

VMWARE, INC.
Form 10-Q
August 05, 2014

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, 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 001-33622

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	(Zip Code)
(Address of principal executive offices)	
(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	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

(Do not check if a 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 28, 2014, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 430,112,408 of which 130,112,408 shares were Class A common stock and 300,000,000 were Class B common stock.

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VMware, VMworld, vSphere, vCloud, vCenter, VMware View, vCloud Suite, Horizon Suite, VMware NSX, Virtual SAN, vCloud Hybrid Service, AirWatch, vShield, Desktone, Dynamic Ops, Nicira, Wanova and Virsto are registered trademarks or trademarks of VMware in the United States and other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

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		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Revenues:				
License	\$614	\$531	\$1,175	\$1,019
Services	843	712	1,642	1,416
Total revenues	1,457	1,243	2,817	2,435
Operating expenses (1):				
Cost of license revenues	46	55	96	112
Cost of services revenues	172	118	323	243
Research and development	317	261	610	532
Sales and marketing	544	442	1,018	859
General and administrative	179	96	330	194
Realignment charges	(1	) 1	(1	) 63
Operating income	200	270	441	432
Investment income	9	7	18	15
Interest expense with EMC	(7	) (1	) (12	) (2
Other income, net	—	18	—	13
Income before income taxes	202	294	447	458
Income tax provision	35	49	81	40
Net income	\$167	\$245	\$366	\$418
Net income per weighted-average share, basic for Class A and Class B	\$0.39	\$0.57	\$0.85	\$0.98
Net income per weighted-average share, diluted for Class A and Class B	\$0.38	\$0.57	\$0.84	\$0.97
Weighted-average shares, basic for Class A and Class B	430,216	428,336	430,050	428,172
Weighted-average shares, diluted for Class A and Class B	434,199	431,987	434,218	432,406

(1) Includes stock-based compensation as follows:

Cost of license revenues	\$1	\$—	\$2	\$1
Cost of services revenues	11	7	20	14
Research and development	66	51	126	113
Sales and marketing	43	33	84	69
General and administrative	18	12	35	26
Realignment charges	—	—	—	6

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

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Net income	\$ 167	\$ 245	\$ 366	\$ 418
Other comprehensive income:				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of \$2, \$(6), \$2 ₃ and \$(5)		(9	) 4	(8
Reclassification of (gains) realized during the period, net of taxes of \$0, \$0, \$0 and \$(1)	—	—	—	(1
Net change in market value of available-for-sale securities	3	(9	) 4	(9
Changes in market value of effective foreign currency forward exchange contracts:				
Unrealized (losses), net of \$0 taxes for all periods	—	(1	) —	(1
Net change in market value of effective foreign currency forward exchange contracts	—	(1	) —	(1
Total other comprehensive income (loss)	3	(10	) 4	(10
Total comprehensive income, net of taxes	\$ 170	\$ 235	\$ 370	\$ 408

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

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VMware, Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

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

(unaudited)

	June 30, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	\$2,054	\$2,305
Short-term investments	4,583	3,870
Accounts receivable, net of allowance for doubtful accounts of \$2	1,119	1,220
Due from related parties, net	40	—
Deferred tax assets	215	190
Other current assets	150	96
Total current assets	8,161	7,681
Property and equipment, net	936	845
Other assets, net	230	107
Deferred tax assets	135	60
Intangible assets, net	799	607
Goodwill	3,898	3,027
Total assets	\$14,159	\$12,327
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$102	\$109
Accrued expenses and other	826	608
Due to related parties, net	—	18
Unearned revenues	2,713	2,558
Total current liabilities	3,641	3,293
Note payable to EMC	1,500	450
Unearned revenues	1,676	1,534
Other liabilities	253	234
Total liabilities	7,070	5,511
Contingencies (see Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 129,983 and 130,349 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	3,399	3,496
Accumulated other comprehensive income	8	4
Retained earnings	3,678	3,312
Total stockholders' equity	7,089	6,816
Total liabilities and stockholders' equity	\$14,159	\$12,327

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

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VMware, Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Three Months Ended		Six Months Ended		
	June 30,		June 30,		
	2014	2013	2014	2013	
Operating activities:					
Net income	\$ 167	\$ 245	\$ 366	\$ 418	
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	81	88	164	179	
Stock-based compensation	139	103	267	219	
Excess tax benefits from stock-based compensation	(11	) (26	) (26	) (48)
Deferred income taxes, net	(50	) 37	(79	) 9)
Non-cash realignment charges	—	—	—	14	
Gain on disposition of certain lines of business and other, net	—	(19	) —	(19)
Other	—	1	2	(1)
Changes in assets and liabilities, net of acquisitions:					
Accounts receivable	(288	) (172	) 130	208	
Other assets	(13	) (34	) (43	) (75)
Due to/from related parties, net	(66	) (25	) (33	) 34	
Accounts payable	3	26	(8	) 18	
Accrued expenses	160	92	56	(23)
Income taxes receivable from EMC	—	16	—	16	
Income taxes payable	71	(4	) 112	(2)
Unearned revenues	216	206	251	263	
Net cash provided by operating activities	409	534	1,159	1,210	
Investing activities:					
Additions to property and equipment	(76	) (75	) (153	) (153)
Purchases of available-for-sale securities	(1,445	) (918	) (1,976	) (1,655)
Sales of available-for-sale securities	530	333	941	819	
Maturities of available-for-sale securities	169	188	322	370	
Proceeds from disposition of certain lines of business	—	31	—	31	
Purchase of strategic investments	(37	) (2	) (40	) (2)
Business acquisitions, net of cash acquired	—	—	(1,068	) (184)
Increase in restricted cash	—	(1	) (76	) (2)
Other investing	(3	) —	(10	) 1)
Net cash used in investing activities	(862	) (444	) (2,060	) (775)
Financing activities:					
Proceeds from issuance of common stock	11	47	99	115	
Proceeds from issuance of note payable to EMC	—	—	1,500	—	
Repayment of note payable to EMC	—	—	(450) —	
Reduction in capital from EMC	—	—	(24) —	
Repurchase of common stock	(238	) (120	) (407	) (302)
Excess tax benefits from stock-based compensation	11	26	26	48	
Shares repurchased for tax withholdings on vesting of restricted stock	(65) (43) (94) (65)

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Net cash provided by (used in) financing activities	(281) (90) 650	(204)
Net (decrease) increase in cash and cash equivalents	(734) —	(251) 231	
Cash and cash equivalents at beginning of the period	2,788	1,840	2,305	1,609	
Cash and cash equivalents at end of the period	\$2,054	\$1,840	\$2,054	\$1,840	
Non-cash items:					
Changes in capital additions, accrued but not paid	\$18	\$9	\$11	\$(4)
Fair value of stock options assumed in acquisition	—	—	24	—	

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

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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 the leader in virtualization infrastructure solutions utilized by organizations to help them transform the way they build, deliver and consume information technology (“IT”) resources. VMware’s virtualization infrastructure solutions, which include a suite of products designed to deliver a software-defined data center, run on industry-standard desktop computers and servers 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

These 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 2014. 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 2013 Annual Report on Form 10-K.

As of June 30, 2014, EMC held approximately 79.8% of VMware’s outstanding common stock and 97.2% 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.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable.

However, the amounts recorded for VMware’s intercompany transactions with EMC and Pivotal Software, Inc.

(“Pivotal,” previously known as “GoPivotal, Inc.”) may not be considered arm’s length with an unrelated third party.

Therefore, the financial statements included herein may not necessarily reflect the financial position, results of operations 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 financial position, results of operations 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 and Pivotal.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and its subsidiaries after elimination of intercompany transactions and account balances between VMware and its subsidiaries. All intercompany transactions with EMC and Pivotal in the condensed consolidated statements of cash flows will be settled in cash, and changes in the current intercompany balances are presented as a component of cash flows from operating, investing and financing activities.

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 not limited to trade receivable valuation, marketing 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 May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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. Upon adoption, entities will be required to

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

recognize the amount of revenue that they expect to be entitled to for the transfer of promised goods or services to their customers. The updated standard is effective for the Company in the first quarter of 2017 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted.

The Company has not selected a transition method and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

B. Business Combinations, Definite-Lived Intangible Assets, Net and Goodwill**Business Combinations**

On February 24, 2014, VMware acquired for cash all of the outstanding membership units of A.W.S. Holding, LLC (“AirWatch Holding”), the sole member and equity holder of AirWatch LLC (“AirWatch”). AirWatch is a leader in enterprise mobile management and security solutions. VMware acquired AirWatch to expand VMware's solutions within the enterprise mobile and security space. The total preliminary purchase price of \$1,128 million included cash of \$1,104 million and the fair value of assumed unvested equity attributed to pre-combination services totaling \$24 million.

Merger consideration totaling \$300 million, including \$75 million being held in escrow, is payable to certain employees of AirWatch subject to specified future employment conditions and will be recognized as expense over the requisite service period on a straight-line basis. Compensation expense of \$41 million and \$60 million was recognized during the three and six months ended June 30, 2014, respectively.

VMware assumed all of AirWatch's unvested stock options and restricted stock outstanding at the completion of the acquisition with an estimated fair value of \$134 million. Of the total fair value, \$24 million was allocated to the purchase price and \$110 million was allocated to future services and will be expensed over the remaining requisite service periods on a straight-line basis. The estimated fair value of the stock options assumed by the Company was determined using the Black-Scholes option pricing model. Pursuant to the purchase agreement, AirWatch's outstanding stock awards were converted into shares of VMware's common stock at the conversion ratio of 0.4.

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

Cash	\$36	
Other current assets	60	
Intangible assets	250	
Goodwill	879	
Other acquired assets	17	
Total assets acquired	1,242	
Unearned revenues	(45)
Other assumed liabilities	(69)
Total liabilities assumed	(114)
Fair value of assets acquired and liabilities assumed	\$1,128	

The excess of the purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. The estimated fair value assigned to the tangible assets, identifiable intangible assets, and assumed liabilities were based on management's estimates and assumptions. The preliminary allocation of the purchase price was based on a preliminary valuation and assumptions and is subject to change within the purchase price allocation period. Additionally, indirect taxes, income taxes payable and deferred taxes may continue to be subject to change as additional information is received and tax returns are finalized. VMware expects to finalize the allocation of purchase consideration as soon as practicable and no later than one year from the acquisition date.

During the three months ended June 30, 2014, the preliminary allocation of the consideration to the fair value of the assets acquired and liabilities assumed was revised primarily to reflect adjustments to deferred taxes and the liability for employer related taxes. As a result, goodwill decreased \$4 million in connection with these adjustments.

Management expects that the majority of goodwill and identifiable intangible assets will be deductible for U.S. income tax purposes.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table summarizes the components of the identifiable intangible assets acquired and their estimated useful lives by VMware in conjunction with the acquisitions of AirWatch (amounts in table in millions):

	Useful Lives (in years)	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	2 – 6	5.9	\$ 118
Customer relationships and customer lists	2 – 8	7.9	78
Trademarks and tradenames	8	8	40
Other	2 – 8	3.2	14
Total identifiable intangible assets			\$250

The following net income pro forma financial information summarizes the combined net income for VMware and AirWatch, which was significant for purposes of the unaudited pro forma financial information disclosure, as though the companies were combined at the beginning of the Company's fiscal year 2013. The amount of revenue of AirWatch was not considered material, and as such, has not been included in the unaudited pro forma financial information disclosure below.

Supplemental information on an unaudited pro forma basis, as if AirWatch had been acquired on January 1, 2013, is presented as follows (table in millions):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Pro forma adjusted net income	\$ 167	\$ 186	\$ 329	\$ 300
Definite-Lived Intangible Assets, Net				

As of June 30, 2014, definite-lived intangible assets consisted of the following (amounts in table in millions):

	June 30, 2014 Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.4	\$ 703	\$(215)	\$ 488
Leasehold interest	34.9			