RED HAT INC
Form 10-Q
January 08, 2015
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended November 30, 2014

OR

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

For the transition period from to .

Commission File Number: 001-33162

RED HAT, INC.

(Exact name of registrant as specified in its charter)

Delaware	**06-1364380**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

100 East Davie Street, Raleigh, North Carolina 27601

(Address of principal executive offices, including zip code)

(919) 754-3700

(Registrant s telephone number, including area code)

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

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

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

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

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

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

As of January 2, 2015, there were 183,414,508 shares of common stock outstanding.

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CAUTIONARY NOTE ON FORWARD-LOOKING STATEMENTS

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

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RED HAT, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands except share and per share amounts)

	November 30, 2014 (Unaudited)	February 28, 2014 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 883,989	$ 646,742
Investments in debt securities, short-term	231,420	335,387
Accounts receivable, net of allowances for doubtful accounts of $2,336 and $1,986, respectively	354,870	360,594
Deferred tax assets, net	106,282	108,264
Prepaid expenses	126,827	118,387
Other current assets	1,629	1,808
Total current assets	$ 1,705,017	$ 1,571,182
Property and equipment, net of accumulated depreciation and amortization of $223,157 and $209,295, respectively	173,599	173,917
Goodwill	939,574	687,430
Identifiable intangibles, net	144,176	133,399
Investments in debt securities, long-term	531,112	505,300
Other assets, net	54,393	35,391
Total assets	$ 3,547,871	$ 3,106,619
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 229,272	$ 179,468
Deferred revenue	941,441	966,832
Other current obligations	1,908	1,786
Total current liabilities	$ 1,172,621	$ 1,148,086
Long-term deferred revenue	358,684	322,365
Convertible notes	710,844	
Other long-term obligations	71,915	85,003
Commitments and contingencies (NOTES 12 and 13)		
Stockholders equity:		
Preferred stock, 5,000,000 shares authorized, none outstanding		
Common stock, $0.0001 per share par value, 300,000,000 shares authorized, 232,883,474 and 230,915,589 shares issued, and 183,372,588 and 189,712,211 shares outstanding at November 30, 2014 and February 28, 2014, respectively	23	23
Additional paid-in capital	1,928,179	1,891,848
Retained earnings	852,673	720,172
Treasury stock at cost, 49,510,886 and 41,203,378 shares at November 30, 2014 and February 28, 2014, respectively	(1,515,288)	(1,056,419)
Accumulated other comprehensive loss	(31,780)	(4,459)
Total stockholders equity	$ 1,233,807	$ 1,551,165
Total liabilities and stockholders equity	$ 3,547,871	$ 3,106,619

(1) Derived from audited financial statements.

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Revenue:				
Subscriptions	$ 394,699	$ 342,770	$ 1,156,161	$ 985,279
Training and services	61,196	53,766	169,387	148,939
Total subscription and training and services revenue	455,895	396,536	1,325,548	1,134,218
Cost of subscription and training and services revenue:				
Cost of subscriptions	28,574	24,544	84,125	71,437
Cost of training and services	42,791	35,883	118,857	100,627
Total cost of subscription and training and services revenue	71,365	60,427	202,982	172,064
Gross profit	384,530	336,109	1,122,566	962,154
Operating expense:				
Sales and marketing	187,218	153,528	538,576	440,568
Research and development	90,613	82,519	275,817	234,619
General and administrative	39,502	39,270	125,786	111,807
Facility exit costs				2,171
Total operating expense	317,333	275,317	940,179	789,165
Income from operations	67,197	60,792	182,387	172,989
Interest income	2,196	1,579	6,048	4,608
Interest expense	3,441	51	3,591	114
Other income (expense), net	1,559	(389)	1,777	446
Income before provision for income taxes	67,511	61,931	186,621	177,929
Provision for income taxes	19,578	9,906	54,120	44,705
Net income	$ 47,933	$ 52,025	$ 132,501	$ 133,224
Basic net income per common share	$ 0.26	$ 0.27	$ 0.71	$ 0.70
Diluted net income per common share	$ 0.26	$ 0.27	$ 0.70	$ 0.69
Weighted average shares outstanding				
Basic	185,039	189,514	187,533	190,024
Diluted	187,674	191,365	190,081	192,049

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Net income	$ 47,933	$ 52,025	$ 132,501	$ 133,224
Other comprehensive income (loss):				
Change in foreign currency translation adjustment	(16,013)	5,248	(27,765)	3,199
Available-for-sale securities:				
Unrealized gain (loss) on available-for-sale securities during the period	399	2,213	567	(503)
Reclassification for (gain) loss realized on available-for-sale securities, reported in Other income (expense), net	(1)	(23)	(151)	(340)
Tax benefit (expense)	(140)	(759)	28	368
Net change in available-for-sale securities (net of tax)	258	1,431	444	(475)
Total other comprehensive income (loss)	(15,755)	6,679	(27,321)	2,724
Comprehensive income	$ 32,178	$ 58,704	$ 105,180	$ 135,948

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

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RED HAT, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Cash flows from operating activities:				
Net income	$ 47,933	$ 52,025	$ 132,501	$ 133,224
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	18,651	18,955	57,114	55,326
Amortization of debt discount and transaction costs	3,085		3,085	
Share-based compensation expense	33,623	30,190	98,942	83,196
Deferred income taxes	(780)	(1,412)	3,125	9,608
Net amortization of bond premium on debt securities available for sale	2,407	2,301	6,965	6,637
Other	(175)	438	(527)	485
Changes in operating assets and liabilities, net of effects of acquisitions:				
Accounts receivable	(75,917)	(75,330)	2,314	(9,249)
Prepaid expenses	(5,922)	(1,109)	(13,502)	(3,503)
Accounts payable and accrued expenses	26,254	12,272	56,175	38,565
Deferred revenue	83,912	56,019	57,955	40,999
Other	(83)	805	1,264	610
Net cash provided by operating activities	132,988	95,154	405,411	355,898
Cash flows from investing activities:				
Purchase of investment in debt securities available for sale	(141,928)	(101,636)	(461,069)	(448,712)
Proceeds from sales and maturities of investment in debt securities available for sale	93,578	118,084	503,110	597,851
Acquisition of businesses, net of cash acquired	(78,317)		(296,121)	
Purchase of other intangible assets	(2,160)	(682)	(3,911)	(13,203)
Purchase of property and equipment	(12,201)	(13,327)	(35,085)	(61,833)
Other	482	(150)	2,917	(2,084)
Net cash provided by (used in) investing activities	(140,546)	2,289	(290,159)	72,019
Cash flows from financing activities:				
Excess tax benefits from share-based payment arrangements	3,488	3,428	4,897	9,071
Proceeds from exercise of common stock options	465	223	1,154	1,311
Payments related to net settlement of share-based compensation awards	(21,754)	(18,307)	(39,314)	(33,122)
Purchase of treasury stock	(375,000)	(40,018)	(535,062)	(239,363)
Proceeds from issuance of convertible notes, net of issuance costs	790,394		790,394	
Purchase of convertible note hedges	(148,040)		(148,040)	
Proceeds from issuance of warrants	79,776		79,776	
Payments on other borrowings	(402)	(362)	(2,392)	(979)
Net cash provided by (used in) financing activities	328,927	(55,036)	151,413	(263,082)

Effect of foreign currency exchange rates on cash and cash equivalents	(22,761)	2,910	(29,418)	(9,808)
Net increase in cash and cash equivalents	298,608	45,317	237,247	155,027
Cash and cash equivalents at beginning of the period	585,381	596,794	646,742	487,084
Cash and cash equivalents at end of the period	$ 883,989	$ 642,111	$ 883,989	$ 642,111

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

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 Company

Red Hat, Inc., incorporated in Delaware, together with its subsidiaries (Red Hat or the Company) is a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, middleware, storage and cloud technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, the Company does not recognize revenue from the licensing of the code itself. The Company provides value to its customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of its Red Hat enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise 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 enterprise technologies. The arrangements with the Company s customers that produce this revenue and cash are explained in further detail in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

NOTE 2 Summary of Significant Accounting Policies

Basis of presentation

The unaudited interim consolidated financial statements as of and for the three months and nine months ended November 30, 2014 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated statements are unaudited and, in the opinion of management, include all adjustments (consisting of normal recurring adjustments and accruals) necessary for a fair statement of the consolidated balance sheets, consolidated operating results, consolidated other comprehensive income and consolidated cash flows for the periods presented in accordance with accounting principles generally accepted in the United States of America. Operating results for the three months and nine months ended November 30, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ending February 28, 2015. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted in accordance with the SEC s rules and regulations for interim reporting. For further information, see the Company s Consolidated Financial Statements, including notes thereto, included in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

There have been no changes to the Company s significant accounting policies from those described in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements contained in the Company s Annual Report on Form 10-K for the fiscal year ended February 28, 2014. These unaudited financial statements should be read in conjunction with such Annual Report on Form 10-K.

Certain reclassifications have been made to the prior year s financial statements to conform to the current year s presentation.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Consolidation policy

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

Use of estimates

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

Recent accounting pronouncements

In June 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (ASU 2014-12). The FASB issued ASU 2014-12 to provide explicit guidance for share-based awards which allow for an employee to vest in an award upon achievement of a performance condition met after completion of a requisite service period regardless of whether the employee is rendering service on the date the performance target is achieved. ASU 2014-12 provides that the performance target should not be reflected in estimating the grant-date fair value of the award but rather compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and recognized prospectively over the remaining requisite service period. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2015, and is effective for the Company as of the first quarter of the fiscal year ending February 28, 2017. The Company has not issued such share-based awards and does not believe that this updated standard will have a material impact on the Company s consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The FASB issued ASU 2014-09 to clarify the principles for recognizing revenue and to develop a common revenue standard for generally accepted accounting principles (GAAP) and International Financial Reporting Standards. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2016, which is effective for the Company as of the first quarter of the fiscal year ending February 28, 2018. The Company is currently evaluating the impact that the implementation of this standard will have on the Company s consolidated financial statements.

In July 2013, the FASB issued Accounting Standards Update No. 2013-11, *Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11), to eliminate diversity in practice of presenting unrecognized tax benefits as a liability or presenting unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances by requiring that an unrecognized tax benefit be presented in the financial statements as a reduction to deferred tax assets excluding certain exceptions. ASU 2013-11 became effective for the Company during the three months ended May 31, 2014. The updated standard did not have a material impact on the Company s consolidated financial statements.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In March 2013, the FASB issued Accounting Standards Update No. 2013-05, *Foreign Currency Matters (Topic 830) Parent s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05), which requires a parent entity to release a related foreign entity s cumulative translation adjustment into net income only if its sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. ASU 2013-05 became effective for the Company during the three months ended May 31, 2014. The updated standard did not have a material impact on the Company s consolidated financial statements.

NOTE 3 Changes in Equity

The following table summarizes the changes in the Company s stockholders equity during the three months ended November 30, 2014 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at August 31, 2014	$ 23	$ 1,942,659	$ 804,740	$ (1,216,741)	$ (16,025)	$ 1,514,656
Net income			47,933			47,933
Other comprehensive income (loss), net of tax					(15,755)	(15,755)
Exercise of common stock options		465				465
Common stock repurchase (see NOTE 10)		(75,000)		(300,000)		(375,000)
Share-based compensation expense		33,623				33,623
Tax benefits related to share-based awards		2,978				2,978
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(21,754)				(21,754)
Equity component of convertible notes		96,890				96,890
Equity component of convertible notes issuance cost		(1,833)				(1,833)
Purchase of convertible note hedges		(148,040)				(148,040)
Proceeds from issuance of warrants		79,776				79,776
Deferred taxes related to convertible notes		19,868				19,868
Other adjustments		(1,453)		1,453		
Balance at November 30, 2014	$ 23	$ 1,928,179	$ 852,673	$ (1,515,288)	$ (31,780)	$ 1,233,807

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the three months ended November 30, 2013 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at August 31, 2013	$ 23	$ 1,846,825	$ 623,079	$ (1,016,401)	$ (11,922)	$ 1,441,604
Net income			52,025			52,025
Other comprehensive income (loss), net of tax					6,679	6,679
Exercise of common stock options		223				223
Common stock repurchase				(40,018)		(40,018)
Share-based compensation expense		30,190				30,190
Tax benefits related to share-based awards		(1,193)				(1,193)
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(18,307)				(18,307)
Balance at November 30, 2013	$ 23	$ 1,857,738	$ 675,104	$ (1,056,419)	$ (5,243)	$ 1,471,203

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the nine months ended November 30, 2014 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 28, 2014	$ 23	$ 1,891,848	$ 720,172	$ (1,056,419)	$ (4,459)	$ 1,551,165
Net income			132,501			132,501
Other comprehensive income (loss), net of tax					(27,321)	(27,321)
Exercise of common stock options		1,154				1,154
Common stock repurchase (see NOTE 10)		(75,000)		(460,062)		(535,062)
Share-based compensation expense		98,942				98,942
Assumed employee share-based awards from acquisitions		895				895
Tax benefits related to share-based awards		4,186				4,186
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(39,314)				(39,314)
Equity component of convertible notes		96,890				96,890
Equity component of convertible notes issuance cost		(1,833)				(1,833)
Purchase of convertible note hedges		(148,040)				(148,040)
Proceeds from issuance of warrants		79,776				79,776
Deferred taxes related to convertible notes		19,868				19,868
Other adjustments		(1,193)		1,193		
Balance at November 30, 2014	$ 23	$ 1,928,179	$ 852,673	$ (1,515,288)	$ (31,780)	$ 1,233,807

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the changes in the Company s stockholders equity during the nine months ended November 30, 2013 (in thousands):

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
Balance at February 28, 2013	$ 23	$ 1,802,899	$ 541,880	$ (816,674)	$ (7,967)	$ 1,520,161
Net income			133,224			133,224
Other comprehensive income (loss), net of tax					2,724	2,724
Exercise of common stock options		1,311				1,311
Common stock repurchase				(239,363)		(239,363)
Share-based compensation expense		83,196				83,196
Tax benefits related to share-based awards		3,072				3,072
Minimum tax withholdings paid by the Company on behalf of employees related to net settlement of employee share-based awards		(33,122)				(33,122)
Other adjustments		382		(382)		
Balance at November 30, 2013	$ 23	$ 1,857,738	$ 675,104	$ (1,056,419)	$ (5,243)	$ 1,471,203

Accumulated other comprehensive loss

The following is a summary of accumulated other comprehensive loss as of November 30, 2014 and February 28, 2014 (in thousands):

	As of November 30, 2014	As of February 28, 2014
Accumulated loss from foreign currency translation adjustment	$ (32,588)	$ (4,823)
Accumulated unrealized gain, net of tax, on available-for-sale securities	808	364
Accumulated other comprehensive loss	$ (31,780)	$ (4,459)

NOTE 4 Identifiable Intangible Assets

Identifiable intangible assets consist primarily of trademarks, copyrights and patents, purchased technologies, customer and reseller relationships and covenants not to compete which are amortized over the estimated useful life, generally on a straight-line basis with the exception of customer and reseller relationships which are generally amortized over the greater of straight-line or the related asset s pattern of economic benefit. Useful lives range from three to ten years. As of November 30, 2014 and February 28, 2014, trademarks with an indefinite estimated useful life totaled $12.1 million and $9.6 million, respectively.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

	As of November 30, 2014			As of February 28, 2014		
	Gross Amount	Accumulated Amortization	Net Amount	Gross Amount	Accumulated Amortization	Net Amount
Trademarks, copyrights and patents	$ 115,091	$ (40,681)	$ 74,410	$ 105,269	$ (34,784)	$ 70,485
Purchased technologies	89,416	(62,343)	27,073	79,433	(55,960)	23,473
Customer and reseller relationships	101,128	(69,120)	32,008	89,992	(63,075)	26,917
Covenants not to compete	11,286	(7,379)	3,907	10,690	(5,977)	4,713
Other intangible assets	8,909	(2,131)	6,778	8,922	(1,111)	7,811
Total identifiable intangible assets	$ 325,830	$ (181,654)	$ 144,176	$ 294,306	$ (160,907)	$ 133,399

Amortization expense associated with identifiable intangible assets recognized in the Company s Consolidated Financial Statements for the three months and nine months ended November 30, 2014 and November 30, 2013 is summarized as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Cost of revenue	$ 3,339	$ 2,848	$ 9,129	$ 8,360
Sales and marketing	1,959	2,244	5,533	6,395
Research and development	250	959	2,167	2,877
General and administrative	1,438	1,288	4,474	4,028
Total amortization expense	$ 6,986	$ 7,339	$ 21,303	$ 21,660

NOTE 5 Income Taxes

Income Tax Expense

The following table summarizes the Company s tax provision for the three months and nine months ended November 30, 2014 and November 30, 2013 (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Provision for income taxes:				
Income before provision for income taxes	$ 67,511	$ 61,931	$ 186,621	$ 177,929
Estimated annual effective tax rate on current year ordinary income excluding discrete tax items (1)	29.0%	22.8%	29.0%	27.5%

Provision for income taxes	19,578	14,131	54,120	48,930
Discrete tax benefit		4,225		4,225
Provision for income taxes	$ 19,578	$ 9,906	$ 54,120	$ 44,705

(1) An effective income tax rate, excluding discrete items, of 22.8% for the three months ended November 30, 2013 results from a change in the Company s estimated annual effective tax rate from 30.0% as of August 31, 2013 to 27.5% as of November 30, 2013.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

For the nine months ended November 30, 2014, the Company s estimated annual effective tax rate of 29.0% differed from the U.S. federal statutory rate of 35.0%, principally due to foreign income taxed at lower rates. For the nine months ended November 30, 2013, the Company s then-estimated annual effective tax rate of 27.5% differed from the U.S. federal statutory rate of 35.0%, principally due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction. Tax expense for the three months and nine months ended November 30, 2013 includes a discrete tax benefit of $4.2 million primarily from the domestic production activities deduction for U.S. federal income tax purposes.

Deferred Taxes

As of November 30, 2014, deferred tax assets net of deferred tax liabilities (current and non-current) totaled $115.2 million, of which $4.5 million was offset by a valuation allowance. The Company continues to maintain a valuation allowance against its acquired deferred tax assets with respect to certain net operating loss (NOL) carryforwards.

As of November 30, 2014, the Company had U.S. federal and state NOL carryforwards of approximately $53.1 million and $145.0 million, respectively. As of November 30, 2014, the Company had U.S. federal and state research tax credit carryforwards of approximately $17.9 million and $12.6 million, respectively. The tax credit carryforwards are scheduled to expire in varying amounts beginning in the fiscal year ending February 28, 2018.

Unrecognized tax benefits

The Company s unrecognized tax benefits were $58.0 million as of November 30, 2014 and $57.1 million as of February 28, 2014. The Company s unrecognized tax benefits at November 30, 2014 and February 28, 2014, which, if recognized, would affect the Company s effective tax rate, were $53.4 million and $49.7 million, respectively.

During the nine months ended November 30, 2014, the amount of unrecognized tax benefits increased by $0.9 million, primarily as a result of increases with respect to tax positions taken during prior periods. The results and timing of the resolution of tax audits is highly uncertain and the Company is unable to estimate the range of possible changes to the balance of unrecognized tax benefits. However, the Company does not anticipate that within the next 12 months the total amount of unrecognized tax benefits will significantly change.

It is the Company s policy to recognize interest and penalties related to uncertain tax positions as income tax expense. Accrued interest and penalties related to unrecognized tax benefits totaled $8.9 million and $6.0 million as of November 30, 2014 and February 28, 2014, respectively.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction and various states and foreign jurisdictions. The following table summarizes the tax years in the Company s major tax jurisdictions that remain subject to income tax examinations by tax authorities as of November 30, 2014. Due to NOL carryforwards, in some cases the tax years continue to remain subject to examination with respect to such NOLs.

Tax Jurisdiction	Years Subject to Income Tax Examination	
U.S. federal	1994	Present
North Carolina	1999	Present
Ireland	2010	Present

Japan (1)	2012	Present

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

(1) The Company has been examined for income tax for years through February 28, 2011. A tax examination was concluded in fiscal 2012 with no significant adjustments resulting. However, the statute of limitations remains open for five years.

The U.S. Internal Revenue Service recently completed its examination with respect to the Company s fiscal year ended February 28, 2010 and proposed certain adjustments. The Company believes that it has adequately provided for any reasonably foreseeable outcomes that may result from the proposed adjustments but, depending on the ultimate outcome, the Company could be required to pay additional income taxes. The Company does not believe that such outcome would have a material effect on its consolidated financial condition or consolidated results of operations.

The Company is currently undergoing an income tax examination in India.

The Company believes it has adequately provided for any reasonably foreseeable outcomes related to tax audits.

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

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

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

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

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

The Company s investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. Liquid investments purchased with a maturity period of 90 days 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. Upon realization, such amounts are reclassified from accumulated other comprehensive income to Other income (expense), net. Realized gains and losses and other than temporary impairments, if any, are reflected in the consolidated statements of operations as

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

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

The Company minimizes its credit risk associated with investments by investing primarily in investment grade, liquid securities. The Company s policy is designed to limit exposures to any one issuer depending on credit quality. Periodic evaluations of the relative credit standing of those issuers are considered in the Company s investment strategy.

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at November 30, 2014 (in thousands):

	As of November 30, 2014	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	$ 263,986	$ 263,986	$	$
Interest-bearing deposits (1)	41		41	
Available-for-sale securities (1):				
Commercial paper	26,999		26,999	
U.S. agency securities	255,615		255,615	
Corporate securities	428,353		428,353	
Foreign government securities	78,523		78,523	
Foreign currency derivatives (2)	7		7	
Liabilities:				
Foreign currency derivatives (3)	(411)		(411)	
Total	$ 1,053,113	$ 263,986	$ 789,127	$

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet at November 30, 2014, in addition to $593.0 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet at November 30, 2014.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at November 30, 2014.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the composition and fair value hierarchy of the Company s financial assets and liabilities at February 28, 2014 (in thousands):

	As of February 28, 2014	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Money markets (1)	$ 178,280	$ 178,280	$	$
Interest-bearing deposits (1)	86,937		86,937	
Available-for-sale securities (1):				
Commercial paper	37,643		37,643	
U.S. agency securities	279,049		279,049	
Corporate securities	382,516		382,516	
Foreign government securities	79,841		79,841	
Foreign currency derivatives (2)	134		134	
Liabilities:				
Foreign currency derivatives (3)	(15)		(15)	
Total	$ 1,044,385	$ 178,280	$ 866,105	$

(1) Included in Cash and cash equivalents, Investments in debt securities, short-term or Investments in debt securities, long-term in the Company s Consolidated Balance Sheet at February 28, 2014, in addition to $443.2 million of cash.
(2) Included in Other current assets in the Company s Consolidated Balance Sheet at February 28, 2014.
(3) Included in Accounts payable and accrued expenses in the Company s Consolidated Balance Sheet at February 28, 2014.

The following table represents the Company s investments measured at fair value as of November 30, 2014 (in thousands):

	Amortized Cost	Gross Unrealized		Aggregate Fair Value	Balance Sheet Classification		
		Gains	Losses (1)		Cash and cash equivalents	Investments in debt securities, short-term	Investments in debt securities, long-term
Money markets	$ 263,986	$	$	$ 263,986	$ 263,986	$	$
Interest-bearing deposits	41			41		41	
Commercial paper	26,999			26,999	26,999		
U.S. agency securities	255,784	81	(250)	255,615		4,998	250,617
Corporate securities	427,353	1,309	(309)	428,353		156,317	272,036
Foreign government securities	78,452	74	(3)	78,523		70,064	8,459

Total	$ 1,052,615	$ 1,464	$ (562)	$ 1,053,517	$ 290,985	$ 231,420	$ 531,112

(1) As of November 30, 2014, there were $0.2 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

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RED HAT, INC.

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(Unaudited)

The following table represents the Company s investments measured at fair value as of February 28, 2014 (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses (1)	Aggregate Fair Value	Balance Sheet Classification: Cash and cash equivalents	Investments in debt securities, short-term	Investments in debt securities, long-term
Money markets	$ 178,280	$	$	$ 178,280	$ 178,280	$	$
Interest-bearing deposits	86,937			86,937		86,937	
Commercial paper	37,643			37,643	25,299	12,344	
U.S. agency securities	279,657	12	(620)	279,049		56,314	222,735
Corporate securities	381,446	1,279	(209)	382,516		131,612	250,904
Foreign government securities	79,818	34	(11)	79,841		48,180	31,661
Total	$ 1,043,781	$ 1,325	$ (840)	$ 1,044,266	$ 203,579	$ 335,387	$ 505,300

(1) As of February 28, 2014, there were $0.2 million of accumulated unrealized losses related to investments that have been in a continuous unrealized loss position for 12 months or longer.

NOTE 7 Derivative Instruments

The Company transacts business in various foreign countries and is, therefore, subject to risk of foreign currency exchange rate fluctuations. The Company from time to time enters into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair market values. The Company has elected not to prepare and maintain the documentation required to qualify for hedge accounting treatment and, therefore, changes in fair value are recorded in the Consolidated Statements of Operations.

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of November 30, 2014 and for the three and nine months then ended (in thousands):

	As of November 30, 2014: Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives: Three Months Ended November 30, 2014	Nine Months Ended November 30, 2014
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 7	$ 1,099	Other income	$ 48	$ 312

				(expense), net		
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(411)	20,324	Other income (expense), net	(811)	(1,352)
TOTAL		$ (404)	$ 21,423		$ (763)	$ (1,040)

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(Unaudited)

The effects of derivative instruments on the Company s Consolidated Financial Statements are as follows as of November 30, 2013 and for the three and nine months then ended (in thousands):

	As of November 30, 2013				Three Months Ended November 30, 2013	Nine Months Ended November 30, 2013
	Balance Sheet Location	Fair Value	Notional Value	Location of Gain (Loss) Recognized in Income on Derivatives	Amount of Gain (Loss) Recognized in Income on Derivatives	
Assets foreign currency forward contracts not designated as hedges	Other current assets	$ 58	$ 10,886	Other income (expense), net	$ 177	$ 800
Liabilities foreign currency forward contracts not designated as hedges	Accounts payable and accrued expenses	(278)	13,860	Other income (expense), net	(389)	(2,399)
TOTAL		$ (220)	$ 24,746		$ (212)	$ (1,599)

NOTE 8 Share-based Awards

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

The following summarizes share-based compensation expense recognized in the Company s Consolidated Financial Statements for the three months and nine months ended November 30, 2014 and November 30, 2013 (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Cost of revenue	$ 3,915	$ 2,922	$ 10,458	$ 8,861
Sales and marketing	15,866	10,268	39,794	30,009
Research and development	8,129	9,161	28,091	25,100
General and administrative	5,713	7,839	20,599	19,226
Total share-based compensation	$ 33,623	$ 30,190	$ 98,942	$ 83,196

Share-based compensation expense qualifying for capitalization was insignificant for each of the three months and nine months ended November 30, 2014 and November 30, 2013. Accordingly, no share-based compensation expense was capitalized during the three months and nine months ended November 30, 2014 and November 30, 2013.

Estimated annual forfeitures An estimated forfeiture rate of 10.0% per annum, which approximates the Company s historical rate, was applied to options and nonvested share units. Awards are adjusted to actual forfeiture rates at vesting. The Company reassesses its estimated forfeiture rate annually or when new information, including actual forfeitures, indicate a change is appropriate.

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

During the three months and nine months ended November 30, 2014, the Company granted the following share-based awards:

	Three Months Ended November 30, 2014		Nine Months Ended November 30, 2014	
	Shares and Shares Underlying Awards	Weighted Average Per Share Fair Value	Shares and Shares Underlying Awards	Weighted Average Per Share Fair Value
Service-based shares and share units	1,181,351	$ 54.93	2,766,093	$ 53.23
Performance share units target (1)		$	695,218	$ 53.24
Performance share awards (2)		$	184,325	$ 50.54
Assumed (3)		$	219,169	$ 48.45
Restricted shares issued as part of a business combination with continued employment service conditions (4)		$	529,057	$ 54.75
Total awards	1,181,351	$ 54.93	4,393,862	$ 53.06

(1) Certain executives and senior management were awarded a target number of performance share units (PSUs). PSU grantees may earn up to 200% of the target number of PSUs. Half of the target number of PSUs can be earned by the grantees depending upon the Company s financial performance measured against the financial performance of specified peer companies during a three-year performance period beginning on March 1, 2014. The remaining target number of PSUs can be earned by the grantees depending upon the Company s total shareholder return performance measured against the total shareholder return of specified peer companies during a three-year period beginning on March 1, 2014.

During the three months ended August 31, 2014, certain executives were awarded a total of 242,352 PSUs that will pay out only if the Company s total shareholder return increases by at least 50% within the three-year performance period beginning on August 6, 2014 (TSR Hurdle PSUs). If the performance goal is achieved during the performance period and the grantee s business relationship with the Company has not ceased, 50% of the TSR Hurdle PSUs shall vest upon achievement of the performance goal and the remaining 50% of the TSR Hurdle PSUs shall vest on the last day of the four-year period beginning on August 6, 2014. If the performance goal is not achieved on or before the last day of the performance period, then all TSR Hurdle PSUs are forfeited.

(2) Certain executives were granted restricted stock awards. These shares were awarded subject to the achievement of a specified dollar amount of revenue for FY2015 (the RSA Performance Goal). If the Company fails to achieve the RSA Performance Goal for FY2015, then all such shares are forfeited. If the Company achieves the RSA Performance Goal for FY2015, then 25% of the restricted stock vests on July 16, 2015, and the remainder vests ratably on a quarterly basis over the course of the subsequent three year period, provided that the grantee s business relationship with the Company has not ceased.

(3) Amount represents partially-vested options assumed as part of a business combination.

(4) As part of the Company s acquisition of eNovance, a total of 529,057 restricted common shares were issued to certain shareholders of eNovance. These restricted shares are conditioned on continued employment with the Company. The shares effectively vest 25% per year and are being amortized on a straight-line basis to share-based compensation expense in the Company s Consolidated Statement of Operations.

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RED HAT, INC.

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NOTE 9 Earnings Per Share

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

The following table reconciles the numerators and denominators of the earnings per share calculation for the three months and nine months ended November 30, 2014 and November 30, 2013 (in thousands, except per share amounts):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Net income, basic and diluted	$ 47,933	$ 52,025	$ 132,501	$ 133,224
Weighted average common shares outstanding	185,039	189,514	187,533	190,024
Incremental shares attributable to assumed vesting or exercise of outstanding equity award shares	2,635	1,851	2,548	2,025
Diluted shares	187,674	191,365	190,081	192,049
Diluted net income per share	$ 0.26	$ 0.27	$ 0.70	$ 0.69

The weighted average number of shares outstanding used in the computation of basic and diluted earnings per share for the three months and nine months ended November 30, 2014 does not include the effect of common stock potentially issuable in accordance with the terms of the Company s convertible notes and warrants. The effects of these potentially outstanding shares were not included in the calculation of diluted earnings per share because the effect would have been anti-dilutive.

With respect to the Company s convertible notes, the Company has the option to pay or deliver, as the case may be, either cash, shares of its common stock or combination of cash and shares of its common stock for the aggregate amount due upon conversion of the notes. The Company s intent is to settle the principal amount of the notes in cash upon conversion. As a result, upon conversion of the 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 15 Convertible Notes to the Company s Consolidated Financial Statements for detailed information on the convertible notes.

The following share awards are not included in the computation of diluted earnings per share because the aggregate value of proceeds considered received upon either exercise or vesting was greater than the average market price of the Company s common stock during the related periods and the effect of including such share awards in the computation would be anti-dilutive (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Number of shares considered anti-dilutive for calculating diluted EPS	39	1,430	151	1,514

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 10 Share Repurchase Programs

On April 15, 2013, the Company announced that its Board of Directors had authorized the repurchase of up to $300.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program commenced on April 16, 2013, and will expire on the earlier of (i) March 31, 2015, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program.

As of November 30, 2014, the amount available under the program for the repurchase of the Company s common stock was $80.0 million.

Accelerated share repurchase

The Company used $375.0 million of the net proceeds from the issuance of the convertible notes discussed in NOTE 15 Convertible Notes to the Company s Consolidated Financial Statements during the three months ended November 30, 2014 to repurchase shares of its common stock under an accelerated share repurchase program (the ASR Agreement) with Goldman, Sachs & Co. (the ASR Counterparty). On October 7, 2014, under the ASR Agreement, the Company paid $375.0 million to the ASR Counterparty and received approximately 5.3 million shares of its common stock from the ASR Counterparty, which represented 80 percent of the shares the Company would have repurchased assuming an average share price of $56.47 (the Company s closing share price at October 1, 2014). The total number of shares of common stock that the Company will repurchase under the ASR Agreement will be based on the average of the daily volume-weighted average prices of the Company s common stock during the term of the ASR Agreement, less a discount. At settlement, the ASR Counterparty may be required to deliver additional shares of the Company s common stock to the Company or, under certain circumstances, the Company may be required to deliver shares of common stock or make a cash payment to the ASR Counterparty. Final settlement of the ASR Agreement is expected to be completed by February 27, 2015, although the settlement may be accelerated at the ASR Counterparty s option.

The Company accounted for the ASR program as two separate transactions: (i) the approximately 5.3 million shares of common stock initially delivered to the Company were accounted for as a treasury stock transaction with $300.0 million, or 80 percent, of the $375.0 million upfront payment being recorded in Treasury stock in the Company s Consolidated Balance Sheet at November 30, 2014 and (ii) the unsettled portion of the ASR Agreement of $75.0 million was recorded in Additional paid-in capital on the Company s Consolidated Balance Sheet as of November 30, 2014. As the remainder of the shares are delivered, which is anticipated to be in the fourth quarter of fiscal year 2015, the associated amounts will be reclassified from Additional paid-in capital to Treasury stock.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 11 Segment Reporting

The following summarizes revenue from unaffiliated customers and income (loss) from operations for the three months and nine months ended November 30, 2014 and November 30, 2013 and total cash, cash equivalents and available-for-sale investment securities and total assets as of November 30, 2014 and November 30, 2013, by geographic segment (in thousands):

	Americas	EMEA	Asia Pacific	Corporate (1)	Consolidated
	Three Months Ended November 30, 2014				
Revenue from unaffiliated customers	$ 290,525	$ 105,755	$ 59,615	$	$ 455,895
Income (loss) from operations	$ 68,620	$ 19,805	$ 12,395	$ (33,623)	$ 67,197
	Three Months Ended November 30, 2013				
Revenue from unaffiliated customers	$ 249,744	$ 93,818	$ 52,974	$	$ 396,536
Income (loss) from operations	$ 51,638	$ 27,265	$ 12,079	$ (30,190)	$ 60,792
	Nine Months Ended November 30, 2014				
Revenue from unaffiliated customers	$ 838,757	$ 310,025	$ 176,766	$	$ 1,325,548
Income (loss) from operations	$ 170,093	$ 70,056	$ 41,180	$ (98,942)	$ 182,387
Total cash, cash equivalents and available-for-sale investment securities	$ 1,078,060	$ 383,972	$ 184,489	$	$ 1,646,521
Total assets	$ 2,546,504	$ 717,611	$ 283,756	$	$ 3,547,871
	Nine Months Ended November 30, 2013				
Revenue from unaffiliated customers	$ 720,818	$ 260,107	$ 153,293	$	$ 1,134,218
Income (loss) from operations	$ 145,666	$ 72,793	$ 37,726	$ (83,196)	$ 172,989
Total cash, cash equivalents and available-for-sale investment securities	$ 700,056	$ 445,688	$ 180,905	$	$ 1,326,649
Total assets	$ 1,995,091	$ 624,269	$ 232,008	$	$ 2,851,368

(1) Amounts represent share-based compensation expense for each of the three months and nine months ended November 30, 2014 and November 30, 2013, which was not allocated to geographic segments.

Supplemental information about geographic areas

The following table lists, for each of the three months and nine months ended November 30, 2014 and November 30, 2013, revenue from unaffiliated customers in the United States, the Company s country of domicile, and revenue from unaffiliated customers from foreign countries (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
United States, the Company s country of domicile	$ 264,242	$ 217,653	$ 746,105	$ 628,195
Foreign	191,653	178,883	579,443	506,023

Total revenue from unaffiliated customers	$ 455,895	$ 396,536	$ 1,325,548	$ 1,134,218

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RED HAT, INC.

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(Unaudited)

Total tangible long-lived assets located in the United States, the Company s country of domicile, and similar tangible long-lived assets held outside the United States are summarized in the following table as of November 30, 2014 and February 28, 2014 (in thousands):

	As of November 30, 2014	As of February 28, 2014
United States, the Company s country of domicile	$ 132,475	$ 137,356
Foreign	41,124	36,561
Total tangible long-lived assets	$ 173,599	$ 173,917

Supplemental information about major customers

For each of the three months and nine months ended November 30, 2014, the U.S. government and its agencies represented approximately 10% of the Company s total revenue. For the three months and nine months ended November 30, 2013, the U.S. government and its agencies represented approximately 9% and 12% of the Company s total revenue, respectively.

Supplemental information about products and services

The following table, for each of the three and nine months ended November 30, 2014 and November 30, 2013, provides further detail, by type, of our subscription and services revenues. Infrastructure-related offerings subscription revenue includes subscription revenue generated from Red Hat Enterprise Linux and related technologies such as Red Hat Enterprise Virtualization. Subscription revenue generated from our Application development-related and other emerging technology offerings includes Red Hat JBoss Middleware, Red Hat Storage Server and Red Hat cloud offerings such as OpenStack and OpenShift (in thousands):

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Subscription revenue:				
Infrastructure-related offerings	$ 332,897	$ 300,047	$ 983,915	$ 866,186
Application development-related and other emerging technology offerings	61,802	42,723	172,246	119,093
Total subscription revenue	394,699	342,770	1,156,161	985,279
Training and services revenue:				
Consulting services	44,588	38,621	125,578	108,168
Training	16,608	15,145	43,809	40,771
Total training and services revenue	61,196	53,766	169,387	148,939
Total subscription and training and services revenue	$ 455,895	$ 396,536	$ 1,325,548	$ 1,134,218

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

NOTE 12 Commitments and Contingencies

Operating leases

As of November 30, 2014, the Company leased office space and certain equipment under various non-cancelable operating leases. Rent expense under operating leases for the three months ended November 30, 2014 and November 30, 2013 was $8.0 million and $7.5 million, respectively. Rent expense under operating leases for the nine months ended November 30, 2014 and November 30, 2013 was $23.0 million and $21.8 million, respectively.

Product indemnification

The Company is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party from losses arising in connection with the Company s services or products, or from losses arising in connection with certain events defined within a particular contract, which may include litigation or claims relating to intellectual property infringement, certain losses arising from damage to property or injury to persons or other matters. In each of these circumstances, payment by the Company is conditioned on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party s claims. Further, the Company s obligations under these agreements may in certain cases be limited in terms of time and/or amount, and in some instances, the Company may have recourse against third-parties for certain payments made by the Company.

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company s obligations and the facts and circumstances involved in each particular agreement. The Company does not record a liability for claims related to indemnification unless the Company concludes that the likelihood of a material claim is probable and estimable. Historically, payments pursuant to these indemnifications have been immaterial.

NOTE 13 Legal Proceedings

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

NOTE 14 Business Combinations

Acquisition of FeedHenry Ltd.

On October 8, 2014 the Company completed its acquisition of all of the shares of FeedHenry Ltd. (FeedHenry). FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand the Company s portfolio of application development, integration and platform-as-a-service solutions, enabling the Company to support mobile application development in public and private environments.

The cash consideration paid as of the closing date was $80.2 million. Based on management s provisional assessment of the acquisition date fair value of the assets acquired and liabilities assumed, the total cash consideration transferred of $80.2 million has been allocated to the Company s assets and liabilities on a preliminary basis as follows: $66.4 million to goodwill, $11.6 million to identifiable intangible assets and the remaining $2.2 million to net working capital.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The Company incurred approximately $1.1 million in transaction costs, including legal and accounting fees, relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company s Consolidated Statement of Operations for the three and nine months ended November 30, 2014.

Acquisition of eNovance, SAS

On June 24, 2014, the Company completed its acquisition of all of the shares of eNovance, SAS (eNovance), a provider of open source cloud computing services. The acquisition is intended to assist in advancing the Company s market position in OpenStack, and the addition of eNovance s systems integration capabilities and engineering talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment.

The cash consideration paid was $67.6 million. Based on management s provisional assessment of the acquisition date fair value of the assets acquired and liabilities assumed, the total cash consideration transferred of $67.6 million has been allocated to the Company s assets on a preliminary basis as follows: $62.5 million to goodwill, $5.3 million to identifiable intangible assets and to net working capital which totaled a net current liability of $0.2 million.

In addition to the cash consideration transferred, the Company issued a total of 529,057 restricted common shares to certain employee-shareholders. The vesting of these restricted shares is conditioned on continued employment with the Company. As a result of the employment condition, the transfer of these shares has been accounted for separate from the business combination. The shares effectively vest 25% per year, with the closing-date date value of the shares being amortized, on a straight-line basis, to share-based compensation expense in the Company s Consolidated Statement of Operations.

The Company incurred approximately $0.9 million in transaction costs, including legal and accounting fees, relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company s Consolidated Statement of Operations for the nine months ended November 30, 2014.

Acquisition of Inktank Storage, Inc.

On April 30, 2014, the Company completed its acquisition of all of the shares of Inktank Storage, Inc. (Inktank), a provider of scale-out, open source storage systems, whose flagship technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds. The acquisition is intended to complement the Company s existing GlusterFS-based storage offering. Under the terms of the purchase agreement, the consideration transferred by the Company totaled $152.5 million. The Company incurred approximately $2.0 million in transaction costs, including legal and accounting fees, relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on the Company s Consolidated Statement of Operations for the nine months ended November 30, 2014.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The total consideration transferred by the Company in connection with the acquisition is summarized in the following table (in thousands):

	Total Consideration Transferred
Cash consideration paid to and/or on behalf of holders of Inktank stock and vested options	$ 151,648
Fair value of nonvested employee share-based awards assumed and attributed to pre-combination services (1)	895
Total consideration transferred (2)	$ 152,543

(1) The total fair value, as of April 30, 2014, of all assumed nonvested share-based awards was $10.6 million, of which $0.9 million has been attributed to pre-acquisition employee services and accordingly has been recognized as consideration transferred. The remaining $9.7 million of fair value will be recognized as compensation expense over the remaining vesting period ranging from 1 month to approximately 4 years.

(2) In addition to the consideration transferred of $152.5 million and the assumed nonvested share-based awards with an acquisition-date fair value of $10.6 million, the Company has committed to pay retention incentives totaling $8.4 million in cash (payable 25% annually from the date of acquisition assuming continued employment). The Company has also committed to granting key employees share-based awards with a combined value of $15.0 million which will vest 25% annually from the date of grant.

The table below represents the estimated tangible and identifiable intangible assets and liabilities (in thousands) based on management s provisional assessment of the acquisition date fair value of the assets acquired and liabilities assumed. The Company expects to finalize its assessment of the acquisition-date fair value of assets acquired and liabilities assumed by the end of its fiscal year 2015:

	Total Consideration Allocated
Identifiable intangible assets (see detail below)	$ 10,770
Cash	27
Accounts receivable	746
Deferred tax assets, net	12,722
Other assets	161
Accrued liabilities	(1,651)
Deferred revenue	(1,016)
Goodwill	130,784
Total consideration allocated	$ 152,543

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

The following table summarizes the allocation of consideration transferred to identifiable intangible assets (in thousands). The fair value of the identifiable intangible assets is being amortized over the estimated useful life of each intangible asset on a straight-line basis which approximates the economic pattern of benefits:

	Amortization Expense Type	Estimated Life (Years)	Total
Customer relationships	Sales and marketing	5	$ 6,800
Tradenames and trademarks	General and administrative	Indefinite	3,300
Covenants not to compete	Research and development	3	370
Developed technology	Cost of revenue	5	300
Total identifiable intangible assets			$ 10,770

Pro forma consolidated financial information

The following unaudited pro forma consolidated financial information reflects the results of operations of the Company for the three and nine months ended November 30, 2014 and November 30, 2013 (in thousands, except per share amounts) as if the acquisitions of FeedHenry, eNovance and Inktank had closed on March 1, 2013, after giving effect to certain purchase accounting adjustments. These pro forma results are not necessarily indicative of what the Company s operating results would have been had the acquisitions actually taken place at the beginning of the period.

	Three Months Ended		Nine Months Ended	
	November 30, 2014	November 30, 2013	November 30, 2014	November 30, 2013
Revenue	$ 456,280	$ 401,239	$ 1,331,007	$ 1,147,536
Net income	47,218	46,078	122,163	118,168
Basic net income per common share	$ 0.26	$ 0.24	$ 0.65	$ 0.62
Diluted net income per common share	$ 0.25	$ 0.24	$ 0.64	$ 0.62

Post-acquisition financial information

The following is a summary of the combined post-acquisition revenue, expenses and losses of FeedHenry, eNovance and Inktank that are included in the Company s Consolidated Statement of Operations for the three and nine months ended November 30, 2014 (in thousands):

	Three Months Ended November 30, 2014	Nine Months Ended November 30, 2014
Revenue	$ 2,994	$ 5,711
Operating expenses	(11,280)	(20,613)
Operating loss	(8,286)	(14,902)
Other income	297	392

Loss before tax benefit		(7,989)		(14,510)
Tax benefit		2,317		4,208
Net loss	$	(5,672)	$	(10,302)

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

Goodwill

The following is a summary of changes in goodwill for the nine months ended November 30, 2014 (in thousands):

Balance at February 28, 2014	$ 687,430
Acquisition of Inktank	130,784
Acquisition of eNovance	62,499
Acquisition of FeedHenry	66,376
Impact of foreign currency fluctuations	(7,515)
Balance at November 30, 2014	$ 939,574

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

NOTE 15 Convertible Notes

Convertible note offering

On October 7, 2014, the Company completed its previously announced offering of $700.0 million aggregate principal amount of its 0.25% Convertible Senior Notes due 2019 (the Notes). The Notes were sold in a private placement under a purchase agreement, dated as of October 1, 2014, entered into by and among the Company and Morgan Stanley & Co. LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Citigroup Global Markets Inc. and J.P. Morgan Securities LLC as representatives of the several initial purchasers named therein (collectively, the Initial Purchasers), for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended (the Securities Act). The Company also granted the Initial Purchasers a right to purchase, within a 30-day period, up to an additional $105.0 million principal amount of Notes on the same terms and conditions, which the Initial Purchasers exercised in full on October 2, 2014 and which additional purchase was also completed on October 7, 2014.

The Company used $148.0 million of the net proceeds from the offering of the Notes to pay the cost of the privately-negotiated convertible note hedge transactions described below. The Company received proceeds of $79.8 million from the sale of warrants pursuant to the warrant transactions described below.

In addition, the Company used $375.0 million of the net proceeds from the offering of the Notes to repurchase shares of its common stock under an accelerated share repurchase program pursuant to an agreement that the Company entered into with one of the Initial Purchasers on October 1, 2014, as described in NOTE 10 Share Repurchase Programs to the Company s Consolidated Financial Statements.

The Company intends to use the remaining net proceeds from the offering for working capital and other general corporate purposes, which may include capital expenditures, potential acquisitions or strategic transactions.

Indenture

On October 7, 2014, the Company entered into an indenture (the Indenture) with respect to the Notes with U.S. Bank National Association, as trustee (the Trustee). Under the Indenture, the Notes will be senior

RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

unsecured obligations of the Company and bear interest at a rate of 0.25% per year, payable semiannually in arrears on April 1 and October 1 of each year, beginning on April 1, 2015. The Notes will mature on October 1, 2019, unless previously purchased or converted.

The Notes are convertible into shares of the Company s common stock at an initial conversion rate of 13.6219 shares per $1,000 principal amount of Notes (which is equivalent to an initial conversion price of approximately $73.41 per share), subject to adjustment upon the occurrence of certain events. The initial conversion price represents a premium of approximately 30% to the $56.47 per share closing price of the Company s common stock on October 1, 2014. Upon conversion of the Notes, holders will receive cash or shares of the Company s common stock or a combination thereof, at the Company s election.

Prior to April 1, 2019, the Notes will be convertible only upon the occurrence of certain circumstances, and will be convertible thereafter at any time until the close of business on the second scheduled trading day immediately preceding the maturity date of the Notes.

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

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

The Indenture contains customary terms and covenants, including that upon certain events of default occurring and continuing, either the Trustee or the holders of at least 25% in principal amount of the outstanding Notes may declare 100% of the principal of, and accrued and unpaid interest, if any, on, all the Notes to be due and payable.

In accounting for the issuance of the Notes, the Company separated the Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the estimated fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component representing the conversion option was determined by deducting the fair value of the liability component from the face value of the Notes as a whole. The excess of the face value of the Notes as a whole over the carrying amount of the liability component (the debt discount) is amortized to interest expense over the term of the Notes using the effective interest method with an effective interest rate of 2.86% per annum. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

As of November 30, 2014, the Notes consisted of the following (in thousands):

	As of November 30, 2014
Liability component	
Principal	$ 805,000
Less: debt discount	(94,156)
Net carrying amount	$ 710,844
Equity component (1)	$ 96,890

(1) Recorded in the Consolidated Balance Sheet in Additional paid-in capital.

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RED HAT, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

(Unaudited)

In accounting for the transaction costs related to the Note issuance, the Company allocated the total amount incurred of $15.2 million to the liability and equity components based on their relative fair values. Issuance costs attributable to the liability component totaled $13.4 million and are being amortized to interest expense over the term of the Notes using the effective interest method. The remaining $1.8 million of issuance costs have been allocated to the equity component and are included in Additional paid-in capital on the Company s Consolidated Balance Sheet as of November 30, 2014. Additionally, the Company recorded a deferred tax asset of $0.7 million related to the $1.8 million equity component of transactional costs which are deductible for tax purposes.

The following table includes total interest expense recognized related to the Notes for the three and nine months ended November 30, 2014 (in thousands):

	Three Months Ended November 30, 2014	Nine Months Ended November 30, 2014
Coupon rate 0.25% per year, payable semiannually	$ 302	$ 302
Amortization of Note issuance costs liability component	351	351
Accretion of debt discount	2,734	2,734
Total interest expense related to Notes	$ 3,387	$ 3,387

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

	As of November 30, 2014		As of February 28, 2014	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Convertible notes	$ 718,810	$ 710,844	$	$

Convertible note hedge transactions and warrant transactions

On October 1, 2014, the Company entered into convertible note hedge transactions and warrant transactions with certain of the Initial Purchasers of the Notes or their respective affiliates (the Option Counterparties). In connection with the exercise in full by the Initial Purchasers of their option to purchase up to an additional $105.0 million in aggregate principal amount of the Notes, on October 2, 2014 the Company entered into additional convertible note hedge transactions and additional warrant transactions with the Option Counterparties.

The convertible note hedge transactions, including the additional convertible note hedge transactions, are expected to offset the potential dilution with respect to shares of the Company s common stock upon any conversion of the Notes and/or offset any cash payments the Company is required to make in excess of the principal amount of the converted Notes, as the case may be. The warrant transactions, including the additional warrant transactions, will have a dilutive effect with respect to the Company s common stock to the extent that the market price per share of the Company s common stock, as measured under the terms of the warrant transactions, exceeds the $101.65 strike price of the warrants. However, subject to certain conditions, the Company may elect to settle all of the warrants in cash. The $101.65 strike price of the warrants represents a premium of approximately 80% over the $56.47 per share closing price of the Company s common stock on October 1, 2014.

The purchase of convertible note hedges and proceeds from issuance of warrants were recorded in stockholders equity and will continue to be classified as stockholders equity.

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

OVERVIEW

We are a leading global provider of open source software solutions, using a community-powered approach to develop and offer reliable and high-performing operating system, virtualization, middleware, storage and cloud technologies.

Open source software is an alternative to proprietary software and represents a different model for the development and licensing of commercial software code than that typically used for proprietary software. Because open source software code is often freely shared, there are customarily no licensing fees for the use of open source software. Therefore, we do not recognize revenue from the licensing of the code itself. We provide value to our customers through the development, aggregation, integration, testing, certification, delivery, maintenance, enhancement and support of our Red Hat enterprise technologies, and by providing a level of performance, reliability, scalability, flexibility, stability and security for the enterprise 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 enterprise 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 enterprise technologies are also offered by cloud providers as a service available on demand, and this revenue is reported to and recognized by us following delivery.

We have focused on introducing and gaining acceptance for Red Hat enterprise technologies that comprise our open source architecture. Red Hat Enterprise Linux (RHEL) and Red Hat JBoss Middleware offerings have gained widespread independent software vendor (ISV) and independent hardware vendor (IHV) support. We have continued to build our open source architecture by expanding our enterprise operating system and middleware offerings and introducing virtualization, storage, cloud and other offerings.

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 enterprise technologies. Our revenue is affected by, among other factors, corporate, government and consumer spending levels. In evaluating the performance of our business, we consider a number of factors, including total revenue, deferred revenue, operating income, operating margin and cash flows from operations.

The arrangements with our customers that produce this revenue and cash are explained in further detail in Part II, Item 7 under Critical Accounting Estimates and in NOTE 2 Summary of Significant Accounting Policies to the Consolidated Financial Statements of our Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

In our fiscal year ended February 28, 2014, we focused on and expect in our fiscal year ending February 28, 2015 to continue to focus on, among other things, (i) promoting the widespread adoption of Red Hat enterprise offerings by enterprise customers globally, (ii) expanding our virtualization, storage, cloud and other enterprise offerings, (iii) investing in the development of open source technologies, (iv) increasing revenue from our existing customer base, (v) increasing revenue by promoting a range of services to help our customers derive additional value, (vi) expanding routes to market, (vii) growing our presence in international markets, and (viii) pursuing strategic acquisitions and alliances.

Revenue

For the three months ended November 30, 2014, total revenue increased 15.0%, or $59.4 million, to $455.9 million from $396.5 million for the three months ended November 30, 2013. Subscription revenue increased 15.1%, or $51.9 million, driven primarily by additional subscriptions related to our principal RHEL and Red Hat

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JBoss Middleware offerings, which continue to gain broader market acceptance in mission-critical areas of computing, and our expansion of sales channels and our geographic footprint. The increase is, in part, a result of the continued migration of enterprises in industries such as financial services, government, technology and telecommunications to our open source solutions from proprietary technologies. Training and services revenue increased 13.8%, or $7.4 million, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013. The increase is driven primarily by customer interest in new products and increased demand for our open source solutions.

We believe our success is influenced by:

- the extent to which we can expand the breadth and depth of our enterprise offerings;
- our ability to enhance the value of Red Hat enterprise offerings through frequent and continuing innovation while maintaining stable platforms over multi-year periods;
- our ability to generate increasing revenue from channel partner and other strategic relationships, including cloud computing providers, distributors, hardware original equipment manufacturers, IHVs, ISVs, systems integrators and value added resellers;
- our ability to generate new and recurring revenue for Red Hat enterprise offerings;
- the widespread and increasing deployment of open source technologies by enterprises and similar institutions, such as government agencies and universities; and
- our ability to provide customers with consulting and training services that generate additional revenue.

Deferred revenue and billings proxy

Our deferred revenue, current and long-term, balance at November 30, 2014 was $1.30 billion. Because of our subscription model and revenue recognition policies, deferred revenue improves predictability of future revenue. For example, current deferred revenue provides a baseline for revenue to be recognized over the next twelve months. Similarly, long-term deferred revenue provides a baseline for revenue to be recognized beyond twelve months. Revenue derived from cloud providers for the delivery of our enterprise technologies as a service available on demand is recognized by us following delivery and not billed in advance. As a result, such revenue has no associated deferred revenue. Total deferred revenue at November 30, 2014 increased $10.9 million, or 0.8%, as compared to the balance at February 28, 2014 of $1.29 billion.

The increase in deferred revenue reported on our Consolidated Balance Sheets of $10.9 million differs from the increase we reported on our Consolidated Statements of Cash Flows for the nine months ended November 30, 2014 of $58.0 million as the amount reported on our Consolidated Statements of Cash Flows for the nine months ended November 30, 2014 excludes (i) the impact of changes in foreign currency exchange rates used to translate deferred revenue balances from our foreign subsidiaries functional currency into U.S. dollars and (ii) deferred revenue acquired as parts of business combinations.

Billings proxy

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

For the four-fiscal-quarter period ended November 30, 2014, our rolling average billings proxy increased $79.8 million, or 19.6%, to $487.1 million from $407.3 million for the four-fiscal-quarter period ended November 30, 2013. For information regarding seasonality, see Part II, Item 7 under Overview of our Annual Report on Form 10-K for the fiscal year ended February 28, 2014.

Subscription revenue

Our enterprise technologies are sold 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 new versions of the software, security updates, fixes, functionality enhancements and upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software applications. Subscription revenue increased sequentially for the first, second and third quarters of fiscal 2015 and for each quarter of fiscal 2014 and fiscal 2013 and is being driven primarily by the increased use of our offerings by enterprise customers and our expansion of sales channels and geographic footprint during these periods.

Revenue by geography

For the three months ended November 30, 2014, approximately $191.7 million, or 42.0%, of our revenue was generated outside the United States compared to approximately $178.9 million, or 45.1%, for the three months ended November 30, 2013. Our international operations are expected to grow as our international sales force and channels become more mature and as we enter new locations or expand our presence in existing locations. As of November 30, 2014, we had offices in more than 80 locations throughout the world.

We operate our business in three geographic regions: the Americas (U.S., Latin America and Canada); EMEA (Europe, Middle East and Africa); and Asia Pacific (principally Australia, China, India, Japan, Singapore and South Korea). Revenue generated by the Americas, EMEA and Asia Pacific for the three months ended November 30, 2014 and the three months ended November 30, 2013 was as follows (in thousands):

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended November 30, 2014	$ 290,525	$ 105,755	$ 59,615	$ 455,895
Three Months Ended November 30, 2013	$ 249,744	$ 93,818	$ 52,974	$ 396,536

Year-over-year revenue growth rates in U.S. dollars for our three geographical regions were as follows for the three months ended November 30, 2014 and three months ended November 30, 2013:

	Americas	EMEA	Asia Pacific	Consolidated
Three Months Ended November 30, 2014	16.3%	12.7%	12.5%	15.0%
Three Months Ended November 30, 2013	13.4%	26.5%	7.8%	15.4%

Excluding the impact of foreign currency exchange rates, Americas, EMEA and Asia Pacific revenue grew 17.3%, 20.1% and 19.6%, respectively, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013.

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

Gross profit

Gross profit margin decreased to 84.3% for the three months ended November 30, 2014 from 84.8% for the three months ended November 30, 2013 primarily due to increased staffing cost to support our emerging cloud offerings, such as OpenStack and OpenShift.

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Gross profit margin by geography

Gross profit margins by our geographic regions for the three months ended November 30, 2014 and November 30, 2013 were as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended November 30, 2014	85.5%	86.0%	82.4%	84.3%
Three Months Ended November 30, 2013	85.0%	88.3%	82.8%	84.8%

(1) Consolidated gross margin includes corporate (non-allocated) share-based compensation expense for the three months ended November 30, 2014 and November 30, 2013 of $3.9 million and $2.9 million, respectively. For additional information, see NOTE 8 Share-based Awards to our Consolidated Financial Statements.

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

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

Income from operations

Operating income was 14.7% and 15.3% of total revenue for the three months ended November 30, 2014 and November 30, 2013, respectively. The decrease in operating income as a percentage of revenue was primarily due to continued investment in new and emerging cloud management technologies and incremental transaction costs related to business combinations. These investments are described further in our analysis of results of operations below.

Income from operations by geography

Operating income as a percentage of revenue generated by our geographic regions for the three months ended November 30, 2014 and the three months ended November 30, 2013 was as follows:

	Americas	EMEA	Asia Pacific	Consolidated (1)
Three Months Ended November 30, 2014	23.6%	18.7%	20.8%	14.7%
Three Months Ended November 30, 2013	20.7%	29.1%	22.8%	15.3%

(1) Consolidated operating income as a percentage of revenue includes corporate (non-allocated) share-based compensation expense for the three months ended November 30, 2014 and November 30, 2013 of $33.6 million and $30.2 million, respectively. For additional information, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

Operating margin for EMEA and Asia Pacific decreased for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013 primarily as a result of increased investments in research and development to support new technologies such as cloud management. The operating margin for EMEA for the three months ended November 30, 2014 also includes incremental expenses resulting from the recent acquisitions of both eNovance and FeedHenry. For further discussion regarding business acquisitions, see NOTE 14 Business Combinations to our Consolidated Financial Statements.

These geographic operating margins exclude the impact of share-based compensation expense, which was not allocated to our geographic segments.

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Cash, cash equivalents, available-for-sale investments in debt securities and cash flow from operations

Cash, cash equivalents and short-term and long-term available-for-sale investments in debt securities balances at November 30, 2014 totaled $1.65 billion. Cash generated from operating activities for the three months ended November 30, 2014 totaled $133.0 million which represents an increase of 39.8% in operating cash flow as compared to the three months ended November 30, 2013. This increase is due to the timing of billing and collections and the timing of accounts payable settlements during the same periods.

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

Foreign currency exchange rates impact on results of operations

Approximately 42.0% of our revenue for the three months ended November 30, 2014 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-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.

Three Months Ended November 30, 2014

Using the average foreign currency exchange rates from the third quarter of our prior fiscal year ended February 28, 2014, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2014 would have been higher than we reported by approximately $13.2 million and $9.8 million, respectively, which would have resulted in income from operations being higher by $3.3 million.

Nine Months Ended November 30, 2014

Using the average foreign currency exchange rates for the nine months ended November 30, 2013, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2014 would have been higher than we reported by approximately $12.2 million and $11.3 million, respectively, which would have resulted in income from operations being higher by $0.9 million.

Business combinations

FeedHenry

On October 8, 2014, we completed our acquisition of all of the shares of FeedHenry for approximately $80.2 million. FeedHenry is a provider of cloud-based enterprise mobile application platforms. The acquisition is intended to expand our portfolio of application development, integration and platform-as-a-service solutions, enabling us to support mobile application development in public and private environments. We incurred approximately $1.1 million in transaction costs including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on our Consolidated Statement of Operations for the three and nine months ended November 30, 2014.

eNovance

On June 24, 2014, we completed our acquisition of all of the shares of eNovance, a provider of open source cloud computing services, for $67.6 million. The acquisition is intended to assist in advancing our market position in OpenStack, and the addition of eNovance s systems integration capabilities and engineering

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talent is expected to help meet growing demand for enterprise OpenStack consulting, design and deployment. We incurred approximately $0.9 million in transaction costs including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and included in general and administrative expense on our Consolidated Statement of Operations for the nine months ended November 30, 2014.

Inktank

On April 30, 2014, we completed our acquisition of all of the shares of Inktank, a provider of scale-out, open source storage systems, whose flagship technology, Inktank Ceph Enterprise, delivers object and block storage software to enterprises deploying public or private clouds for consideration of $152.5 million. The acquisition is intended to complement our existing GlusterFS-based storage offering. We incurred approximately $2.0 million in transaction costs, including legal and accounting fees relating to the acquisition. These transaction costs have been expensed as incurred and are included in general and administrative expense on our Consolidated Statement of Operations for the nine months ended November 30, 2014.

As a result of the acquisitions of Inktank, eNovance and FeedHenry, operating expenses, other than acquisition-related expenses described above, increased by approximately $11.3 million and $20.6 million, respectively, for the three months and nine months ended November 30, 2014 as compared to the three months and nine months ended November 30, 2013. For further discussion, see NOTE 14 Business Combinations to our Consolidated Financial Statements.

Convertible note offering

On October 7, 2014, we completed our offering of $700.0 million aggregate principal amount of our 0.25% Convertible Senior Notes due 2019 (the Notes). The Notes were sold in a private placement under a purchase agreement, dated as of October 1, 2014, entered into by and among us and Morgan Stanley & Co. LLC, Merrill Lynch, Pierce, Fenner & Smith Incorporated, Citigroup Global Markets Inc. and J.P. Morgan Securities LLC as representatives of the several initial purchasers named therein (collectively, the Initial Purchasers), for resale to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended (the Securities Act). We also granted the Initial Purchasers a right to purchase, within a 30-day period, up to an additional $105.0 million principal amount of Notes on the same terms and conditions, which the Initial Purchasers exercised in full on October 2, 2014 and was also completed on October 7, 2014.

We used $148.0 million of the net proceeds from the offering of the Notes to pay the cost of the privately-negotiated convertible note hedge transactions described in NOTE 15 Convertible Notes to our Consolidated Financial Statements. Proceeds of $79.8 million were received by us from the sale of warrants pursuant to the warrant transactions also described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

In addition, we used $375.0 million of the net proceeds from the offering of the Notes to repurchase shares of our common stock under an accelerated share repurchase program pursuant to an agreement that we entered into with one of the Initial Purchasers on October 1, 2014, as described in NOTE 10 Share Repurchase Programs to our Consolidated Financial Statements.

We intend to use the remaining net proceeds from the offering for working capital and other general corporate purposes, which may include capital expenditures, potential acquisitions or strategic transactions.

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RESULTS OF OPERATIONS

Three months ended November 30, 2014 and November 30, 2013

The following table is a summary of our results of operations for the three months ended November 30, 2014 and November 30, 2013 (in thousands):

	Three Months Ended (Unaudited)			
	November 30, 2014	November 30, 2013	$ Change	% Change
Revenue:				
Subscriptions	$ 394,699	$ 342,770	$ 51,929	15.1%
Training and services	61,196	53,766	7,430	13.8
Total subscription and training and services revenue	455,895	396,536	59,359	15.0
Cost of subscription and training and services revenue:				
Cost of subscriptions	28,574	24,544	4,030	16.4
As a % of subscription revenue	7.2%	7.2%		
Cost of training and services	42,791	35,883	6,908	19.3
As a % of training and services revenue	69.9%	66.7%		
Total cost of subscription and training and services revenue	71,365	60,427	10,938	18.1
As a % of total revenue	15.7%	15.2%		
Total gross profit	384,530	336,109	48,421	14.4
Operating expense:				
Sales and marketing	187,218	153,528	33,690	21.9
Research and development	90,613	82,519	8,094	9.8
General and administrative	39,502	39,270	232	0.6
Total operating expense	317,333	275,317	42,016	15.3
Income from operations	67,197	60,792	6,405	10.5
Interest income	2,196	1,579	617	39.1
Interest expense	3,441	51	3,390	6,647.1
Other income (expense), net	1,559	(389)	1,948	500.8
Income before provision for income taxes	67,511	61,931	5,580	9.0
Provision for income taxes (1)	19,578	9,906	9,672	97.6
Net income	$ 47,933	$ 52,025	$ (4,092)	(7.9)%
Gross profit margin-subscriptions	92.8%	92.8%		
Gross profit margin-training and services	30.1%	33.3%		
Gross profit margin	84.3%	84.8%		
As a % of total revenue:				
Subscription revenue	86.6%	86.4%		
Training and services revenue	13.4%	13.6%		
Sales and marketing expense	41.1%	38.7%		
Research and development expense	19.9%	20.8%		

General and administrative expense	8.7%	9.9%
Total operating expenses	69.6%	69.4%
Income from operations	14.7%	15.3%
Income before provision for income taxes	14.8%	15.6%
Net income	10.5%	13.1%
Estimated annual effective income tax rate (1)	29.0%	27.5%

(1) Provision for income taxes for the three months ended November 30, 2013 includes a net discrete tax benefit of $4.2 million and the impact of the change in our estimated annual effective tax rate from 30% to 27.5%. See NOTE 5 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 enterprise offerings, increased by 15.1%, or $51.9 million, to $394.7 million for the three months ended November 30, 2014 from $342.8 million for the three months ended November 30, 2013.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 10.9%, or $32.9 million, to $332.9 million for the three months ended November 30, 2014 from $300.0 million for the three months ended November 30, 2013 and is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of enterprises 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 44.7%, or $19.1 million, to $61.8 million for the three months ended November 30, 2014 from $42.7 million for the three months ended November 30, 2013. The increase is primarily due to additional subscriptions for Red Hat JBoss Middleware offerings. 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 enterprise technologies and for delivery of added functionality to Red Hat enterprise technologies for our major customers and OEM partners. Total training and services revenue increased by 13.8%, or $7.4 million, to $61.2 million for the three months ended November 30, 2014 from $53.8 million for the three months ended November 30, 2013. The increase is primarily due to services revenue which increased by 15.5%, or $6.0 million, as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Training revenue increased by 9.7%, or $1.5 million, due to increased training related to the introduction of RHEL 7 and for OpenStack. Combined training and services revenue decreased slightly as a percentage of total revenue to 13.4% for the three months ended November 30, 2014 from 13.6% for the three months ended November 30, 2013.

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 enterprise offerings. These costs include labor-related costs to provide technical support, security updates and fixes, as well as costs for fulfillment, physical media, literature, packaging and shipping. Cost of subscription revenue increased by 16.4%, or $4.0 million, to $28.6 million for the three months ended November 30, 2014 from $24.5 million for the three months ended November 30, 2013. The increase is primarily 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, and includes additional compensation of $2.7 million. The remaining increase is driven primarily by incremental facilities costs and amortization expense related to technology acquisitions. Gross profit margin on subscriptions was 92.8% for each of the three months ended November 30, 2014 and November 30, 2013. As the number of open source technology subscriptions continues to increase, we expect associated support cost will continue to increase, although we anticipate this will occur at a rate slower than that of subscription revenue growth due to economies of scale.

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 19.3%, or $6.9 million, to $42.8 million for the three months ended November 30, 2014 from $35.9 million for the three months ended November 30, 2013. Costs to deliver our services revenue increased by 21.8%, or $6.1 million, and relate to additional employee compensation and travel associated with additions to our emerging technologies staff. Total costs to deliver training and services as a percentage of training and services revenue was 69.9% and 66.7% for each of the three month periods ended November 30, 2014 and November 30, 2013, respectively.

Gross profit

Gross profit margin decreased to 84.3% for the three months ended November 30, 2014 from 84.8% for the three months ended November 30, 2013 primarily due to an increase in staffing costs to support our emerging cloud offerings, such as OpenStack and OpenShift.

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 21.9%, or $33.7 million, to $187.2 million for the three months ended November 30, 2014 from $153.5 million for the three months ended November 30, 2013. This increase was primarily due to a $26.8 million increase in selling costs, which includes $24.3 million of additional employee compensation expense attributable to the expansion of our sales force from the prior year and $1.4 million related to travel. The remaining increase relates to marketing costs, which grew 18.0%, or $6.9 million, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013. As a result of expanded sales staffing, sales and marketing expense increased as a percentage of revenue to 41.1% for the three months ended November 30, 2014 from 38.7% for the three months ended November 30, 2013.

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 9.8%, or $8.1 million, to $90.6 million for the three months ended November 30, 2014 from $82.5 million for the three months ended November 30, 2013. The increase in research and development costs primarily resulted from the expansion of our engineering group as a result of both direct hires and business combinations as we continue investing in cloud management and our other emerging technologies. Employee compensation increased by $8.0 million. Research and development expense was 19.9% and 20.8% of total revenue for the three months ended November 30, 2014 and November 30, 2013, respectively.

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 0.6%, or $0.2 million, to $39.5 million for the three months ended November 30, 2014 from $39.3 million for the three months ended November 30, 2013. General and administrative expense decreased as a percentage of revenue to 8.7% for the three months ended November 30, 2014 from 9.9% for the three months ended November 30, 2013. We expect general and administrative costs to decrease as a percentage of total revenue as we continue to realize and leverage benefits from investments made during the prior fiscal year in process and technology infrastructure enhancements to support our corporate functions.

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Interest income

Interest income increased by 39.1%, or $0.6 million, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013. The increase in interest income for the three months ended November 30, 2014 is attributable to slightly higher prevailing yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $3.4 million, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013. The increase in interest expense for the three months ended November 30, 2014 is attributable to the issuance of convertible senior notes which are described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

Other income (expense), net

Other income (expense), net increased by $1.9 million, for the three months ended November 30, 2014 as compared to the three months ended November 30, 2013. The increase is primarily due to both net gains recognized from the settlement of foreign currency transactions and unrealized net gains recognized from the remeasurement of foreign currency transactions not yet settled during the three months ended November 30, 2014.

Income taxes

During the three months ended November 30, 2014, we recorded $19.6 million of income tax expense, which is based on an estimated annual effective tax rate of 29.0%. Our estimated annual effective tax rate of 29.0% is less than the U.S. federal statutory rate of 35.0% primarily due to foreign income taxed at lower rates.

During the three months ended November 30, 2013, we recorded $9.9 million of income tax expense, which is based on an estimated annual effective tax rate of 27.5%, less a net discrete tax benefit of $4.2 million. Our estimated annual effective tax rate of 27.5%, which excludes the impact of the discrete tax benefit, is less than the U.S. federal statutory rate of 35.0% primarily due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction.

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Nine months ended November 30, 2014 and November 30, 2013

The following table is a summary of our results of operations for the nine months ended November 30, 2014 and November 30, 2013 (in thousands):

	Nine Months Ended (Unaudited)			
	November 30, 2014	November 30, 2013	$ Change	% Change
Revenue:				
Subscriptions	$ 1,156,161	$ 985,279	$ 170,882	17.3%
Training and services	169,387	148,939	20,448	13.7
Total subscription and training and services revenue	1,325,548	1,134,218	191,330	16.9
Cost of subscription and training and services revenue:				
Cost of subscriptions	84,125	71,437	12,688	17.8
As a % of subscription revenue	7.3%	7.3%		
Cost of training and services	118,857	100,627	18,230	18.1
As a % of training and services revenue	70.2%	67.6%		
Total cost of subscription and training and services revenue	202,982	172,064	30,918	18.0
As a % of total revenue	15.3%	15.2%		
Total gross profit	1,122,566	962,154	160,412	16.7
Operating expense:				
Sales and marketing	538,576	440,568	98,008	22.2
Research and development	275,817	234,619	41,198	17.6
General and administrative	125,786	111,807	13,979	12.5
Facility exit costs		2,171	(2,171)	(100.0)
Total operating expense	940,179	789,165	151,014	19.1
Income from operations	182,387	172,989	9,398	5.4
Interest income	6,048	4,608	1,440	31.3
Interest expense	3,591	114	3,477	3,050.0
Other income, net	1,777	446	1,331	298.4
Income before provision for income taxes	186,621	177,929	8,692	4.9
Provision for income taxes (1)	54,120	44,705	9,415	21.1
Net income	$ 132,501	$ 133,224	$ (723)	(0.5)%
Gross profit margin-subscriptions	92.7%	92.7%		
Gross profit margin-training and services	29.8%	32.4%		
Gross profit margin	84.7%	84.8%		
As a % of total revenue:				
Subscription revenue	87.2%	86.9%		
Training and services revenue	12.8%	13.1%		
Sales and marketing expense	40.6%	38.8%		
Research and development expense	20.8%	20.7%		

General and administrative expense	9.5%	9.9%
Facility exit costs	%	0.2%
Total operating expenses	70.9%	69.6%
Income from operations	13.8%	15.3%
Income before provision for income taxes	14.1%	15.7%
Net income	10.0%	11.7%
Estimated annual effective income tax rate (1)	29.0%	27.5%

(1) The estimated annual effective tax rate for the nine months ended November 30, 2013 is based on estimated annual ordinary income and excludes a net discrete tax benefit of $4.2 million. See NOTE 5 Income Taxes to our Consolidated Financial Statements for further discussion.

Revenue

Subscription revenue

Subscription revenue increased by 17.3%, or $170.9 million, to $1.16 billion for the nine months ended November 30, 2014 from $985.3 million for the nine months ended November 30, 2013.

Revenue derived from the sale of subscriptions supporting our Infrastructure-related offerings increased by 13.6%, or $117.7 million, to $983.9 million for the nine months ended November 30, 2014 from $866.2 million for the nine months ended November 30, 2013 and is primarily due to increases in volumes sold, including additional subscriptions attributable to geographic expansion and the continued migration of enterprises 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 44.6%, or $53.2 million, to $172.2 million for the nine months ended November 30, 2014 from $119.1 million for the nine months ended November 30, 2013. The increase is primarily due to additional subscriptions for Red Hat JBoss Middleware offerings.

Training and services revenue

Total training and services revenue increased by 13.7%, or $20.4 million, to $169.4 million for the nine months ended November 30, 2014 from $148.9 million for the nine months ended November 30, 2013. The increase is primarily due to services revenue which increased by 16.1%, or $17.4 million, as a result of an increase in consulting engagements driven by increased demand for our open source solutions. Combined training and services revenue decreased as a percentage of total revenue to 12.8% for the nine months ended November 30, 2014 from 13.1% for the nine months ended November 30, 2013.

Cost of revenue

Cost of subscription revenue

Cost of subscription revenue increased by 17.8%, or $12.7 million, to $84.1 million for the nine months ended November 30, 2014 from $71.4 million for the nine months ended November 30, 2013. The increase is primarily 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, and includes additional compensation of $9.4 million. The remaining increase is driven primarily by incremental facilities costs and amortization expense related to technology acquisitions. Gross profit margin on subscriptions was 92.7% for each of the nine months ended November 30, 2014 and November 30, 2013. As the number of open source technology subscriptions continues to increase, we expect associated support cost will continue to increase, although we anticipate this will occur at a rate slower than that of subscription revenue growth due to economies of scale.

Cost of training and services revenue

Cost of training and services revenue increased by 18.1%, or $18.2 million, to $118.9 million for the nine months ended November 30, 2014 from $100.6 million for the nine months ended November 30, 2013. Costs to deliver our services revenue increased by 21.2%, or $16.7 million, and relate to additional employee compensation and travel associated with additions to our emerging technologies staff as a result of both direct hires and business combinations. Total costs to deliver training and services as a percentage of training and services revenue was 70.2% and 67.6% for each of the nine months month periods ended November 30, 2014 and November 30, 2013, respectively.

Gross profit

Gross profit margin was 84.7% and 84.8% for each of the nine months ended November 30, 2014 and November 30, 2013, respectively. A favorable mix shift, which increased subscription sales relative to total sales was offset by an increase in staffing costs to support our emerging cloud offerings, such as OpenStack and OpenShift.

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Operating expenses

Sales and marketing

Sales and marketing expense increased by 22.2%, or $98.0 million, to $538.6 million for the nine months ended November 30, 2014 from $440.6 million for the nine months ended November 30, 2013. This increase was primarily due to a $78.7 million increase in selling costs, which includes $65.3 million of additional employee compensation expense attributable to the expansion of our sales force from the prior year and $5.3 million related to travel. The remaining increase relates to marketing costs, which grew 17.7%, or $19.3 million, for the nine months ended November 30, 2014 as compared to the nine months ended November 30, 2013. As a result of expanded sales staffing, sales and marketing expense increased as a percentage of revenue to 40.6% for the nine months ended November 30, 2014 from 38.8% for the nine months ended November 30, 2013.

Research and development

Research and development expense increased by 17.6%, or $41.2 million, to $275.8 million for the nine months ended November 30, 2014 from $234.6 million for the nine months ended November 30, 2013. The increase in research and development costs primarily resulted from the expansion of our engineering group as a result of both direct hires and business combinations as we continue investing in cloud management and our other emerging technologies. Employee compensation increased by $32.9 million. The remaining increase in research and development costs relates primarily to process and technology infrastructure enhancements, which increased $4.7 million. Research and development expense was 20.8% and 20.7% of total revenue for the nine months ended November 30, 2014 and November 30, 2013, respectively.

General and administrative

General and administrative expense increased by 12.5%, or $14.0 million, to $125.8 million for the nine months ended November 30, 2014 from $111.8 million for the nine months ended November 30, 2013. The increase in general and administrative expenses results from increased compensation-related expense of $10.3 million. The remaining increase includes $4.0 million of transaction costs related to business combinations. General and administrative expense decreased as a percentage of revenue to 9.5% for the nine months ended November 30, 2014 from 9.9% for the nine months ended November 30, 2013. We expect general and administrative costs to decrease as a percentage of total revenue as we continue to realize and leverage benefits from investments made during the prior fiscal year in process and technology infrastructure enhancements to support our corporate functions.

Interest income

Interest income increased by 31.3%, or $1.4 million, for the nine months ended November 30, 2014 as compared to the nine months ended November 30, 2013. The increase in interest income for the nine months ended November 30, 2014 is attributable to slightly higher yields earned on larger cash and investment balances.

Interest expense

Interest expense increased by $3.5 million, for the nine months ended November 30, 2014 as compared to the nine months ended November 30, 2013. The increase in interest expense for the nine months ended November 30, 2014 is attributable to the issuance of convertible senior notes which are described in NOTE 15 Convertible Notes to our Consolidated Financial Statements.

Other income, net

Other income, net increased by $1.3 million, for the nine months ended November 30, 2014 as compared to the nine months ended November 30, 2013. The increase is primarily due to a gain on the sale of an investment during the nine months ended November 30, 2014.

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Income taxes

During the nine months ended November 30, 2014, we recorded $54.1 million of income tax expense, which is based on an estimated annual effective tax rate of 29.0%. Our estimated annual effective tax rate of 29.0% is less than the U.S. federal statutory rate of 35.0% primarily due to foreign income taxed at lower rates.

During the nine months ended November 30, 2013, we recorded $44.7 million of income tax expense, which is based on an estimated annual effective tax rate of 27.5%, less a net discrete tax benefit of $4.2 million. Our estimated annual effective tax rate of 27.5%, which excludes the impact of the net discrete tax benefit, is less than the U.S. federal statutory rate of 35.0% primarily due to foreign income taxed at lower rates, research tax credits and the domestic production activities deduction.

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 recent issuance of convertible senior notes with par value totaling $805.0 million described above, in Overview Convertible note offering and in detail in NOTE 15 Convertible Notes to our Consolidated Financial Statements. At November 30, 2014, we had total cash and investments of $1.65 billion, which was comprised of $884.0 million in cash and cash equivalents, $231.4 million of short-term, available-for-sale, fixed-income investments and $531.1 million of long-term, available-for-sale fixed-income investments. This compares to total cash and investments of $1.49 billion at February 28, 2014

With $884.0 million in cash and cash equivalents on hand, we believe our cash and cash equivalent balances, 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 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 those investments. At November 30, 2014 and February 28, 2014, net accumulated unrealized gains on our available-for-sale debt securities totaled $0.9 million and $0.5 million, respectively.

Nine months ended November 30, 2014

Cash flows overview

At November 30, 2014, cash and cash equivalents totaled $884.0 million, an increase of $237.2 million as compared to February 28, 2014. The increase in cash and cash equivalents for the nine months ended November 30, 2014 is primarily the result of operating cash flows which generated $405.4 million and the issuance of our convertible senior notes which generated $790.4 million, net of issuance costs. Partially offsetting cash generated by operations and the issuance of our convertible senior notes were acquisitions of Inktank, eNovance and FeedHenry, which included net cash consideration of $296.1 million, and the repurchase of 8,355,757 shares of our common stock for $535.1 million.

Cash flows from operations

Cash provided by operations of $405.4 million during the nine months ended November 30, 2014 includes net income of $132.5 million, adjustments to exclude the impact of non-cash revenues and expenses, which totaled a $168.7 million net source of cash, and changes in operating assets and liabilities, which totaled a $104.2

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million net source of cash. Cash provided by changes in operating assets and liabilities for the nine months ended November 30, 2014 was primarily due to both the growth in billings, which resulted in incremental operating cash flow from an increase in deferred revenue of $58.0 million and the timing of disbursements settlement which increased accounts payable and accrued expenses by $56.2 million.

Cash flows from investing

Cash used in investing activities of $290.2 million for the nine months ended November 30, 2014 includes net cash of $296.1 million used to acquire Inktank, eNovance and FeedHenry and investments in property and equipment of $35.1 million, primarily related to information technology infrastructure and leasehold improvements. These business, property and equipment acquisitions were partially offset by proceeds from net maturities of available-for-sale debt securities of $42.0 million.

Cash flows from financing

Cash provided by financing activities of $151.4 million for the nine months ended November 30, 2014 includes $790.4 million from the issuance of our convertible senior notes, net of issuance costs, proceeds of $79.8 million from issuance of warrants and proceeds from excess tax benefits related to share-based payment arrangements which totaled $4.9 million. Partially offsetting the cash provided by our convertible senior notes issuance and excess tax benefits is $535.1 million used to repurchase 8,355,757 shares of our common stock and $148.0 million used in note hedge transactions. See NOTE 10 Share Repurchase Programs and NOTE 15 Convertible Notes to our Consolidated Financial Statements for further discussion of our share repurchase program and our issuance of convertible senior notes. Payments made in return for common shares received from employees to satisfy employees minimum tax withholding obligations related to restricted share awards vesting during the nine months ended November 30, 2014 totaled $39.3 million.

Investments in debt securities

Our investments are comprised primarily of debt securities that are classified as available for sale and recorded at their fair market values. At November 30, 2014 and February 28, 2014, 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 market value, 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 market value.

Capital requirements

We have experienced a substantial increase in our operating expenses since our inception in connection with the growth of our operations, the development of our enterprise technologies, the expansion of our services operations and our acquisition activity. Our capital requirements during the fiscal year ending February 28, 2015 will depend on numerous factors, including the amount of resources we devote to:

- funding the continued development of our enterprise 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.

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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 $1.65 billion of cash and investments held at November 30, 2014, we believe our cash and cash equivalent balances, 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 cash flows from operations will continue to improve; however, there can be no assurances that we will improve our cash flows from operations from 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 geography 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 November 30, 2014, our cash, cash equivalents and available-for-sale investment securities totaled $1.65 billion, of which $613.7 million was held outside the U.S. Our intent is to reinvest the earnings of foreign subsidiaries indefinitely outside the U.S. to fund both organic growth and acquisitions. For further discussion related to geographic segments, see NOTE 11 Segment Reporting to our Consolidated Financial Statements.

With $1.03 billion or 62.7% of our available cash, cash equivalents and available-for-sale investments, as of November 30, 2014, held within the U.S., we do not anticipate a need to repatriate any foreign earnings for the foreseeable future. However, if cash held outside the U.S. were needed to fund our U.S. operations, under current tax law we would be subject to additional taxes on the portion related to repatriated earnings of our foreign subsidiaries. As of February 28, 2014, cumulative undistributed foreign earnings totaled $296.4 million. For further discussion, see NOTE 11 Income Taxes to our Consolidated Financial Statements contained in our Annual Report on Form 10-K for the year ended February 28, 2014.

Off-balance sheet arrangements

As of November 30, 2014 and February 28, 2014, 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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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Interest rate risk

Our exposure to market rate risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal and liquidity while at the same time maximizing yields without significantly increasing risk. To achieve this objective, we maintain our portfolio of short-term 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 market 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 which 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 November 30, 2014. For further discussion related to our investments as of November 30, 2014 and February 28, 2014, see NOTE 6 Assets and Liabilities Measured at Fair Value on a Recurring Basis to our Consolidated Financial Statements.

Investment risk

The fair market 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 $12.9 million decrease in the fair value of our available-for-sale investment securities as of November 30, 2014. For further discussion related to our investments as of November 30, 2014 and February 28, 2014, see NOTE 6 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 market 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

No individual customer accounted for 10% or more of our total accounts receivable as of November 30, 2014 or February 28, 2014.

Foreign currency risk

Approximately 42.0% of our revenue for the three months ended November 30, 2014 was produced by sales outside the United States. We are exposed to significant risks of foreign currency fluctuation primarily from receivables denominated in foreign currency and are subject to transaction gains and losses, which are recorded as a component of net income. The income statements of our non-U.S. operations are translated into U.S. dollars at the average exchange rates for each applicable month in a period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency statements results in increased revenue and operating expenses for our non-U.S. operations. Similarly, our revenue and operating expenses for our non-U.S. operations decreases if the U.S. dollar strengthens against foreign currencies.

Using the average foreign currency exchange rates from the third quarter of our prior fiscal year ended February 28, 2014, our revenue and operating expenses from non-U.S. operations for the three months ended November 30, 2014 would have been higher than we reported by approximately $13.2 million and $9.8 million, respectively, which would have resulted in income from operations being higher by $3.3 million.

Using the average foreign currency exchange rates for the nine months ended November 30, 2013, our revenue and operating expenses from non-U.S. operations for the nine months ended November 30, 2014 would have been higher than we reported by approximately $12.2 million and $11.3 million, respectively, which would have resulted in income from operations being higher by $0.9 million.

Convertible Senior Notes

In October 2014, we issued $805.0 million of 0.25% convertible senior notes due 2019. The Notes have a fixed annual interest rate of 0.25%, and therefore we do not have economic interest rate exposure on the Notes. However, the fair market value of the Notes is exposed to interest rate risk. Generally, the fair market value of the Notes will increase as interest rates fall and decrease as interest rates rise. For further discussion regarding the fair value of the Notes, see NOTE 15 Convertible Notes to our Consolidated Financial Statements.

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

Derivative instruments

We transact business in various foreign countries and are, therefore, subject to risk of foreign currency exchange rate fluctuations. From time to time we enter into forward contracts to economically hedge transactional exposure associated with commitments arising from trade accounts receivable, trade accounts payable and fixed purchase obligations denominated in a currency other than the functional currency of the respective operating entity. All derivative instruments are recorded on the Consolidated Balance Sheets at their respective fair market values. We have elected not to prepare and maintain the documentation required to qualify our forward contracts for hedge accounting treatment and, therefore, changes in fair value are recorded in our Consolidated Statements of Operations. For further discussion related to our management of foreign currency risk see NOTE 7 Derivative Instruments to our Consolidated Financial Statements.

The aggregate notional amount of outstanding forward contracts at November 30, 2014 was $21.4 million. The fair value of these outstanding contracts at November 30, 2014 was a gross less than $0.1 million asset and a gross $0.4 million liability, and is recorded in Other current assets and Accounts payable and accrued expenses,

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respectively, on our Consolidated Balance Sheets. The forward contracts generally expire within three months of the period ended November 30, 2014. The forward contracts will settle in Australian dollars, Euros, Japanese yen, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs and U.S. dollars.

The aggregate notional amount of outstanding forward contracts at February 28, 2014 was $28.3 million. The fair value of these outstanding contracts at February 28, 2014 was a gross $0.1 million asset and a gross less than $0.1 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, 2014. The forward contracts will settle in Argentine pesos, Australian dollars, Chilean pesos, Czech koruna, Danish krone, Euros, Israeli shekels, Japanese yen, Korean won, Norwegian krona, Singapore dollars, Swedish krona, Swiss francs, and U.S. dollars.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2014, the FASB issued Accounting Standards Update 2014-12, *Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period* (ASU 2014-12). The FASB issued ASU 2014-12 to provide explicit guidance for share-based awards which allow for an employee to vest in an award upon achievement of a performance condition met after completion of a requisite service period regardless of whether the employee is rendering service on the date the performance target is achieved. ASU 2014-12 provides that the performance target should not be reflected in estimating the grant-date fair value of the award but rather compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and recognized prospectively over the remaining requisite service period. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2015, and is effective for us as of the first quarter of the fiscal year ending February 28, 2017. We have not issued such share-based awards and do not believe that this updated standard will have a material impact on our consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update 2014-09, *Revenue from Contracts with Customers* (ASU 2014-09). The FASB issued ASU 2014-09 to clarify the principles for recognizing revenue and to develop a common revenue standard for GAAP and International Financial Reporting Standards. The standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes the most current revenue recognition guidance. This guidance is effective for fiscal years and interim periods within those years beginning after December 15, 2016, which is effective for us as of the first quarter of the fiscal year ending February 28, 2018. We are currently evaluating the impact that the implementation of this standard will have on our consolidated financial statements.

In July 2013, the FASB issued Accounting Standards Update No. 2013-11, *Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* (ASU 2013-11), to eliminate diversity in practice of presenting unrecognized tax benefits as a liability or presenting unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances by requiring that an unrecognized tax benefit be presented in the financial statements as a reduction to deferred tax assets excluding certain exceptions. ASU 2013-11 became effective for us during the three months ended May 31, 2014. The updated standard did not have a material impact on our consolidated financial statements.

In March 2013, the FASB issued Accounting Standards Update No. 2013-05, *Foreign Currency Matters (Topic 830) Parent s Accounting for the Cumulative Translation Adjustment upon Derecognition of Certain Subsidiaries or Groups of Assets within a Foreign Entity or of an Investment in a Foreign Entity* (ASU 2013-05), which requires a parent entity to release a related foreign entity s cumulative translation adjustment into net income only if its sale or transfer results in the complete or substantially complete liquidation of the foreign entity in which the subsidiary or group of assets had resided. ASU 2013-05 became effective for us during the three months ended May 31, 2014. The updated standard did not have a material impact on our consolidated financial statements.

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ITEM 4. CONTROLS AND PROCEDURES

Role of Controls and Procedures

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) or our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system s objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of the controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error and mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. Also projections of any evaluation of effectiveness of controls and procedures to future periods are subject to the risk that the controls and procedures may become inadequate because of changes in conditions, or that the degree of compliance with the controls and procedures may have deteriorated.

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control Over Financial Reporting

No changes in our internal control over financial reporting occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II

ITEM 1. LEGAL PROCEEDINGS

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

ITEM 1A. RISK FACTORS

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

RISKS RELATED TO BUSINESS UNCERTAINTY

We face intense competition.

The enterprise software industry is rapidly evolving and intensely competitive, and is subject to changing technologies, shifting customer needs, and frequent introductions of new products and services. We compete based on our ability to provide our customers with enterprise software 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. As the enterprise software industry evolves, the competitive pressure for the Company to innovate encompasses a wider range of products and services, including new offerings that require different expertise than our current offerings. Some competitors may be able to innovate and provide products and services faster than we can.

Industry consolidation may affect competition by creating larger and potentially stronger competitors in the markets in which we compete. We also compete in certain areas with our partners and potential partners, 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 and frequent new product and service announcements. Our continued success will depend on our ability to adapt to rapidly changing technologies, to adapt our offerings to evolving industry standards, to predict user preferences and industry changes and to improve the performance and reliability of our offerings. Our failure to adapt to such changes could harm our business. In addition, the widespread adoption of other technological changes could require substantial expenditures on our part to modify or adapt 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.

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 providers, enterprise solution providers, hardware manufacturers, and software vendors, such as Amazon.com, Inc., Cisco Systems, Inc., Dell Inc., Fujitsu Limited, Hewlett-Packard Co., International Business Machines Corporation, NEC Corporation, Oracle Corporation, SAP AG and others. Many of these strategic partners have engineered and certified that their products and services run on or with our offerings, and in some cases have built their products 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 providers, distributors, hardware original equipment manufacturers (OEMs), and 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 regulatory requirements and Red Hat s quality standards. Our channel partners may offer their own products and services that are competitive 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, afford us any exclusive marketing or distribution rights. In addition, if a channel partner is acquired by a competitor or its business units are reorganized or divested, our revenue derived from that partner may be adversely impacted.

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

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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.

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.

The duration and extent of economic downturns, regional financial instability, and economic and market conditions generally 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 customer segments and 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 segments may also be affected by uncertain or changing economic conditions within that region or segment. Continuing 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, these 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, these 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 segments, remain uncertain or persist, spread or deteriorate further, 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 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 and dilute stockholder value.

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

- Integrating the acquired business accounting, financial reporting, management, information and information security, human resource and other administrative systems to permit effective management and reporting, and the lack of control if such integration is delayed or not implemented;

- 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;

- Increased operating expenses related to the acquired business or technology;

- Maintaining or establishing acceptable standards, controls, procedures and policies;

- Disruption of our ongoing business and distraction of management;

- Impairment of 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;

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Maintaining good relationships with customers or business partners of the acquired business;

Effective evaluation of talent at an acquired business or cultural challenges associated with integrating employees from the acquired business into our organization;

Loss of key employees of the acquired business;

Incorporating and further developing acquired products or technology into our offerings and maintaining quality standards consistent with our brands;

Achieving the expected benefits of the transaction;

Expenses related to the transaction;

Claims and liabilities we may assume 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;

Impairment of intangible assets and goodwill acquired in transactions; and

For foreign transactions, 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.

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 rapidly in recent years. For example, our total revenue increased from $1.33 billion for the fiscal year ended February 28, 2013 to $1.53 billion for the fiscal year ended February 28, 2014. Moreover, the total number of our employees increased from over 5,600 as of February 28, 2013 to approximately 6,300 as of February 28, 2014. 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.

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Industry consolidation may lead to increased competition and may adversely affect our business, financial condition, operating results and cash flows.

There has been a trend of consolidation in the technology industry. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry. For example, as the computing, networking, storage, and software technologies that comprise the enterprise data center converge, many companies seek to position themselves as key or single-source vendors providing end-to-end technology solutions for the data center. Also, some of our current and potential competitors have made acquisitions or announced new strategic alliances designed to position them as a key or single-source vendor. As a result of these developments, we face greater competition, including competition from entities that are among our key business partners. This increased competition could adversely affect our business, financial condition, operating results and cash flows.

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, 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, any one of which could adversely affect our business, financial condition, operating results and cash flows.

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, including our CEO. 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 the technology sector performs well and/or if companies with more generous compensation packages or greater perceived growth opportunities compete for the same personnel. In addition, historically we have used share-based compensation as a key component of our compensation packages. Changes in the accounting for share-based compensation could adversely affect our earnings or make it more beneficial for us to use more cash compensation to attract and retain capable personnel. 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 shareholder 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.

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

Competition in our industry for qualified employees, especially technical employees, is intense and our competitors 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. Moreover, the loss of these individuals, 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. 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.

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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.

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, and we are required to implement more complex organizational management structures, 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.

Our subscription-based business model may encounter customer resistance or we may experience a decline in the demand for our offerings.

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 new versions of the software, security updates, fixes, functionality enhancements and upgrades to the technology, if and when available, and compatibility with an ecosystem of certified hardware and software applications. 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, we may still encounter customer resistance to this distribution model or customers may fail to honor the terms of our subscription agreements. To the extent we are unsuccessful in promoting or defending this distribution model, our business, financial condition, operating results and cash flows could be adversely affected.

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

As technologies and the markets for our enterprise offerings change, our 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 virtualization and cloud) enable customers to consume computing resources on an hourly basis or for free. We also develop and offer disruptive technologies, which may have an effect on the demand for our subscription-based offerings.

An increased focus on developing and providing virtualization, storage and cloud computing offerings may require a greater focus on marketing more holistic solutions, rather than individual offerings. Consequently, we may need to develop appropriate marketing and pricing strategies for our offerings, our customers   purchasing decisions may become more complex and require additional levels of approval and the duration of sales cycles for our offerings may increase.

If we are unable to adapt our business model to changes in the marketplace or 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, or if they renew on less favorable terms, 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 opt for a lower-priced edition of our offerings or for fewer subscriptions. We have limited historical data with respect to rates of customer subscription renewals, so we cannot accurately predict customer renewal rates. Our customers renewal rates may decline or fluctuate as a result of a number of factors, including their level of satisfaction with our services and their ability to continue their operations and spending levels. 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. If we experience a decline in the renewal rates 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.

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 software or hardware 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.

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Our offerings may contain defects that may be costly to correct, delay market acceptance of our enterprise technologies and expose us to claims and litigation.

Despite our testing procedures, errors have been and may continue to be found in our offerings after deployment. This risk is increased by the fact that much of the code in our offerings is developed by independent parties over whom we exercise no supervision or control. If errors are discovered, we may have to make significant expenditures of capital and devote significant technical resources to analyze, correct, eliminate or work around them, and we may not be able to successfully do so in a timely manner or at all. Errors and failures in our offerings could result in a loss of, or delay in, market acceptance of our enterprise technologies, loss of existing or potential customers and delayed or lost revenue and could damage our reputation and our ability to convince enterprise users of the benefits of our technologies.

In addition, errors in our technologies could cause system failures, loss of data or other adverse effects for our customers who may assert warranty and other claims for substantial damages against us. Although our agreements with our customers often contain provisions which 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 conditions, operating results and cash flows.

Our virtualization, storage and cloud computing offerings are based on emerging technologies and business models, and the potential market for these offerings remains uncertain.

Our virtualization, storage and cloud computing offerings are based on emerging technologies and business models, the success of which will depend on the perceived technological and operational benefits and cost savings associated with the adoption of these technologies. Virtualization, storage and cloud computing 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 are successful or otherwise develop into industry standards.

Adoption of virtualization, storage and cloud computing offerings 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 virtualization, storage and cloud computing 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 virtualization, storage and cloud computing offerings may unfavorably impact demand for our other offerings, including software subscriptions and related professional services. If the market for our virtualization, storage and cloud computing offerings fails to develop adequately, it could have an adverse effect on our business, financial condition, operating results and cash flows.

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 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.

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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 growth will likely 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, our revenue growth rates may slow or our revenue may decline, which could adversely affect our stock price.

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 (or third parties with whom we contract) receive, store and process our data, as well as our customers and partners data. While we take security and testing measures relating to our offerings and operations, those measures may not prevent security breaches and data loss that could harm our business or the businesses of our customers and partners. Advances in computer capabilities, new discoveries in the field of cryptography, inadequate technology or facility security measures or other factors may result in data loss 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 third parties with whom we contract). These security measures may be breached or data lost as a result of actions by third parties or employee error or malfeasance. 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 or disclosure of some or all of this information, cause interruptions 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. These risks may increase as we continue to grow our cloud and services offerings and as we receive, store and process more of our customers data. Actual or perceived vulnerabilities may lead to regulatory investigations, claims against us by customers, partners or other third parties, or costs, such as those related to providing customer 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 implementing further data protection measures could be significant. 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 third parties with whom we contract) could result in a loss of confidence in the security of our offerings, damage our reputation, lead to legal liability and adversely affect our business, financial condition, operating results and cash flows.

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, 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 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, legal liability, all of which may adversely affect our business, financial condition, operating results and cash flows interruptions.

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A decline in or reprioritization of funding in the U.S. government budget 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. government agencies. Government deficit reduction and austerity measures, along with continued economic challenges, continue to place pressure on U.S. government spending. 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. If we acquire or adopt new technology and incorporate it into our offerings but competing technology becomes more widely used or accepted, the market appeal of our offerings may be reduced and that could 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 made 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 any 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 it is non-infringing; or (iii) replace the infringing component with a non-infringing component, and indemnify 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 the 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 indemnify 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 like 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, 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 unfavorable 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. As a result, we may also be required to develop alternative non-infringing technology or practices or discontinue the practices. The development of alternative non-infringing technology or practices could require significant effort and expense or may not be feasible.

An unfavorable legal decision regarding the intellectual property in and to our technology and other offerings could adversely affect our business, financial condition, operating results and cash flows. See Part II, Item 1, Legal Proceedings for additional information.

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

In many foreign countries, particularly in certain developing economies, it is not uncommon to engage in 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, 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.

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

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to be unenforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Any ruling by a court that these licenses are not enforceable, or that open source components of our offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our offerings. 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 no longer be compatible with other open source licenses in our offerings or our end user license agreement, and thus could, among other consequences, prevent us from continuing to distribute 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. 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.

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. 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, and 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, not to enforce our patent rights against users of open source software covered by certain open source licenses, including the GNU General Public License version 2.0 and version 3.0, GNU Lesser General Public License version 2.1 and version 3.0, IBM Public License version 1.0, Common Public License version 1.0, Q Public License version 1.0, Open Software License version 3.0 and any other open source license granted by Red Hat. While we may be able to claim protection of our intellectual property under other rights, such as trade secrets or contractual rights, our Patent Promise effectively limits our ability to assert our patent rights against these third parties (even if we were to conclude that their use infringes our patents with competing offerings), unless any such third party asserts its patent rights against us. This limitation on our ability to assert our patent rights against others could harm our business and ability to compete.

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

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

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Our business is subject to a variety of U.S. and international laws regarding data privacy and protection.

Our business is subject to federal, state and international laws regarding privacy and protection of user data. We post, on our website, our privacy policies and practices concerning the use and disclosure of user data. As Internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies becomes more likely. The introduction of new offerings by us may cause new and different regulations to apply to our business. New or increased laws and regulations applying to the solicitation, collection, processing, protection, use or other treatment of information could affect our ability to use and share data, or the adoption of our cloud offerings by customers.

It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data policies and practices. If so, in addition to the possibility of fines and penalties, a governmental order could require that we change our data policies and practices. Compliance with these regulations may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or orders that we cease conducting the noncompliant activity.

Any failure or perceived failure by us to comply with our posted privacy policies or other federal, state or international privacy-related or data protection laws, government regulations or directives, or industry self-regulatory principles, or a requirement to change our data practices 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 procurements regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with the specific provisions in our customer contracts or any violation of government contracting regulations 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. There is increased pressure for governments and their agencies, both domestically and internationally, to reduce spending. If our customer contracts are terminated, if we are suspended from government work, 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 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 for breaches of contract, defamation, fraud, libel, negligence, patent, copyright or trademark infringement, tort, unfair competition, unlawful activity, or other theories 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.

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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. 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 44.7% of our total revenue for the fiscal year ended February 28, 2014, continue to expand.

Our international operations accounted for approximately 44.7% of total revenue for the fiscal year ended February 28, 2014. 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 overseas that may adversely affect our operating results include:

- Fluctuations in exchange rates;
- Pricing environments;
- Longer payment cycles and less financial stability of customers;
- Economic, political, compliance and regulatory risks associated with specific countries;
- Laws and policies of the U.S. and other jurisdictions affecting trade, foreign investment, loans, and taxes;
- Difficulty selecting and monitoring channel partners outside of the U.S.;
- Lower levels of availability or use of the Internet, through which our software is often delivered;
- Difficulty protecting our intellectual property rights overseas 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, 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 the our brands;

Export and import laws and regulations could prevent us from delivering our offerings into and from certain countries;

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

Limitations on the repatriation and investment of funds and foreign currency exchange restrictions;

Changes in import/export duties, quotas or other trade barriers that could affect the competitive pricing of our offerings and reduce our market share in some countries; and

Economic or political instability or terrorist acts in some international markets that could adversely affect our business in those markets or result in the loss or forfeiture of some foreign assets and the loss of sums spent developing and marketing those assets and the revenue associated with them.

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

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

During our fiscal year ended February 28, 2014, a substantial portion of our subscription revenue was derived from our Red Hat Enterprise Linux technologies. 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;

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. 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 may be subject to greater tax liabilities.

We are subject to income and other taxes in the U.S. and in numerous foreign jurisdictions. Our domestic and foreign tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions. Additionally, the amount of taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we operate. Significant judgment is required in determining our worldwide provision for income taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. We are regularly subject to audits by tax authorities. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. Economic and political pressures to increase tax revenue in various jurisdictions may make resolving tax disputes more difficult. The results of an audit or litigation could adversely affect our financial statements in the period or periods for which that determination is made.

We earn a significant amount of our operating income from outside the U.S., and any repatriation of funds currently held in foreign jurisdictions may result in higher effective tax rates for the company. In addition, there have been proposals to change U.S. tax laws that would significantly impact how U.S. multinational corporations are taxed on foreign earnings. Although we cannot predict whether or in what form this proposed legislation may pass, if enacted it could adversely affect our tax expense and cash flows.

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

We generally recognize subscription revenue from customers ratably over the term of their subscription agreements, which are generally 12 to 36 months. As a result, much of the revenue we report in each quarter is deferred revenue from subscription agreements entered into during previous quarters. Consequently, a decline in subscriptions in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will

negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect this reduced revenue. Accordingly, the effect of significant downturns in sales and market acceptance of our service, and potential changes in our rate of renewals, may not be fully reflected in our operating results until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term.

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

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

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

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

If we fail to maintain an effective system of disclosure controls or internal control over financial reporting, including satisfaction of the requirements of the Sarbanes-Oxley Act, we may not be able to accurately or timely report on our financial results or adequately identify and reduce fraud. As a result, the financial condition of our business could be adversely affected; current and potential future shareholders 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 Securities and Exchange Commission and various bodies formed to interpret and create 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 and may retroactively affect previously reported results.

Our investment portfolio is subject to credit and illiquidity 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 as of February 28, 2014 consisted primarily of money market funds, U.S. government and agency securities, German sovereign and agency securities, certificates of deposit, and corporate securities. Although we follow an established investment policy and seek to minimize the risks associated with our investments by investing primarily in investment grade, highly liquid securities and by limiting the amounts invested with any one institution, type of security or issuer, we cannot give assurances that the assets in our investment portfolio will not lose value or become impaired, or that our interest income will not decline.

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

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

Our investments in 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.

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

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 or natural disasters 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 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 overseas, the disruption of utility services to our facilities or to suppliers, partners or customers, or disruption in our communications with our customers.

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RISKS RELATED TO THE NOTES

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

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

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

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

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

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

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

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

In the event the conditional conversion feature of the notes is triggered, holders of notes will be entitled to convert the notes at any time during specified periods at their option. If one or more holders elect to convert their notes, unless we elect to satisfy our conversion obligation by delivering solely shares of our common stock (other than paying cash in lieu of delivering any fractional share), we would be required to settle a portion or all of our conversion obligation through the payment of cash, which could adversely affect our liquidity. In addition, even if holders do not elect to convert their notes, we could be required under applicable accounting rules to reclassify all or a portion of the outstanding principal of the notes as a current rather than long-term liability, which would result in a material reduction of our net working capital.

The accounting method for convertible debt securities that may be settled in cash, such as the 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 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 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 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 notes to their principal amount over the term of the notes. We will report lower net income (or greater net losses) in our consolidated financial results because ASC 470-20 will require interest to include both the current period s amortization of the original issue discount and the instrument s non-convertible interest rate. This could adversely affect our reported or future consolidated financial results, the trading price of our common stock and the trading price of the notes.

In addition, under certain circumstances, in calculating earnings per share, convertible debt instruments (such as the 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 notes, if any, are not included in the calculation of diluted earnings per share except to the extent that the conversion value of the 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 notes, if any, then our diluted consolidated earnings per share would be adversely affected.

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

In connection with the sale of the 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 generally to reduce the potential dilution to our common stock upon any conversion of notes and/or offset any cash payments we are required to make in excess of the principal amount upon conversion of any 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 notes (and are likely to do so during any observation period related to a conversion of notes or following any repurchase of notes by us in connection with any fundamental change repurchase date or otherwise). This activity could cause or avoid an increase or a decrease in the market price of our common stock.

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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 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.

RISKS RELATED TO OWNERSHIP OF OUR COMMON STOCK

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

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

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

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

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

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

We do not intend to pay dividends on our common stock so any returns will be limited to changes in the value of our common stock.

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

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

The conversion of the 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 notes could adversely affect prevailing market prices of our common stock. In addition, the existence of the notes may encourage short selling by market participants due to this dilution or may facilitate trading strategies involving the notes and our common stock.

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Provisions of our certificate of incorporation, by-laws and Delaware law 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 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.

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

Recent Sales of Unregistered Securities

Information relating to the issuance of the Notes and the warrant transactions entered into by the Company was provided in the Current Report on Form 8-K filed on October 7, 2014. Pursuant to the warrant transactions, the Company sold warrants to acquire, subject to anti-dilution adjustments, 10,965,630 shares of the Company s common stock and received aggregate proceeds of $79.8 million.

Issuer Purchases of Equity Securities

The table below sets forth information regarding the Company s purchases of its common stock during its third fiscal quarter ended November 30, 2014:

Period	Total Number of Shares Purchased (1)	Weighted Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)(3)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs (2)
September 1, 2014 September 30, 2014		$		$ 80.0 million
October 1, 2014 October 31, 2014	5,704,954	$ 56.40	5,312,555	$ 80.0 million
November 1, 2014 November 30, 2014		$		$ 80.0 million
Total	5,704,954		5,312,555	

(1) During the three months ended November 30, 2014, the Company withheld an aggregate of 392,399 shares of its common stock (with a weighted average share price of $55.44) from employees to satisfy minimum tax withholding obligations relating to the vesting of restricted share awards. These shares were not withheld pursuant to the program described in Note (2) below.

(2) On April 15, 2013, the Company announced that its Board of Directors had authorized the repurchase of up to $300.0 million of Red Hat s common stock from time to time on the open market or in privately negotiated transactions. The program commenced on April 16, 2013, and will expire on the earlier of (i) March 31, 2015, or (ii) a determination by the Board, Chief Executive Officer or Chief Financial Officer to discontinue the program. No shares were repurchased under this program during the three months ended November 30, 2014.

(3) The Company used $375.0 million of the net proceeds from the issuance of the Notes during the three months ended November 30, 2014 to repurchase shares of its common stock under an accelerated share repurchase program (the ASR Agreement) with Goldman, Sachs & Co. (the ASR Counterparty). On October 7, 2014, under the ASR Agreement, the Company paid $375.0 million to the ASR Counterparty and received 5,312,555 shares of its common stock from the ASR Counterparty, which represented 80 percent of the shares the Company would have repurchased assuming an average share price of $56.47 (the Company s closing share price at October 1, 2014). The total number of shares of common stock that the Company will repurchase under the ASR Agreement will be based on the average of the daily volume-weighted average prices of the Company s common stock during the term of the ASR Agreement, less a discount. At settlement, the ASR Counterparty may be required to deliver additional shares of the Company s common stock to the Company or, under certain circumstances, the Company may be required to deliver shares of common stock or make a cash payment to the ASR Counterparty. Final settlement of the ASR Agreement is expected to be completed by February 27, 2015, although the settlement may be accelerated at the ASR Counterparty s option. For further discussion regarding the Notes and ASR Agreement, see NOTE 15 Convertible Notes and NOTE 10 Share Repurchase Programs to the Consolidated Financial Statements.

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ITEM 6. EXHIBITS

(a) List of Exhibits

Exhibit No.	Exhibit
4.1+	Indenture (including form of Note) with respect to Red Hat s 0.25% Convertible Senior Notes due 2019, dated as of October 7, 2014, between Red Hat and U.S. Bank National Association, as trustee (incorporated by reference to Exhibit 4.1 to the registrant s Current Report on Form 8-K filed with the SEC on October 7, 2014 (File No. 001-33162))
10.1+	Form of Call Option Confirmation between Red Hat and each Option Counterparty (incorporated by reference to Exhibit 10.1 to the registrant s Current Report on Form 8-K filed with the SEC on October 7, 2014 (File No. 001-33162))
10.2+	Form of Warrant Confirmation between Red Hat and each Option Counterparty (incorporated by reference to Exhibit 10.2 to the registrant s Current Report on Form 8-K filed with the SEC on October 7, 2014 (File No. 001-33162))
10.3+	Master Confirmation between Goldman, Sachs & Co. and Red Hat, dated October 2, 2014 (incorporated by reference to Exhibit 10.3 to the registrant s Current Report on Form 8-K filed with the SEC on October 7, 2014 (File No. 001-33162))
10.4+	Supplemental Confirmation between Goldman, Sachs & Co. and Red Hat, dated October 2, 2014 (incorporated by reference to Exhibit 10.4 to the registrant s Current Report on Form 8-K filed with the SEC on October 7, 2014 (File No. 001-33162))
31.1	Certification of the registrant s Chief Executive Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the registrant s Chief Financial Officer pursuant to Rule 13a-14(a)/Rule 15d-14(a) under the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the registrant s principal executive officer and principal financial officer pursuant to 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase

\+ Previously filed.

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SIGNATURES

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

	RED HAT, INC.	
Date: January 8, 2015	By:	/s/ JAMES M. WHITEHURST **James M. Whitehurst** **President and Chief Executive Officer** **(Duly Authorized Officer on Behalf of the Registrant)**
	RED HAT, INC.	
Date: January 8, 2015	By:	/s/ CHARLES E. PETERS, JR. **Charles E. Peters, Jr.** **Executive Vice President and** **Chief Financial Officer** **(Principal Financial Officer)**
	RED HAT, INC.	
Date: January 8, 2015	By:	/s/ MARK E. COOK **Mark E. Cook** **Vice President Finance and Controller** **(Principal Accounting Officer)**