FINANCIAL MEMORANDUM

To: CEO, CFO & VP, VMWare

From: Kartik Lande

Date: 10/21/2022

Subject: Potential Areas of Expansion and Investment Recommendations

Introduction

VMware is a leading provider of multi-cloud services for all apps, enabling digital innovation with enterprise control. As a trusted foundation to accelerate innovation, VMware software gives businesses the flexibility and choice they need to build the future. VMware has a current market cap of $46.54 billion as listed on NYSE.

This report evaluates the finances of VMware primarily for the last two years, 2021 and 2022, from a strategic and accounting perspective and aims to provide recommendations for strengthening its financial stance through expansion policies and investment tradeoffs. It also takes into account the ongoing acquisition of VMware by Broadcom and its predicted impact on VMware's financials.

External Financial and Strategic Analysis

During fiscal 2022, I continued to see an increase in sales through our subscription and SaaS offerings compared to the portion of our on-premises solutions sold as perpetual licenses. However, revenue share growth is seen in the subscription and SaaS with a reduction in services and licenses. I expect this trend to continue. As a result, a more significant portion of our revenue will be recognized over time as subscription and SaaS revenue rather than license revenue, typically recognized in the fiscal period in which sales occur. The combination of subscription, SaaS, and license revenue was $1.74 billion for the second quarter, an increase of 15% from the second quarter of fiscal 2022.

Segment Performance - Actual

Segment		Historical Estimates	
		FY2021	FY2022
License			
	Revenue	3033	3128
	YoY Growth %	25.77%	3.13%
Services			
	Revenue	6147	6518
	YoY Growth %	6.84%	6.04%
Subscription and SAAS			
	Revenue	2587	3025
	YoY Growth %	21.98%	23.88%
Total		11767	12671

Segment Performance – 3yrs forecast

Segment		Forecast Estimates		
		FY2023	FY2024	FY2025
License				
	Revenue	2954	2829	2602
	YoY Growth %	-5.57%	-4.23%	-8.01%
Services				
	Revenue	6659	6829	6815
	YoY Growth %	2.17%	4.77%	-0.21%
Subscription and SAAS				
	Revenue	3992	5022	6511
	YoY Growth %	31.97%	25.81%	29.64%
Total		13605	14680	15928

Fig. 1.

Total revenue in the fiscal year 2022 increased by 9% to $12.9 billion. We can see a growth of **24%** in the revenue generated by SaaS, **3%** in the revenue generated by licenses, and **6%** in the revenue generated by services as per financial statements reported in the FY2022 10-K. The rate of growth in our license revenue and services, which has historically been viewed as a leading indicator of our business performance, may be less relevant on a standalone basis. I believe that the overall growth rate of our combined license and subscription and SaaS revenue will become better indicators of our future growth prospects.

The non-GAAP financial measure of free cash flow is meaningful to our investors as expenditures are considered to be a necessary component of ongoing operations. **$284 million of free cash flow** was reported at the end of the second quarter financial year 2023.

	Cash Flow from FY 2021 - FY 2022 (in millions)
Change in cash provided by operating activities	($53)
Change in cash used by investing activities	($383)
Change in cash used by financing activities	$3200

Analyst Reports

Sadif report September 19, 2022

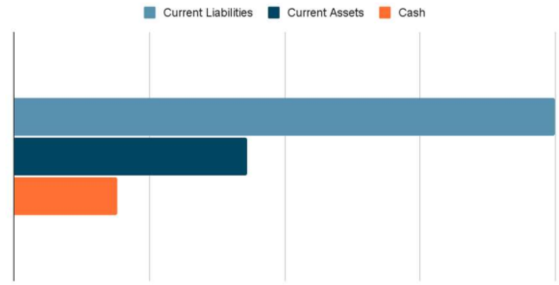
Analyst summary statement: The company's high-quality financials are the result of strong cash generation efficiency, attractive performance but a risky financial position.

Our opinion :

VMware's financial statements back up this analytical statement by Sadif mainly in terms of:

- **Revenue growth:** For Q1FY23, Total Revenue increased by 3.13% to $3,088mn as compared to $2,994mn in Q1FY22, led by strong growth in SaaS and Subscription offering. This is also evident in the revenue growth from 8.8% in FY21 to 9.2% in FY22.
- **Operating margin and ROA:** The operating margin has stayed almost stable around 20% while the return on assets reports a turnover ratio of 11% for the last two fiscal years.

- **Cash ratio and current ratio:** The cash ratio for VMware for FY2022 is 0.19 whereas the current ratio is 0.43. This means that it has 5 times as many current liabilities as the current cash and cash equivalent deposits, and 2 times as many current liabilities as current assets.



These measures suggest positive financial growth in terms of financial performance and cash generation. However, the liquidity and solvency ratios put the company at a risky financial position as well.

Zacks report October 14, 2022

Analyst statements:

- **Intensifying competition, sluggish license bookings** and **leveraged balance sheet** are major headwinds for the company and hence have given a neutral recommendation for VMWare.
- VMware holds a prime position in the virtualization market and has placed itself well to **benefit from the increasing adoption of cloud-based solutions.**

Our opinion:

- The **10-K form** released by VMware for FY2022 backs up the competition claims saying - “A significant percentage of new application development is happening in the public cloud, with providers such as AWS, Microsoft Azure (“Azure”) or Google Cloud” and “Our products and services will need to increasingly compete for customers’ IT workloads with Datadog in monitoring and IT telemetry and ServiceNow in the automation space”.

  However, the company is dealing with intensifying **competition** by **partnering** with AWS, IBM, Microsoft, Google, Oracle and Accenture. VMware Cloud Services enables its customers to run, manage, connect and better secure their applications across hybrid and multiple public clouds including Amazon Web Services (AWS), Microsoft Azure, Google Cloud and IBM Cloud.

- The sluggish license bookings are because VMware has already been striving to **transition** itself and its customers away from its traditional enterprise software licensing agreements and into SaaS and subscription and clearly VMware has been successful at doing it because there has been a **24% rise** in the revenue generated by Subscription and SaaS in fiscal year 2022.

- The strategy used by VMware for development of products and services in virtualization as well as multi cloud platforms are strongly and positively supported by predicted numbers estimated by analyst reports. The predicted forecast earnings as referenced in Fig. 1 show a predicted **63% growth in revenue** from FY2023 to FY2035 in **SaaS and subscription**.

VMWare’s Expansion Areas and Prospective Threats

- I noted the strong preference for licenses in some countries which are **reluctant to switch** to SaaS. We can target these geographic regions specifically by **discounting** SaaS products, **free trials** and **extending customer support** in these regions.

- A major strategy employed by VMware is **partnering with competitive companies** in the same market to provide joint solutions, especially in a multi cloud environment for providing customers with a custom hybrid cloud platform of their choice. Broadcom's major competitors include giants like IBM, Cisco and Microsoft, which are currently active partners of VMware. After VMware’s acquisition by Broadcom, there can be **prohibitions on the extent of partnership** with such competition or even the existence of one, which can severely affect the revenue generation of VMware.

- **Broadcom** contends that after acquiring VMWare, it can increase VMware’s annual profits from **$4.7 billion to $8.5 billion** within three years by “eliminating duplicative general and administration functions across human resources, finance, legal, facilities and information technology.”

  Eliminating duplicative back-office functions will not add up to the nearly $4 billion in additional profits Broadcom seeks. The worry is that Broadcom will take the **scalpel to other areas, such as customer support and R&D.**

Investment Recommendations

- Borrowing from the above point raises another concern that there might be a negative impact on the **attrition rate** of VMWare. This might seem a favorable outcome given that the cash provided by operating activities decreased by $53 million during fiscal 2022 compared to fiscal 2021, primarily due to increased cash payments for employee-related expenses. However, institutional knowledge if lost can drain a company of its ability to operate efficiently. That’s why, I would strongly recommend **investing in retaining** upper management employees with a vision for the company by giving out stock options and increasing compensation.

- There is Broadcom’s track record of hiking prices, trimming operating budgets, and cutting support after acquisitions (Symantec and CA), a track record which, according to a survey by 451 Research, already worries VMware’s existing customers. VMware should **invest more** time and money in forming healthier **relationships** with their customers and assuring them of steady operations in spite of the takeover by Broadcom.

Investment Trade Offs

- During fiscal 2022, I continued to see an increase in the portion of our sales occurring through our subscription and SaaS offerings compared to the portion of our on-premises solutions sold as perpetual licenses. I expect this trend to continue and as a result, **lowering on the operational expenses** related to perpetual licenses would be a good strategy to follow. (Under performance of licenses)

- VMware gave out **USD 11,499 billion as dividends** in fiscal 2022. While paying dividends sends a clear, powerful message about a company's prospects and performance, with competitors like AWS, Azure and GCP in the cloud space, we should instead **reinvest the capital** in Sales, marketing and in Research & Development to expand in the cloud space. This reinvestment of retained earnings will reflect in a rising share price and capital gains for investors. (Risk of competitors)

- VMware, as a multi cloud platform needs the highest level of cyber security to offer to its customers, a task currently handled by **Carbon Black** which was acquired by VMware in 2019. After Broadcom's acquisition of VMware, **Symantec** by Broadcom and Carbon Black will be brought under the same roof to provide combined security protocols.

  The main **competitor** for both VMware and Broadcom in this domain is **Cortex XDR**, which is rated much higher than Carbon Black and on par with Symantec by multiple analyst reports. I recommend **investing in a partnership with Cortex** for its cyber security services instead of continuing investment in Carbon Black, an investment trade off, that will yield better services and generate more customer base. Partnering with Cortex XDR will **eliminate the competition** for Symantec, **extending its customer base** and provide a more **secure solution** than VMware's Carbon Black. This will help VMware **cut down on its operating expenses**, helping counter under-performance and increase revenue, benefiting both VMware and Broadcom.

- By acquiring VMware, Broadcom will increase revenue earned from software sales to approximately 49% of all revenue. Furthermore, Broadcom expects to add about $8.5 billion to its EBITDA within three years of closing the transaction, **about a 50% increase** from where it is today.

  Taking these estimates into account, I recommend cutting down on operating expenses by **optimizing mid management duplicative personnel** and reassigning said resources for the formation of an executive committee. This committee, including both Broadcom and VMware management executives, will focus solely on policies and operations expanding the SaaS and subscription sales of Broadcom through VMware.

- According to the cash flow statements in 10-K form for FY2022, the accounts receivable increased from USD 37 million in 2021 to USD 379 million, **a 10x increase.** Yet we can see the **receivables turnover ratio** is maintained around 6 for both years, meaning cash is collected for credit sales every 60 days. Owing to the drastic increase in AR receivables, I recommend **shortening the term of credit sales** to 30-45 days, especially for customers having huge credit debts. This can be done by incentivizing early payments and charging late fees for payments after the due date.