



Rating
Buy

North America
United States

TMT
Software

Company
Red Hat

Reuters
RHT.N

Bloomberg
RHT US

Exchange
NYS

Ticker
RHT

Date
20 September 2018

Results

Price at 19 Sep 2018 (USD)	143.16
Price target	170.00
52-week range	176.27 - 105.76

Growth Slows But Could be Bottoming

Revs Growth Falls Short

Following a surprisingly soft 1QF19 print, Red Hat posted a slightly weaker-than-expected print, highlighted by c/c total revs growth of 14%, down from 17% in the prior quarter and modestly below our estimate. While the “emerging” product segment accelerated to 31% growth and c/c billings growth of 16% recovered, core RHEL subscription revs growth slowed to just 8%, from 11%-15% in prior quarters, due to the softer ELA renewal base and to a lesser extent a customer loss. On a positive note, Red Hat reaffirmed all key FY19 targets and argued that 2QF19 marked a bottom, that revs growth should accelerate starting in the current 3QF19 quarter and that the renewal base should pick up in 1QF20, an outlook that should limit the downside in the stock. While disappointed by the last two quarters, we reaffirm our BUY rating.

What We Think

We’d flag: 1. The guide is for accelerating total revs growth to 15%-16% in the November/3QF19 quarter and about 20% in the February/4QF19 quarter. Absent a recovery in the renewal base, Red Hat is pinning this 2H pickup on pending RHEL deals, as well as large (OpenShift-related) services projects expected to close in 4QF19. If revs growth accelerates in 2HF19 and then the ELA renewal base accelerates in 1HF20, we conclude that the worst is likely behind us. 2. Red Hat flagged one customer loss to a “legacy on-premise” server OS rival (not Suse or Microsoft, perhaps Oracle Linux?). While a negative, we don’t want to make too much of one loss and in our checks we don’t see evidence of share losses in Red Hat’s core Linux business or any slowdown in the overall on-premise spending strength. 3. Red Hat cited strong demand for OpenShift and Ansible, so much so that its reps may have over-indexed on OpenShift and will be encouraged to refocus on core RHEL. There was no evidence from the print or our callback that rival Pivotal’s recent billings miss was a negative read through to Red Hat’s high-growth OpenShift business.

Reaffirm BUY Rating

Despite two weak prints, we maintain our BUY rating because we see no evidence in our checks of RHEL/Linux share losses or any loss of momentum in OpenShift/container demand. As a result, we accept Red Hat’s explanation that the 1H revs growth slowdown is a deal/ELA timing issue that will pass and if indeed we’re sitting in front of a 2H growth acceleration (Red Hat doesn’t have a track record of setting unrealistic guidance), then now may not be the time to get overly negative. At 21x CY19e FCF (assuming the stock trades down 5% off this print as indicated by after-hours trading) for what looks like a 15%-20% growth story with modest

Valuation & Risks

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Key changes

EPS (USD)	2.97 to 2.99	↑	0.7%
Source: Deutsche Bank			

Price/price relative

Performance (%)	1m	3m	12m
Absolute	2.1	-16.1	33.6
S&P 500 INDEX	2.0	5.3	16.0
Source: Deutsche Bank			

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margin expansion, we conclude that this multiple is reasonable. Our unchanged PT of \$170 is based on an assumed FY20e FCF of 25x, which we deem fair given the growth profile. Downside risks include a slowdown in RHEL growth, given the mix shift to cloud.

Appendix 1

Important Disclosures

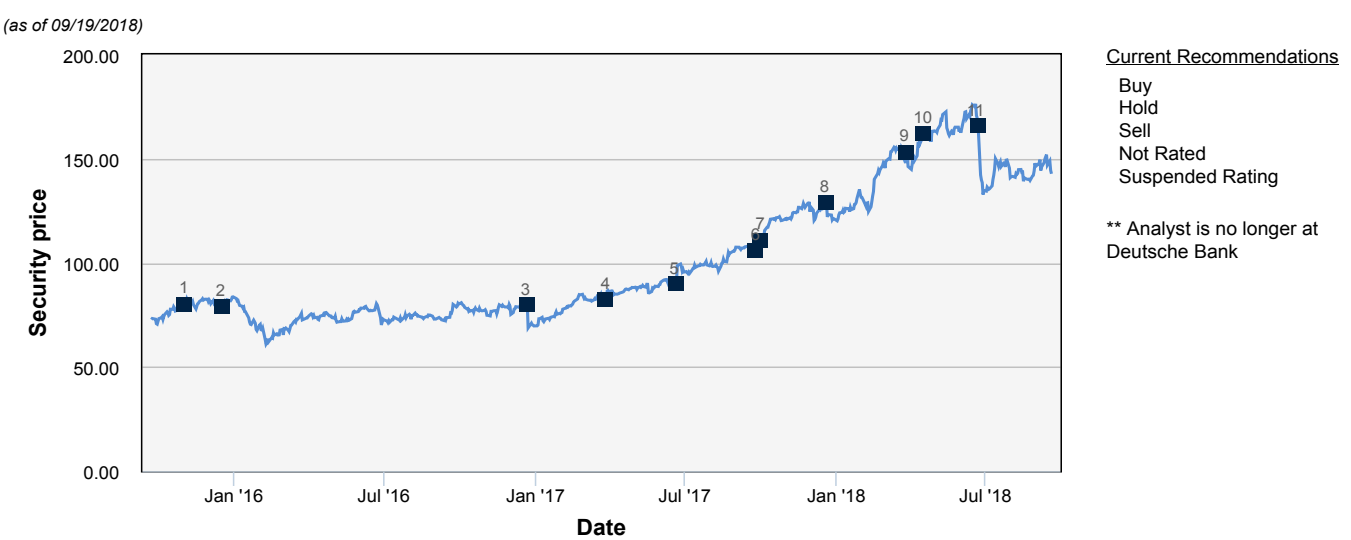
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Disclosure checklist			
Company	Ticker	Recent price*	Disclosure
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1.	11/03/2015	Buy, Target Price Change USD 90.00 Karl Keirstead	7.	10/02/2017	Buy, Target Price Change USD 130.00 Karl Keirstead
2.	12/18/2015	Buy, Target Price Change USD 95.00 Karl Keirstead	8.	12/20/2017	Buy, Target Price Change USD 150.00 Karl Keirstead
3.	12/22/2016	Buy, Target Price Change USD 90.00 Karl Keirstead	9.	03/27/2018	Buy, Target Price Change USD 170.00 Karl Keirstead
4.	03/28/2017	Buy, Target Price Change USD 100.00 Karl Keirstead	10.	04/17/2018	Buy, Target Price Change USD 185.00 Karl Keirstead
5.	06/21/2017	Buy, Target Price Change USD 110.00 Karl Keirstead	11.	06/22/2018	Buy, Target Price Change USD 170.00 Karl Keirstead
6.	09/26/2017	Buy, Target Price Change USD 120.00 Karl Keirstead			

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Equity Rating Key

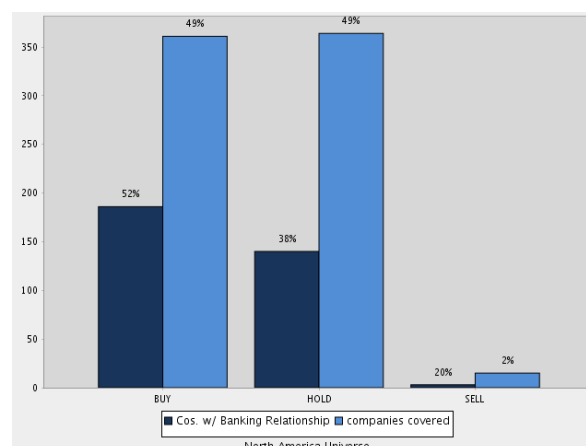
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Sell: Based on a current 12-month view of total share-holder return, we recommend that investors sell the stock.

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Equity rating dispersion and banking relationships



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