency for these operations was the Argentine peso. Argentina's economy is now considered hyperinflationary. While we still continue to conduct our operations in Argentina in Argentine pesos, the functional currency was changed to U.S. dollars effective September 1, 2018 for our financial reporting in accordance with U.S. GAAP. The change in functional currency to U.S. dollars is currently not expected to have a material impact on our financial position, operating results or cash flows.

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Using the average foreign currency exchange rates from fiscal 2018, our revenue and operating expenses from non-U.S. operations for fiscal 2019 would have been higher than we reported by approximately $19.6 million and $22.9 million, respectively, which would have resulted in income from operations being lower by $3.3 million.

Convertible notes

In October 2014, we issued $805.0 million of 0.25% convertible notes due October 2019. The convertible notes have a fixed annual interest rate of 0.25%, and, therefore, we do not have economic interest-rate exposure on the convertible notes. However, the fair value of the convertible notes is exposed to interest rate risk. Generally, the fair value of the convertible notes will increase as interest rates fall and decrease as interest rates rise. For further discussion regarding the fair value of the convertible notes, see NOTE 12—Convertible Notes to our Consolidated Financial Statements.

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

Derivative instruments

We transact business in various foreign countries and are, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time we enter into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded in the Consolidated Balance Sheets at their respective fair values. We generally elect not to prepare and maintain the documentation required to qualify our forward contracts for hedge accounting treatment and, therefore, changes in fair value are recorded in our Consolidated Statements of Operations. However, during the fourth quarter of fiscal 2018, we repatriated cash from certain of our foreign subsidiaries and entered into a foreign currency forward contract designated as a net investment hedge. As a result of this designation, changes in fair value of the forward contract were recognized as a charge included in Other comprehensive income—change in foreign currency translation adjustment. For further discussion related to our management of foreign currency risk, see NOTE 10—Derivative Instruments to our Consolidated Financial Statements.

The aggregate notional amount of outstanding forward contracts at February 28, 2019 was $75.6 million. The fair value of these outstanding contracts at February 28, 2019 was a gross asset less than $0.1 million and a gross $0.2 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses, respectively, on our Consolidated Balance Sheets. The forward contracts generally expire within three months of the period ended February 28, 2019. The forward contracts will settle in Euros, Hong Kong dollars, Japanese yen, and Singapore dollars.

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

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA
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REPORT OF MANAGEMENT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act). Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of the end of the period covered by this report based on the framework in *Internal Control—Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this evaluation, management concluded that the Company's internal control over financial reporting was effective as of the end of the period covered by this report.

Our independent registered public accounting firm, which has audited the financial statements included in Part II, Item 8 of this report, has also audited the effectiveness of the Company's internal control over financial reporting as of February 28, 2019, as stated in their attestation report on our internal control over financial reporting, which is included below.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Red Hat, Inc.:

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Red Hat, Inc. and its subsidiaries (the "Company") as of February 28, 2019 and February 28, 2018, and the related consolidated statements of operations, comprehensive income, stockholders' equity and cash flows for each of the three years in the period ended February 28, 2019, including the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of February 28, 2019, based on criteria established in *Internal Control - Integrated Framework* (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of February 28, 2019 and February 28, 2018, and the results of its operations and its cash flows for each of the three years in the period ended February 28, 2019 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 28, 2019, based on criteria established in *Internal Control - Integrated Framework* (2013) issued by the COSO.

Change in Accounting Principle

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for revenues from contracts with customers during the fiscal year ended February 28, 2019.

Basis for Opinions

The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express opinions on the Company's consolidated financial statements and on the Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

Raleigh, North Carolina
April 24, 2019

We have served as the Company’s auditor since 1999.

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

	February 28, 2019	February 28, 2018 (1)
ASSETS		
Current assets:		
Cash, cash equivalents and restricted cash	$1,883,096	$1,724,132
Investments in debt and equity securities, short-term	293,361	318,358
Accounts receivable, net of allowances for doubtful accounts of $4,561 and $2,167, respectively	980,188	806,744
Prepaid expenses	282,507	267,197
Other current assets	24,504	25,666
Total current assets	3,463,656	3,142,097
Property and equipment, net of accumulated depreciation and amortization of $316,432 and $269,429, respectively	198,969	206,105
Goodwill	1,276,853	1,288,830
Identifiable intangibles, net	206,083	224,953
Investments in debt securities, long-term	248,512	430,442
Deferred tax assets, net	112,568	92,606
Other assets, net	81,648	89,460
Total assets	$5,588,289	$5,474,493
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$491,259	$427,139
Deferred revenue, short-term	2,161,206	1,853,719
Other current obligations	282	843
Convertible notes	69,827	23,806
Total current liabilities	2,722,574	2,305,507
Deferred revenue, long-term	821,218	741,453
Convertible notes	231,540	744,194
Other long-term obligations	199,025	205,215
Commitments and contingencies (NOTES 14 and 15)		
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, 244,402,737 and 238,688,708 shares issued, and 176,800,502 and 177,073,904 shares outstanding, respectively	24	24
Additional paid-in capital	2,791,895	2,416,080
Retained earnings	2,054,069	1,619,688
Treasury stock, at cost, 67,602,235 and 61,614,804 shares, respectively	(3,189,434)	(2,525,072)
Accumulated other comprehensive loss	(42,622)	(32,596)
Total stockholders' equity	1,613,932	1,478,124
Total liabilities and stockholders' equity	$5,588,289	$5,474,493

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

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

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

	Fiscal Years Ended February 28, 2019	February 28, 2018 (1)	February 28, 2017 (1)
Revenue:			
Subscriptions	$2,949,059	$2,574,178	$2,135,780
Training and services	413,010	346,283	276,023
Total revenue	3,362,069	2,920,461	2,411,803
Cost of revenue:			
Subscriptions	213,843	185,339	158,977
Training and services	284,408	246,458	195,401
Total cost of revenue	498,251	431,797	354,378
Gross profit	2,863,818	2,488,664	2,057,425
Operating expense:			
Sales and marketing	1,378,278	1,195,286	1,034,191
Research and development	668,542	578,330	480,668
General and administrative	304,766	239,316	208,491
Total operating expense	2,351,586	2,012,932	1,723,350
Income from operations	512,232	475,732	334,075
Interest income	30,531	18,493	13,921
Interest expense	19,838	24,569	23,822
Other (expense) income, net	(4,870)	8,335	(2,164)
Income before provision for income taxes	518,055	477,991	322,010
Provision for income taxes	84,067	216,140	66,620
Net income	$433,988	$261,851	$255,390
Net income per share:			
Basic	$2.46	$1.48	$1.42
Diluted	$2.33	$1.42	$1.40
Weighted average shares outstanding:			
Basic	176,773	177,150	179,642
Diluted	186,321	184,602	182,961

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

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

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

	Fiscal Years Ended		
	February 28, 2019	February 28, 2018 (1)	February 28, 2017 (1)
Net income	$433,988	$261,851	$255,390
Other comprehensive (loss) income:			
Change in foreign currency translation adjustment	(11,821)	58,105	(14,008)
Available-for-sale securities:			
Unrealized gain (loss) on available-for-sale securities during the period	2,500	(2,866)	14
Reclassification for gain realized on available-for-sale securities, reported in Other (expense) income, net	(125)	(451)	(21)
Tax (expense) benefit	(580)	968	112
Net change in available-for-sale securities (net of tax)	1,795	(2,349)	105
Total other comprehensive (loss) income	(10,026)	55,756	(13,903)
Comprehensive income	$423,962	$317,607	$241,487

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

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

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RED HAT, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(in thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings [1]	Treasury Stock	Accumulated Other Comprehensive Loss	Total Stockholders' Equity [1]
Balance at February 29, 2016	234,896	$ 23	$ 2,162,264	$ 1,102,897	$ (1,853,144)	$ (74,449)	$ 1,337,591
Net income	—	—	—	255,390	—	—	255,390
Other comprehensive loss, net of tax	—	—	—	—	—	(13,903)	(13,903)
Vest and exercise of share-based awards	1,909	1	3,828	—	—	—	3,829
Common stock repurchase	—	—	—	—	(458,661)	—	(458,661)
Share-based compensation expense	—	—	192,530	—	—	—	192,530
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(66,529)	—	—	—	(66,529)
Cumulative-effect adjustment from adoption of ASU 2016-09	—	—	2,369	(450)	—	—	1,919
Balance at February 28, 2017	236,805	$ 24	$ 2,294,462	$ 1,357,837	$ (2,311,805)	$ (88,352)	$ 1,252,166
Net income	—	—	—	261,851	—	—	261,851
Other comprehensive income, net of tax	—	—	—	—	—	55,756	55,756
Vest and exercise of share-based awards	1,884	—	4,895	—	—	—	4,895
Common stock repurchase	—	—	—	—	(237,002)	—	(237,002)
Share-based compensation expense	—	—	192,249	—	—	—	192,249
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(89,506)	—	—	—	(89,506)
Re-issuance of treasury stock under employee stock purchase plan	—	—	18,983	—	23,749	—	42,732
Transactions related to convertible note conversions	—	—	13	—	(14)	—	(1)
Other adjustments	—	—	(5,016)	—	—	—	(5,016)
Balance at February 28, 2018	238,689	$ 24	$ 2,416,080	$ 1,619,688	$ (2,525,072)	$ (32,596)	$ 1,478,124
Net income	—	—	—	433,988	—	—	433,988
Other comprehensive loss, net of tax	—	—	—	—	—	(10,026)	(10,026)
Vest and exercise of share-based awards	1,970	—	2,075	—	—	—	2,075
Common stock repurchase	—	—	—	—	(412,845)	—	(412,845)
Share-based compensation expense	—	—	209,096	—	—	—	209,096
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards	—	—	(131,895)	—	—	—	(131,895)
Re-issuance of treasury stock under employee stock purchase plan	—	—	32,629	—	23,201	—	55,830
Convertible note conversions	3,744	—	(10,835)	—	—	—	(10,835)
Exercises of convertible note hedges	—	—	274,745	—	(274,718)	—	27
Cumulative-effect adjustment from adoption of ASU 2016-01				393			393
Balance at February 28, 2019	244,403	$ 24	$ 2,791,895	$ 2,054,069	$ (3,189,434)	$ (42,622)	$ 1,613,932

Note: No preferred stock was issued or outstanding during the three fiscal years ended February 28, 2019.

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

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

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

	Fiscal Years Ended February 28, 2019	February 28, 2018 (1)	February 28, 2017 (1)
Cash flows from operating activities:			
Net income	$ 433,988	$ 261,851	$ 255,390
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	109,046	97,138	85,309
Amortization of debt discount and transaction costs	18,765	22,401	21,691
Repayments of convertible notes attributable to debt discount	(59,993)	—	—
Deferred income taxes	(18,693)	(18,695)	12,458
Share-based compensation expense	209,096	192,249	192,530
Net amortization of bond premium on debt securities available for sale	1,623	8,405	12,623
Other	5,986	(11,500)	946
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(188,980)	(154,119)	(119,102)
Other receivables	2,063	(4,019)	(14,010)
Prepaid expenses	(16,449)	(68,228)	(78,617)
Accounts payable and accrued expenses	54,061	161,834	71,038
Deferred revenue	463,782	432,182	348,534
Other	(1,513)	3,639	(5,073)
Net cash provided by operating activities	1,012,782	923,138	783,717
Cash flows from investing activities:			
Purchase of investment in debt securities available for sale	(217,951)	(299,789)	(500,849)
Proceeds from maturities of investment in debt securities available for sale	402,844	426,074	457,710
Proceeds from sales of investment in debt securities available for sale	8,491	199,614	43,273
Proceeds from sales of strategic equity investments	1,300	14,204	—
Acquisition of businesses, net of cash acquired	(11,550)	(315,081)	(28,667)
Purchase of developed software and other intangible assets	(10,543)	(16,720)	(11,774)
Purchase of property and equipment	(61,266)	(84,967)	(69,123)
Other	(1,365)	(189)	(703)
Net cash provided by (used in) investing activities	109,960	(76,854)	(110,133)
Cash flows from financing activities:			
Proceeds from exercise of common stock options	2,075	4,895	3,829
Proceeds from employee stock purchase program	62,062	50,097	18,852
Payments related to net settlement of share-based compensation awards	(131,895)	(89,506)	(66,529)
Purchase of treasury stock	(412,845)	(237,002)	(458,661)
Payments on other borrowings	(913)	(1,547)	(1,684)
Repayments of convertible notes attributable to principal	(438,410)	(36)	—
Net cash used in financing activities	(919,926)	(273,099)	(504,193)
Effect of foreign currency exchange rates on cash, cash equivalents and restricted cash	(43,852)	60,139	(6,361)
Net increase in cash, cash equivalents and restricted cash	158,964	633,324	163,030
Cash, cash equivalents and restricted cash at beginning of year	1,724,132	1,090,808	927,778
Cash, cash equivalents and restricted cash at end of year	$ 1,883,096	$ 1,724,132	$ 1,090,808
Supplemental cash flow information:			
Cash paid for interest	$ 1,656	$ 2,062	$ 2,080
Cash paid for income taxes	$ 103,158	$ 110,865	$ 56,655
Restricted cash included in cash, cash equivalents and restricted cash	$—	$ 4,236	$ 3,116

Non-cash investing and financing activities:			
Fixed assets acquired under capital leases	$ 60	$ 332	$ 1,652
Accrued fixed and intangible asset purchases	$ 11,917	$ 8,027	$ 16,069

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

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

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RED HAT, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
NOTE 1—Company and Merger Agreement

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 and storage technologies.

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

The Company derives its revenue and generates cash from customers primarily from two sources: (i) subscription revenue and (ii) training and services revenue. These arrangements typically involve subscriptions to Red Hat technologies. The arrangements with the Company's customers that produce this revenue and cash are explained in further detail in NOTE 2—Summary of Significant Accounting Policies.

Merger Agreement

On October 28, 2018, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with International Business Machines Corporation, a New York corporation ("IBM), and Socrates Acquisition Corp., a Delaware corporation and a wholly-owned subsidiary of IBM ("Sub"), pursuant to which, among other things, Sub will merge with and into the Company, with the Company surviving as a wholly-owned subsidiary of IBM (the "Merger"). The Board of Directors of the Company and the Board of Directors of IBM each approved the Merger and the Merger Agreement.

At the effective time of the Merger (the "Effective Time"), subject to the terms and conditions of the Merger Agreement, each share of common stock, par value $0.0001 per share, of the Company issued and outstanding immediately prior to the Effective Time (other than (i) canceled shares, (ii) dissenting shares, and (iii) subsidiary converted shares) shall be converted into the right to receive $190.00 in cash without interest. On December 12, 2018, the Company filed its definitive proxy statement on Schedule 14A (the "Proxy Statement") with the Securities and Exchange Commission ("SEC") for a special meeting of its stockholders to be held on January 16, 2019 in connection with the Merger. The Merger Agreement was adopted and approved by the Company's stockholders at the January 16, 2019 special meeting of stockholders. The transaction is expected to close in the latter half of 2019, subject to certain conditions, including receipt of regulatory approvals. Until the closing, the Company will continue to operate as an independent company. The Company has incurred Merger-related costs of $33.7 million, which are included in General and administrative expenses in the Company's Consolidated Statement of Operations for the fiscal year ended February 28, 2019.

Consummation of the Merger is subject to certain customary conditions, including, without limitation, (i) the receipt of approvals, or the expiration or termination of the applicable waiting periods, under certain antitrust laws (including the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act") and clearance under Council Regulation 139/2004 of the European Union); and (ii) the absence of any temporary restraining order, preliminary or permanent injunction or other judgment or law issued by certain courts of competent jurisdiction or other governmental entity, in each case prohibiting consummation of the Merger, and no action or proceeding by a governmental entity before any court or certain other governmental entities of competent jurisdiction seeking to enjoin, restrain or otherwise prohibit consummation of the Merger. Each party's obligation to consummate the Merger is subject to certain other customary conditions.

The Merger Agreement contains certain customary termination rights for the Company and IBM. Subject to certain limitations, the Merger Agreement may be terminated by either IBM or the Company if (i) the Merger is not consummated on or before October 28, 2019, which is subject to extension for two consecutive three month periods by either party if all conditions are satisfied other than receipt of regulatory approvals and absence of legal restraints and (ii) an order having the effect of making the Merger illegal or otherwise prohibiting consummation of the Merger becomes final and non-appealable.

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

The foregoing description of the Merger Agreement is qualified in its entirety by reference to the full text of the Merger Agreement, which has been filed as Exhibit 2.1 to the Company's Current Report on Form 8-K filed with the SEC on October 29, 2018.

NOTE 2—Summary of Significant Accounting Policies

Basis of presentation

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.

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

For additional discussion related to recent accounting pronouncements the Company has either recently adopted or is currently evaluating the impact from future adoption, see "Recent accounting pronouncements" in this note.

In addition to the adjustments resulting from application of ASC 606, certain other amounts for the fiscal years ended February 28, 2018 and February 28, 2017 have been reclassified to conform to the current year presentation.

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

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. ("U.S. GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the balance sheet dates and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from such estimates. Estimates are used for, but not limited to, revenue recognition, goodwill and other long-lived assets, share-based compensation, income taxes and loss contingencies.

Revenue recognition

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

The Company applies the following five steps to recognize revenue:

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

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

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

The Company’s contracts do not contain significant financing components. Specifically, the Company does not typically extend customer payment terms beyond a standard 30- to 60-day term and as a result the Company has elected the one-year-or-less safe harbor expedient and does not impute any interest.
The Company has elected to exclude all taxes from the transaction price (e.g., sales, use, value-added, etc). Revenue is recognized net of such taxes.
4) *Allocate the transaction price to performance obligations in the contract.* When a contract contains a single performance obligation, the entire transaction price is allocated to that one performance obligation. Contracts that contain multiple performance obligations require an allocation of the transaction price to each performance obligation based on a relative standalone selling price (“SSP”). The Company typically determines SSP based on the observable price when the Company sells the subscriptions or training and services separately, taking into consideration the geographical region of the customer, type of offering and sales channel. In instances where SSP is not directly observable, the Company determines SSP either from the renewal rate paid for the performance obligation to the extent it is the same rate as stipulated in the initial customer contract or by using the expected-cost-plus-margin approach.
5) *Recognize revenue when or as the performance obligation is satisfied.* Revenue is recognized at the time the related performance obligation is satisfied by transferring the promised subscription offerings and training and services to a customer. For each performance obligation, a determination is made as to whether the control is transferred over time or at a point in time. For performance obligations satisfied over time, a method to measure progress toward complete satisfaction is selected, based upon the most faithful depiction of performance. The selected method for each performance obligation type is applied consistently to similar contracts.
Subscription revenue
Subscription revenue is comprised of direct and indirect sales of subscriptions relating to Red Hat technologies. Accounts receivable and deferred revenue are recorded at the time a customer enters into a binding and non-cancellable subscription agreement for the purchase of a subscription, subscription services are made available to the customer and the customer is billed. The deferred revenue amount is recognized as revenue ratably over the subscription period. Red Hat technologies are generally offered with base subscription periods of either one year or three years; the majority of the Company’s subscriptions have terms of one year. Under these subscription agreements, renewal rates are generally specified for renewal terms of one year or three years. Subscriptions generally entitle the end user to the technology itself and post-contract customer support, generally consisting of varying levels of support services as well as access to security updates, fixes, functionality enhancements, upgrades to the technologies, each on an if and when available basis, and compatibility with an ecosystem of certified hardware and software, during the term of the subscription. The Company sells its offerings through two principal channels: (1) direct, which includes sales by the Company’s sales force as well as web store sales, and (2) indirect, which includes certified cloud and service providers (“CCSPs”), distributors, original equipment manufacturers (“OEMs”), systems integrators and value added resellers.
The Company recognizes revenue from the sale of Red Hat technologies ratably over the period of the subscription beginning on the commencement date of the subscription agreement. The Company has determined that the delivery of software code underlying the subscription is a distinct performance obligation as it is both capable of being distinct and is distinct within the context of a customer contract. The Company uses a non-proprietary open source development and licensing model to provide its software technologies to customers and therefore the amount of transaction price allocated to the underlying software code is negligible. The Company derives a portion of its revenue from CCSPs that provide public clouds with, and allow users to consume, computing resources as a service. The Company earns revenue based on subscription units consumed by the CCSP or its end users. The Company uses its historical cloud-usage data to estimate the amount of revenue earned and recognized each month and adjusts to actual amounts earned upon receipt of usage reports from the CCSPs in the following month. The differences between actual amounts earned and estimates made have generally been insignificant.

Training and services revenue

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

See NOTE 22—Segment Reporting for further information, including revenue by geographic area and significant product and service offerings.

Contract Balances

Timing of revenue recognition may differ from the timing of invoicing to customers. The Company records a receivable when revenue is recognized prior to invoicing, or deferred revenue when revenue is recognized subsequent to invoicing. For multi-year arrangements, the Company will generally invoice customers upfront or annually at the beginning of each annual coverage period. See below for the accounting policy related to receivables and see NOTE 17—Deferred Revenue and Performance Obligations for further information on deferred revenue balances.

Deferred selling costs

Deferred commissions are the incremental costs that are directly associated with non-cancellable subscription contracts with customers and consist of sales commissions and certain related fringe benefits earned by the Company's sales force. The commissions are deferred and amortized on a straight-line basis over a period that approximates the subscription period. In determining the period that approximates the subscription period, the Company utilizes a portfolio approach that allows for the analysis of customer contracts with similar characteristics. The Company has determined that the effects on the financial statements of the portfolio approach would not differ materially from an individual customer contract analysis approach. The commission payments are paid in full subsequent to the month in which the customer's service commences. The deferred commission amounts are recoverable through the future revenue streams under the non-cancellable customer contracts. In addition, the Company has the ability and intent under the commission plans with its sales force to recover commissions previously paid to its sales force in the event that customers breach the terms of their subscription agreements and do not fully pay for their subscription agreements. See NOTE 8—Deferred Selling Costs for further information on deferred commissions and the related amortization of deferred commissions.

Goodwill and other long-lived assets

Goodwill

The Company evaluates goodwill for impairment during the fourth quarter of its fiscal year or more frequently if events or changes in circumstances indicate that an impairment to goodwill may have occurred. For fiscal years ended February 28, 2019, February 28, 2018 and February 28, 2017, the Company applied its test for goodwill impairment as permitted by Accounting Standards Update 2011-08, *Intangibles—Goodwill and Other (Topic 350): Testing Goodwill for Impairment* ("ASU 2011-08"), which allows the Company to first assess qualitative factors to determine whether it is "more likely than not" that the fair value of a reporting unit is less than its carrying value. The outcome of these qualitative tests determines whether it is necessary to proceed with a quantitative impairment assessment.

After considering such qualitative factors as macroeconomic conditions, actual or anticipated changes to cost factors (for example, selling and delivery), overall financial performance and other Company-specific factors, such as potential changes in strategy, the Company determined that it was not more likely than not that any impairment to goodwill had occurred during the fiscal years ended February 28, 2019, February 28, 2018 and February 28, 2017.

Other long-lived assets

The Company evaluates the recoverability of its property and equipment and other long-lived assets whenever events or changes in circumstances indicate that 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.

Cash, cash equivalents and restricted cash

The Company considers highly liquid investments purchased with a maturity period of three months or less at the date of purchase to be cash equivalents. The Company had no restricted cash at February 28, 2019 and restricted cash totaled $4.2 million at February 28, 2018, which was restricted as part of collateral for certain office facilities. Restricted cash is included with Cash, cash equivalents and restricted cash in the Company's Consolidated Balance

Sheets.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Accounts receivable and allowance for doubtful accounts

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is the Company's estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience and other qualitative factors. The Company reviews its allowance for doubtful accounts monthly. Past due balances over 90 days and over a specified amount are reviewed individually for collectability. All other balances are reviewed on a pooled basis by type of receivable. Account balances are charged off against the allowance when the Company determines it is probable the receivable will not be recovered. The Company does not have off-balance sheet credit exposure related to its customers. Unbilled receivables related to subscription and training and services contracts are included in accounts receivable. See NOTE 3—Accounts Receivable for further information on accounts receivable balances.

Fair value measurements

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

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

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

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

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

Unrealized gains and temporary losses on investments classified as available for sale are included within accumulated other comprehensive income, net of any related tax effect. Realized gains and losses are recorded using the specific identification method and upon realization, such amounts are reclassified from accumulated other comprehensive income to Other (expense) income, net. Realized gains and losses and other than temporary impairments, if any, are reflected in the Company's Consolidated Statements of Operations as Other (expense) income, net. The Company does not recognize changes in the fair value of its investments in income unless a decline in value is considered other than temporary. The vast majority of the Company's investments are priced by pricing vendors. These pricing vendors use the most recent observable market information in pricing these securities or, if specific prices are not available for these securities, use other observable inputs. In the event observable inputs are not available, the Company assesses other factors to determine the security's market value, including broker quotes or model valuations. Independent price verifications of all holdings are performed by pricing vendors that are then reviewed by the Company. In the event a price fails a pre-established tolerance check, it is researched so that the Company can assess the cause of the variance to determine what the Company believes is the appropriate fair value. See NOTE 21—Assets and Liabilities Measured at Fair Value on a Recurring Basis for further discussion on fair value measurements.

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.

Internal use software

The Company capitalizes costs related to the development of internal use software for its website, enterprise resource planning system and systems management applications. The Company amortizes the costs of computer software developed for internal use on a straight-line basis over an estimated useful life of five years. The carrying value of internal use software is included in property and equipment in the Company's Consolidated Balance Sheets.

Capitalized software costs

Capitalization of software development costs for products to be sold to third parties begins upon the establishment of technological feasibility and ceases when the product is available for general release. As a result of the Company's practice of frequently releasing source code that it has developed on an on-going basis for unrestricted download on the Internet, there is generally no passage of time between achievement of technological feasibility and the availability of the Company's product for general release. Therefore, at February 28, 2019 and February 28, 2018, the Company had no internally developed capitalized software costs for products to be sold to third parties.

Property and equipment

Property and equipment is primarily comprised of furniture, computer and other equipment, computer software and leasehold improvements, which are recorded at cost and depreciated or amortized using the straight-line method. Expenditures for maintenance and repairs are charged to operations as incurred; major expenditures for renewals and betterments are capitalized and depreciated. Property and equipment acquired under capital leases are depreciated over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease.

Share-based compensation

The Company measures share-based compensation cost as of 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 ("PSUs") are measured at their underlying closing share price on the date of grant. The Company's share-based compensation is described further in NOTE 19—Share-based Awards.

Sales and marketing expenses

Sales and marketing expenses consist of costs, including salaries, sales commissions and related expenses, such as travel, of all personnel involved in the sales and marketing process. Sales and marketing expenses also include costs of advertising, sales lead generation programs, cooperative marketing arrangements and trade shows. Payments made to resellers or other customers are recognized as a reduction of revenue unless the Company (i) receives an identifiable benefit (goods or services) in exchange for such payments that is sufficiently separable from the purchase of the Company's products and (ii) the Company can reasonably estimate the fair value of the benefit identified. Advertising costs are expensed as incurred.

Advertising expense totaled $127.0 million, $111.5 million and $95.7 million for the fiscal years ended February 28, 2019, February 28, 2018 and February 28, 2017, respectively.

Research and development expenses

Research and development expenses include all direct costs, primarily salaries for Company personnel and outside consultants, related to the development of new software products, significant enhancements to existing software products, and the portion of costs of development of internal use software required to be expensed. Research and development costs are charged to operations as incurred.

Income taxes

The Company accounts for income taxes using the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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

The Company continues to assess the realizability of its deferred tax assets, which primarily consist of share-based compensation expense deductions, tax credit carryforwards and deferred revenue. In assessing the realizability of these deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will be realized. The Company continues to maintain a valuation allowance against its deferred tax assets with respect to certain foreign net operating loss ("NOL") carryforwards.

With respect to foreign earnings, it has been the Company's policy to invest the earnings of foreign subsidiaries indefinitely outside the U.S. On December 22, 2017, the Tax Cuts and Jobs Act (the "Tax Act") was enacted into law. This new law includes a provision that imposes a transition tax on foreign earnings whether or not such earnings are repatriated to the U.S. In light of this new tax, the Company no longer considers earnings from certain foreign subsidiaries to be indefinitely reinvested, but has maintained an indefinite reinvestment assertion for the earnings in the majority of its foreign jurisdictions.

Because tax laws are complex and subject to different interpretations, significant judgment is required. As a result, the Company makes certain estimates and assumptions in (i) calculating its income tax expense, deferred tax assets and deferred tax liabilities, (ii) determining any valuation allowance recorded against deferred tax assets and (iii) evaluating the amount of unrecognized tax benefits, as well as the interest and penalties related to such uncertain tax positions. The Company's estimates and assumptions may differ significantly from tax benefits ultimately realized. The Company's income tax expense and deferred taxes are described further in NOTE 11—Income Taxes.

Foreign currency translation

The Euro has been determined to be the primary functional currency for the Company's European operations, and local currencies have been determined to be the functional currencies for the Company's Asia Pacific and Latin American operations. Foreign exchange gains and losses, which result from the process of remeasuring foreign currency transactions into the appropriate functional currency, are included in Other (expense) income, net in the Company's Consolidated Statements of Operations.

The impact of changes in foreign currency exchange rates resulting from the translation of foreign currency financial statements into U.S. dollars for financial reporting purposes is included in other comprehensive income, which is a separate component of stockholders' equity. Assets and liabilities are translated into U.S. dollars at exchange rates in effect at the balance sheet date. Income and expense items are translated at average rates for the period.

Customers and credit risk

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash, cash equivalents, investments and trade receivables. The Company primarily places its cash, cash equivalents and investments with high-credit quality financial institutions that invest predominantly in U.S. government instruments, investment grade corporate bonds and certificates of deposit guaranteed by banks that are members of the Federal Deposit Insurance Corporation. Cash deposits are primarily in financial institutions in the U.S. and the United Kingdom. However, cash for monthly operating costs of international operations are deposited in banks outside the U.S.

The Company performs credit evaluations to reduce credit risk and generally requires no collateral from its customers. Management estimates the allowance for uncollectible accounts based on its historical experience and credit evaluation. The Company's standard credit terms are net 30 days in North America, net 30 to net 45 days in EMEA (Europe, Middle East and Africa) and Latin America, and range from net 30 to net 60 days in Asia Pacific (principally Australia, China, India, Japan, Singapore and South Korea).

Net income per common 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.

With respect to the Company's 0.25% convertible senior notes due October 2019 (the "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 notes are considered in diluted earnings per share under the treasury stock method. See NOTE 12—Convertible Notes for detailed information on the convertible notes.

Segment reporting

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

The Company has offices in more than 105 locations around the world. The Company manages its international business on an Americas-wide, EMEA-wide and Asia Pacific-wide basis. See NOTE 22—Segment Reporting for further discussion.

Recent accounting pronouncements

Accounting pronouncements adopted

In February 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update 2018-02, *Income Statement—Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* ("ASU 2018-02"). The FASB issued ASU 2018-02 to give entities the option to reclassify tax effects stranded in accumulated other comprehensive income as a result of the enactment of the Tax Act to retained earnings. The Company adopted ASU 2018-02 as of June 1, 2018. The Company opted not to reclassify tax effects stranded in accumulated other comprehensive income as a result of the enactment of the Tax Act to retained earnings.

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. Along with ASU 2016-01, the Company evaluated the Accounting Standards Update 2018-03, *Technical Corrections and Improvements to Financial Instruments Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("ASU 2018-03"), which was issued in February 2018, and Accounting Standards Update 2018-04, *Investments—Debt Securities (Topic 320) and Regulated Operations (Topic 980): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273* ("ASU 2018-04"), which was issued in March 2018. The Company adopted ASU 2016-01, ASU 2018-03 and ASU 2018-04 as of March 1, 2018. The adoption of these standards did not significantly impact the Company's Consolidated Financial Statements.

In May 2014, the FASB issued ASC 606 to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. ASC 606 requires the recognition of revenue when control of performance obligations as stipulated in the contracts, is transferred to a customer for an amount that reflects the consideration the entity expects to receive in exchange promised goods and services. The standard also includes Subtopic 340-40, *Other Assets and Deferred Costs—Contracts with Customers,* which requires the deferral of incremental costs of obtaining a contract with a customer. Collectively, ASC 606 and Subtopic 340-40 are referred to as "ASC 606."

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The Company adopted ASC 606 as of March 1, 2018, utilizing the full retrospective method of transition, which requires a restatement of each prior reporting period presented. In adopting ASC 606, the Company used the practical expedient where the transaction price allocated to the remaining performance obligations before the date of the initial application is not disclosed. The Company implemented new policies, processes and systems to enable both the preparation of financial information and internal controls over financial reporting in connection with its adoption of ASC 606. The impact of adopting ASC 606 on the Company's fiscal 2018 and fiscal 2017 revenue was not material. The primary impact of adopting the standard related to the deferral of incremental commission and other costs of obtaining contracts with customers. Previously, the Company deferred direct and incremental commission costs to obtain a contract and amortized those costs on a straight-line basis over a period that approximated the subscription period, and under ASC 606, the Company now also defers related fringe benefit costs.
Select adjusted financial statement information, which reflects the Company's adoption of ASC 606, is set forth below.
Consolidated balance sheets (in thousands):

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

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

	Fiscal Years Ended					
	February 28, 2018			February 28, 2017		
	As Reported	Adjustments	As Adjusted	As Reported	Adjustments	As Adjusted
Operating expense:						
Sales and marketing	$1,198,576	$(3,290)	$1,195,286	1,036,021	(1,830)	$1,034,191
Net income	$258,803	$3,048	$261,851	253,703	1,687	$255,390
Net income per share:						
Basic	$1.46	$0.02	$1.48	1.41	0.01	$1.42
Diluted	$1.40	$0.02	$1.42	1.39	0.01	$1.40

The Company's adoption of ASC 606 had no impact on net cash provided by or used in operating, investing or financing activities for any of the periods reported.
Accounting pronouncements being evaluated
In August 2018, the FASB issued Accounting Standards Update 2018-15, *Intangibles—Goodwill and Other—Internal-Use Software: Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract (a consensus of the FASB Emerging Issues Task Force)* ("ASU 2018-15"). The FASB issued ASU 2018-15 to align the requirements for capitalizing implementation costs in a cloud computing arrangement service contract with the requirements for capitalizing implementation costs incurred for an internal-use software license. The guidance is effective for the Company as of the first quarter of its fiscal year ending February 29, 2020, with early adoption permitted. The Company expects to early adopt this updated standard effective March 1, 2019, but does not believe this update will have a significant impact on its consolidated financial statements.

In February 2016, the FASB issued Accounting Standards Update 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). The FASB issued ASU 2016-02 to increase transparency and comparability among organizations with respect to accounting for leases. Under ASU 2016-02, lessees will recognize a right-of-use asset and a lease liability for virtually all of their leases (other than leases that meet the definition of a short-term lease). The liability will be equal to the present value of lease payments. The asset will be based on the liability, subject to adjustment, such as for initial direct costs. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. This guidance is effective for the Company as of the first quarter of its fiscal year ending February 29, 2020. Along with ASU 2016-02, the Company is also evaluating Accounting Standards Update 2018-10, *Codification Improvements to Topic 842 Leases* ("ASU 2018-10"), Accounting Standards Update 2018-11, *Targeted Improvements to Topic 842 Leases* ("ASU 2018-11") and Accounting Standards update 2018-20, *Leases (Topic 842) Narrow-Scope Improvements for Lessors* ("ASU 2018-20"). The Company expects to adopt the transition method, which will not require adjustments to comparative periods nor require modified disclosures in those comparative periods. Upon adoption, the Company expects to elect the transition package of practical expedients permitted within the new standard, which among other things, allows the carryforward of the historical lease classification. Further, upon implementation of the new guidance, the Company intends to elect the practical expedients to combine lease and non-lease components for all asset classes, to not recognize right-of-use assets and lease liabilities for short-term leases for all asset classes and to use hindsight in determining the lease term and assessing impairment of right-of-use assets.

The Company has substantially completed its assessment of the potential impact of ASU 2016-02, ASU 2018-10, ASU 2018-11 and ASU 2018-20, codified as Accounting Standards Codification Topic 842 ("ASC 842"), including for example, changes to and investments in the Company's policies, processes, systems and internal controls over financial reporting that are required to comply with the new guidance related to identifying and measuring right-of-use assets and lease liabilities. At February 28, 2019, the Company's undiscounted operating lease commitments were approximately $286.1 million, which is expected to approximate the March 1, 2019, balance of operating lease liabilities, which will be discounted by the Company's incremental borrowing rate. The Company continues to evaluate all impacts that ASC 842 will have on its consolidated financial statements, including new disclosures that will be ad

NOTE 3—Accounts Receivable

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

Fiscal year ended	Balance at beginning of period	(Recovery of) charged to expense	Adjustments [1]	Balance at end of period
February 28, 2017	$ 2,798	(140)	133	$ 2,791
February 28, 2018	$ 2,791	172	(796)	$ 2,167
February 28, 2019	$ 2,167	3,247	(853)	$ 4,561

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

Included in accounts receivable, net of allowance for doubtful accounts, are unbilled receivables of $40.2 million and $25.8 million as of February 28, 2019 and February 28, 2018, respectively.

As of February 28, 2019, the Company had one customer whose accounts receivable balance individually represented 10% of total accounts receivable. As of February 28, 2018, no individual customer accounted for 10% or more of the Company's accounts receivable.

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NOTE 4—Prepaid Expenses

Prepaid expenses were comprised of the following (in thousands):

	February 28, 2019	February 28, 2018 (1)
Deferred commissions	$201,971	$188,944
Professional services	30,359	32,309
Taxes	12,296	15,969
Insurance	4,286	3,910
Other	33,595	26,065
Total prepaid expenses	$282,507	$267,197

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

See NOTE 8—Deferred Selling Costs for additional information about deferred commissions.

NOTE 5—Property and Equipment

The Company's property and equipment is recorded at cost and consisted of the following (in thousands):

	Estimated Useful Life (Years)	February 28, 2019	February 28, 2018
Computer and other equipment	3-5	$196,618	$171,745
Software, including software developed for internal use	5	98,579	94,123
Furniture and fixtures	7	41,197	39,934
Leasehold improvements	up to 15	174,566	167,623
Property and equipment—in progress	—	4,441	2,109
Property and equipment		515,401	475,534
Less: accumulated depreciation		(316,432)	(269,429)
Property and equipment, net		$198,969	$206,105

Property and equipment is depreciated or amortized using the straight-line method over the respective asset's estimated useful life. Leasehold improvements are depreciated up to 15 years, over the lesser of the estimated remaining useful life of the asset or the remaining term of the lease. Depreciation expense recognized in the Company's Consolidated Financial Statements is summarized as follows (in thousands):

	Fiscal Years Ended		
	February 28, 2019	February 28, 2018	February 28, 2017
Total depreciation expense	$67,897	$64,317	$54,077

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

NOTE 6—Identifiable Intangible Assets

Identifiable intangible assets consist primarily of trademarks, copyrights and patents, purchased technologies, customer and reseller relationships and covenants not to compete, all of which are amortized over the estimated useful life, generally on a straight-line basis, with the exception of customer and reseller relationships, which are generally amortized over the greater of straight-line over the estimated useful life or the related asset's pattern of economic benefit. Useful lives range from two years to 10 years. As of February 28, 2019 and February 28, 2018, trademarks with an indefinite estimated useful life totaled \$11.4 million and \$12.0 million, respectively. The following is a summary of identifiable intangible assets (in thousands):

	February 28, 2019			February 28, 2018		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$176,704	$(82,967)	$93,737	$167,005	$(70,749)	$96,256
Purchased technologies	219,196	(113,617)	105,579	208,096	(93,748)	114,348
Customer and reseller relationships	105,737	(100,947)	4,790	106,076	(95,558)	10,518
Covenants not to compete	15,787	(14,728)	1,059	15,861	(14,324)	1,537
Other intangible assets	8,833	(7,915)	918	8,833	(6,539)	2,294
Total identifiable intangible assets	$526,257	$(320,174)	$206,083	$505,871	$(280,918)	$224,953

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

Balance at February 28, 2018	$224,953
Purchase of identifiable intangible assets from Noobaa, primarily developed technologies	9,250
Purchase of developed software and other intangible assets	10,484
Amortization expense	(41,149)
Impact of foreign currency fluctuations and other adjustments	2,545
Balance at February 28, 2019	$206,083

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

	Fiscal Years Ended		
	February 28, 2019	February 28, 2018	February 28, 2017
Cost of revenue	$25,872	$	