

VMWARE, INC.

Form 10-Q

August 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2016

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 001-33622

---

VMWARE, INC.

(Exact name of registrant as specified in its charter)

---

Delaware	94-3292913
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

3401 Hillview Avenue	94304
Palo Alto, CA	
(Address of principal executive offices) (Zip Code)	
(650) 427-5000	
(Registrant's telephone number, including area code)	

---

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

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

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) 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

As of July 31, 2016, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 424,408,248 of which 124,408,248 shares were Class A common stock and 300,000,000 were Class B common stock.

TABLE OF CONTENTS

	Page
<u>PART I – FINANCIAL INFORMATION</u>	
Item 1. <u>Financial Statements (unaudited)</u>	<u>3</u>
<u>Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2016 and 2015</u>	<u>3</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Three and Six Months Ended June 30, 2016 and 2015</u>	<u>4</u>
<u>Condensed Consolidated Balance Sheets at June 30, 2016 and December 31, 2015</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2016 and 2015</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>23</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>34</u>
Item 4. <u>Controls and Procedures</u>	<u>34</u>
<u>PART II – OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	<u>35</u>
Item 1A. <u>Risk Factors</u>	<u>35</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>52</u>
Item 6. <u>Exhibits</u>	<u>52</u>
<u>SIGNATURE</u>	<u>53</u>
<u>EXHIBIT INDEX</u>	<u>54</u>

VMware, vSphere, NSX, vCloud, vCloud Air, Workspace ONE, AirWatch, Horizon, VMware Virtual SAN, vSAN, vRealize and Horizon Suite are registered trademarks or trademarks of VMware or its subsidiaries in the United States and other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

Table of Contents

## PART I

## FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Revenues:				
License	\$644	\$ 638	\$1,216	\$1,214
Services	1,049	959	2,066	1,894
GSA settlement	—	(76 )	—	(76 )
Total revenues	1,693	1,521	3,282	3,032
Operating expenses <sup>(1)</sup> :				
Cost of license revenues	40	46	81	96
Cost of services revenues	221	204	432	397
Research and development	363	322	720	627
Sales and marketing	580	565	1,144	1,100
General and administrative	167	180	338	367
Realignment charges	(1 )	(2 )	52	21
Operating income	323	206	515	424
Investment income	19	13	35	25
Interest expense with EMC	(7 )	(7 )	(13 )	(13 )
Other income (expense), net	2	1	—	—
Income before income taxes	337	213	537	436
Income tax provision	72	41	111	68
Net income	\$265	\$ 172	\$426	\$368
Net income per weighted-average share, basic for Class A and Class B	\$0.62	\$ 0.41	\$1.00	\$0.86
Net income per weighted-average share, diluted for Class A and Class B	\$0.62	\$ 0.40	\$1.00	\$0.86
Weighted-average shares, basic for Class A and Class B	425,107	424,169	424,169	426,055
Weighted-average shares, diluted for Class A and Class B	427,102	426,797	425,729	428,772

<sup>(1)</sup> Includes stock-based compensation as follows:

Cost of license revenues	\$—	\$—	\$1	\$1
Cost of services revenues	13	10	25	22
Research and development	74	53	144	107
Sales and marketing	47	43	95	81
General and administrative	18	17	36	31

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

Table of Contents

VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
	2016	2015	2016	2015
Net income	\$265	\$172	\$426	\$368
Other comprehensive income (loss):				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of \$6, \$(4), \$15 and \$0	10	(5 )	24	1
Reclassification of (gains) losses realized during the period, net of taxes of \$0, \$0, \$2 and \$0	—	—	3	—
Net change in market value of available-for-sale securities	10	(5 )	27	1
Changes in market value of effective foreign currency forward contracts:				
Unrealized gains (losses), net of taxes of \$0 for all periods	(3 )	5	—	(3 )
Reclassification of (gains) losses realized during the period, net of taxes of \$0 for all periods	1	(2 )	1	—
Net change in market value of effective foreign currency forward contracts	(2 )	3	1	(3 )
Total other comprehensive income (loss)	8	(2 )	28	(2 )
Total comprehensive income (loss), net of taxes	\$273	\$170	\$454	\$366

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

Table of Contents

VMware, Inc.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	June 30, 2016	December 31, 2015
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$2,991	\$2,493
Short-term investments	5,674	5,016
Accounts receivable, net of allowance for doubtful accounts of \$2 and \$2	1,215	1,633
Due from related parties, net	96	74
Other current assets	167	144
Total current assets	10,143	9,360
Property and equipment, net	1,073	1,128
Other assets	218	193
Deferred tax assets	442	456
Intangible assets, net	577	616
Goodwill	4,031	3,993
Total assets	\$16,484	\$15,746
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$115	\$138
Accrued expenses and other	735	746
Unearned revenues	3,276	3,245
Total current liabilities	4,126	4,129
Notes payable to EMC	1,500	1,500
Unearned revenues	1,846	1,831
Other liabilities	376	363
Total liabilities	7,848	7,823
Contingencies (refer to Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 125,792 and 121,947 shares	1	1
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	2,991	2,728
Accumulated other comprehensive income (loss)	20	(8)
Retained earnings	5,621	5,195
Total VMware, Inc.'s stockholders' equity	8,636	7,919
Non-controlling interests	—	4
Total stockholders' equity	8,636	7,923
Total liabilities and stockholders' equity	\$16,484	\$15,746

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

Table of Contents

VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Six Months Ended June 30,	
	2016	2015
Operating activities:		
Net income	\$426	\$368
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	174	159
Stock-based compensation	301	242
Excess tax benefits from stock-based compensation	(1 )	(26 )
Deferred income taxes, net	(5 )	(22 )
Impairment of strategic investments	5	—
Gain on sales of strategic investments	(1 )	(1 )
Other	5	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	417	305
Other assets	(23 )	(13 )
Due to/from related parties, net	(18 )	63
Accounts payable	(10 )	(33 )
Accrued expenses	18	27
Income taxes payable	(36 )	(49 )
Unearned revenues	45	(21 )
Net cash provided by operating activities	1,297	999
Investing activities:		
Additions to property and equipment	(79 )	(184 )
Purchases of available-for-sale securities	(2,211 )	(2,095 )
Sales of available-for-sale securities	979	1,373
Maturities of available-for-sale securities	619	524
Proceeds from disposal of assets	3	—
Purchases of strategic investments	(27 )	(4 )
Sales of strategic investments	1	2
Business acquisitions, net of cash acquired	(59 )	(21 )
Decrease (increase) in restricted cash	(2 )	1
Net cash used in investing activities	(776 )	(404 )
Financing activities:		
Proceeds from issuance of common stock	52	69
Proceeds from non-controlling interests	—	4
Payment to acquire non-controlling interests	(4 )	—
Repurchase of common stock	—	(850 )
Excess tax benefits from stock-based compensation	1	26
Shares repurchased for tax withholdings on vesting of restricted stock	(72 )	(124 )
Net cash provided by (used in) financing activities	(23 )	(875 )
Net increase (decrease) in cash and cash equivalents	498	(280 )
Cash and cash equivalents at beginning of the period	2,493	2,071
Cash and cash equivalents at end of the period	\$2,991	\$1,791

Edgar Filing: VMWARE, INC. - Form 10-Q

Supplemental disclosures of cash flow information:

Cash paid for interest	\$14	\$14
Cash paid for taxes, net	135	136
Non-cash items:		
Changes in capital additions, accrued but not paid	\$(19 )	\$(22 )

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

Table of Contents

VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is a leader in virtualization and cloud infrastructure solutions that enable businesses to transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is based on their specific needs. VMware’s virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, run on industry-standard desktop computers, servers and mobile devices and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”).

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2016. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2015 Annual Report on Form 10-K.

As of June 30, 2016, EMC Corporation (“EMC”) held 80.6% of VMware’s outstanding common stock and 97.4% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements. On October 12, 2015, Dell Inc. (“Dell”), Denali Holding Inc. (“Denali”) and EMC entered into a definitive merger agreement under which Denali has agreed to acquire EMC (the “Dell Acquisition”). On July 19, 2016, EMC shareholders approved the Dell Acquisition. The closing of the transaction remains subject to certain regulatory approvals.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with EMC may not be considered arm’s length with an unrelated third party. Therefore, the financial statements included herein may not necessarily reflect the results of operations, financial position and cash flows had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware’s historical financial information is not necessarily indicative of what the Company’s results of operations, financial position and cash flows will be in the future if and when VMware contracts at arm’s length with unrelated third parties for the services the Company receives from and provides to EMC.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders’ equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. The portion of results of operations attributable to the non-controlling interests is eliminated in other income (expense), net on the condensed consolidated statements of income and is not presented separately as the amount was not material for the periods presented. During the second quarter of 2016, VMware acquired all of the non-controlling interests previously presented as a separate component within total stockholders’ equity. Refer to Note B for further discussion. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and its subsidiaries are generally



settled in cash and are classified on the condensed consolidated statements of cash flows based upon the nature of the underlying transaction.

Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements.

Estimates are used for, but

7

---

Table of Contents

VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

not limited to, trade receivable valuation, marketing development funds and rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

**New Accounting Pronouncements**

During March 2016, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2016-09, Compensation—Stock Compensation (Topic 718), which impacts the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated standard is effective for interim and annual periods beginning after December 15, 2016 and permits early adoption in any interim or annual period. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

During February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires a lessee to recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. This ASU also requires additional disclosure regarding leasing arrangements. The updated lease standard is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures, and expects that most of its lease commitments will be subject to the updated standard and recognized as lease liabilities and right-of-use assets upon adoption of ASU 2016-02.

During May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. In 2016, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12, which provide interpretive clarifications on the new guidance in Topic 606. The updates are effective for the Company in the first quarter of 2018 and permit the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. The Company has not selected a transition method and is currently evaluating the effect that the updates will have on its consolidated financial statements and related disclosures.

**B. Business Combination, Definite-Lived Intangible Assets, Net, Goodwill and Joint Venture****Business Combination**

On June 21, 2016, VMware acquired all of the outstanding shares of Arkin Net, Inc. (“Arkin”) for approximately \$67 million of cash, net of liabilities assumed. VMware acquired Arkin, a provider of software-defined data center security and operations, as part of a strategy to accelerate customers’ adoption of VMware NSX and software-defined data centers. The pro forma financial information assuming the acquisition had occurred as of the beginning of the calendar year prior to the year of acquisition, as well as the revenues and earnings generated during the current year, were not material for disclosure purposes.

The following table summarizes the preliminary allocation of the consideration to the fair value of the assets acquired and liabilities assumed (table in millions):

Cash	\$7
Intangible assets	26
Goodwill	38
Deferred tax assets	5
Other acquired assets	1
Total assets acquired	77
Deferred tax liabilities	(10 )
Total liabilities assumed	(10 )
Fair value of assets acquired and liabilities assumed	\$67

The identifiable intangible assets acquired were primarily related to purchased technology with estimated useful lives of four to five years. Goodwill is not expected to be deductible for U.S. income tax purposes. Prior to the closing of the acquisition on June 21, 2016, EMC owned approximately 16% of the outstanding shares of Arkin. As a result of the acquisition, cash paid to EMC was approximately \$13 million.

Table of Contents

VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Definite-Lived Intangible Assets, Net

As of June 30, 2016 and December 31, 2015, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	June 30, 2016			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$ 672	\$ (345 )	\$ 327
Leasehold interest	34.9	149	(22 )	127
Customer relationships and customer lists	8.3	135	(56 )	79
Trademarks and tradenames	8.6	61	(20 )	41
Other	5.4	5	(2 )	3
Total definite-lived intangible assets		\$ 1,022	\$ (445 )	\$ 577
	December 31, 2015			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$ 648	\$ (298 )	\$ 350
Leasehold interest	34.9	149	(20 )	129
Customer relationships and customer lists	8.4	148	(62 )	86
Trademarks and tradenames	8.6	61	(16 )	45
Other	2.9	20	(14 )	6
Total definite-lived intangible assets		\$ 1,026	\$ (410 )	\$ 616

Amortization expense on definite-lived intangible assets was \$32 million and \$65 million during the three and six months ended June 30, 2016, respectively, and \$37 million and \$74 million during the three and six months ended June 30, 2015, respectively.

Based on intangible assets recorded as of June 30, 2016 and assuming no subsequent additions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

Remainder of 2016	\$66
2017	127
2018	115
2019	93
2020	43
Thereafter	133
Total	\$577

## Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the six months ended June 30, 2016 (table in millions):

Balance, January 1, 2016	3,993
Increase in goodwill related to a business combination	38
Balance, June 30, 2016	\$4,031

Table of Contents

VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Joint Venture

During the year ended December 31, 2014, VMware established a joint venture intended to expand VMware vCloud Air services in Japan. At December 31, 2015, VMware had a controlling interest in the joint venture and approximately 51% of the ownership. Accordingly, VMware consolidated the financial results of the joint venture. During the second quarter of 2016, VMware acquired all of the remaining non-controlling interests in the joint venture for \$4 million.

## C. Realignment Charges

On January 22, 2016, VMware approved a plan to streamline its operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the six months ended June 30, 2016. VMware recognized \$49 million of severance-related realignment charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. Additionally, VMware is in the process of consolidating certain facilities as part of this plan, which resulted in the recognition of \$3 million of related charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. As of June 30, 2016, \$5 million remained in accrued expenses and other on the condensed consolidated balance sheets, which is generally expected to be paid during 2016. Actions associated with the plan were substantially completed by June 30, 2016.

During the first quarter of 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, \$21 million of realignment charges were recognized during the six months ended June 30, 2015, which consisted of severance-related costs. An immaterial credit was recognized during the three months ended June 30, 2015.

The following table summarizes the activity for the accrued realignment charges for the six months ended June 30, 2016 and June 30, 2015 (tables in millions):

	For the Six Months Ended June 30, 2016			
	Balance as of January 1, 2016	Realignment Charges	Utilization	Balance as of June 30, 2016
Severance-related costs	\$3	\$ 49	\$ (50 )	\$ 2
Costs to exit facilities	—	3	—	3
Total	\$3	\$ 52	\$ (50 )	\$ 5
	For the Six Months Ended June 30, 2015			
	Balance as of January 1, 2015	Realignment Charges	Utilization	Balance as of June 30, 2015
Severance-related costs	\$8	21	(27)	