

VMWARE, INC.

Form 10-Q

June 11, 2018

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 May 4, 2018

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

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VMWARE, INC.

(Exact name of registrant as specified in its charter)

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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)	

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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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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As of June 1, 2018, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 406,861,758, of which 106,861,758 shares were Class A common stock and 300,000,000 were Class B common stock.

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## 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	
	May 4, 2018	May 5, 2017 <sup>(1)</sup>
Revenue <sup>(2)</sup> :		
License	\$774	\$ 641
Services	1,234	1,124
Total revenue	2,008	1,765
Operating expenses <sup>(3)</sup> :		
Cost of license revenue	45	39
Cost of services revenue	251	250
Research and development	453	421
Sales and marketing	706	579
General and administrative	169	151
Realignment and loss on disposition	2	64
Operating income	382	261
Investment income	48	23
Interest expense	(34 )	(7 )
Other income (expense), net	779	4
Income before income tax	1,175	281
Income tax provision	233	36
Net income	\$942	\$ 245
Net income per weighted-average share, basic for Classes A and B	\$2.33	\$ 0.60
Net income per weighted-average share, diluted for Classes A and B	\$2.29	\$ 0.59
Weighted-average shares, basic for Classes A and B	404,968	408,431
Weighted-average shares, diluted for Classes A and B	410,932	414,018

(1) Adjusted to reflect the retrospective adoption of Accounting Standards Codification 606, Revenue from Contracts with Customers ("Topic 606").

(2) Includes related party license revenue of \$167 million and \$113 million and related party services revenue of \$204 million and \$140 million during the three months ended May 4, 2018 and May 5, 2017, respectively (refer to Note C).

(3) Includes stock-based compensation as follows:

Cost of license revenue	\$—	\$ 1
Cost of services revenue	11	14
Research and development	84	82
Sales and marketing	46	48
General and administrative	20	18

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	
	May 4, 2018	May 5, 2017 <sup>(1)</sup>
Net income	\$942	\$ 245
Other comprehensive income (loss):		
Changes in market value of available-for-sale securities:		
Unrealized gains (losses), net of tax provision (benefit) of (\$5) and \$5	(15 )	8
Reclassification of (gains) losses realized during the period, net of tax benefit of \$— for all periods	—	1
Net change in market value of available-for-sale securities	(15 )	9
Changes in market value of effective foreign currency forward contracts:		
Unrealized gains (losses), net of tax provision of \$— for all periods	(9 )	5
Reclassification of (gains) losses realized during the period, net of tax provision of \$— for all periods	—	1
Net change in market value of effective foreign currency forward contracts	(9 )	6
Total other comprehensive income (loss)	(24 )	15
Total comprehensive income, net of taxes	\$918	\$ 260

<sup>(1)</sup> Adjusted to reflect the retrospective adoption of Topic 606.

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)

	May 4, 2018	February 2, 2018 <sup>(1)</sup>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$7,101	\$ 5,971
Short-term investments	5,529	5,682
Accounts receivable, net of allowance for doubtful accounts of \$2 and \$2	1,001	1,394
Due from related parties, net	181	532
Other current assets	289	257
Total current assets	14,101	13,836
Property and equipment, net	1,098	1,074
Other assets	1,710	924
Deferred tax assets	48	227
Intangible assets, net	535	548
Goodwill	4,596	4,597
Total assets	\$22,088	\$ 21,206
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$126	\$ 15
Accrued expenses and other	1,141	1,357
Unearned revenue	3,370	3,438
Total current liabilities	4,637	4,810
Notes payable to Dell	270	270
Long-term debt	3,966	3,964
Unearned revenue	2,386	2,401
Income tax payable	957	954
Other liabilities	212	183
Total liabilities	12,428	12,582
Contingencies (refer to Note K)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 106,434 and 103,776 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	992	844
Accumulated other comprehensive loss	(54	) (15 )
Retained earnings	8,718	7,791
Total stockholders' equity	9,660	8,624
Total liabilities and stockholders' equity	\$22,088	\$ 21,206

<sup>(1)</sup> Adjusted to reflect the retrospective adoption of Topic 606.

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	
	May 4, 2018	May 5, 2017 <sup>(1)</sup>
Operating activities:		
Net income	\$942	\$245
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	156	136
Stock-based compensation	161	163
Deferred income taxes, net	180	2
Unrealized (gain) loss on equity securities, net	(776)	—
Loss on disposition	1	63
Loss on disposition of assets, revaluation and impairment	—	3
Loss on Dell stock purchase	—	2
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	393	321
Other current assets and other assets	(136)	(66)
Due to/from related parties, net	351	(34)
Accounts payable	101	59
Accrued expenses and other liabilities	(215)	(42)
Income taxes payable	20	15
Unearned revenue	(83)	(90)
Net cash provided by operating activities	1,095	777
Investing activities:		
Additions to property and equipment	(61)	(49)
Purchases of available-for-sale securities	(391)	(506)
Sales of available-for-sale securities	148	548
Maturities of available-for-sale securities	371	418
Purchases of strategic investments	(2)	(6)
Proceeds from disposition of assets	2	—
Business combinations, net of cash acquired	(26)	—
Net cash paid on disposition of a business	(2)	—
Net cash provided by investing activities	39	405
Financing activities:		
Proceeds from issuance of common stock	91	7
Repurchase of common stock	—	(425)
Shares repurchased for tax withholdings on vesting of restricted stock	(94)	(120)
Net cash used in financing activities	(3)	(538)
Net increase in cash, cash equivalents and restricted cash	1,131	644
Cash, cash equivalents and restricted cash at beginning of the period	6,003	3,239
Cash, cash equivalents and restricted cash at end of the period	\$7,134	\$3,883
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$63	\$9
Cash paid for taxes, net	42	27
Non-cash items:		

Changes in capital additions, accrued but not paid	\$11	\$5
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<sup>(1)</sup> Adjusted to reflect the retrospective adoption of Topic 606 and ASU 2016-18, Statement of Cash Flows: Restricted Cash (Topic 230). The adoption of Topic 606 had no impact to net cash provided by or used in operating, investing and financing activities.

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”) pioneered the development and application of virtualization technologies with x86 server-based computing, separating application software from the underlying hardware. Information technology (“IT”) driven innovation is disrupting markets and industries. Technologies emerge faster than organizations can absorb, creating increasingly complex environments. To take on this challenge, businesses need a flexible and secure digital foundation. VMware provides compute, cloud, mobility, networking and security infrastructure software to businesses that provides a flexible digital foundation for the applications that empower businesses to serve their customers globally.

Accounting Principles

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

VMware adopted Accounting Standards Codification 606, Revenue from Contracts with Customers (“Topic 606”) and Accounting Standards Update (“ASU”) No. 2016-18, Statement of Cash Flows: Restricted Cash (Topic 230), effective February 3, 2018 using retrospective application. As part of the adoption, certain prior period amounts have been adjusted or reclassified within the condensed consolidated financial statements.

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 fiscal year 2019. 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 Form 10-K filed on March 29, 2018.

Effective September 7, 2016, Dell Technologies Inc. (“Dell”) (formerly Denali Holding Inc.) acquired EMC Corporation (“EMC”), VMware’s parent company, including EMC’s majority control of VMware (the “Dell Acquisition”). As of May 4, 2018, Dell controlled 81.4% of VMware’s outstanding common stock and 97.6% of the combined voting power of VMware’s outstanding common stock, including 31 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock.

As VMware is a majority-owned and controlled subsidiary of Dell, its results of operations and financial position are consolidated with Dell’s financial statements. Transactions prior to the effective date of the Dell Acquisition represent transactions only with EMC and its consolidated subsidiaries.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with Dell and its consolidated subsidiaries may not be considered arm’s length with an unrelated third party. Therefore, the condensed consolidated 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 products and services the Company receives from and provides to Dell.

Principles of Consolidation

The unaudited condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with Dell and its consolidated 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.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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 revenue 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 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.

Significant Accounting Policies

During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606). In 2016, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12, which provided interpretive clarifications on the guidance in Topic 606 (collectively, “Topic 606”). The updated revenue standard replaced all existing revenue recognition guidance under GAAP and established common principles for recognizing revenue for all industries. It also provided guidance on the accounting for costs to fulfill or obtain a customer contract. The core principle underlying the updated standard is the recognition of revenue based on consideration expected to be entitled from the transfer of goods or services to a customer. VMware adopted Topic 606 on a full retrospective basis effective February 3, 2018, consequently, previously reported amounts were adjusted to reflect the adoption of Topic 606.

Significant accounting policies applicable to revenue recognition and deferred commissions have been updated to reflect the adoption of Topic 606. There were no other changes to the VMware’s significant accounting policies described in the Form 10-K filed on March 29, 2018 that have had a material impact on the Company’s condensed consolidated financial statements and the related notes.

Revenue Recognition

VMware derives revenue primarily from licensing software under perpetual licenses or consumption-based contracts, related software maintenance and support, training, consulting services and hosted services. VMware accounts for a contract with a customer if all criteria defined by the guidance are met, including collectibility of consideration is probable. Revenue is recognized upon transfer of control of licenses or services to the customer in an amount that reflects the consideration VMware expects to receive in exchange for those licenses or services. Control of a promised good or service may be transferred to a customer either at a point in time or over time, which affects the timing of revenue recognition. VMware’s contracts with customers may include a combination of licenses and services that are accounted for as distinct performance obligations. Certain contracts include third-party offerings and revenue may be recognized net of the third-party costs, based upon an assessment as to whether VMware had control of the underlying third-party offering. Revenue is recognized net of any taxes invoiced to customers, which are subsequently remitted to governmental authorities.

License Revenue

VMware generally sells its license software through distributors, resellers, system vendors, systems integrators and through its direct sales force. Performance obligations related to license revenue, including the license portion of term licenses, represent functional intellectual property under which a customer has the right to use the software license. The license provides significant standalone functionality and is a separate performance obligation from the maintenance and support, and professional services sold by VMware. On-premises license revenue is recognized at a point in time, upon delivery and transfer of control of the underlying license to the customer.

License revenue from on-premises license software sold to original equipment manufacturers (“OEMs”) is recognized when the sale occurs. Revenue is recognized upon reporting by the OEMs of their sales, and for the period where information of the underlying sales has not been made available, revenue is recognized based upon estimated sales. VMware Cloud Provider Program (“VCP”) partners rent on-premises licenses from VMware, and the rental fee is recognized as license revenue upon consumption. Generally, contracts with VCP partners include cancellation rights. License revenue is based upon reported consumption by VCP partners and includes estimates for the period when

consumption information has not been made available.

License revenue also includes an allocated portion of hosted services, which is recognized as revenue based on delivery over time.

#### Services Revenue

VMware's services revenue generally consists of software maintenance and support, professional services and an allocated portion of hosted services. Software maintenance and support offerings entitle customers to receive major and minor product

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

upgrades on a when-and-if-available basis, and technical support. Maintenance and support services are comprised of multiple performance obligations including updates, upgrades to licenses and technical support. While separate performance obligations are identified within maintenance and support services, the underlying performance obligations generally have a consistent continuous pattern of transfer to a customer during the term of a contract. Maintenance and support services revenue is recognized over time on a ratable basis over the contract duration. Professional services include design, implementation, training and consulting services. Professional services performed by VMware represent distinct performance obligations as they do not modify or customize licenses sold and such services are not highly interdependent or highly interrelated to licenses sold such that a customer would not be able to use the licenses without the professional services. Revenue from fixed fee professional services engagements is recognized as the project is being completed as progress against the contractual deliverables of the project can be reasonably estimated. As a practical expedient, VMware recognizes revenue from professional services engagements invoiced on a time and materials basis as the hours are incurred based on VMware's right to invoice amounts for performance completed to date.

VMware's hosted services consist of certain software offerings sold as a service-based technology without the customer's ability to take possession of the software over the subscription term. Currently, hosted services are recognized as revenue equally in both license and services over time as customers consume the services or ratably over the term of the subscription, commencing upon provisioning of the service.

**Contracts with Multiple Performance Obligations**

VMware enters into revenue contracts with multiple performance obligations in which a customer may purchase combinations of licenses, maintenance and support, training, consulting services, hosted services and rights to future products and services. For contracts with multiple performance obligations, VMware allocates total transaction value to the identified underlying performance obligations based on relative standalone selling price ("SSP"). VMware typically estimates SSP of services based on observable transactions when the services are sold on a standalone basis and those prices fall within a reasonable range. VMware utilizes the residual approach to estimate SSP of license as the licenses are not sold standalone and the same products are sold to different customers at a broad range of prices which are highly variable.

**Deferred Commissions**

Sales commissions, including the employer portion of payroll taxes, earned by VMware's sales force are considered incremental and recoverable costs of obtaining a contract, and are deferred and generally amortized on a straight-line basis over the expected period of benefit. The expected period of benefit is determined using the contract term or underlying technology life, if renewals are expected and the renewal commission is not commensurate with the initial commission. Sales commissions related to software maintenance and support renewals are deferred and amortized on a straight-line basis over the contractual renewal period.

**U.S. Tax Cuts and Jobs Act**

The United States ("U.S.") Tax Cuts and Jobs Act enacted on December 22, 2017 (the "2017 Tax Act") introduced significant changes to U.S. income tax law, including a reduction of the U.S. statutory corporate income tax rate from 35% to 21%. During December 2017, the SEC staff issued Staff Accounting Bulletin No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act ("SAB 118"), which allows recognition of provisional tax amounts during a measurement period not to extend beyond one year of the enactment date. Due to the timing of the enactment and the complexity involved in applying the provisions of the 2017 Tax Act, VMware has made reasonable estimates for these effects and recorded provisional amounts on its condensed consolidated financial statements for the three months ended May 4, 2018. The Company expects to complete its analysis within the measurement period permitted under SAB 118.

The Global Intangible Low-Taxed Income ("GILTI") provisions of the 2017 Tax Act require VMware to include in its U.S. income tax return foreign subsidiary earnings in excess of an allowable return on the foreign subsidiary's tangible assets. VMware has not elected its accounting policy as to the implementation of the GILTI provisions but plans to do

so within the measurement period permitted under SAB 118. VMware recognized the tax impacts associated with GILTI as a current expense on its condensed consolidated statements of income during the three months ended May 4, 2018.

New Accounting Pronouncements

ASU No. 2016-02, Leases

During February 2016, the Financial Accounting Standards Board (“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-of-use asset for the right to use the underlying asset for the lease term. The updated standard also requires additional disclosure regarding leasing

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

arrangements. It is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. VMware is currently evaluating the effect that the updated standard 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.

## B. Revenue

## Full Retrospective Adoption

The adoption of Topic 606 impacted VMware's previously reported results as follows (tables in millions):

	Three Months Ended May 5, 2017		
	As Reported	Topic 606 Adjustments	As Adjusted
Selected Captions from the Condensed Consolidated Statements of Income			
Revenue:			
License	\$610	\$ 31	\$ 641
Services	1,126	(2 )	1,124
Total revenue	1,736	29	1,765
Operating expenses:			
Sales and marketing	586	(7 )	579
Realignment and loss on disposition	51	13	64
Operating income	238	23	261
Income before income tax	258	23	281
Income tax provision	26	10	36
Net income	232	13	245

February 2, 2018

	As Reported	Topic 606 Adjustments	As Adjusted
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## Selected Captions from the Condensed Consolidated Balance Sheets

Accounts receivable, net of allowance for doubtful accounts	\$1,312	\$ 82	\$ 1,394
Other current assets	237	20	257
Other assets	323	601	924
Deferred tax assets	346	(119 )	227
Accrued expenses and other	1,241	116	1,357
Unearned revenue	6,250	(411 )	5,839
Other liabilities	152	31	183
Retained earnings	6,943	848	7,791

The adoption of Topic 606 had no impact to net cash provided by or used in operating, investing and financing activities on VMware's condensed consolidated statements of cash flows during the three months ended May 5, 2017.

## Receivables

VMware records a receivable when an unconditional right to consideration exists and transfer of control has occurred, such that only the passage of time is required before payment of consideration is due. Timing of revenue recognition may differ from the timing of invoicing to customers.

Payment terms vary based on license or service offerings and payment is generally required within 30 to 45 days from date of invoicing. Certain performance obligations may require payment before delivery of the license or service to the customer.





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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Contract Assets

A contract asset is recognized when a conditional right to consideration exists and transfer of control has occurred. Contract assets include fixed fee professional services where transfer of services has occurred in advance of the Company's right to invoice. Contract assets are classified as accounts receivables upon invoicing. Contract assets are included in other current assets on the condensed consolidated balance sheets. Contract assets were \$20 million and \$27 million as of May 4, 2018 and February 2, 2018, respectively. Contract asset balances will fluctuate based upon the timing of transfer of services, billings and customer's acceptance of contractual milestones.

Contract Liabilities

Contract liabilities consist of unearned revenue, which is generally recorded when VMware has the right to invoice or payments have been received for undelivered products or services. Refer to Note L for further information.

Customer Deposits

Customer deposits include prepayments from customers related to amounts received for contracts that include cancellation rights. Purchased credits eligible for redemption of VMware's hosted services ("cloud credits") are included in customer deposits until the cloud credit is consumed or is contractually committed to a specific hosted service. Cloud credits are redeemable by the customer for the gross value of the hosted offering. Upon contractual commitment for a hosted service, the net value of the cloud credits that are expected to be recognized as revenue as the obligation is fulfilled will be classified as unearned revenue.

As of May 4, 2018, customer deposits related to customer prepayments and cloud credits of \$186 million were included in accrued expenses and other and \$25 million were included in other long-term liabilities on the condensed consolidated balance sheets. As of February 2, 2018, customer deposits related to customer prepayments were \$126 million and were included in accrued expenses and other on the condensed consolidated balance sheets.

Deferred Commissions

Deferred commissions are classified as current or non-current based on the duration of the expected period of benefit. Deferred commissions, including employer portion of payroll taxes, included in other current assets as of May 4, 2018 and February 2, 2018 was not significant. Deferred commissions included in other assets was \$650 million and \$638 million as of May 4, 2018 and February 2, 2018, respectively.

For the three months ended May 4, 2018 and May 5, 2017, amortization expense for deferred commissions was \$67 million and \$51 million, respectively, and was included in sales and marketing on the condensed consolidated statements of income.

Upon adoption of Topic 606, VMware recognized an impairment on its deferred commission of \$13 million during the three months ended May 5, 2017, relating to the sales of vCloud Air services. VMware completed the sale of its vCloud Air business ("vCloud Air") to OVH US LLC ("OVH") during the second quarter of fiscal 2018.

C. Related Parties

The information provided below includes a summary of the transactions entered into with Dell and Dell's consolidated subsidiaries, including EMC (collectively, "Dell").

Transactions with Dell

VMware and Dell engaged in the following ongoing intercompany transactions, which resulted in revenue and receipts and unearned revenue for VMware:

Pursuant to OEM and reseller arrangements, Dell integrates or bundles VMware's products and services with Dell's products and sells them to end users. Dell also acts as a distributor, purchasing VMware's standalone products and services for resale to end-user customers through VMware-authorized resellers. Revenue under these arrangements is presented net of related marketing development funds and rebates paid to Dell. In addition, VMware provides professional services to end users based upon contractual agreements with Dell.

Dell purchases products and services from VMware for its internal use.

Pursuant to an ongoing distribution agreement, VMware acts as the selling agent for certain products and services of Pivotal Software, Inc. ("Pivotal"), a subsidiary of Dell, in exchange for an agency fee. Under this agreement, cash is

collected from the end user by VMware and remitted to Pivotal, net of the contractual agency fee.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Dell purchases VMware products and services directly from VMware, as well as through VMware's channel partners. Information about VMware's revenue and receipts, and unearned revenue from such arrangements, for the periods presented consisted of the following (table in millions):

	Revenue and Receipts Three Months Ended May 4, 2018		Unearned Revenue As of May 5, 2018	
	2017	2018	May 4, 2018	February 2, 2018
Reseller revenue	\$360	\$249	\$1,311	\$ 1,236
Internal-use revenue	7	4	6	12
Agency fee revenue	4	—	—	—

VMware and Dell engaged in the following ongoing intercompany transactions, which resulted in costs to VMware:

• VMware purchases and leases products and purchases services from Dell.

From time to time, VMware and Dell enter into agreements to collaborate on technology projects, and VMware pays Dell for services provided to VMware by Dell related to such projects and Dell also provides funding for such projects.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with Dell subsidiaries for support services and support from Dell personnel who are managed by VMware. The costs incurred by Dell on VMware's behalf related to these employees are charged to VMware with a mark-up intended to approximate costs that would have been incurred had VMware contracted for such services with an unrelated third-party. These costs are included as expenses on VMware's condensed consolidated statements of income and primarily include salaries, benefits, travel and occupancy expenses. Dell also incurs certain administrative costs on VMware's behalf in the U.S. that are recorded as expenses on VMware's condensed consolidated statements of income. From time to time, VMware invoices end users on behalf of Dell for certain services rendered by Dell. Cash related to these services is collected from the end user by VMware and remitted to Dell.

Information about VMware's costs from such arrangements during the periods presented consisted of the following (table in millions):

	Three Months Ended May 4, 2018		May 5, 2017	
	2018	2017	2018	2017
Purchases and leases of products and purchases of services	\$49	\$ 36		
Dell subsidiary support and administrative costs	28	29		

VMware also purchases Dell products through Dell's channel partners. Purchases of Dell products through Dell's channel partners were not significant during the periods presented.

From time to time, VMware and Dell also enter into joint marketing and product development arrangements, for which both parties may incur costs.

Dell Financial Services ("DFS")

DFS provided financing to certain of VMware's end customers based on the customer's discretion. Upon acceptance of the financing arrangement by both VMware's end customer and DFS, amounts classified as trade accounts receivable

are reclassified to due from related parties, net on the condensed consolidated balance sheets. Revenue recognized on transactions financed through DFS was recorded net of financing fees, which were \$16 million during the three months ended May 4, 2018. Financing fees during the three months ended May 5, 2017 were not significant.

**Tax Sharing Agreement with Dell**

Payments made to Dell pursuant to a tax sharing agreement were not significant during the three months ended May 4, 2018. There were no payments to Dell pursuant to the tax sharing agreement during the three months ended May 5, 2017.

Payments from VMware to Dell under the tax sharing agreement relate to VMware's portion of federal income taxes on Dell's consolidated tax return as well as state tax payments for combined states. The timing of the tax payments due to and from

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related parties is governed by the tax sharing agreement. The amounts that VMware pays to Dell for its portion of federal income taxes on Dell's consolidated tax return differ from the amounts VMware would owe on a separate tax return basis and the difference is recognized as a component of additional paid-in capital, generally in the period in which the consolidated return is filed. The difference between the amount of tax calculated on a separate tax return basis and the amount of tax calculated pursuant to the tax sharing agreement that was recorded in additional paid-in capital during the three months ended May 4, 2018 and May 5, 2017 was not significant.

## Due To/From Related Parties, Net

Amounts due to and from related parties, net as of the periods presented consisted of the following (table in millions):

	May 4, 2018	February 2, 2018
Due to related parties	\$134	\$ 106
Due from related parties	315	638
Due from related parties, net	\$181	\$ 532

Income tax due to related parties \$804 \$ 781

Amounts included in due from related parties, net, excluding DFS and tax obligations, are generally settled in cash within 60 days of each quarter-end.

## Stock Purchase Arrangements with Dell

From time to time, VMware enters into stock purchase arrangements with Dell. The following table summarizes purchases of VMware Class A common stock from Dell during the three months ended May 5, 2017, pursuant to stock purchase agreements entered into on December 15, 2016 and March 29, 2017 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended May 5, 2017
Aggregate purchase price	\$ 357
Class A common shares repurchased <sup>(1)</sup>	4,161
Weighted-average price per share	\$ 85.85

<sup>(1)</sup> The aggregate number of shares purchased was determined based upon a volume-weighted average price during a defined period, less an agreed upon discount.

There were no purchases of VMware Class A common stock from Dell during the three months ended May 4, 2018.

## Notes Payable to Dell

On January 21, 2014, VMware entered into a note exchange agreement with its parent company providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million, which consisted of outstanding principal due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022.

On August 21, 2017, VMware repaid two of the notes payable to Dell in the aggregate principal amount of \$1,230 million, representing repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount. The remaining note payable of \$270 million due December 1, 2022 may be prepaid without penalty or premium.

Interest is payable quarterly in arrears, at the annual rate of 1.75%. Interest expense recognized during the three months ended May 4, 2018 and May 5, 2017 was not significant.



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## Pivotal

As of February 2, 2018, VMware had a 20% ownership interest in Pivotal, and the investment was accounted for using the cost method. The value of the investment included on the condensed consolidated balance sheets was \$20 million as of February 2, 2018. Prior to Pivotal's initial public offering on April 20, 2018, VMware's previously held preferred shares were converted to shares of non-trading Class B common stock, resulting in VMware having an 18% ownership interest and a 24% voting interest in Pivotal. As a result of Pivotal's initial public offering, VMware's investment in Pivotal was adjusted to its fair value of \$801 million, and VMware recognized a gain of \$781 million in other income (expense), net on the condensed consolidated statements of income. VMware also recognized a discrete tax impact of \$179 million related to its book and tax basis difference on the investment in Pivotal, net of the reversal of the previously recorded valuation allowance. Refer to Note I for further discussion.

## D. Definite-Lived Intangible Assets, Net

During the first quarter of fiscal 2019, VMware completed four asset acquisitions, in which the Company acquired certain intangible assets classified as completed technology. The aggregate purchase price of the intangible assets acquired was \$26 million.

As of the periods presented, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	May 4, 2018			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.4	\$ 752	\$ (472 )	\$ 280
Leasehold interest	34.9	149	(30 )	119
Customer relationships and customer lists	7.8	177	(79 )	98
Trademarks and tradenames	8.4	70	(33 )	37
Other	7.5	3	(2 )	1
Total definite-lived intangible assets		\$ 1,151	\$ (616 )	\$ 535
	February 2, 2018			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.4	\$ 750	\$ (466 )	\$ 284
Leasehold interest	34.9	149	(29 )	120
Customer relationships and customer lists	7.8	177	(74 )	103
Trademarks and tradenames	8.4	70	(31 )	39
Other	5.7	5	(3 )	2
Total definite-lived intangible assets		\$ 1,151	\$ (603 )	\$ 548

Amortization expense on definite-lived intangible assets was \$39 million and \$32 million during the three months ended May 4, 2018 and May 5, 2017, respectively.

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Based on intangible assets recorded as of May 4, 2018 and assuming no subsequent additions, dispositions or impairment of underlying assets, the remaining estimated annual amortization expense over the next five fiscal years and thereafter is expected to be as follows (table in millions):

Remainder of 2019 \$113

2020	128
2021	74
2022	58
2023	36
Thereafter	126
Total	\$535

## E. Realignment and Loss on Disposition

## Disposition of VMware vCloud Air Business

On April 4, 2017, VMware announced the sale of vCloud Air to OVH. The loss recognized in connection with this transaction was \$64 million and was included in realignment and loss on disposition on the condensed consolidated statements of income. The loss of \$64 million included the impairment of deferred commissions resulting from the retrospective adoption of Topic 606, which was \$13 million during the three months ended May 5, 2017. VMware completed the sale of vCloud Air to OVH during the second quarter of fiscal 2018.

## F. Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, including performance stock units, and stock options, including purchase options under VMware's employee stock purchase plan. Securities are excluded from the computation of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

The following table sets forth the computations of basic and diluted net income per share during the periods presented (table in millions, except per share amounts and shares in thousands):

	Three Months Ended	
	May 4, 2018	May 5, 2017
Net income	\$942	\$ 245
Weighted-average shares, basic for Classes A and B	404,968	408,431
Effect of other dilutive securities	5,964	5,587
Weighted-average shares, diluted for Classes A and B	410,932	414,018
Net income per weighted-average share, basic for Classes A and B	\$2.33	\$ 0.60
Net income per weighted-average share, diluted for Classes A and B	\$2.29	\$ 0.59



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The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the periods presented, because their effect would have been anti-dilutive (shares in thousands):

Three  
Months  
Ended  
May May  
4, 5,  
2018 2017

Anti-dilutive securities:

Employee stock options	—	895
Restricted stock units	177	44
Total	177	939

G. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of the periods presented consisted of the following (tables in millions):

	May 4, 2018			Aggregate
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Cash	\$413	\$ —	\$ —	\$ 413
Cash equivalents:				
Money-market funds	\$6,621	\$ —	\$ —	\$ 6,621
U.S. and foreign corporate debt securities	67	—	—	67
Total cash equivalents	\$6,688	\$ —	\$ —	\$ 6,688
Short-term investments:				
U.S. Government and agency obligations	\$956	\$ —	\$ (9 )	\$ 947
U.S. and foreign corporate debt securities	4,402	1	(48 )	4,355
Foreign governments and multi-national agency obligations	97	—	(1 )	96
Mortgage-backed securities	107	—	(3 )	104
Total short-term investments <sup>(1)</sup>	\$5,562	\$ 1	\$ (61 )	\$ 5,502

<sup>(1)</sup> Short-term investments on the condensed consolidated balance sheets as of May 4, 2018 includes the marketable equity investment carried at fair value. Refer to Note I for further information.

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	February 2, 2018			Aggregate
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Cash	\$423	\$ —	\$ —	\$ 423
Cash equivalents:				
Money-market funds	\$5,460	\$ —	\$ —	\$ 5,460
U.S. and foreign corporate debt securities	88	—	—	88
Total cash equivalents	\$5,548	\$ —	\$ —	\$ 5,548
Short-term investments:				
U.S. Government and agency obligations	\$965	\$ —	\$ (8 )	\$ 957
U.S. and foreign corporate debt securities	4,503	1	(31 )	4,473
Foreign governments and multi-national agency obligations	99	—	(1 )	98
Mortgage-backed securities	123	—	(2 )	121
Marketable available-for-sale equity securities	15	18	—	33
Total short-term investments	\$5,705	\$ 19	\$ (42 )	\$ 5,682

VMware evaluated its available-for-sale investments as of May 4, 2018 and February 2, 2018 for other-than-temporary declines in fair value and did not consider any to be other-than-temporarily impaired. The realized gains and losses on investments during the three months ended May 4, 2018 and May 5, 2017 were not significant.

Unrealized losses on available-for-sale investments, which have been in a net loss position for less than twelve months as of the periods presented, were classified by sector as follows (table in millions):

	May 4, 2018		February 2, 2018	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	\$3,097	\$ (37 )	\$ 3,100	\$ (22 )

As of the periods presented, unrealized losses on available-for-sale investments in the other investment categories, which have been in a net loss position for less than twelve months, were not significant.

Unrealized losses on available-for-sale investments, which have been in a net loss position for twelve months or greater as of the periods presented, were classified by sector as follows (table in millions):

	May 4, 2018		February 2, 2018	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	\$670	\$ (11 )	\$ 693	\$ (9 )

As of the periods presented, unrealized losses on available-for-sale investments in the other investment categories, which have been in a net loss position for twelve months or greater, were not significant.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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## Contractual Maturities

The contractual maturities of fixed income securities included in short-term investments on the condensed consolidated balance sheets and held as of May 4, 2018, consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	\$ 2,392	\$ 2,384
Due after 1 year through 5 years	3,010	2,963
Due after 5 years through 10 years	91	88
Due after 10 years	69	67
Total fixed income securities	\$ 5,562	\$ 5,502

## Restricted Cash

During November 2016, the FASB issued ASU 2016-18, for which restricted cash or restricted cash equivalents is included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. The updated standard is effective for interim and annual periods beginning after December 15, 2017 and requires a full retrospective transition method. VMware adopted ASU 2016-18 during the first quarter of fiscal 2019 and has applied the standard retrospectively to all periods presented. The adoption of ASU 2016-18 did not have a significant impact on the condensed consolidated statements of cash flows for the three months ended May 5, 2017.

The following table provides a reconciliation of the Company's cash and cash equivalents, current portion of restricted cash and non-current portion of restricted cash reported within the condensed consolidated balance sheets that sum to the total cash, cash equivalents and restricted cash shown in the Company's condensed consolidated statements of cash flows for the periods presented (table in millions):

	May 4, 2018	February 2, 2018
Cash and cash equivalents	\$7,101	\$ 5,971
Restricted cash within other current assets	24	22
Restricted cash within other assets	9	10
Total cash, cash equivalents and restricted cash	\$7,134	\$ 6,003

Amounts included in restricted cash primarily relate to certain employee-related benefits, as well as amounts related to installment payments to certain employees as part of acquisitions, subject to the achievement of specified future employment conditions.

## H. Debt

## Long-term Debt

On August 21, 2017, VMware issued three series of unsecured senior notes ("Senior Notes") pursuant to a public debt offering. The proceeds from the issuance were \$3,961 million, net of debt discount of \$9 million and debt issuance costs of \$30 million.

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The carrying value of the Senior Notes as of the periods presented were as follows (amounts in millions):

	May 4, 2018	February 2, 2018	Effective Interest Rate
Long-term debt:			
2.30% Senior Note Due August 21, 2020	\$ 1,250	\$ 1,250	2.56%
2.95% Senior Note Due August 21, 2022	1,500	1,500	3.17%
3.90% Senior Note Due August 21, 2027	1,250	1,250	4.05%
Total principal amount	4,000	4,000	
Less: unamortized discount	(8 )	(8 )	
Less: unamortized debt issuance costs	(26 )	(28 )	
Net carrying amount	\$ 3,966	\$ 3,964	

Interest is payable semiannually in arrears, on February 21 and August 21 of each year. During the three months ended May 4, 2018, \$32 million of interest expense, which included amortization of discount and issuance costs, was recognized on the condensed consolidated statements of income. The discount and issuance costs are amortized over the term of the Senior Notes on a straight-line basis, which approximates the effective interest method.

The Senior Notes are redeemable in whole at any time or in part from time to time at VMware's option, subject to a make-whole premium. In addition, upon the occurrence of certain change-of-control triggering events and certain downgrades of the ratings on the Senior Notes, VMware may be required to repurchase the notes at a repurchase price equal to 101% of the aggregate principal plus any accrued and unpaid interest on the date of purchase. The Senior Notes rank equally in right of payment with VMware's other unsecured and unsubordinated indebtedness. The Senior Notes also include restrictive covenants that, in certain circumstances, limit VMware's ability to create certain liens, to enter into certain sale and leaseback transactions and to consolidate, merge, sell or otherwise dispose of all or substantially all of VMware's assets.

Refer to Note C for information regarding the notes payable to Dell.

**Revolving Credit Facility**

On September 12, 2017, VMware entered into an unsecured credit agreement establishing a revolving credit facility ("Credit Facility") with a syndicate of lenders that provides the Company with a borrowing capacity of up to \$1,000 million, which may be used for general corporate purposes. Commitments under the Credit Facility are available for a period of five years, which may be extended, subject to the satisfaction of certain conditions, by up to two one-year periods. As of May 4, 2018, there were no outstanding borrowings under the Credit Facility. The credit agreement contains certain representations, warranties and covenants. Commitment fees, interest rates and other terms of borrowing under the Credit Facility may vary based on VMware's external credit ratings. The amount paid in connection with the ongoing commitment fee, which is payable quarterly in arrears, was not significant during the three months ended May 4, 2018.

**I. Fair Value Measurements****Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis**

Certain financial assets and liabilities are measured at fair value on a recurring basis. VMware determines fair value using the following hierarchy:

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 noted as being 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; and

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

VMware's fixed income securities were primarily classified as Level 2, with the exception of some of the U.S.

Government and agency obligations that were classified as Level 1. Additionally, VMware's Level 2 classification

included forward contracts, notes payable to Dell and the Senior Notes.

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As of May 4, 2018 and February 2, 2018, VMware's Level 2 investment securities were generally priced using non-binding market consensus prices that were corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques.

VMware did not have any significant assets or liabilities that were classified as Level 3 of the fair value hierarchy for the periods presented, and there have been no transfers between fair value measurement levels during the periods presented.

The following tables set forth the fair value hierarchy of VMware's cash equivalents, short-term investments and derivatives that were required to be measured at fair value as of the periods presented (tables in millions):

	May 4, 2018		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$6,621	\$—	\$6,621
U.S. and foreign corporate debt securities	—	67	67
Total cash equivalents	\$6,621	\$67	\$6,688
Short-term investments:			
U.S. Government and agency obligations	\$679	\$268	\$947
U.S. and foreign corporate debt securities	—	4,355	4,355
Foreign governments and multi-national agency obligations	—	96	96
Mortgage-backed securities	—	104	104
Marketable equity securities	27	—	27
Total short-term investments	\$706	\$4,823	\$5,529

	February 2, 2018		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$5,460	\$—	\$5,460
U.S. and foreign corporate debt securities	—	88	88
Total cash equivalents	\$5,460	\$88	\$5,548
Short-term investments:			
U.S. Government and agency obligations	\$684	\$273	\$957
U.S. and foreign corporate debt securities	—	4,473	4,473
Foreign governments and multi-national agency obligations	—	98	98
Mortgage-backed securities	—	121	121
Marketable available-for-sale equity securities	33	—	33
Total short-term investments	\$717	\$4,965	\$5,682

The notes payable to Dell and the Senior Notes were not adjusted to fair value. The fair value of the notes payable to Dell was approximately \$245 million and \$246 million as of May 4, 2018 and February 2, 2018, respectively. The fair value of the Senior Notes was approximately \$3,829 million and \$3,863 million as of May 4, 2018 and February 2, 2018, respectively. Fair value for both the notes payable to Dell and the Senior Notes was estimated primarily based on observable market interest rates (Level 2 inputs).

VMware offers a deferred compensation plan for eligible employees, which allows participants to defer payment for part or all of their compensation. The net impact to the condensed consolidated statements of income is not significant since changes in the fair value of the assets substantially offset changes in the fair value of the liabilities. As such, assets and liabilities associated with this plan have not been included in the above tables. Assets associated with this

plan were the same as the liabilities at approximately \$66 million and \$60 million as of May 4, 2018 and February 2, 2018, respectively, and are included in other assets and other liabilities on the condensed consolidated balance sheets.

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Equity securities

During January 2016, the FASB issued ASU No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”), which requires equity investments with readily determinable fair values (other than those accounted for under the equity method or those that result in consolidation of the investee) to be measured at fair value with changes in fair value for certain equity investments recognized in other income (expenses), net on the condensed consolidated statements of income.

Securities Carried at Fair Value

VMware holds an equity security, which is publicly traded and measured at fair value using quoted prices for identical assets in an active market (Level 1). Prior to the adoption of ASU 2016-01, unrealized gains or losses on this equity security were recognized in accumulated other comprehensive income on the condensed consolidated balance sheets. Effective February 3, 2018, VMware adopted ASU 2016-01 and reclassified the unrealized gain on this security of \$11 million to retained earnings as a cumulative-effect adjustment on the condensed consolidated balance sheets. Unrealized gains and losses are now recognized in other income (expense), net on the condensed consolidated statements of income. As of May 4, 2018, the fair value of this equity security was \$27 million and was included in short-term investments on the condensed consolidated balance sheets. The unrealized loss recognized during the three months ended May 4, 2018 was not significant.

Based upon VMware’s voting interest in Pivotal, VMware elected the fair value option of accounting because it believes that fair value is the most relevant measurement for this investment. Consequently, VMware recognized a gain of \$781 million in other income (expense), net on the condensed consolidated statements of income to adjust its investment in Pivotal to its fair value of \$801 million. The fair value was determined using the quoted market price of Pivotal’s Class A common stock as of May 4, 2018, adjusted for the impact of lack of marketability and superior voting rights (Level 2). Financial information of Pivotal is made publicly available and is not considered material for purposes of disclosure for the three months ended May 4, 2018.

Securities Without a Readily Determinable Fair Value

VMware’s equity securities also include investments in privately held companies, which do not have a readily determinable fair value. Prior to the adoption of ASU 2016-01, VMware accounted for these equity securities at cost less impairment and recorded realized gains and losses on securities sold or impaired in other income (expense), net on the condensed consolidated statements of income. As of February 2, 2018, equity securities accounted for under the cost method had a carrying value of \$146 million.

Upon adoption of ASU 2016-01, VMware elected to measure these equity securities at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar security of the same issuer. As of May 4, 2018, these equity securities had a carrying value of \$126 million and were included in other assets on the condensed consolidated balance sheets. All gains and losses on these equity securities, whether realized or unrealized, are recognized in other income (expense), net on the condensed consolidated statements of income.

J. Derivatives and Hedging Activities

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate a portion of this risk, VMware utilizes hedging contracts as described below, which potentially expose the Company to credit risk to the extent that the counterparties may be unable to meet the terms of the agreements. VMware manages counterparty risk by seeking counterparties of high credit quality, by monitoring credit ratings and credit spreads of, and other relevant public information about its counterparties. VMware does not, and does not intend to, use derivative instruments for trading or speculative purposes.

Cash Flow Hedges

To mitigate its exposure to foreign currency fluctuations resulting from certain operating expenses denominated in certain foreign currencies, VMware enters into forward contracts that are designated as cash flow hedging instruments as the accounting criteria for such designation are met. Therefore, the effective portion of gains or losses resulting



from changes in the fair value of these instruments is initially reported in accumulated other comprehensive loss on the condensed consolidated balance sheets and is subsequently reclassified to the related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. During the three months ended May 4, 2018 and May 5, 2017, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not significant. Interest charges or “forward points” on VMware’s forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income (expense), net on the condensed consolidated statements of income as incurred.

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These forward contracts have contractual maturities of twelve months or less, and as of May 4, 2018 and February 2, 2018, outstanding forward contracts had a total notional value of \$240 million and \$318 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three months ended May 4, 2018 and May 5, 2017, all cash flow hedges were considered effective.

**Forward Contracts Not Designated as Hedges**

VMware has established a program that utilizes forward contracts to offset the foreign currency risk associated with net outstanding monetary asset and liability positions. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net on the condensed consolidated statements of income.

These forward contracts have a contractual maturity of one month, and as of May 4, 2018 and February 2, 2018, outstanding forward contracts had a total notional value of \$676 million and \$1,020 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three months ended May 4, 2018, VMware recognized a gain of \$30 million related to the settlement of forward contracts. The loss recognized during the three months ended May 5, 2017 was not significant. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

The combined gains and losses related to the settlement of forward contracts and the underlying foreign currency denominated assets and liabilities were not significant during the three months ended May 4, 2018 and May 5, 2017. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

**K. Contingencies**

**Litigation**

On August 10, 2015, the Company received a subpoena from the California Attorney General's office ("California AG"), following the Company's settlement with the Department of Justice and the General Services Administration during June 2015. In this matter, the California AG is investigating the accuracy of the Company's sales practices with departments and agencies within the State of California. The Company held an initial meeting with the California AG's representatives on November 5, 2015, and thereafter provided certain requested documents to the California AG. The Company did not receive any further communications from the California AG until the fall of 2017. Since then, the California AG and the Company have exchanged communications regarding the legal bases for the allegations, and the Company has provided additional information requested by the California AG. In January 2018, the California AG advised the Company that it was ready to further discuss the matter. The Company is unable at this time to reasonably assess whether or to what extent it may be found liable and believes a loss is not considered probable and is not estimable.

On March 4, 2015, Christoph Hellwig, a software developer who alleged that software code he wrote is used in a component of the Company's vSphere product, filed a lawsuit against VMware in the Hamburg Regional Court in Germany alleging copyright infringement for failing to comply with the terms of the open source General Public License v.2 ("GPL v.2"). On July 8, 2016, the German court issued a written decision dismissing Mr. Hellwig's lawsuit. Mr. Hellwig has appealed this decision and both parties have filed their initial opening appellate briefs. No hearing schedule has yet been set by the appellate court. The Company intends to continue vigorously defending itself against this lawsuit.

While VMware believes that it has valid defenses against each of the above legal matters, given the unpredictable nature of legal proceedings, an unfavorable resolution of one or more legal proceedings, claims, or investigations could have a material adverse effect on VMware's condensed consolidated financial statements.

VMware accrues for a liability when a determination has been made that a loss is both probable and the amount of the loss can be reasonably estimated. If only a range can be estimated and no amount within the range is a better estimate than any other amount, an accrual is recorded for the minimum amount in the range. Significant judgment is required

in both the determination that the occurrence of a loss is probable and is reasonably estimable. In making such judgments, VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal costs are generally recognized as expense when incurred.

VMware is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business or in connection with business mergers and acquisitions, including claims with respect to commercial, contracting and sales practices, product liability, intellectual property, employment, corporate and securities law, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has discussions with government entities and stockholders on various matters. As of May 4, 2018, amounts accrued relating to these other

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

matters arising as part of the ordinary course of business were considered not material. VMware does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on its condensed consolidated financial statements.

## L. Unearned Revenue and Remaining Performance Obligations

## Unearned Revenue

Unearned revenue as of the periods presented consisted of the following (table in millions):

	May 4, February 2,	
	2018	2018
Unearned license revenue	\$157	\$ 184
Unearned software maintenance revenue	5,024	5,082
Unearned professional services revenue	575	573
Total unearned revenue	\$5,756	\$ 5,839

Unearned license revenue is primarily related to the allocated portion of VMware's SaaS offerings and is generally recognized over time as customers consume the services or ratably over the term of the subscription, commencing upon provisioning of the service.

Unearned software maintenance revenue is attributable to VMware's maintenance contracts and is generally recognized over time on a ratable basis over the contract duration. The weighted-average remaining term as of May 4, 2018 was approximately two years. In addition, unearned software maintenance revenue also includes the allocated portion of VMware's SaaS offerings. Unearned professional services revenue results primarily from prepaid professional services and is generally recognized as the services are performed.

Unearned revenue on current quarter billings was \$1,210 million and revenue recognized during the three months ended May 4, 2018, from amounts previously classified as unearned revenue, was \$1,215 million and did not include revenue for performance obligations that were fully satisfied upon delivery, such as on-premises license.

During the three months ended May 4, 2018, cloud credits totaling \$77 million were reclassified from unearned revenue to customer deposits, due to the addition of third-party offerings that would be recognized net of associated cost upon redemption of cloud credits.

Revenue recognized during the three months ended May 5, 2017, from amounts previously classified as unearned revenue, was \$1,128 million and did not include revenue for performance obligations that were fully satisfied upon delivery, such as on-premises license.

## Remaining Performance Obligations

Remaining performance obligations represent the aggregate amount of the transaction price in contracts allocated to performance obligations not delivered, or partially undelivered, as of the end of the reporting period. Remaining performance obligations include unearned revenue, multi-year contracts with future installment payments and certain unfulfilled orders against accepted customer contracts at the end of any given period.

As of May 4, 2018, the aggregate transaction price allocated to remaining performance obligations was \$6,125 million. Approximately 60% is expected to be recognized as revenue over the next 12 months and the remainder thereafter. VMware applied the practical expedient to not disclose the amount of transaction price allocated to remaining performance obligations for periods prior to adoption of Topic 606.

## M. Stockholders' Equity

## VMware Stock Repurchases

VMware purchases stock from time to time in open market transactions, subject to market conditions. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate, legal and regulatory requirements and other market and economic conditions. VMware is not obligated to purchase any shares under its stock repurchase programs. Purchases can be discontinued at any time VMware believes additional purchases are not warranted. From time to time, VMware also purchases stock in private transactions, such as those with Dell. All shares repurchased

under VMware's stock repurchase programs are retired.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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During August 2017, VMware's board of directors authorized the repurchase of up to \$1,000 million of Class A common stock through August 31, 2018. As of May 4, 2018, the cumulative authorized amount remaining for stock repurchases was \$876 million.

There were no repurchases of VMware Class A common stock during the three months ended May 4, 2018.

The following table summarizes stock repurchase activity, including shares purchased from Dell, during the three months ended May 5, 2017 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended May 5, 2017
Aggregate purchase price <sup>(1)</sup>	\$ 357
Class A common shares repurchased	4,161
Weighted-average price per share	\$ 85.85

<sup>(1)</sup> The aggregate purchase price of repurchased shares is classified as a reduction to additional paid-in capital.

**VMware Restricted Stock**

VMware's restricted stock primarily consists of restricted stock unit ("RSU") awards, which have been granted to employees. The value of an RSU grant is based on VMware's stock price on the date of grant. The shares underlying the RSU awards are not issued until the RSUs vest. Upon vesting, each RSU converts into one share of VMware Class A common stock.

VMware's restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain VMware executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based or market-based vesting component. Upon vesting, PSU awards convert into VMware's Class A common stock at various ratios ranging from 0.5 to 2.0 shares per PSU, depending upon the degree of achievement of the performance or market-based target designated by each award. If minimum performance thresholds are not achieved, then no shares are issued.

The following table summarizes restricted stock activity since February 3, 2018 (units in thousands):

	Number of Units	Weighted-Average Grant Date Fair Value (per unit)
Outstanding, February 3, 2018	17,360	\$ 78.62
Granted	1,263	124.26
Vested	(2,210 )	73.38
Forfeited	(504 )	77.67
Outstanding, May 4, 2018	15,909	83.00

The aggregate vesting date fair value of VMware restricted stock that vested during the three months ended May 4, 2018 was \$290 million. As of May 4, 2018, restricted stock representing 15.9 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of \$2,137 million based on VMware's closing stock price as of May 4, 2018.

**Net excess tax benefits**

Net excess tax benefits recognized in connection with stock-based awards are included in the income tax provision on the condensed consolidated statements of income. Net excess tax benefits recognized during the three months ended May 4, 2018 and May 5, 2017 were \$27 million and \$31 million, respectively.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Accumulated Other Comprehensive Income (Loss)

The changes in components of accumulated other comprehensive income (loss) during the periods presented were as follows (tables in millions):

	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, February 2, 2018	\$ (15 )	\$ —	\$(15 )
Adjustments related to adoption of ASU 2016-01 and 2018-02	(15 )	—	(15 )
Unrealized gains (losses), net of tax (benefit) of (\$5), \$— and (\$5)	(15 )	(9 )	(24 )
Amounts reclassified from accumulated other comprehensive income (loss) to the condensed consolidated statements of income, net of tax benefit of \$—	—	—	—
Other comprehensive income (loss), net	(15 )	(9 )	(24 )
Balance, May 4, 2018	\$ (45 )	\$ (9 )	\$(54 )
	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, February 3, 2017	\$ (6 )	\$ 2	\$(4 )
Unrealized gains (losses), net of tax provision of \$5, \$— and \$5	8	5	13
Amounts reclassified from accumulated other comprehensive income (loss) to the condensed consolidated statements of income, net of taxes of \$—	1	1	2
Other comprehensive income (loss), net	9	6	15
Balance, May 5, 2017	\$ 3	\$ 8	\$11

Unrealized gains and losses on VMware's available-for-sale securities are reclassified to investment income on the condensed consolidated statements of income in the period that such gains and losses are realized.

The effective portion of gains or losses resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments is reclassified to its related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense functional line items on the condensed consolidated statements of income were not significant to the individual functional line items during the periods presented.

During October 2016, the FASB issued ASU No. 2016-16, Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory (Topic 740) ("ASU 2016-16"), which requires entities to recognize at the transaction date the income tax consequences of intra-entity asset transfers. The updated standard is effective for annual and interim periods beginning after December 15, 2017 and requires a modified retrospective transition method.

Effective February 3, 2018, VMware adopted ASU 2016-16 on a modified retrospective basis. Historically, VMware transferred intellectual property between its legal entities and the income tax consequences were recorded on the condensed consolidated balance sheets and recognized to tax provision over a period of time. VMware recorded the cumulative-effect adjustment of \$27 million to retained earnings on the Company's condensed consolidated balance sheets as of the beginning of the period of adoption. Subsequent to adoption, any transfers of intellectual property between VMware's legal entities will be recorded on the condensed consolidated statements of income in the period that the transfer occurs.





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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

During February 2018, the FASB issued ASU 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (“ASU 2018-02”), which allows companies to reclassify stranded tax effects resulting from the 2017 Tax Act from accumulated other comprehensive income to retained earnings. ASU 2018-02 is effective for interim and annual periods beginning after December 15, 2018, with early adoption permitted, and should be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the 2017 Tax Act is recognized.

Effective February 3, 2018, VMware early adopted ASU 2018-02 and elected to reclassify income tax effects due to the 2017 Tax Act from accumulated other comprehensive loss to retained earnings on the Company’s condensed consolidated balance sheets in the period of adoption. The impact of the reclassification of stranded tax effects was not significant.

**N. Segment Information**

VMware operates in one reportable operating segment, thus all required financial segment information is included in the condensed consolidated financial statements. Operating segments are defined as components of an enterprise for which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. VMware’s chief operating decision maker allocates resources and assesses performance based upon discrete financial information at the consolidated level.

Revenue by type during the periods presented was as follows (table in millions):

	Three Months Ended May 4, May 5, 2018 2017	
Revenue:		
License	\$774	\$641
Services:		
Software maintenance	1,077	979
Professional services	157	145
Total services	1,234	1,124
Total revenue <sup>(1)</sup>	\$2,008	\$1,765

<sup>(1)</sup> Includes revenue derived from VMware’s Hybrid Cloud computing subscription and SaaS offerings, which was \$210 million and \$168 million during the three months ended May 4, 2018 and May 5, 2017, respectively. Hybrid Cloud Computing offerings consisted primarily of VCPP revenue.

Revenue by geographic area during the periods presented was as follows (table in millions):

	Three Months Ended May 4, May 5, 2018 2017	
United States	\$938	\$890
International	1,070	875
Total	\$2,008	\$1,765

Revenue by geographic area is based on the ship-to addresses of VMware’s customers. No individual country other than the U.S. accounted for 10% or more of revenue during the three months ended May 4, 2018 and May 5, 2017.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of the periods presented were as follows (table in millions):

	May 4,	February 2,

	2018	2018
United States	\$806	\$ 784
International	114	117
Total	\$920	\$ 901

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

No individual country other than the U.S. accounted for 10% or more of these assets as of May 4, 2018 and February 2, 2018.

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

The following management's discussion and analysis is provided in addition to the accompanying condensed consolidated financial statements and notes to assist in understanding our results of operations and financial condition. Financial information as of May 4, 2018 should be read in conjunction with our consolidated financial statements for the year ended February 2, 2018 contained in our Form 10-K filed on March 29, 2018. Multiple accounting standards were adopted during the three months ended May 4, 2018, which resulted in adjustments or reclassifications of amounts previously reported. Refer to the Notes to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion.

Period-over-period changes are calculated based upon the respective underlying, non-rounded data. We refer to our fiscal years ended February 1, 2019 and February 2, 2018 as "fiscal 2019" and "fiscal 2018," respectively. Unless the context requires otherwise, we are referring to VMware, Inc. and its consolidated subsidiaries when we use the terms "VMware," the "Company," "we," "our" or "us."

Overview

We pioneered the development and application of virtualization technologies with x86 server-based computing, separating application software from the underlying hardware. Information technology ("IT") driven innovation is disrupting markets and industries. Technologies emerge faster than organizations can absorb them, creating increasingly complex environments. To take on this challenge, businesses need a flexible and secure digital foundation. We provide compute, cloud, mobility, networking and security infrastructure software to businesses that provides a flexible digital foundation for the applications that empower businesses to serve their customers globally. Over the years, we have increased our product and solution offerings beyond compute virtualization to include offerings that allow organizations to manage IT resources across private clouds and complex multi-cloud, multi-device environments by leveraging synergies across three product categories: Software-Defined Data Center ("SDDC"), Hybrid Cloud Computing and End-User Computing ("EUC"). Our portfolio supports and addresses the four key IT priorities of our customers: modernizing data centers, integrating public clouds, empowering digital workspaces and transforming security.

We sell our solutions using enterprise agreements ("EAs") or as part of our non-EA, or transactional, business. EAs are comprehensive volume license offerings, offered both directly by us and through certain channel partners that also provide for multi-year maintenance and support. We continue to experience strong renewals, including renewals of our EAs, resulting in additional license sales of both our existing and newer products and solutions.

SDDC or Software-Defined Data Center

Our SDDC technologies form the foundation of our customers' private cloud environments and provide the capabilities for our customers to extend their private cloud to the public cloud and to help them run, manage, secure and connect all their applications across all clouds and devices. During the three months ended May 4, 2018, we continued to see broad-based strength of our SDDC solutions. While sales from our management products increased during the three months ended May 4, 2018, future sales growth rate may fluctuate period to period, depending largely upon the extent to which management products are included in our particular larger EAs.

Hybrid Cloud Computing

Our overarching cloud strategy contains three key components: (i) continue to expand beyond compute virtualization in the private cloud; (ii) extend the private cloud into the public cloud; and (iii) connect and secure endpoints across a range of public clouds. During the three months ended May 4, 2018, Hybrid Cloud Computing was primarily comprised of VMware Cloud Provider Program ("VCP") and also includes VMware Cloud Services, which enable customers to run, manage, connect and secure their applications across private and public clouds.

During the three months ended May 4, 2018, revenue growth in our Hybrid Cloud Computing offerings was primarily driven by our VCP offerings. VMware Cloud on AWS is currently available in certain geographies, and we expect to continue expanding into additional regions.

End-User Computing

Our EUC solution consists of VMware Workspace ONE ("Workspace ONE"), our digital workspace platform, which includes VMware AirWatch ("AirWatch") and VMware Horizon. Our AirWatch business model includes an

on-premises solution that we offer through the sale of perpetual licenses and software-as-a-service (“SaaS”) solutions. Workspace ONE continued to be our primary growth driver within our EUC product group during the three months ended May 4, 2018.

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## Dell Synergies

During the three months ended May 4, 2018, we continued joint marketing, sales, branding and product development efforts with Dell Technologies Inc. (“Dell”) and other Dell Technologies companies to enhance the collective value we deliver to our mutual customers. As a result of our collective business built with Dell, we have experienced synergies benefiting our sales during the three months ended May 4, 2018.

## Results of Operations

Approximately 70% of our sales are denominated in the United States (“U.S.”) dollar, however, in certain countries we also invoice and collect in the following currencies: euro; British pound; Japanese yen; Australian dollar; and Chinese renminbi. In addition, we incur and pay operating expenses in currencies other than the U.S. dollar. As a result, our financial statements, including our revenue, operating expenses, unearned revenue and the resulting cash flows derived from the U.S. dollar equivalent of foreign currency transactions, are affected by foreign exchange fluctuations.

## Revenue

Our revenue during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017 <sup>(1)</sup>	\$ Change	% Change
Revenue:				
License	\$774	\$641	\$ 134	21 %
Services:				
Software maintenance	1,077	979	98	10
Professional services	157	145	11	8
Total services	1,234	1,124	109	10
Total revenue	\$2,008	\$1,765	\$ 243	14

## Revenue:

United States	\$938	\$890	\$ 48	5 %
International	1,070	875	195	22
Total revenue	\$2,008	\$1,765	\$ 243	14

<sup>(1)</sup> Fiscal 2018 amounts have been adjusted to reflect the impact of our retrospective adoption of Accounting Standards Codification 606, Revenue from Contracts with Customers (“Topic 606”), effective February 3, 2018.

Revenue from our Hybrid Cloud Computing offerings consisted primarily of VCPP, and revenue from our SaaS offerings consisted primarily of our AirWatch mobile solution within Workspace ONE. VCPP revenue is included in license revenue and SaaS revenue is allocated equally between license and services revenue. Hybrid Cloud Computing, together with our SaaS offerings, increased to approximately 10% of our total revenue during the three months ended May 4, 2018 from greater than 9% of our total revenue during the three months ended May 5, 2017. License revenue relating to the sale of perpetual licenses that are part of a multi-year contract is generally recognized upon delivery of the underlying license, whereas revenue derived from our Hybrid Cloud Computing and SaaS offerings is recognized on a consumption basis or over a period of time.

## License Revenue

License revenue during the three months ended May 4, 2018 compared to the three months ended May 5, 2017 benefited from broad-based growth across our diverse portfolio, including our core SDCC solutions driven in part by strength in our management products and continued growth of our VCPP offering, and in all geographies. Strength in our renewal business, including EAs, also contributed to license revenue growth during the three months ended May 4, 2018 compared to the three months ended May 5, 2017.

## Services Revenue

During the three months ended May 4, 2018, software maintenance revenue continued to benefit from strong renewals of our EAs, maintenance contracts sold in previous periods and additional maintenance contracts sold in conjunction

with new software license sales. In each period presented, customers purchased, on a weighted-average basis, approximately three years of support and maintenance with each new license purchased.

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Professional services revenue increased 8% during the three months ended May 4, 2018 as compared to the three months ended May 5, 2017. We have continued our focus on solution deployments, including our VMware NSX (“NSX”) products, which contributed to the increase in professional services revenue. We continue to focus on enabling our partners to deliver professional services for our solutions and as such, our professional services revenue may vary as we continue to leverage our partners. Timing of service engagements will also impact the amount of professional services revenue we recognize during a period.

**Unearned Revenue**

Unearned revenue as of the periods presented consisted of the following (table in millions):

	May 4, February 2, 2018 2018 <sup>(1)</sup>	
Unearned license revenue	\$157	\$ 184
Unearned software maintenance revenue	5,024	5,082
Unearned professional services revenue	575	573
Total unearned revenue	\$5,756	\$ 5,839

<sup>(1)</sup> Fiscal 2018 amounts have been adjusted to reflect the impact of our retrospective adoption of Topic 606, effective February 3, 2018.

Unearned license revenue is primarily related to the allocated portion of our SaaS offerings and is generally recognized over time as customers consume the services or ratably over the term of the subscription, commencing upon provisioning of the service.

Unearned software maintenance revenue is attributable to our maintenance contracts and is generally recognized over time on a ratable basis over the contract duration. The weighted-average remaining term as of May 4, 2018 was approximately two years. In addition, unearned software maintenance revenue also includes the allocated portion of our SaaS offerings. Unearned professional services revenue results primarily from prepaid professional services and is generally recognized as the services are performed.

**Remaining Performance Obligations and Backlog****Remaining Performance Obligations**

Remaining performance obligations represent the aggregate amount of the transaction price in contracts allocated to performance obligations not delivered, or partially undelivered, as of the end of the reporting period. Remaining performance obligations include unearned revenue, multi-year contracts with future installment payments and certain unfulfilled orders against accepted customer contracts at the end of any given period.

As of May 4, 2018, the aggregate transaction price allocated to remaining performance obligations was \$6,125 million. Approximately 60% is expected to be recognized as revenue over the next 12 months and the remainder thereafter.

**Backlog**

Backlog is comprised of unfulfilled purchase orders or unfulfilled executed agreements received at the end of a given period and is net of related estimated rebates and marketing development funds. As of May 4, 2018, our total backlog was \$301 million, generally consisting of licenses, maintenance and services. Our backlog related to licenses was \$122 million, which we generally expect to deliver and recognize as revenue during the following quarter. Backlog totaling \$65 million as of May 4, 2018, is excluded from the remaining performance obligations because such contracts are subject to cancellation until fulfillment of the performance obligation occurs. As of February 2, 2018, our total backlog was \$285 million, generally consisting of licenses, maintenance and services. Our backlog related to licenses was \$99 million.

The amount and composition of backlog will fluctuate period to period, and backlog is managed based upon multiple considerations, including product and geography. We do not believe the amount of backlog is indicative of future sales or revenue or that the mix of backlog at the end of any given period correlates with actual sales performance of a particular geography or particular products and services.

**Cost of License Revenue, Cost of Services Revenue and Operating Expenses**

Our cost of services revenue and operating expenses primarily reflected increasing cash-based employee-related expenses, driven by incremental growth in salaries and headcount across most of our income statement expense



categories during the three months ended May 4, 2018. We expect increases in cash-based employee-related expenses to continue.

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## Cost of License Revenue

Cost of license revenue primarily consists of the cost of fulfillment of our software, royalty costs in connection with technology licensed from third-party providers and amortization of intangible assets. The cost of fulfillment of our software includes personnel costs and related overhead associated with the physical and electronic delivery of our software products.

Cost of license revenue during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Cost of license revenue	\$45	\$38	\$ 6	17 %
Stock-based compensation	—	1	—	(54 )
Total expenses	\$45	\$39	\$ 6	16
% of License revenue	6 %	6 %		

Cost of license revenue increased during the three months ended May 4, 2018 compared to the three months ended May 5, 2017 primarily due to an increase in amortization of intangible assets.

## Cost of Services Revenue

Cost of services revenue primarily includes the costs of personnel and related overhead to physically and electronically deliver technical support for our products and hosted services and to provide professional services. Additionally, cost of services revenue includes depreciation of equipment supporting our service offerings.

Cost of services revenue during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Cost of services revenue	\$240	\$236	\$ 3	1 %
Stock-based compensation	11	14	(2 )	(17 )
Total expenses	\$251	\$250	\$ 1	—
% of Services revenue	20 %	22 %		

Cost of services revenue was relatively flat during the three months ended May 4, 2018 compared to the three months ended May 5, 2017.

## Research and Development Expenses

Research and development expenses include the personnel and related overhead associated with the development of our product software and service offerings. We continue to invest in our key growth areas, including NSX and VMware vSAN, while also investing in areas that we expect to be significant growth drivers in future periods.

Research and development expenses during the periods presented were as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Research and development	\$369	\$339	\$ 30	9 %
Stock-based compensation	84	82	2	2
Total expenses	\$453	\$421	\$ 32	7
% of Total revenue	23 %	24 %		

Research and development expenses increased during the three months ended May 4, 2018 compared to the three months ended May 5, 2017. The increase was primarily due to growth in cash-based employee-related expenses of \$37 million, driven by incremental growth in headcount and salaries.

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## Sales and Marketing Expenses

Sales and marketing expenses include personnel costs, sales commissions and related overhead associated with the sale and marketing of our license and services offerings, as well as the cost of product launches and marketing initiatives. A significant portion of our sales commissions are deferred and recognized over the expected period of benefit.

Sales and marketing expenses during the periods presented were as follows (dollars in millions):

	Three Months Ended			
	May 4,	May 5,		
	2018	2017 <sup>(1)</sup>	\$	%
			Change	Change
Sales and marketing	\$660	\$531	\$ 131	25 %
Stock-based compensation	46	48	(4 )	(8 )
Total expenses	\$706	\$579	\$ 127	22
% of Total revenue	35 %	33 %		

<sup>(1)</sup> Fiscal 2018 amounts have been adjusted to reflect the impact of our retrospective adoption of Topic 606, effective February 3, 2018.

Sales and marketing expenses increased during the three months ended May 4, 2018 compared to the three months ended May 5, 2017. The increase was primarily due to growth in cash-based employee-related expenses of \$86 million, driven by incremental growth in headcount and salaries, as well as higher commission costs, resulting from increased sales volume and headcount. The increase was also driven by an increase in costs incurred for sales enablement-based initiatives of \$30 million during the three months ended May 4, 2018 and fluctuations in the exchange rates for foreign currencies in which we incur expenses.

## General and Administrative Expenses

General and administrative expenses include personnel and related overhead costs to support the business. These expenses include the costs associated with finance, human resources, IT infrastructure and legal, as well as expenses related to corporate costs and initiatives, including certain charitable donations to the VMware Foundation.

General and administrative expenses during the periods presented were as follows (dollars in millions):

	Three Months Ended			
	May 4,	May 5,		
	2018	2017	\$	%
			Change	Change
General and administrative	\$ 149	\$ 133	\$ 16	12 %
Stock-based compensation	20	18	3	15
Total expenses	\$ 169	\$ 151	\$ 18	12
% of Total revenue	8 %	9 %		

General and administrative expenses increased during the three months ended May 4, 2018 compared to the three months ended May 5, 2017, but remained relatively consistent as a percentage of total revenue.

## Realignment and Loss on Disposition

Realignment expenses and loss on disposition during the periods presented were as follows (dollars in millions):

	Three Months Ended			
	May 4,	May 5, 4,		
	2018	2017 <sup>(1)</sup>	\$	%
			Change	Change
Realignment and loss on disposition	\$ 2	\$ 64	\$ (62 )	(97 )%

% of Total revenue — % 4 %

(1) Fiscal 2018 amounts have been adjusted to reflect the impact of our retrospective adoption of Topic 606, effective February 3, 2018.

On April 4, 2017, we announced the sale of our vCloud Air business (“vCloud Air”) to OVH US LLC (“OVH”). The loss recognized in connection with this transaction was \$64 million and included the impairment of deferred commissions resulting from the retrospective adoption of Topic 606, which was \$13 million during the three months ended May 5, 2017. Losses recognized on the disposition of vCloud Air included the impairment of fixed assets identified as part of the sale, as well as the

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costs associated with certain transition services, which primarily included employee-related expenses and costs associated with data-center colocation services. Transition services are to be provided over a period of 18 months, starting from the date of the sale. We completed the sale of vCloud Air to OVH during the second quarter of fiscal 2018.

## Investment Income

Investment income during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Investment income	\$48	\$23	\$26	112%
% of Total revenue	2%	1%		

Investment income increased during the three months ended May 4, 2018 compared to the three months ended May 5, 2017, primarily driven by increased interest income earned on our short-term investments resulting from higher yields and higher invested balances.

## Interest expense

Interest expense during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Interest expense	\$34	\$7	\$27	413%
% of Total revenue	2%	—%		

On August 21, 2017, we issued three series of unsecured senior notes (“Senior Notes”) pursuant to a public debt offering in the aggregate amount of \$4,000 million. Upon closing, a portion of the net proceeds from the offering was used to repay two of the notes payable to Dell in the aggregate principal amount of \$1,230 million. Interest expense increased by \$27 million during the three months ended May 4, 2018 compared to the three months ended May 5, 2017, due to the issuance of the Senior Notes, offset in part by a reduction in interest expense on the notes payable to Dell. We expect interest expense for fiscal 2019 to be approximately \$130 million.

## Other Income (Expense), net

Other income (expense), net during the periods presented was as follows (dollars in millions):

	Three Months Ended			
	May 4, 2018	May 5, 2017	\$ Change	% Change
Other income (expense), net	\$779	\$4	\$774	19375%
% of Total revenue	39%	—%		

Upon adoption of Accounting Standards Update (“ASU”) No. 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (“ASU 2016-01”), the carrying value of our non-marketable equity securities is adjusted to fair value based upon observable transactions for identical

or similar investments of the same issuer or impairment (referred to as the measurement alternative). All gains and losses on non-marketable equity securities, realized and unrealized, are recognized in other income (expense), net on the condensed consolidated statements of income. As a result of Pivotal Software, Inc's ("Pivotal") initial public offering, we recognized an unrealized gain of \$781 million, during the three months ended May 4, 2018 related to our investment in Pivotal.

The fair value of our investment is determined primarily using the quoted market price of Pivotal's Class A common stock. As a result, any volatility in Pivotal's publicly traded Class A common stock introduces a degree of variability to our condensed consolidated statements of income.

#### Income Tax Provision

Our quarterly effective income tax rate is based on our estimated annual income tax rate forecast and discrete tax items recognized in the period. Our quarterly effective income tax rate was 19.8% and 12.8% during the three months ended

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May 4, 2018 and May 5, 2017, respectively. Our effective income tax rate for the three months ended May 4, 2018 increased primarily due to the discrete tax impacts of \$179 million related to our book and tax basis difference on the investment in Pivotal, net of the reversal of the previously recorded valuation allowance. Our estimated annual effective income tax rate for fiscal 2019 decreased when compared to the annual effective income tax rate for fiscal 2018 primarily due to the reduction in the U.S. statutory corporate tax rate from 35% to 21% for fiscal 2019 partially offset by the expected increase due to Global Intangible Low-Taxed Income provisions of the U.S. Tax Cuts and Jobs Act enacted on December 22, 2017 (the “2017 Tax Act”).

Due to the timing of the enactment and the complexity involved in applying the provisions of the 2017 Tax Act, we made reasonable estimates for the related tax effects and recorded provisional amounts on our consolidated financial statements for fiscal 2018. As we complete our analysis of the 2017 Tax Act, collect and prepare necessary data, and interpret any additional guidance issued by the U.S. Treasury Department, the Internal Revenue Service, and other standard-setting bodies and relevant authorities, we may make adjustments to provisional amounts that we recorded that may materially impact our provision for income taxes in the period in which the adjustments are made.

We are included in Dell’s consolidated tax group for U.S. federal income tax purposes and will continue to be included in Dell’s consolidated group for periods in which Dell beneficially owns at least 80% of the total voting power and value of our combined outstanding Class A and Class B common stock as calculated for U.S. federal income tax purposes. The percentage of voting power and value calculated for U.S. federal income tax purposes may differ from the percentage of outstanding shares beneficially owned by Dell due to the greater voting power of our Class B common stock as compared to our Class A common stock and other factors. Each member of a consolidated group during any part of a consolidated return year is jointly and severally liable for tax on the consolidated return of such year and for any subsequently determined deficiency thereon. Should Dell’s ownership fall below 80% of the total voting power or value of our outstanding stock in any period, then we would no longer be included in the Dell consolidated group for U.S. federal income tax purposes, and our U.S. federal income tax would be reported separately from that of the Dell consolidated group.

Although our results are included in the Dell consolidated return for U.S. federal income tax purposes, our income tax provision, including provisional estimates of taxes relating to the 2017 Tax Act, is calculated primarily as though we were a separate taxpayer. However, under certain circumstances, transactions between us and Dell are assessed using consolidated tax return rules.

Our future effective tax rate will depend upon the proportion of our income before provision for income taxes earned in the U.S. and in jurisdictions with a tax rate lower than the U.S. statutory rate. Our non-U.S. earnings are primarily earned by our subsidiaries organized in Ireland where the rate of taxation is lower than our U.S. tax rate, and as such, our annual effective tax rate can be significantly affected by the composition of our earnings in the U.S. and non-U.S. jurisdictions. Our future effective tax rate may also be affected by such factors as changes in tax laws, changes in our business or statutory rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation and the recognition of excess tax benefits and tax deficiencies within the income tax provision in the period in which they occur, the impact of accounting for business combinations, changes in the composition of earnings in the U.S. compared with other regions in the world and overall levels of income before tax, changes in our international organization, as well as the expiration of statute of limitations and settlements of audits.

**Our Relationship with Dell**

As of May 4, 2018, Dell controlled 31 million shares of Class A common stock and all 300 million shares of Class B common stock, representing 81.4% of our total outstanding shares of common stock and 97.6% of the combined voting power of our outstanding common stock. For a description of related risks, refer to “Risks Related to Our Relationship with Dell” in Part II, Item 1A of this Quarterly Report on Form 10-Q.

The information provided below includes a summary of the transactions entered into with Dell and Dell’s consolidated subsidiaries, including EMC Corporation (collectively, “Dell”). Transactions prior to September 7, 2016 reflect transactions only with EMC Corporation and its consolidated subsidiaries.

**Transactions with Dell**

We engaged with Dell in the following ongoing intercompany transactions, which resulted in revenue and receipts and unearned revenue for us:



Pursuant to OEM and reseller arrangements, Dell integrates or bundles our products and services with Dell's products and sells them to end users. Dell also acts as a distributor, purchasing our standalone products and services for resale to end-user customers through VMware-authorized resellers. Revenue under these arrangements is presented net of related marketing development funds and rebates paid to Dell. In addition, we provide professional services to end users based upon contractual agreements with Dell.

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Dell purchases products and services from us for its internal use.

Pursuant to an ongoing distribution agreement, we act as the selling agent for certain products and services of Pivotal, a subsidiary of Dell, in exchange for an agency fee. Under this agreement, cash is collected from the end user by us and remitted to Pivotal, net of the contractual agency fee.

Dell purchases our products and services directly from us, as well as through our channel partners. Information about our revenue and receipts, and unearned revenue from such arrangements, for the periods presented consisted of the following (table in millions):

	Revenue and Receipts		Unearned Revenue	
	Three Months Ended		As of	
	May 4, 2018	May 5, 2017 <sup>(1)</sup>	May 4, 2018	February 2, 2018 <sup>(1)</sup>
Reseller revenue	\$360	\$ 249	\$1,311	\$ 1,236
Internal-use revenue	7	4	6	12
Agency fee revenue	4	—	—	—

<sup>(1)</sup> Fiscal 2018 amounts have been adjusted to reflect the impact of our retrospective adoption of Topic 606, effective February 3, 2018.

We engaged with Dell in the following ongoing intercompany transactions, which resulted in costs to us:

• We purchase and lease products and purchase services from Dell.

• From time to time, we and Dell enter into agreements to collaborate on technology projects, and we pay Dell for services provided to us by Dell related to such projects and Dell also provides funding for such projects.

In certain geographic regions where we do not have an established legal entity, we contract with Dell subsidiaries for support services and support from Dell personnel who are managed by us. The costs incurred by Dell on our behalf related to these employees are charged to us with a mark-up intended to approximate costs that would have been incurred had we contracted for such services with an unrelated third-party. These costs are included as expenses on our condensed consolidated statements of income and primarily include salaries, benefits, travel and occupancy expenses. Dell also incurs certain administrative costs on our behalf in the U.S. that are recorded as expenses on our condensed consolidated statements of income.

• From time to time, we invoice end users on behalf of Dell for certain services rendered by Dell. Cash related to these services is collected from the end user by us and remitted to Dell.

Information about our costs from such arrangements during the periods presented consisted of the following (table in millions):

	Three Months Ended	
	May 4, 2018	May 5, 2017
Purchases and leases of products and purchases of services	\$49	\$ 36
Dell subsidiary support and administrative costs	28	29

We also purchase Dell products through Dell's channel partners. Purchases of Dell products through Dell's channel partners were not significant during the periods presented.

From time to time, we and Dell also enter into joint marketing and product development arrangements, for which both parties may incur costs.

Dell Financial Services ("DFS")

DFS provided financing to certain of our end customers based on the customer's discretion. Upon acceptance of the financing arrangement by both our end customer and DFS, amounts classified as trade accounts receivable are reclassified to due from related parties, net on the condensed consolidated balance sheets. Revenue recognized on transactions financed through DFS was recorded net of financing fees, which were \$16 million during the three months ended May 4, 2018. Financing fees during the three months ended May 5, 2017 were not significant.

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## Tax Sharing Agreement with Dell

Payments made to Dell pursuant to a tax sharing agreement were not significant during the three months ended May 4, 2018. There were no payments to Dell pursuant to the tax sharing agreement during the three months ended May 5, 2017.

Payments from us to Dell under the tax sharing agreement relate to our portion of federal income taxes on Dell's consolidated tax return as well as state tax payments for combined states. The timing of the tax payments due to and from related parties is governed by the tax sharing agreement. The amounts that we pay to Dell for its portion of federal income taxes on Dell's consolidated tax return differ from the amounts we would owe on a separate tax return basis and the difference is recognized as a component of additional paid-in capital, generally in the period in which the consolidated return is filed. The difference between the amount of tax calculated on a separate tax return basis and the amount of tax calculated pursuant to the tax sharing agreement that was recorded in additional paid-in capital during the three months ended May 4, 2018 and May 5, 2017 was not significant.

## Due To/From Related Parties, Net

Amounts due to and from related parties, net as of the periods presented consisted of the following (table in millions):

	May 4, 2018	February 2, 2018
Due to related parties	\$ 134	\$ 106
Due from related parties	315	638
Due from related parties, net	\$ 181	\$ 532

Income tax due to related parties \$ 804 \$ 781

Amounts included in due from related parties, net, excluding DFS and tax obligations, are generally settled in cash within 60 days of each quarter-end.

## Stock Purchase Arrangements with Dell

From time to time, we enter into stock purchase arrangements with Dell. The following table summarizes purchases of our Class A common stock from Dell during the three months ended May 5, 2017, pursuant to stock purchase agreements entered into on December 15, 2016 and March 29, 2017 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended May 5, 2017
Aggregate purchase price	\$ 357
Class A common shares repurchased <sup>(1)</sup>	4,161
Weighted-average price per share	\$ 85.85

<sup>(1)</sup> The aggregate number of shares purchased was determined based upon a volume-weighted average price during a defined period, less an agreed upon discount.

There were no purchases of our Class A common stock from Dell during the three months ended May 4, 2018.

## Notes Payable to Dell

On January 21, 2014, we entered into a note exchange agreement with our parent company providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million, which consisted of outstanding principal due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022.

On August 21, 2017, we repaid two of the notes payable to Dell in the aggregate principal amount of \$1,230 million, representing repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount. The remaining note payable of \$270 million due December 1, 2022 may be prepaid without penalty or premium.

Interest is payable quarterly in arrears, at the annual rate of 1.75%. Interest expense recognized during the three months ended May 4, 2018 and May 5, 2017 was not significant.

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## Pivotal

As of February 2, 2018, we had a 20% ownership interest in Pivotal, and the investment was accounted for using the cost method. The value of the investment included on the condensed consolidated balance sheets was \$20 million as of February 2, 2018. Prior to Pivotal's initial public offering on April 20, 2018, our previously held preferred shares were converted to shares of non-trading Class B common stock, resulting in us having an 18% ownership interest and a 24% voting interest in Pivotal. As a result of Pivotal's initial public offering, our investment in Pivotal was adjusted to its fair value of \$801 million, and we recognized a gain of \$781 million in other income (expense), net on the condensed consolidated statements of income. We also recognized a discrete tax impact of \$179 million related to our book and tax basis difference on the investment in Pivotal, net of the reversal of the previously recorded valuation allowance. Refer to Note I to the condensed consolidated financial statements in Part I, Item I of this Quarterly Report on Form 10-Q for further discussion.

## Liquidity and Capital Resources

As of the periods presented, we held cash, cash equivalents and short-term investments as follows (table in millions):

	May 4, 2018	February 2, 2018
Cash and cash equivalents	\$7,101	\$ 5,971
Short-term investments	5,529	5,682
Total cash, cash equivalents and short-term investments	\$12,630	\$ 11,653

We hold a diversified portfolio of money market funds and fixed income securities. Our fixed income securities are denominated in U.S. dollars and primarily consist of highly liquid debt instruments of the U.S. Government and its agencies, municipal obligations, mortgage-backed securities and U.S. and foreign corporate debt securities. We limit the amount of our investments with any single issuer and monitor the diversity of the portfolio and the amount of investments held at any single financial institution, thereby diversifying our credit risk.

The 2017 Tax Act imposes a mandatory one-time transition tax on accumulated earnings of foreign subsidiaries and eliminates U.S. Federal taxes on foreign subsidiary distributions. As a result of the transition tax, we recorded a provisional estimate for income tax expense of approximately \$800 million during fiscal 2018 that was calculated on a separate tax return basis. The 2017 Tax Act includes a deferral election for an eight-year installment payment method on such transition tax obligations. We currently expect to pay our transition tax obligation over a period of eight years. Actual tax payments made to Dell pursuant to the tax sharing agreement may differ materially from our total estimated tax liability calculated on a separate tax return basis. The difference between our estimated liability and the amount paid to Dell is recognized as a component of additional paid-in capital, generally in the period in which the consolidated tax return is filed.

We expect that cash generated by operations will be our primary source of liquidity. We also believe that existing cash and cash equivalents and investments, together with any cash generated from operations, will be sufficient to fund our operations for at least the next twelve months. As a result of the enactment of the 2017 Tax Act, we have greater flexibility to repatriate foreign earnings in future periods without significant U.S. tax impact. While we believe these cash sources will be sufficient to fund our operations, our overall level of cash needs may be affected by capital allocation decisions that may include the number and size of acquisitions and stock repurchases, among other things. Our cash flows summarized for the periods presented were as follows (table in millions):

	Three Months Ended	
	May 4, 2018	May 5, 2017
Net cash provided by (used in):		
Operating activities	\$1,095	\$777
Investing activities	39	405
Financing activities	(3 )	(538 )
Net increase in cash, cash equivalents and restricted cash	\$1,131	\$644

Operating Activities

Cash provided by operating activities increased \$318 million during the three months ended May 4, 2018 compared to the three months ended May 5, 2017. Cash provided by operating activities benefited from a net increase in cash collections due to increased sales. In addition, the negative affect of the change in our fiscal year end on our cash collections during the three

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months ended May 5, 2017 also contributed to the increase in cash provided by operating activities. These positive impacts were partially offset by increased cash payments for employee-related expenses, including salaries, bonuses and commissions, resulting primarily from growth in headcount, as well as increased cash payments for our employee stock purchase plan.

### Investing Activities

Cash used in investing activities is generally attributable to the purchase of available-for-sale securities, business acquisitions and capital expenditures. Cash provided by investing activities is affected by the sales and maturities of our available-for-sale securities.

Cash provided by investing activities decreased \$366 million during the three months ended May 4, 2018 compared to the three months ended May 5, 2017, driven primarily by a net decrease in cash provided by our available-for-sale securities of \$331 million, as well as an increase in cash used in business combinations of \$26 million.

### Financing Activities

Cash used in financing activities decreased \$535 million during the three months ended May 4, 2018 compared to the three months ended May 5, 2017 primarily because we did not execute any repurchases of shares of our Class A common stock during the three months ended May 4, 2018 due to the temporary suspension of our stock repurchase program in light of the Schedule 13D/A filed by Dell on February 2, 2018 (“the 13D/A”). In addition, cash proceeds from the issuance of common stock increased by \$84 million, which resulted primarily from our employee stock purchase plan.

### Long-term Debt

On August 21, 2017, we issued Senior Notes pursuant to a public debt offering in the aggregate amount of \$4,000 million, which consisted of outstanding principal due on the following dates: \$1,250 million due August 21, 2020, \$1,500 million due August 21, 2022 and \$1,250 million due August 21, 2027. The notes bear interest, payable semi-annually in arrears on February 21 and August 21 of each year, at annual rates of 2.30%, 2.95% and 3.90%, respectively. During the three months ended May 4, 2018, \$61 million was paid for interest related to the Senior Notes. In future periods, the aggregate annual interest expense related to the three notes is expected to be approximately \$130 million. We used a portion of the net proceeds from the offering to repay certain notes payable to Dell due May 1, 2018 and May 1, 2020, and intend to use the remaining proceeds to fund additional purchases of up to \$1,000 million of our Class A common stock through August 31, 2018 and for general corporate purposes, such as mergers and acquisitions and repaying other indebtedness.

The Senior Notes also include restrictive covenants that, in certain circumstances, limit our ability to create certain liens, to enter into certain sale and leaseback transactions and to consolidate, merge, sell or otherwise dispose of all or substantially all of our assets.

### Revolving Credit Facility

On September 12, 2017, we entered into an unsecured credit agreement establishing a revolving credit facility (“Credit Facility”) with a syndicate of lenders that provides the Company with a borrowing capacity of up to \$1,000 million, which may be used for general corporate purposes. The credit agreement contains certain representations, warranties and covenants. Commitments under the Credit Facility are available for a period of five years, which may be extended, subject to the satisfaction of certain conditions, by up to two one-year periods. As of May 4, 2018, there were no outstanding borrowings under the Credit Facility.

### Notes Payable to Dell

On January 21, 2014, we entered into a note exchange agreement with Dell providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million, which consisted of outstanding principal due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022. During fiscal 2018, we repaid the notes due May 1, 2018 and May 1, 2020.

Interest is payable quarterly in arrears, at the annual rate of 1.75%. The amount paid for interest related to these notes was not significant during the three months ended May 4, 2018 and May 5, 2017.

### Stock Repurchase Program

From time to time, we repurchase stock pursuant to authorized stock repurchase programs in open market transactions as permitted by securities laws and other legal requirements. We are not obligated to purchase any shares under our



stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased depends on a variety of factors, including our stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time we believe additional purchases are not warranted. From time to time, we also purchase stock in private transactions, such as with Dell. All shares repurchased under our stock repurchase programs are retired. During August 2017, our board of directors authorized the

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repurchase of up to \$1,000 million of Class A common stock through August 31, 2018. As of May 4, 2018, the cumulative authorized amount remaining for repurchase under an authorize program was \$876 million. Refer to Note M to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion.

While we have temporarily suspended our stock repurchase program in light of the 13D/A and a subsequent filing by Dell on Form 8-K on May 17, 2018, we continue to see stock repurchases as a key component of our capital allocation program. The 13D/A stated that Dell's board of directors is evaluating potential business opportunities that include continuing with their existing ownership structure, a public offering of Dell common stock, or a business combination with us.

### Critical Accounting Policies and Estimates

In preparing our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP"), we are required to make estimates, assumptions and judgments that affect the amounts reported on our financial statements and the accompanying disclosures. Estimates and assumptions about future events and their effects cannot be determined with certainty and therefore require the exercise of judgment. We base our estimates, assumptions and judgments on historical experience and various other factors that we believe to be reasonable under the circumstances. These estimates may change, as new events occur and additional information is obtained, and are recognized in the condensed consolidated financial statements as soon as they become known. Actual results could differ from those estimates and any such differences may be material to our financial statements. We believe that the critical accounting policies and estimates set forth within Item 7 of our Form 10-K filed on March 29, 2018 involve a higher degree of judgment and complexity in their application than our other significant accounting policies. Our senior management has reviewed our critical accounting policies and related disclosures with the Audit Committee of the Board of Directors. Historically, our assumptions, judgments and estimates relative to our critical accounting policies have not differed materially from actual results.

Effective February 3, 2018, the Company adopted ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). As a result, the accounting policies covering revenue recognition and deferred commissions have been updated to reflect the adoption of Topic 606. There were no other changes to the Company's significant accounting policies described in the Form 10-K filed on March 29, 2018 that have had a material impact on our condensed consolidated financial statements and the related notes.

### Revenue Recognition

We derive revenue primarily from licensing software under perpetual licenses or consumption-based contracts, related software maintenance and support, training, consulting services and hosted services. We account for a contract with a customer if all criteria defined by the guidance are met, including collectibility of consideration is probable. Revenue is recognized upon transfer of control of licenses or services to our customer in an amount that reflects the consideration we expect to receive in exchange for those licenses or services. Control of a promised good or service may be transferred to a customer either at a point in time or over time, which affects the timing of revenue recognition. Our contracts with customers may include a combination of licenses and services that are accounted for as distinct performance obligations. Determining whether our licenses and services are considered distinct performance obligations that should be accounted for separately or together often involves assumptions and significant judgments that can have a significant impact on the timing and amount of revenue recognized.

In addition, revenue from on-premises license software sold to original equipment manufacturers ("OEMs") is recognized when the sale occurs. Revenue is recognized upon reporting by the OEMs of their sales, and for the period where information of the underlying sales has not been made available, revenue is recognized based upon estimated sales. The Company's VCPP partners rent on-premises licenses from us, and the rental fee is recognized as license revenue upon consumption. License revenue is based upon reported consumption by VCPP partners and includes estimates for the period when consumption information has not been made available. Certain contracts include third-party offerings and revenue may be recognized net of the third-party costs, based upon an assessment as to whether we had control of the underlying third-party offering.

We enter into revenue contracts with multiple performance obligations in which a customer may purchase combinations of licenses, maintenance and support, training, consulting services, hosted services and rights to future

products and services. For contracts with multiple performance obligations, we allocate total transaction value to the identified underlying performance obligations based on relative standalone selling price (“SSP”). We typically estimate SSP of services based on observable transactions when the services are sold on a standalone basis and those prices fall within a reasonable range. We utilize the residual approach to estimate SSP of license as the licenses are not sold standalone and the same products are sold to different customers at a broad range of prices which are highly variable. Changes in assumptions or judgments used in determining standalone selling price could have a significant impact on the timing and amount of revenue we report in a particular period.

Professional services include design, implementation, training and consulting services. Professional services performed by us represent distinct performance obligations as they do not modify or customize licenses sold and such services are not highly interdependent or highly interrelated to licenses sold such that a customer would not be able to use the licenses without the professional services. Revenue from professional services engagements performed for a fixed fee, for which we are able to

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make reasonably dependable estimates of progress toward completion, is recognized based on progress. We believe this method of measurement provides the closest depiction of our performance in transferring control of the professional services.

### Deferred Commissions

Sales commissions, including the employer portion of payroll taxes, earned by our sales force are considered incremental and recoverable costs of obtaining a contract, and are deferred and generally amortized on a straight-line basis over the expected period of benefit. The expected period of benefit is determined using the contract term or underlying technology life, if renewals are expected and the renewal commission is not commensurate with the initial commission. The determination of the expected period of benefit requires us to make significant estimates and assumptions, including the life of the underlying technology and the estimated period of contract renewal. We believe the assumptions and estimates we have made are reasonable. Differences in the estimated period of benefit could have a significant impact on the timing and amount of amortization expense recognized.

### Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements. All statements other than statements of historical fact could be deemed forward-looking statements, and words such as “expect,” “anticipate,” “target,” “goal,” “project,” “intend,” “plan,” “believe,” “momentum,” “seek,” “estimate,” “continue,” “potential,” “future,” “endeavor,” “will,” “may,” “should,” “depend,” “predict,” and variations or the negative expression of such words and similar expressions are intended to identify forward-looking statements. Forward-looking statements in this report include statements relating to expected industry trends and conditions; future financial performance, trends or plans; anticipated impacts of developments in accounting rules and tax laws and rates; VMware’s expectations regarding the timing of tax payments; plans for and anticipated benefits of VMware products, services and solutions and partner and alliance relationships; plans for and anticipated benefits of corporate transaction, acquisitions, stock repurchases and investment activities; the outcome or impact of pending litigation, claims or disputes; and any statements of assumptions underlying any of the foregoing. These statements are based on current expectations about the industries in which VMware operates and the beliefs and assumptions of management. These forward-looking statements involve risks and uncertainties and the cautionary statements set forth above and those contained in the section of this report entitled “Risk Factors” identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. All forward-looking statements in this document are made as of the date hereof, based on information available to us as of the date hereof. We assume no obligation to, and do not currently intend to, update these forward-looking statements.

### Available Information

Our website is located at [www.vmware.com](http://www.vmware.com), and our investor relations website is located at <http://ir.vmware.com>. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, all of which is made available free of charge, including:

- our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission (“SEC”);
- announcements of investor conferences, speeches and events at which our executives discuss our products, services and competitive strategies;
- webcasts of our quarterly earnings calls and links to webcasts of investor conferences at which our executives appear (archives of these events are also available for a limited time);
- additional information on financial metrics, including reconciliations of non-GAAP financial measures discussed in our presentations to the nearest comparable GAAP measure;
- press releases on quarterly earnings, product and service announcements, legal developments and international news; corporate governance information including our certificate of incorporation, bylaws, corporate governance guidelines, board committee charters, business conduct guidelines (which constitutes our code of business conduct and ethics) and other governance-related policies;
- other news, blogs and announcements that we may post from time to time that investors might find useful or interesting; and

opportunities to sign up for email alerts and RSS feeds to have information pushed in real time.

The information found on our website is not part of, and is not incorporated by reference into, this or any other report we file with, or furnish to, the SEC.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There were no material changes to our market risk exposures during the three months ended May 4, 2018. See Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk” of our Form 10-K filed on March 29, 2018 for a detailed discussion of our market risk exposures.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We carried out an evaluation required by the Securities Exchange Act of 1934, amended (the “Exchange Act”), under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Exchange Act, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

**Changes in Internal Control Over Financial Reporting**

During the first quarter of fiscal 2019, we completed the implementation of a new revenue recognition accounting system and related controls to enable us to adopt Topic 606, Revenue from Contracts with Customers.

There were no other changes in our internal control over financial reporting during the most recent fiscal quarter ended May 4, 2018 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Limitations on Controls**

Our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives as specified above. Our management, including our principal executive officer and principal financial officer, conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management does not expect, however, that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all errors and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Refer to Note K of the “Notes to Condensed Consolidated Financial Statements” in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of legal proceedings. See also the risk factor entitled “We are involved in litigation, investigations and regulatory inquiries and proceedings that could negatively affect us” in Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of potential risks to our results of operations and financial condition that may arise from legal proceedings.

ITEM 1A. RISK FACTORS

The risk factors that appear below could materially affect our business, financial condition and operating results. The risks and uncertainties described below are not the only risks and uncertainties facing us. Our business is also subject to general risks and uncertainties that affect many other companies. Specific risk factors related to our status as a controlled subsidiary of Dell Technologies Inc. (“Dell”) following Dell’s acquisition of our former majority stockholder EMC Corporation (“EMC”) on September 7, 2016 (the “Dell Acquisition”), including, among other things, the uncertainty arising from Dell’s Schedule 13D/A filing of February 2, 2018, overlapping business opportunities, Dell’s ability to control certain transactions and resource allocations and related persons transactions with Dell and its other affiliated companies are set forth below under the heading “Risks Related to Our Relationship with Dell.”

Risks Related to Our Business

Our success depends increasingly on customer acceptance of our newer products and services.

Our products and services are primarily based on server virtualization and related compute technologies used for virtualizing on-premises data center servers, which form the foundation for private cloud computing. As the market for server virtualization continues to mature, the rate of growth in license sales of VMware vSphere (“vSphere”) has declined. We are increasingly directing our product development and marketing efforts toward products and services that enable businesses to utilize virtualization as the foundation for private, public and hybrid cloud-based computing and mobile computing, including our vSphere-based software-defined data center (“SDDC”) products such as our vRealize management and automation offerings, VMware vSAN (“vSAN”) storage virtualization offerings, and network virtualization (“NSX”) offerings, as well as our Horizon client virtualization offerings, VMware AirWatch (“AirWatch”) mobile device management offerings and our VMware Cloud on AWS offering, which became available in certain geographies in fiscal 2018. We have also been introducing software-as-a-service (“SaaS”) versions of our on-premises products, including VMware Horizon Suite and certain AirWatch offerings, and are working to extend our SDDC and NSX offerings and management software into the public cloud and to introduce cloud products and services by investing in cloud and SaaS initiatives and partnering with public cloud providers such as Amazon Web Services (“AWS”) and IBM. These initiatives present new and difficult technological and compliance challenges, and significant investments will be required to develop or acquire solutions to address those challenges. Our success depends on our current and future customers perceiving technological and operational benefits and cost savings associated with adopting our private and hybrid cloud solutions and our client virtualization and mobile device management solutions. As the market for our server virtualization products continues to mature, and the scale of our business has increased, our rate of revenue growth increasingly depends upon the success of our newer product and service offerings. To the extent that our newer products and services are adopted more slowly than revenue growth in our established server virtualization offerings declines, our revenue growth rates may slow materially or our revenue may decline substantially, we may fail to realize returns on our investments in new initiatives and our operating results could be materially adversely affected.

A significant decrease in demand for our server virtualization products would adversely affect our operating results. A significant portion of our revenue is derived, and will for the foreseeable future continue to be derived, from our server virtualization products. As more businesses achieve high levels of virtualization in their data centers, the market for our vSphere product continues to mature. Additionally, as businesses increasingly utilize public cloud and SaaS-based offerings, they are building more of their new compute workloads off-premises and are increasingly shifting some of their existing and many of their new workloads to public cloud providers, thereby limiting growth, and potentially reducing, the market for on-premises deployments of vSphere. Although sales of vSphere have

declined as a portion of our overall business, and we expect this trend to continue, vSphere remains key to our future growth, as it serves as the foundation for our newer SDDC, network virtualization and our newer cloud and SaaS offerings. Although we have launched, and are continuing to develop products to extend our vSphere-based SDDC offerings to the public cloud, due to our product concentration a significant decrease in demand for our server virtualization products would adversely affect our operating results.



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We face intense competition that could adversely affect our operating results.

The virtualization, cloud computing, end-user computing and software-defined data center industries are interrelated and rapidly evolving, and we face intense competition across all the markets for our products and services. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do. Additionally, the adoption of public cloud, micro-services, containers, and open source technologies has the potential to erode our profitability.

We face competition from, among others:

Providers of public cloud infrastructure and SaaS-based offerings. As businesses increasingly utilize public cloud and SaaS-based offerings, they are building more of their new compute workloads off-premises and may also shift some of their existing workloads. As a result, the demand for on-premises information technology (“IT”) resources is expected to slow, and our products and services will need to increasingly compete for customers’ IT workloads with off-premises public cloud and SaaS-based offerings. If our private, hybrid and public cloud products and services fail to address evolving customer requirements, the demand for VMware’s virtualization products and services may decline, and we could experience lower growth. Additionally, VMware Cloud Provider Program (“VCP”) offerings from our partners may compete directly with infrastructure-as-a-service (“IaaS”) offerings from various public cloud providers such as AWS and Microsoft. In fiscal 2018, we made VMware Cloud on AWS, a strategic alliance with AWS to deliver a vSphere-based cloud service running in AWS data centers, available in certain geographies. Our strategic alliance with Amazon may also be seen as competitive with VCP offerings and adversely affect our relationship with VCP partners, while some VCP partners may elect to include VMware Cloud on AWS as part of their managed services provider offerings.

Large, diversified enterprise software and hardware companies. These competitors supply a wide variety of products and services to, and have well-established relationships with, our current and prospective end users. For example, small- to medium-sized businesses and companies in emerging markets that are evaluating the adoption of virtualization-based technologies and solutions may be inclined to consider Microsoft solutions because of their existing use of Windows and Office products. Some of these competitors have in the past and may in the future take advantage of their existing relationships to engage in business practices that make our products and services less attractive to our end users. Other competitors have limited or denied support for their applications running in VMware virtualization environments. In addition, these competitors could integrate competitive capabilities into their existing products and services and make them available without additional charge. For example, Oracle provides free server virtualization software intended to support Oracle and non-Oracle applications, Microsoft offers its own server, network, and storage virtualization software packaged with its Windows Server product as well as built-in virtualization in the client version of Windows and Cisco includes network virtualization technology in many of their data center networking platforms. As a result, existing and prospective VMware customers may elect to use products that are perceived to be “free” or “very low cost” instead of purchasing VMware products and services for certain applications where they do not believe that more advanced and robust capabilities are required.

Companies offering competing platforms based on open source technologies. Open source technologies for virtualization, containerization and cloud platforms such as Xen, KVM, Docker, Rocket, OpenShift, Mesos, Kubernetes and OpenStack appear to provide pricing competition and enable competing vendors to leverage these open source technologies to compete directly with our SDDC initiative. Enterprises and service providers have shown interest in building their own clouds based on open source projects such as OpenStack, and other companies have indicated their intention to expand offerings of virtual management and cloud computing solutions as well.

Additionally, a number of enterprise IT hardware vendors have released solutions based on OpenStack, including IBM and Cisco. VMware is delivering container technologies such as Pivotal Container Services, which we co-developed and market in partnership with Pivotal Software, Inc. (“Pivotal”), and vSphere Integrated Containers that are designed to help customers adopt micro-services architectures. The adoption of distributed micro-service application architectures, and their alignment with container technologies, represents an emerging area of competition.

Other industry alliances. Many of our competitors have entered into or extended partnerships or other strategic relationships to offer more comprehensive virtualization and cloud computing solutions than they individually had

offered. We expect these trends to continue as companies attempt to strengthen or maintain their positions in the evolving virtualization infrastructure and enterprise IT solutions industry. These alliances may result in more compelling product and service offerings than we offer.

Our partners and members of our developer and technology partner ecosystem. We face competition from our partners. For example, third parties currently selling our products and services could build and market their own competing products and services or market competing products and services of other vendors. Additionally, as formerly distinct sectors of enterprise IT such as software-based virtualization and hardware-based server, networking and storage solutions converge, we also increasingly compete with companies who are members of our developer and technology partner ecosystem. Consequently, we may find it more difficult to continue to work together productively on other projects, and the advantages we derive from our ecosystem could diminish.

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This competition could result in increased pricing pressure and sales and marketing expenses, thereby materially reducing our operating margins, and could also prevent our new products and services from gaining market acceptance, thereby harming our ability to increase, or causing us to lose, market share.

The loss of key management personnel could harm our business.

We depend on the continued services of key management personnel. We generally do not have employment or non-compete agreements with our employees, and, therefore, they could terminate their employment with us at any time without penalty and could pursue employment opportunities with any of our competitors. In addition, we do not maintain any key-person life insurance policies. The loss of key management personnel could harm our business. Competition for our target employees is intense and costly, and we may not be able to attract and retain highly skilled employees.

To execute on our strategy, we must continue to attract and retain highly qualified personnel. Competition for these personnel is intense, especially for senior sales executives and engineers with significant experience designing and developing software and cloud offerings. We may not be successful in attracting and retaining qualified personnel. We have in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Many of the companies with which we compete for experienced personnel have greater resources than we have. Research and development personnel are also aggressively recruited by startup and emerging growth companies, which are especially active in many of the technical areas and geographic regions in which we conduct product and service development. Competition for our key personnel results in increased costs in the form of cash and stock-based compensation and can have a dilutive impact on our stock. Additionally, changes in immigration and work permit laws and regulations or the administration or interpretation of such laws or regulations could impair our ability to attract and retain highly qualified employees. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could suffer.

The final impact of the 2017 Tax Cuts and Jobs Act on our tax liabilities is highly uncertain, may differ substantially from our provisional estimates and may adversely impact our operating results.

The 2017 Tax Cuts and Jobs Act (the “2017 Tax Act”), enacted on December 22, 2017, significantly affects United States (“U.S.”) tax law by changing how the U.S. imposes income tax on multinational corporations. The U.S. Department of Treasury has broad authority to issue regulations and interpretative guidance that may significantly impact how we will apply the law and impact our results of operations.

The 2017 Tax Act requires complex computations to be performed that were not previously required in U.S. tax law, significant judgments to be made in interpretation of the provisions of the 2017 Tax Act, significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The 2017 Tax Act also imposes additional changes in the taxation of consolidated tax groups, such as the consolidated tax group of which Dell is the parent and of which VMware is a member, which we must then interpret in the context of our tax sharing agreement with Dell to determine our actual tax liability. Furthermore, the Internal Revenue Service (the “IRS”) has yet to issue guidance on certain issues that could be material to us and may not do so prior to the time when our next tax filings are due.

As such, the application of accounting guidance for significant items under the 2017 Tax Act is highly uncertain. Further, the U.S. Treasury Department and other standard-setting bodies will continue to issue guidance and interpret how provisions of the 2017 Tax Act will be administered and applied to specific situations important to us that are different from our interpretations and expectations.

Based upon the guidance issued thus far by U.S. tax and accounting authorities, we have provided a provisional estimate of the effect of the 2017 Tax Act in our consolidated financial statements for fiscal 2018 and for fiscal 2019 through the current period. Our analysis, which will be recorded in the period completed, may differ significantly from our current provisional estimates. Furthermore, additional adjustments may become necessary pursuant to any subsequent authoritative guidance issued after such analysis is complete. Accordingly, our final analysis may show that our tax obligations and our effective tax rate are higher than our provisional estimates, which could have a material adverse effect on our financial condition and our operating results.

Adverse economic conditions may harm our business.

Our business depends on the overall demand for IT and on the economic health of our current and prospective customers. The purchase of our products and services is often discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions or significant uncertainty regarding the stability of financial markets could adversely impact our business, financial condition and operating results in a number of ways, including by lengthening sales cycles, affecting the size of enterprise agreements (“EAs”) that customers will commit to, reducing the level of our non-EA transactional sales, lowering prices for our products and services, reducing unit sales and reducing the rate of adoption of our

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products and services by new customers and the willingness of current customers to purchase upgrades to our existing products and services. For example, a recurrence of the sovereign debt crisis in Europe, repercussions from the United Kingdom's planned exit from the European Union ("EU") or that region's failure to sustain its recovery from recession would threaten to suppress demand and our customers' access to credit in that region which is an important market for our products and services. In response to sustained economic uncertainty, many national and local governments that are current or prospective customers for our products and services, including the U.S. federal government, have made, or threatened to make, significant spending cutbacks which could reduce the amount of government spending on IT and the potential demand for our products and services from the government sector.

Regional economic uncertainty can also result in general and ongoing tightening in the credit markets, lower levels of liquidity, increases in the rates of default and bankruptcy and significant volatility in the credit, equity and fixed income markets. Changes in governmental fiscal, monetary and tax policies may also impact interest rates on credit and debt, which have been at relatively low levels for several years. As a result, current or potential customers may be unable to fund software purchases, which could cause them to delay, decrease or cancel purchases of our products and services. Increases in our cost of borrowing could also impact our ability to access capital markets should we wish to raise additional funding for business investments, which could adversely affect our ability to repay or refinance our outstanding indebtedness, fund future product development and acquisitions or conduct stock buybacks.

We may not be able to respond to rapid technological changes with new solutions and services offerings.

The virtualization, cloud computing, end-user computing and SDDC industries are characterized by rapid technological change, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of third-party solutions embodying new technologies and the emergence of new industry standards could make our existing and future software solutions obsolete and unmarketable. Cloud computing has proven to be a disruptive technology that is altering the way that businesses consume, manage and provide physical IT resources, applications, data and IT services. We may not be able to establish or sustain our thought leadership in the cloud computing and enterprise software fields, and our customers may not view our products and services as cost effective, innovative and best-of-breed, which could result in a reduction in market share and our inability to command a pricing premium over competitor products and services. We may not be able to develop updated products and services that keep pace with technological developments and emerging industry standards, that address the increasingly sophisticated needs of our customers or that interoperate with new or updated operating systems and hardware devices. We may also fail to adequately anticipate and prepare for the commercialization of emerging technologies such as blockchain and the development of new markets and applications for our technology such as the Internet of Things and "edge" computing and thereby fail to take advantage of new market opportunities or fall behind early movers in those markets.

Our ability to react quickly to new technology trends and customer requirements is negatively impacted by the length of our development cycle for new products and services and product and service enhancements, which has frequently been longer than we originally anticipated. This is due in part to the increasing complexity of our product offerings as we increase their interoperability, and enable and maintain their compatibility with multiple IT resources such as public clouds utilized by our customers, which can significantly increase the development time and effort necessary to achieve the interoperability of our offerings while maintaining product quality. When we release significant new versions of our existing offerings, the complexity of our products may require existing customers to remove and replace prior versions in order to take full advantage of substantial new features and capabilities, which may subdue initial demand for the new versions or, conversely, depress demand for existing versions until the customer is ready to purchase and install the newest release. If we are unable to evolve our solutions and offerings in time to respond to and remain ahead of new technological developments, our ability to retain or increase market share and revenue in the virtualization, cloud computing, end-user computing and SDDC industries could be materially adversely affected.

With respect to our SDDC products, if we fail to introduce compelling new features in future upgrades to our vSphere product line, manage the transition to hybrid cloud platforms, develop new or tightly integrate existing applications for our virtualization technology that address customer requirements for integration, automation and management of their IT systems with public cloud resources, overall demand for products and services based on vSphere may decline. Additionally, if we fail to realize returns on investments in our newer SaaS and cloud initiatives, our operating

margins and results of operations will be adversely impacted.

Breaches of our cybersecurity systems or the systems of our vendors, partners and suppliers could seriously harm our business.

We increasingly depend upon our IT systems and the IT systems of key SaaS providers to conduct virtually all of our business operations, ranging from our internal operations and product development activities to our marketing and sales efforts and communications with our customers and business partners. Unauthorized parties (which may have included nation states and individuals sponsored by them) have penetrated our network security and our website in the past and such unauthorized parties may do so in the future. Employees or contractors have introduced vulnerabilities in, and enabled the exploitation of, our IT environments in the past and may do so in the future. These cyber-attacks threaten to misappropriate our proprietary

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information, cause interruptions of our IT services and commit fraud. Because the techniques used by unauthorized persons to access or sabotage networks change frequently and may not be recognized until launched against a target, we may be unable to anticipate these tactics. Further, if unauthorized access or sabotage remains undetected for an extended period of time, the effects of such breach could be exacerbated. In addition, sophisticated hardware and operating system software and applications that we produce or procure from third parties may contain defects in design or manufacture, including “bugs” and other problems that could unexpectedly interfere with the operation of our systems and processes. Our exposure to cybersecurity threats and negative consequences of cybersecurity breaches will likely increase as our customers conduct more purchase and service transactions online, and as we store increasing amounts of customer data and host or manage parts of customers’ businesses in cloud-based IT environments. Additionally, as we increasingly market the security features in our products, our products may be targeted by computer hackers seeking to compromise product security.

We have also outsourced a number of our business functions to third parties, and we rely upon distributors, resellers, system vendors and systems integrators to sell our products and services. Accordingly, if our cybersecurity systems and those of our contractors, partners and vendors fail to protect against breaches, our ability to conduct our business could be damaged in a number of ways, including:

- sensitive data regarding our business, including intellectual property and other proprietary data, could be stolen;
  - our electronic communications systems, including email and other methods, could be disrupted, and our ability to conduct our business operations could be seriously damaged until such systems can be restored and secured;
  - our ability to process customer orders and electronically deliver products and services could be degraded, and our distribution channels could be disrupted, resulting in delays in revenue recognition;
  - defects and security vulnerabilities could be exploited or introduced into our software products or our hybrid cloud and SaaS offerings and impair or disrupt their availability, thereby damaging the reputation and perceived reliability and security of our products and services and potentially making the data systems of our customers vulnerable to further data loss and cyber incidents; and
  - personally identifiable or confidential data of our customers, employees and business partners could be stolen or lost.
- Should any of the above events occur, or are perceived to have occurred, we could be subject to significant claims for liability from our customers, we could face regulatory actions and sanctions from governmental agencies, our ability to protect our intellectual property rights could be compromised, our reputation and competitive position could be materially harmed and we could incur significant costs in order to upgrade our cybersecurity systems and remediate damages. Consequently, our business, financial condition and operating results could be materially adversely affected. Our operating results may fluctuate significantly.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful, and our past results should not be relied upon as an indication of our future performance. In addition, a significant portion of our quarterly sales typically occurs during the last two weeks of the quarter, which generally reflects customer buying patterns for enterprise technology. As a result, our quarterly operating results are difficult to predict even in the near term. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our Class A common stock would likely decline substantially.

Factors that may cause fluctuations in our operating results include, among others, the factors described elsewhere in this risk factors section and the following:

- fluctuations in demand, adoption rates, sales cycles and pricing levels for our products and services;
- changes in customers’ budgets for information technology purchases and in the timing of their purchasing decisions;
- the timing of announcements or releases of new or upgraded products and services by us or by our competitors;
- the timing and size of business realignment plans and restructuring charges;
- our ability to maintain scalable internal systems for reporting, order processing, license fulfillment, product delivery, purchasing, billing and general accounting, among other functions;
- our ability to control costs, including our operating expenses;
- credit risks of our distributors, who account for a significant portion of product revenue and accounts receivable;

the timing of when sales orders are processed, which can cause fluctuations in our backlog and impact our bookings and timing of revenue recognition;

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- seasonal factors such as the end of fiscal period budget expenditures by our customers and the timing of holiday and vacation periods;
- renewal rates and the amounts of the renewals for EAs as original EA terms expire;
- the timing and amount of internally developed software development costs that may be capitalized;
- unplanned events that could affect market perception of the quality or cost-effectiveness of our products and solutions;
- fluctuations in the fair value of our investment in Pivotal, which are primarily based on Pivotal's closing stock price on the last trading day of each fiscal quarter;
- the impact of new accounting pronouncements, for example, the adoption of Accounting Standards Update ("ASU") 2016-16, which could result in increased volatility in the provision for income taxes in periods in which transfers of intellectual property between our legal entities occur; and
- our ability to accurately predict the degree to which customers will elect to purchase our subscription-based offerings in place of licenses to our on-premises offerings.

We are exposed to foreign exchange risks.

Because we conduct business in currencies other than the U.S. dollar but report our operating results in U.S. dollars, we face exposure to fluctuations in currency exchange rates. During the three months ended May 4, 2018, approximately 30% of our sales were invoiced and collected in non-U.S. dollar denominated currencies. The realized gain or loss on foreign currency transactions is dependent upon the types of foreign currency transactions that we enter into, the exchange rates associated with these transactions and changes in those rates, the net realized gain or loss on our foreign currency forward contracts, and other factors. Although we hedge a portion of our foreign currency exposure, a significant fluctuation in exchange rates between the U.S. dollar and foreign currencies may adversely affect our operating results. For example, we experienced a measurable negative impact to our revenue in 2015 due to exchange rate fluctuations. Any future weakening of foreign currency exchange rates against the U.S. dollar would likely result in additional adverse impact on our revenue.

We operate a global business that exposes us to additional risks.

Our international activities account for a substantial portion of our revenue and profits, and we plan to further expand internationally. In addition, our investment portfolio includes investments in non-U.S. financial instruments and holdings in non-U.S. financial institutions, including European institutions. In addition to the risks described elsewhere in these risk factors, our international operations subject us to a variety of risks, including:

- difficulties in enforcing contracts and collecting accounts receivable and longer payment cycles, especially in emerging markets;
- difficulties in delivering support, training and documentation in certain foreign markets;
- tariffs and trade barriers, which could increase due to the current geopolitical climate, and other regulatory or contractual limitations on our ability to sell or develop our products and services in certain foreign markets;
- changes and instability in government policies and international trade arrangements that could adversely affect the ability of U.S.-based companies to conduct business in non-U.S. markets;
- economic or political instability and security concerns in countries that are important to our international sales and operations;
- difficulties in transferring funds from certain countries;
- increased compliance risks, particularly in emerging markets; and
- difficulties in maintaining appropriate controls relating to revenue recognition practices.

An example is the ongoing efforts of the Chinese government to more closely regulate network security. In that respect, the Chinese government enacted a new Cyber Security Law in November 2016 that came into effect on June 1, 2017. The new Cyber Security Law promotes utilization of "secure and reliable" network products and services, requires the sale of certain key network equipment and network security products to be subject to security certification, and imposes data localization measures and various network security measures relevant to a vaguely defined scope of "critical information infrastructure." Among those network security measures is a requirement that certain network products and services procured by operators of "critical information infrastructure" undergo a formal security assessment in order to evaluate their "security" and "controllability." The specific technical requirements of the

security assessment have not yet been clarified.

Also, in December 2015, China enacted an Anti-Terrorism Law that gives local public security and state security authorities the broad discretionary authority to require companies to provide access to their equipment and decryption support

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in particular cases. Failure to comply with such requests can result in fines and imprisonment. In addition, a broad range of businesses will be required to verify the identities of customers and are prohibited from providing services to customers whose identities are unclear or who refuse to cooperate in the verification process. If we are not able to, or choose not to, comply with these and other information and network security standards that the Chinese government might implement in the future, our business in China may suffer.

Furthermore, if we fail to comply with legal and regulatory requirements covering the foreign activities of U.S. corporations, such as export control requirements and the Foreign Corrupt Practices Act, as well as with local regulatory requirements in non-U.S. jurisdictions, we may be exposed to significant fines and penalties and reputational harm. These risks will increase as we expand our operations in locations with a higher incidence of corruption and fraudulent business practices.

In addition, potential fallout from past disclosures related to the U.S. Internet and communications surveillance and possible efforts to enable increased surveillance could make foreign customers reluctant to purchase products and services from U.S.-based technology companies and impair our growth rate in foreign markets.

Our failure to manage any of these risks successfully could negatively affect our reputation and adversely affect our operating results.

We have outstanding indebtedness in the form of unsecured notes and may incur other debt in the future, which may adversely affect our financial condition and future financial results.

During fiscal 2018, we issued \$4,000 million in unsecured notes through a debt offering and repaid \$1,230 million of the notes payable to Dell, utilizing a portion of the proceeds from the offering. An additional unsecured promissory note with an outstanding principal amount of \$270 million owed to Dell remains outstanding. We also entered into a \$1,000 million unsecured credit agreement establishing a revolving credit facility (“Credit Facility”) that is currently undrawn. Our current and any future debt may adversely affect our financial condition and future financial results by, among other things:

requiring the dedication of a portion of our expected cash flow from operations to service our indebtedness, thereby reducing the amount of expected cash flow available for other purposes, including capital expenditures and acquisitions; and

limiting our flexibility in planning for, or reacting to, changes in our business and our industry.

The terms of our unsecured notes and Credit Facility impose restrictions on us and require us to maintain compliance with specified and customary covenants. Our ability to comply with these covenants may be affected by events beyond our control, including prevailing economic, financial, and industry conditions. If we breach any of the covenants and do not obtain a waiver from the lenders or note holders, then, subject to applicable cure periods, any outstanding indebtedness may be declared immediately due and payable.

In addition, any actual or anticipated changes to our credit ratings, including any announcement that our credit ratings are under review, by any rating agency may negatively impact the value and liquidity of both our debt and equity securities. Under certain circumstances, if our credit ratings are downgraded or other negative action is taken, the interest rate payable by us and the cost of borrowing under our Credit Facility could increase. Downgrades in our credit ratings could also affect the terms of and restrict our ability to obtain additional financing in the future. In addition, upon the occurrence of certain downgrades of the ratings of our unsecured notes, we may be required to repurchase our unsecured notes at a repurchase price equal to 101% of the aggregate principal plus any accrued and unpaid interest on the date of purchase.

Additionally, our parent company, Dell, currently has a significant level of debt financing. Accordingly, negative changes to Dell’s credit rating could also negatively impact our credit rating and the value and liquidity of any future debt we might raise. Refer to “Liquidity and Capital Resources” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I, Item 2 of this Quarterly Report on Form 10-Q for more information on our outstanding indebtedness.

Our current research and development efforts may not produce significant revenue for several years, if at all.

Developing our products and services is expensive. In particular, developing and launching disruptive technologies in new areas, as we are continuing to do with our NSX virtual networking, vSAN virtual storage, cloud and SaaS initiatives, requires significant investments of resources and often entails greater risk than incremental investments in

existing products and services. Our investment in research and development may not result in marketable products or services or may result in products and services that generate less revenue than we anticipate. Our research and development expenses were approximately 23% of our total revenue during the three months ended May 4, 2018. Our future plans include significant investments in software research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. However, we may not receive significant revenue from these investments for several years, if at all.

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We are involved in litigation, investigations and regulatory inquiries and proceedings that could negatively affect us. From time to time, we are involved in various legal, administrative and regulatory proceedings, claims, demands and investigations relating to our business, which may include claims with respect to commercial, product liability, intellectual property, breach of contract, employment, class action, whistleblower and other matters. In the ordinary course of business, we also receive inquiries from and have discussions with government entities regarding the compliance of our contracting and sales practices with laws and regulations.

We have been, and expect to continue to be, subject to intellectual property infringement claims, including claims by entities that do not have operating businesses of their own and therefore may limit our ability to seek counterclaims for damages and injunctive relief. In addition to monetary judgments, a judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Third parties may also assert infringement claims against our customers and channel partners, which could require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and channel partners from claims of infringement of proprietary rights of third parties in connection with the use of our products. These matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Allegations made in the course of regulatory or legal proceedings may also harm our reputation, regardless of whether there is merit to such claims. Furthermore, because litigation and the outcome of regulatory proceedings are inherently unpredictable, our business, financial condition or operating results could be materially affected by an unfavorable resolution of one or more of these proceedings, claims, demands or investigations.

Refer to Note K to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of certain claims and litigation.

We may not be able to adequately protect our intellectual property rights.

We depend on our ability to protect our proprietary technology. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. As such, despite our efforts, the steps we have taken to protect our proprietary rights may not be adequate to prevent misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation or infringement is uncertain, particularly in countries outside of the U.S. In addition, we rely on confidentiality or license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely on "click-wrap" and "shrink-wrap" licenses in some instances.

Detecting and protecting against the unauthorized use of our products, technology proprietary rights and intellectual property rights is expensive, difficult and, in some cases, impossible. Litigation is necessary from time to time to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which could result in a substantial loss of our market share.

Our use of "open source" software in our products could negatively affect our ability to sell our products and subject us to litigation.

Many of our products and services incorporate so-called "open source" software, and we may incorporate open source software into other products and services in the future. Open source software is generally licensed by its authors or other third parties under open source licenses. Open source licensors generally do not provide warranties or assurance of title or controls on origin of the software, which exposes us to potential liability if the software fails to work or infringes the intellectual property of a third party.

We monitor our use of open source software in an effort to avoid subjecting our products to conditions we do not intend and avoid exposing us to unacceptable financial risk. However, the processes we follow to monitor our use of open source software could fail to achieve their intended result. In addition, although we believe that we have complied with our obligations under the various applicable licenses for open source software that we use, there is little

or no legal precedent governing the interpretation of terms in most of these licenses, which increases the risk that a court could interpret the license differently than we do.

From time to time, we receive inquiries or claims from authors or distributors of open source software included in our products regarding our compliance with the conditions of one or more open source licenses. An adverse outcome to a claim could require us to:

pay significant damages;

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- stop distributing our products that contain the open source software;
- revise or modify our product code to remove alleged infringing code;
- release the source code of our proprietary software; or
- take other steps to avoid or remedy an alleged infringement.

In March 2015, a software developer who alleges that software code he wrote is used in a component of our vSphere product filed a lawsuit against us in Germany alleging copyright infringement for failing to comply with the terms of the open source General Public License v.2 (“GPL v.2”) and seeking an order requiring us to comply with the GPL v.2 or cease distribution of any affected code within Germany. On July 8, 2016, the German court issued a written decision dismissing the lawsuit. On August 9, 2016, a Notice of Appeal was filed. We have filed our responsive appellate brief. An adverse outcome to this claim on appeal or to other claims could have a material adverse impact on our intellectual property rights, our operating results and financial condition.

The evolution of our business requires more complex go-to-market strategies, which involve significant risk. Our increasing focus on developing and marketing IT management and automation and IaaS (including software-defined networking, VCPP-integrated virtual desktop and mobile device, cloud and SaaS) offerings that enable customers to transform their IT systems requires a greater focus on marketing and selling product suites and more holistic solutions, rather than selling on a product-by-product basis. Consequently, we have developed, and must continue to develop, new strategies for marketing and selling our offerings. In addition, marketing and selling new technologies to enterprises requires significant investment of time and resources in order to educate customers on the benefits of our new product offerings. These investments can be costly and the additional effort required to educate both customers and our own sales force can distract from their efforts to sell existing products and services.

Our success depends upon our ability to develop appropriate business and pricing models.

If we cannot adapt our business models to keep pace with industry trends, including the industry-wide transition to cloud-based computing, our revenue could be negatively impacted. Certain of our product initiatives, such as our VCPP and SaaS offerings, have a subscription model. As we increase our adoption of subscription-based pricing models for our products, we may fail to set pricing at levels appropriate to maintain our revenue streams or our customers may choose to deploy products from our competitors that they believe are priced more favorably. In addition, we may fail to accurately predict subscription renewal rates or their impact on operating results, and because revenue from subscriptions is recognized for our services over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our results. Additionally, as customers transition to our hybrid cloud and SaaS products and services, our revenue growth rate may be adversely impacted during the period of transition as we will recognize less revenue up front than we would otherwise recognize as part of the multi-year license contracts through which we typically sell our established offerings. Finally, as we offer more services that depend on converting users of free services to users of premium services and converting purchasers of our on-premises products to our SaaS offerings, and as such services grow in size, our ability to maintain or improve and to predict conversion rates will become more important.

Our products and services are highly technical and may contain errors, defects or security vulnerabilities.

Our products and services are highly technical and complex and, when deployed, have contained and may contain errors, defects or security vulnerabilities. Some errors in our products or services may only be discovered after a product or service has been installed and used by customers. Undiscovered vulnerabilities in our products or services could expose our customers to hackers or other unscrupulous third parties who develop and deploy viruses, worms and other malicious software programs that could attack our products or services. In the past, VMware has been made aware of public postings by hackers of portions of our source code. It is possible that the released source code could expose unknown security vulnerabilities in our products and services that could be exploited by hackers or others. VMware products and services are also subject to known and unknown security vulnerabilities resulting from integration with products or services of other companies (such as applications, operating systems or semi-conductors). For example, vulnerabilities in certain microprocessors were recently publicly announced under the names Spectre and Meltdown. Actual or perceived errors, defects or security vulnerabilities in our products or services could harm our reputation and lead some customers to return products or services, reduce or delay future purchases or use competitive products or services, all of which could negatively impact our business, operating results and stock price.

Failure to effectively manage our product and service lifecycles could harm our business.

As part of the natural lifecycle of our products and services, we periodically inform customers that products or services will be reaching their end of life or end of availability and will no longer be supported or receive updates and security patches. To the extent these products or services remain subject to a service contract with the customer, we offer to transition the customer to alternative products or services. Failure to effectively manage our product and service lifecycles could lead to customer dissatisfaction and contractual liabilities, which could adversely affect our business and operating results.



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Our success depends on the interoperability of our products and services with those of other companies.

The success of our products depends upon the cooperation of hardware and software vendors to ensure interoperability with our products and offer compatible products and services to end users. In addition, we have begun to extend the functionality of various products to work with native public cloud applications, which may require the cooperation of public cloud vendors. To the extent that hardware, software and public cloud vendors perceive that their products and services compete with ours or those of our controlling stockholder, Dell, they may have an incentive to withhold their cooperation, decline to share access or sell to us their proprietary APIs, protocols or formats, or engage in practices to actively limit the functionality, compatibility and certification of our products. In addition, vendors may fail to certify or support or continue to certify or support our products for their systems. If any of the foregoing occurs, our product development efforts may be delayed or foreclosed and it may be difficult and more costly for us to achieve functionality and service levels that would make our services attractive to end users, any of which could negatively impact our business and operating results.

Disruptions to our distribution channels could harm our business.

Our future success is highly dependent on our relationships with distributors, resellers, system vendors and systems integrators, which account for a significant portion of our revenue. Recruiting and retaining qualified channel partners and training them in the use of our technology and product offerings requires significant time and resources. Our failure to maintain good relationships with channel partners would likely lead to a loss of end users of our products and services, which would adversely affect our revenue. We generally do not have long-term contracts or minimum purchase commitments with our distributors, resellers, system vendors and systems integrators, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours.

Three of our distributors each accounted for 10% or more of our consolidated revenue during the three months ended May 4, 2018. Although we believe that we have in place, or would have in place by the date of any such termination, agreements with replacement distributors sufficient to maintain our revenue from distribution, if we were to lose the distribution services of a significant distributor, such loss could have a negative impact on our operating results until such time as we arrange to replace these distribution services with the services of existing or new distributors.

Our SaaS offerings rely on third-party providers for data center space and colocation services.

Our SaaS offerings rely upon third-party providers to supply data center space, equipment maintenance and other colocation services. Although we have entered into various agreements for the lease of data center space, equipment maintenance and other services, third parties could fail to live up to the contractual obligations under those agreements. The failure of a third-party provider to prevent service disruptions, data losses or security breaches may require us to issue credits or refunds or indemnify or otherwise be liable to customers or third parties for damages that may occur. Additionally, if these third-party providers fail to deliver on their obligations, our reputation could be damaged, our customers could lose confidence in us and our ability to maintain and expand our SaaS offerings would be impaired.

Joint ventures may not yield expected benefits and outcomes.

As we expand our offerings into new technologies such as the public cloud and seek more efficient methods of marketing our products and services in regions where local partners can operate more easily, we sometimes rely upon joint ventures with established providers of IT products and services in particular regions, for example as go-to-market and channel partners. Joint ventures are inherently risky and the requirements for close ongoing cooperation and commitments from the joint venture partners to devote adequate resources often present significant challenges. Joint ventures can also be difficult to manage, given the potentially different interests of joint venture partners.

Accordingly, there can be no guarantee that our joint ventures will achieve their intended objectives. If we are unable to continue our strategic alignment with joint venture partners or obtain the cooperation and commitments we are relying upon, our ability to successfully expand our offerings globally and in certain regions may diminish.

SaaS offerings, which involve various risks, constitute an important part of our business.

As we continue to develop and offer SaaS versions of our products, we will need to continue to evolve our processes to meet a number of regulatory, intellectual property, contractual and service compliance challenges. These challenges include compliance with licenses for open source and third-party software embedded in our SaaS offerings, maintaining compliance with export control and privacy regulations, including HIPAA, protecting our services from

external threats, maintaining the continuous service levels and data security expected by our customers, preventing the inappropriate use of our services and adapting our go-to-market efforts. The expansion of our SaaS and related cloud offerings also requires significant investments, and our operating margins, results of operations and operating cash flows may be adversely affected if our new offerings are not widely adopted by customers.

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Improper disclosure and use of personal data could result in liability and impact our business.

Our business is subject to a wide variety of laws and regulations regarding privacy and protection of personal data. Federal, state and foreign governments and agencies have adopted or are considering adopting laws and regulations regarding the collection, storage, use, processing and disclosure of this information. We collect contact and other personal or identifying information from our customers, and our customers increasingly use our services to store and process personal information and other regulated data, including protected health information subject to stringent data privacy laws. As an employer, we also maintain personal data of our employees and share that information with third-party service providers, such as payroll and benefits providers. Our cloud computing service offerings, pursuant to which we offer cloud services and enable third-party service providers to offer cloud services built on our technology, expose us to particularly significant risks. We rely on the contractual representations of these third parties that they do not violate any applicable privacy laws and regulations or their own privacy policies and in some cases covenants requiring them to maintain certain security measures and protections.

Any failure or perceived failure by us or our business partners to comply with posted privacy policies, other federal, state or international privacy-related or data protection laws and regulations, or the privacy commitments contained in contracts could result in proceedings against us by governmental entities or others and significant fines, which could have a material adverse effect on our business and operating results and harm our reputation. Further, any systems failure, unauthorized access or other compromise of our security that results in the release of our customers' or employees' data could (i) subject us to substantial damage claims, (ii) expose us to significant fines and costly regulatory remediation, (iii) harm our reputation and brand, and (iv) disrupt our business activities. The application of U.S. and international data privacy laws and regulations to cloud computing vendors is evolving and uncertain, and our existing contractual provisions may prove to be inadequate to protect us from claims for data loss or regulatory noncompliance made against cloud computing providers with whom we may partner. Additionally, privacy laws and regulations could negatively affect demand for our services, thereby reducing our revenue.

Our ability to collect and use data could be restricted by laws and regulations as well as by consumers' rights to opt out. Restrictions on our ability to collect data or the ability of our customers to collect data utilizing our products and services could negatively impact our business.

The EU data protection law, the General Data Protection Regulation ("GDPR"), which became effective in May 2018, is wide-ranging in scope. In order to adapt to these new requirements, we have enhanced our policies and controls across our business units and services relating to how we collect and use personal data relating to customers, employees and vendors, and we will continue to invest resources necessary to maintain compliance with GDPR. Additionally, we expect that the international transfer of personal data will present ongoing compliance challenges and complicate our business transactions as we negotiate and implement suitable arrangements with international customers and international and domestic vendors. As a result, our data transfers could require us to implement additional costly measures and require similar adjustments by our customers in order to continue utilizing our products and services. Failure to comply may lead to fines of up to €20 million or up to 4% of the annual global revenues of the infringer, whichever is greater. EU data protection laws and their interpretations continue to develop, and may be inconsistent from jurisdiction to jurisdiction, which may further impact our information processing activities.

Further, laws such as the EU's proposed e-Privacy Regulation are increasingly aimed at the use of personal information for marketing purposes, and the tracking of individuals' online activities. The currently proposed e-Privacy Regulation may change significantly before it is adopted, making its future scope and impact uncertain, and therefore require us to alter our current preparations for the GDPR. Once finalized, revised e-Privacy Regulation may impact our use of cookies and tracking technologies inside products and online, which could hamper our ability to collect and use data to monitor and improve the performance of our products and services. The final regulation may also change the rules around e-marketing and online tracking which could harm our ability to run promotions and effectively market our offerings. In addition, countries outside the EU are considering or have passed legislation that requires local storage and processing of data, which could increase the cost and complexity of delivering our services. Our current arrangements for the transfer of personal data will need to continue to adapt to future judicial decisions and regulatory activity as laws on privacy and the protection of personal data continue to evolve in the countries in which we do business.

If we fail to comply with our customer contracts or government contracting regulations, our business could be adversely affected.

Contracts with many of our customers include unique and specialized performance requirements. In particular, our contracts with federal, state, local and non-U.S. governmental customers and our arrangements with distributors and resellers who may sell directly to governmental customers are subject to various procurement regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with 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

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our government contracts, fines and suspension from future government contracting. 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. In the ordinary course of business, we also receive inquiries from and have ongoing discussions with government entities regarding the compliance of our contracting and sales practices with laws and regulations. A failure in the future to comply with federal and state governmental contracting requirements could result in the termination of customer contracts, our suspension from government work, the imposition of fines or other government sanctions or an inability to compete for new contracts, any of which could adversely affect our business, operating results or financial condition.

Acquisitions and divestitures could harm our business and operating results.

We have acquired in the past, and plan to acquire in the future, other businesses, products or technologies. We also from time to time sell or divest businesses, products and technologies. For instance, in May 2017, we sold the VMware vCloud Air business (“vCloud Air”) to OVH US LLC. Acquisitions and divestitures involve significant risks and uncertainties, which include:

- disrupting our ongoing operations, diverting management from day-to-day responsibilities, increasing our expenses, and adversely impacting our business, financial condition and operating results;
- failure of an acquired business to further our business strategy;
- uncertainties in achieving the expected benefits of an acquisition or disposition, including enhanced revenue, technology, human resources, cost savings, operating efficiencies and other synergies;
- reducing cash available for operations, stock repurchase programs and other uses and resulting in potentially dilutive issuances of equity securities or the incurrence of debt;
- incurring amortization expense related to identifiable intangible assets acquired that could impact our operating results;
- difficulty integrating the operations, systems, technologies, products and personnel of acquired businesses effectively;
- the need to provide transition services in connection with a disposition, such as the sale of vCloud Air, which may result in the diversion of resources and focus;
- difficulty achieving expected business results due to a lack of experience in new markets, products or technologies or the initial dependence on unfamiliar distribution partners or vendors;
- retaining and motivating key personnel from acquired companies;
- declining employee morale and retention issues affecting employees of businesses that we acquire or dispose of, which may result from changes in compensation, or changes in management, reporting relationships, future prospects or the direction of the acquired or disposed business;
- assuming the liabilities of an acquired business, including acquired litigation-related liabilities and regulatory compliance issues, and potential litigation or regulatory action arising from a proposed or completed acquisition;
- lawsuits resulting from an acquisition or disposition;
- maintaining good relationships with customers or business partners of an acquired business or our own customers as a result of any integration of operations or the divestiture of a business upon which our customers rely, such as our recent divestiture of our vCloud Air business;
- unidentified issues not discovered during the diligence process, including issues with the acquired or divested business’s intellectual property, product quality, security, privacy practices, accounting practices, regulatory compliance or legal contingencies;
- maintaining or establishing acceptable standards, controls, procedures or policies with respect to an acquired business;
- risks relating to the challenges and costs of closing a transaction; and
- the need to later divest acquired assets at a loss if an acquisition does not meet our expectations.

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

We may not realize all the economic benefit from our business acquisitions, which could result in an impairment of goodwill or intangibles. As of May 4, 2018, goodwill and amortizable intangible assets were \$4,596 million and \$535 million, respectively. We review our goodwill and amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least

annually. Factors

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that may lead to impairment include a substantial decline in stock price and market capitalization or cash flows, reduced future cash flow estimates related to the assets and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, which would negatively impact our operating results.

Problems with our information systems could interfere with our business and could adversely impact our operations. We rely on our information systems and those of third parties for processing customer orders, delivering products, providing services and support to our customers, billing and tracking our customer orders, fulfilling contractual obligations, performing accounting operations and otherwise running our business. If our systems fail, our disaster and data recovery planning and capacity may prove insufficient to enable timely recovery of important functions and business records. Any disruption in our information systems and those of the third parties upon whom we rely could have a significant impact on our business.

In addition, we continuously work to enhance our information systems, such as our enterprise resource planning software. The implementation of these types of enhancements is frequently disruptive to the underlying business of an enterprise, which may especially be the case for us due to the size and complexity of our business. Implementation may disrupt internal controls and business processes and could introduce unintended vulnerability to error.

Additionally, our information systems may not support new business models and initiatives and significant investments could be required in order to upgrade them. For example, in February 2017 we implemented a change in our fiscal calendar, which required us to make adjustments to our critical business processes and data systems, and in February 2018 we implemented new revenue accounting software.

We may have exposure to additional tax liabilities, and our operating results may be adversely impacted by higher than expected tax rates.

As a multinational corporation, we are subject to income taxes as well as non-income based taxes, such as payroll, sales, use, value-added, net worth, property and goods and services taxes, in both the U.S. and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions and the timing of recognizing revenue and expenses. Significant judgment is required in determining our worldwide provision for income taxes and other tax liabilities. We are subject to income and indirect tax examinations. The Dell-owned EMC consolidated group is routinely under audit by the IRS. All U.S. federal income tax matters have been concluded for years through 2011, except for any matters under appeal. In addition, we are under corporate income tax audits in various states and non-U.S. jurisdictions. While we believe we have complied with all applicable income tax laws, a governing tax authority could have a different interpretation of the law and assess us with additional taxes. Any assessment of additional taxes could materially affect our financial condition and operating results.

Our future effective tax rate may be affected by such factors as changes in tax laws, changes in our business or statutory rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation and the recognition of excess tax benefits and tax deficiencies within the income tax provision in the period in which they occur, the impact of accounting for business combinations, shifts in the amount of earnings in the U.S. compared with other regions in the world and overall levels of income before tax, changes in our international organization, as well as the expiration of statute of limitations and settlements of audits.

In addition, in the ordinary course of our global business, there are many intercompany transactions, including the transfer of intellectual property, where the ultimate tax determination is uncertain. Although we believe that our tax estimates are reasonable, the final determination of tax audits or tax disputes may differ from what is reflected in our historical income tax provisions and accruals.

Our effective tax rate in the future will depend upon the proportion of our income before provision for income taxes earned in the U.S. and in jurisdictions with a tax rate lower than the U.S. statutory rate. Our non-U.S. earnings are primarily earned by our subsidiaries organized in Ireland where the rate of taxation is lower than our U.S. tax rate, and as such, our annual effective tax rate can be significantly affected by the composition of our earnings in the U.S. and non-U.S. jurisdictions. During October 2014, Ireland announced revisions to its tax regulations that will require foreign earnings of our subsidiaries organized in Ireland to be taxed at higher rates. We will be impacted by the changes in tax laws in Ireland beginning in 2021. Prior to this date, we may proactively make structural changes in

Ireland that may reduce the impact to our future tax rates. Currently, there are certain structural changes in Ireland that may be available to multi-national companies. However, due to the Dell Acquisition, we could be subject to higher tax obligations in the event we executed similar structural changes.

Any other significant changes to U.S. or international tax laws could have a material impact on our effective tax rate, financial condition, operating results and timing and amount of tax payments.



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In addition, numerous other countries have recently enacted or are considering enacting changes to tax laws, administrative interpretations, decisions, policies and positions. These changes could adversely affect our effective tax rate or result in higher cash tax liabilities.

Catastrophic events or geo-political conditions could disrupt our business.

Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. A significant natural disaster, such as an earthquake, fire, flood or other act of God, could have a material adverse impact on our business and operating results. Abrupt political change, terrorist activity and armed conflict pose a risk of general economic disruption in affected countries, and disease pandemics could temporarily sideline a substantial part of our or our customers' workforce at any particular time, any of which could disrupt our business. Furthermore, some of our new product initiatives and business functions are hosted and carried out by third parties that may be vulnerable to disruptions of these sorts, many of which may be beyond our control. Unanticipated disruptions in services provided through localized physical infrastructure, such as utility or telecommunication outages, can curtail the functioning of local offices as well as critical components of our information systems, and adversely affect our ability to process orders, provide services, respond to customer requests and maintain local and global business continuity.

To the extent that such disruptions result in delays or cancellations of customer orders, or the deployment or availability of our products and services, our revenue would be adversely affected. Additionally, any such catastrophic event could cause us to incur significant costs to repair damages to our facilities, equipment and infrastructure.

Changes in accounting principles and guidance could result in unfavorable accounting charges or effects.

We prepare our condensed 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 create and interpret appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a material effect on our reported results, as well as our processes and related controls, and may retroactively affect previously reported results. For example, during February 2016, the Financial Accounting Standards Board 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-of-use asset for the right to use the underlying asset for the lease term. The updated standard also requires additional disclosure regarding leasing arrangements. It is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. VMware is currently evaluating the effect that the updated standard 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.

### Risks Related to Our Relationship with Dell

Our stock price has fluctuated significantly following the announcement of the Dell Acquisition, and our relationship with Dell may adversely impact our business and stock price in the future.

Our stock price has fluctuated significantly following the announcement of Dell's acquisition of EMC, our parent company, in September 2016. Our stock price has been particularly volatile following press reports, subsequently confirmed by Dell in a Schedule 13D/A filing on February 2, 2018 and a subsequent filing by Dell on Form 8-K on May 17, 2018, that Dell is evaluating potential business opportunities, including a public offering of Dell, a potential business combination between Dell and VMware, or maintaining the status quo and that Dell is considering the conversion of its Class V common stock, that is intended to reflect our economic performance, into shares of its DHI common stock which it is considering offering to the public. Speculation regarding the outcome of Dell's evaluation creates uncertainty for our customers, partners and employees, which could negatively impact sales, make it difficult to attract and retain employees and distract management's focus from executing on other strategic initiatives.

A number of other factors relating to our future relationship with Dell could adversely affect our business or our stock price in the future, including:

- Dell is able to control matters requiring our stockholders' approval, including the election of a majority of our directors and the other matters over which EMC formerly had control, as described in the risk factors below.
- Dell could implement changes to our business, including changing our commercial relationship with Dell or taking other corporate actions that our other stockholders may not view as beneficial.

We have arrangements with a number of companies that compete with Dell, and our relationship with Dell could adversely affect our relationships with these companies or other customers, suppliers and partners.

Dell has a right to approve certain matters under our certificate of incorporation, including acquisitions or investments in excess of \$100 million, and Dell may choose not to consent to matters that our board of directors believes are in the best interests of VMware.

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• We anticipate certain synergies and benefits from the Dell Acquisition that may not be realized.

In connection with the Dell Acquisition, Dell issued a tracking stock to EMC shareholders, Class V common stock, that is intended to reflect our economic performance as partial consideration to the EMC shareholders. The Class V common stock tracks the performance of an approximately 50% economic interest in our business. The Class V common stock, while not a VMware issued security, increases the supply of publicly traded securities that track VMware's economic performance and may create the perception that the Class V common stock dilutes the holdings of our public stockholders, both of which may put downward pressure on our stock price. Prospective changes to the rights and privileges of the Class V common stock, such as a conversion to a different class of Dell common stock which Dell has disclosed it is considering per the Form 8-K filing referenced above, could also impact the market for Class V common stock. Any volatility in the market for Class V common stock could contribute to volatility in the price of VMware Class A common stock.

Dell is highly leveraged and commits a substantial portion of its cash flows to servicing its indebtedness. Dell's significant debt could create the perception that Dell may exercise its control over us to limit our growth in favor of its other businesses or cause us to transfer cash to Dell. In addition, if Dell defaults, or appears in danger of defaulting, on its indebtedness, the trading price of the Class V common stock issued by Dell would be adversely affected, which could negatively impact the price of our Class A common stock, and uncertainty as to the impact of such a default on VMware could disrupt our business.

• Investor perceptions of Dell's performance, future plans and prospects could contribute to volatility in the price of our Class A common stock

• Some of our products compete directly with products sold or distributed by Dell, which could result in reduced sales. Holders of our Class A common stock have limited ability to influence matters requiring stockholder approval.

As of May 4, 2018, Dell controlled 30,679,000 shares of our Class A common stock and all 300,000,000 shares of our Class B common stock, representing 81.4% of the total outstanding shares of common stock or 97.6% of the voting power of outstanding common stock held by EMC. Through its control of the Class B common stock, which is generally entitled to 10 votes per share, Dell controls the vote to elect all of our directors and to approve or disapprove all other matters submitted to a stockholder vote.

Prior to a distribution by Dell to its stockholders under Section 355 of the Internal Revenue Code of 1986, as amended (a "355 Distribution"), shares of Class B common stock transferred to any party other than a successor-in-interest or a subsidiary of EMC automatically convert into Class A common stock. Dell's voting control over VMware will continue so long as the shares of Class B common stock it controls continue to represent at least 20% of our outstanding stock. If its ownership falls below 20% of the outstanding shares of our common stock, all outstanding shares of Class B common stock will automatically convert to Class A common stock. If Dell effects a 355 Distribution at a time when it holds shares of Class B common stock, its stockholders will receive Class B common stock. These shares will remain entitled to 10 votes per share, holders of these shares will remain entitled to elect 80% of the total number of directors on our board of directors and the holders of our Class A common stock will continue to have limited ability to influence matters requiring stockholder approval and have limited ability to elect members of our board of directors. Following a 355 Distribution, shares of Class B common stock may convert to Class A common stock if such conversion is approved by VMware stockholders after the 355 Distribution and we have obtained a private letter ruling from the Internal Revenue Service. In January 2014, the IRS announced in Revenue Procedure 2014-3 that, generally, it would no longer issue private letter rulings on 355 Distributions.

Dell has the ability to prevent us from taking actions that might be in our best interest.

Under our certificate of incorporation and the master transaction agreement we entered into with EMC, we must (subject to certain exceptions) obtain the consent of EMC (which is controlled by Dell) or its successor-in-interest, as the holder of our Class B common stock, prior to taking specified actions, such as acquiring other companies for consideration in excess of \$100 million, issuing stock or other VMware securities, except pursuant to employee benefit plans (provided that we obtain Class B common stockholder approval of the aggregate annual number of shares to be granted under such plans), paying dividends, entering into any exclusive or exclusionary arrangement with a third party involving, in whole or in part, products or services that are similar to EMC's or amending certain provisions of our charter documents. In addition, we have agreed that for so long as EMC or its successor-in-interest

continues to own greater than 50% of the voting control of our outstanding common stock, we will not knowingly take or fail to take any action that could reasonably be expected to preclude the ability of EMC or its successor-in-interest (including Dell) to undertake a tax-free spin-off. Dell is entitled to exercise the voting control and contractual rights of EMC, and may do so in a manner that could vary significantly from EMC's historic practice. If Dell does not provide any requisite consent allowing us to conduct such activities when requested, we will not be able to conduct such activities. As a result, we may have to forgo capital raising or acquisition opportunities that would otherwise be available to us, and we may be precluded from pursuing certain growth initiatives.

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By becoming a stockholder in our company, holders of our Class A common stock are deemed to have notice of and have consented to the provisions of our certificate of incorporation and the master transaction agreement with respect to the limitations that are described above.

Dell has the ability to prevent a change-in-control transaction and may sell control of VMware without benefiting other stockholders.

Dell's voting control and its additional rights described above give Dell the ability to prevent transactions that would result in a change of control of VMware, including transactions in which holders of our Class A common stock might otherwise receive a premium for their shares over the then-current market price. In addition, Dell is not prohibited from selling a controlling interest in us to a third party and may do so without the approval of the holders of our Class A common stock and without providing for a purchase of any shares of Class A common stock held by persons other than Dell. Accordingly, shares of Class A common stock may be worth less than they would be if Dell did not maintain voting control over us or if Dell did not have the additional rights described above.

If Dell's level of ownership significantly increases, Dell could unilaterally effect a merger of VMware into Dell without a vote of VMware stockholders or the VMware Board of Directors at a price per share that might not reflect a premium to then-current market prices.

As of May 4, 2018, Dell controlled 81.4% of VMware's outstanding common stock, and Dell's percentage ownership of VMware common stock could increase as a result of repurchases by VMware of its Class A common stock or purchases by Dell. Section 253 of the Delaware General Corporation Law permits a parent company, when it owns 90% or more of each class of a subsidiary's stock that generally would be entitled to vote on a merger of that subsidiary with the parent, to unilaterally effect a merger of the subsidiary into the parent without a vote of the subsidiary's board or stockholders. Accordingly, if Dell becomes the holder of at least 90% of VMware's outstanding stock, neither VMware's board of directors nor VMware's stockholders would be entitled to vote on a merger of VMware into Dell (the "short-form merger"). Moreover, a short-form merger is not subject to the stringent "entire fairness" standard and the parent company is not required to negotiate with a special committee of disinterested directors that would serve to approximate arm's length negotiations designed to ensure that a fair price is paid. Rather, a minority stockholder's sole remedy in the context of a short-form merger is to exercise appraisal rights under Delaware law. In such a proceeding, petitioning stockholders may be awarded more or less than the merger price or the amount they would have received in a merger negotiated between the parent and a disinterested special committee advised by independent financial and legal advisors. Dell is prohibited through September 7, 2018 under its charter from purchasing or otherwise acquiring any shares of common stock of VMware if such acquisition would cause the common stock of VMware to no longer be publicly traded on a U.S. securities exchange or VMware to no longer be required to file reports under Sections 13 and 15(d) of the Exchange Act, in each case, unless such acquisition of VMware common stock is required in order for VMware to continue to be a member of the affiliated group of corporations filing a consolidated tax return with Dell.

We engage in related persons transactions with Dell that may divert our resources, create opportunity costs and prove to be unsuccessful.

We currently engage in a number of related persons transactions with Dell that include joint product development, go-to-market, branding, sales, customer service activities, real estate and various support services, and we expect to engage in additional related persons transactions with Dell to leverage the benefits of our strategic alignment. Additionally, in 2013 we contributed technology and transferred employees to Pivotal. We continue to hold a significant ownership interest in Pivotal which was converted from preferred stock to non-trading Class B common stock prior to Pivotal's initial public offering on April 20, 2018.

We believe that these related persons transactions provide us a unique opportunity to leverage the respective technical expertise, product strengths and market presence of Dell and its subsidiaries for the benefit of our customers and stockholders while enabling us to compete more effectively with competitors who are much larger than us. However, these transactions may prove not to be successful and may divert our resources or the attention of our management from other opportunities. Negotiating and implementing these arrangements can be time consuming and cause delays in the introduction of joint product and service offerings and disruptions to VMware's business. We cannot predict whether our stockholders and industry or securities analysts who cover us will react positively to announcements of

new related persons transactions with Dell, and such announcements could have a negative impact on our stock price. Our participation in these transactions may also cause certain of our other vendors and ecosystem partners who compete with Dell and its subsidiaries to also view us as their competitors. Additionally, following Pivotal's initial public offering, VMware held a 24% voting interest in Pivotal, which was accounted for using the fair value option. The fair value of VMware's investment is determined primarily using the quoted market price of Pivotal's Class A common stock. Any volatility in Pivotal's publicly traded Class A common stock therefore introduces a degree of variability to our condensed consolidated balance sheets and statements of income, over which we have little control so long as we maintain our ownership interest.

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Our business and Dell's businesses overlap, and Dell may compete with us, which could reduce our market share. We and Dell are IT infrastructure companies providing products and services that overlap in various areas, including software-based storage, management, hyper-converged infrastructure and cloud computing. Dell competes with us in these areas now and may engage in increased competition with us in the future. In addition, the intellectual property agreement that we have entered into with EMC (which is controlled by Dell) provides EMC the ability to use our source code and intellectual property, which, subject to limitations, it may use to produce certain products that compete with ours. EMC's rights in this regard extend to its majority-owned subsidiaries, which could include joint ventures where EMC holds a majority position and one or more of our competitors hold minority positions.

Dell could assert control over us in a manner that could impede our growth or our ability to enter new markets or otherwise adversely affect our business. Further, Dell could utilize its control over us to cause us to take or refrain from taking certain actions, including entering into relationships with channel, technology and other marketing partners, enforcing our intellectual property rights or pursuing business combinations, other corporate opportunities (which EMC is expressly permitted to pursue under the circumstances set forth in our certificate of incorporation) or product development initiatives that could adversely affect our competitive position, including our competitive position relative to that of Dell in markets where we compete with Dell. In addition, Dell maintains significant partnerships with certain of our competitors, including Microsoft.

Dell's competition in certain markets may affect our ability to build and maintain partnerships.

Our existing and potential partner relationships may be negatively affected by our relationship with Dell. We partner with a number of companies that compete with Dell in certain markets in which Dell participates. Dell's control of EMC's majority ownership in us may affect our ability to effectively partner with these companies. These companies may favor our competitors because of our relationship with Dell.

Dell competes with certain of our significant channel, technology and other marketing partners, including IBM and Hewlett-Packard. Pursuant to our certificate of incorporation and other agreements that we have with EMC, EMC and Dell may have the ability to impact our relationship with those of our partners that compete with EMC or Dell, which could have a material adverse effect on our operating results and our ability to pursue opportunities which may otherwise be available to us.

We could be held liable for the tax liabilities of other members of Dell's consolidated tax group, and compared to our historical results as a member of the EMC consolidated tax group, our tax liabilities may increase, fluctuate more widely and be less predictable.

We have historically been included in EMC's consolidated group for U.S. federal income tax purposes, as well as in certain consolidated, combined or unitary groups that include EMC Corporation or certain of its subsidiaries for state and local income tax purposes, and since the Dell Acquisition, we have been included in Dell's consolidated tax group. Effective as of the close of the Dell Acquisition, we amended our tax sharing agreement with EMC to include Dell. Although our tax sharing agreement provides that our tax liability is calculated primarily as though VMware were a separate taxpayer, certain tax attributes and transactions are assessed using consolidated tax return rules as applied to the Dell consolidated tax group and are subject to other specialized terms under the tax sharing agreement. Pursuant to our agreement, we and Dell generally will make payments to each other such that, with respect to tax returns for any taxable period in which we or any of our subsidiaries are included in Dell's consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of Dell or its subsidiaries, the amount of taxes to be paid by us will be determined, subject to certain consolidated return adjustments, as if we and each of our subsidiaries included in such consolidated, combined or unitary group filed our own consolidated, combined or unitary tax return. Consequently, compared to our historical results as a member of the EMC consolidated tax group, the amount of our tax sharing payment compared to our separate return basis liability may increase, vary more widely from period to period and be less predictable. Additionally, the impact of the 2017 Tax Act upon consolidated groups is highly complex and uncertain and its impact must be further interpreted in the context of the tax sharing agreement to determine VMware's tax sharing payment. VMware and Dell are reviewing the tax sharing agreement in connection with the enactment of the 2017 Tax Act.

When we become subject to federal income tax audits as a member of Dell's consolidated group, the tax sharing agreement provides that Dell has authority to control the audit and represent Dell and our interests to the IRS.

Accordingly, if we and Dell or its successor-in-interest differ on appropriate responses and positions to take with respect to tax questions that may arise in the course of an audit, our ability to affect the outcome of such audits may be impaired. In addition, if Dell effects a 355 Distribution or other transaction that is subsequently determined to be taxable, we could be liable for all or a portion of the tax liability, which could have a material adverse effect on our operating results and financial condition.

We have been included in the EMC consolidated group for U.S. federal income tax purposes since our acquisition by EMC in 2004, and will continue to be included in Dell's consolidated group for periods in which Dell or its successor-in-interest beneficially owns at least 80% of the total voting power and value of our outstanding stock. Each member of a consolidated group during any part of a consolidated return year is jointly and severally liable for tax on the consolidated return of such year



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and for any subsequently determined deficiency thereon. Similarly, in some jurisdictions, each member of a consolidated, combined or unitary group for state, local or foreign income tax purposes is jointly and severally liable for the state, local or foreign income tax liability of each other member of the consolidated, combined or unitary group. Accordingly, for any period in which we are included in the Dell consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of Dell and its subsidiaries, we could be liable in the event that any income tax liability was incurred, but not discharged, by any other member of any such group.

Also, under the tax sharing agreement, if it is subsequently determined that the tracking stock issued in connection with the Dell Acquisition constitutes a taxable distribution, we could be liable for all or a portion of the tax liability, which could have a material adverse effect on our operating results and financial condition.

We have limited ability to resolve favorably any disputes that arise between us and Dell.

Disputes may arise between Dell and us in a number of areas relating to our ongoing relationships, including our reseller, technology and other business agreements with Dell, areas of competitive overlap, strategic initiatives, requests for consent to activities specified in our certificate of incorporation and the terms of our intercompany agreements. We may not be able to resolve any potential conflicts with Dell, and even if we do, the resolution may be less favorable than if we were dealing with an unaffiliated party.

While we are controlled by Dell, we may not have the leverage to negotiate renewals or amendments to these agreements, if required, on terms as favorable to us as those we would negotiate with an unaffiliated third party, if at all.

Our CEO, our CFO and some of our directors have potential conflicts of interest with Dell.

Our CEO, our CFO and some of our directors received shares of Dell Class V common stock in partial consideration for their EMC common stock when the Dell Acquisition closed. In addition, some of our directors are executive officers or directors of Dell, and Dell, through its control of EMC, which is the sole holder of our Class B common stock, is entitled to elect 7 of our 8 directors and possesses sufficient voting control to elect the remaining director. Ownership of Dell Class V common stock by our directors and the presence of executive officers or directors of Dell on our board of directors could create, or appear to create, conflicts of interest with respect to matters involving both us and Dell that could have different implications for Dell than they do for us. Our Board has approved resolutions that address corporate opportunities that are presented to our directors or officers that are also directors or officers of Dell. These provisions may not adequately address potential conflicts of interest or ensure that potential conflicts of interest will be resolved in our favor. As a result, we may not be able to take advantage of corporate opportunities presented to individuals who are officers or directors of both us and Dell and we may be precluded from pursuing certain growth initiatives.

We are a “controlled company” within the meaning of the New York Stock Exchange rules and, as a result, are relying on exemptions from certain corporate governance requirements that provide protection to stockholders of companies that are not “controlled companies.”

Dell owns more than 50% of the total voting power of our common stock and, as a result, we are a “controlled company” under the New York Stock Exchange corporate governance standards. As a controlled company, we are exempt under the New York Stock Exchange standards from the obligation to comply with certain New York Stock Exchange corporate governance requirements, including the requirements:

- that a majority of our board of directors consists of independent directors;
- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities;
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee’s purpose and responsibilities; and

• for an annual performance evaluation of the nominating and governance committee and compensation committee.

While we have voluntarily caused our Compensation and Corporate Governance Committee to currently be composed entirely of independent directors, reflecting the requirements of the New York Stock Exchange, we are not required to maintain the independent composition of the committee. As a result of our use of the “controlled company” exemptions, holders of our Class A common stock will not have the same protection afforded to stockholders of companies that are subject to all of the New York Stock Exchange corporate governance requirements.

Dell's ability to control our board of directors may make it difficult for us to recruit independent directors. So long as Dell beneficially owns shares of our common stock representing at least a majority of the votes entitled to be cast by the holders of outstanding voting stock, Dell can effectively control and direct our board of directors. Further, the

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interests of Dell and our other stockholders may diverge. Under these circumstances, it may become difficult for us to recruit independent directors.

Our historical financial information as a majority-owned subsidiary may not be representative of the results of a completely independent public company.

The financial information covering the periods included in this report does not necessarily reflect what our financial condition, operating results or cash flows would have been had we been a completely independent entity during those periods. In certain geographic regions where we do not have an established legal entity, we contract with Dell subsidiaries for support services and Dell personnel who are managed by us. The costs incurred by Dell on our behalf related to these employees are passed on to us and we are charged a mark-up intended to approximate costs that would have been charged had we contracted for such services with an unrelated third party. These costs are included as expenses on our condensed consolidated statements of income. Additionally, we engage with Dell in intercompany transactions, including agreements regarding the use of Dell's and our intellectual property and real estate, agreements regarding the sale of goods and services to one another and to Pivotal, and agreements for Dell to resell our products and services to third party customers. If Dell were to distribute its shares of our common stock to its stockholders or otherwise divest itself of all or a significant portion of its VMware shares, there would be numerous implications to us, including the fact that we could lose the benefit of these arrangements with Dell. There can be no assurance that we would be able to renegotiate these arrangements with Dell or replace them on the same or similar terms.

Additionally, our business could face significant disruption and uncertainty as we transition from these arrangements with Dell. Moreover, our historical financial information is not necessarily indicative of what our financial condition, operating results or cash flows would be in the future if and when we contract at arm's length with independent third parties for the services we have received and currently receive from Dell. During the three months ended May 4, 2018, we recognized revenue of \$371 million and as of May 4, 2018, \$1,317 million of sales were included in unearned revenue from such transactions with Dell. For additional information, refer to "Our Relationship with Dell" in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part I, Item 2 and Note C to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q.

**Risks Related to Owning Our Class A Common Stock**

The price of our Class A common stock has fluctuated significantly in recent years and may fluctuate significantly in the future.

The trading price of our Class A common stock has fluctuated significantly in the past and could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this report. The trading market for Dell Class V common stock that was issued upon the closing of the Dell Acquisition that is expected to track the performance of VMware, as well as continuing volatility in technology company share prices, could also lead to volatility in our stock price.

Dell, which beneficially owned 81.4% of our outstanding stock as of May 4, 2018, is not restricted from selling its shares and is entitled to certain registration rights. If a significant number of shares enters the public trading markets in a short period of time, the market price of our Class A common stock may decline. In addition, if our Class B common stock is distributed to Dell stockholders and remains outstanding, it would trade separately from and potentially at a premium to our Class A common stock, and could thereby contribute additional volatility to the price of our Class A common stock.

Broad market and industry factors may also decrease the market price of our Class A common stock, regardless of our actual operating performance. The stock market in general and technology companies in particular have often experienced extreme price and volume fluctuations. Our public float is also relatively small due to Dell's holdings, which can result in greater volatility in our stock compared to that of other companies with a market capitalization similar to ours. It is also uncertain what impact the trading of Dell Class V common stock, which represents approximately 50% of the economic interest in us, will have on the volatility and the liquidity of our Class A common stock and how the Dell Class V common stock will trade in relation to our Class A common stock over time. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted, including against us, and, if not resolved swiftly, can result in substantial costs and a diversion of management's attention and resources.

If securities or industry analysts change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

The trading market for our Class A common stock is influenced by the research and reports that industry or securities analysts publish about us, our business, our market or our competitors. If any of the analysts who cover us or who cover the Dell Class V common stock change their recommendation regarding our stock adversely, or provide more favorable relative recommendations about our competitors, our stock price would likely decline.

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Anti-takeover provisions in Delaware law and our charter documents could discourage takeover attempts.

As our controlling stockholder, Dell has the ability to prevent a change in control of VMware. Provisions in our certificate of incorporation and bylaws may also have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the division of our board of directors into three classes, with each class serving for a staggered three-year term, which prevents stockholders from electing an entirely new board of directors at any annual meeting;
- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;
- following a 355 Distribution of Class B common stock by Dell to its stockholders, the restriction that a beneficial owner of 10% or more of our Class B common stock may not vote in any election of directors unless such person or group also owns at least an equivalent percentage of Class A common stock or obtains approval of our board of directors prior to acquiring beneficial ownership of at least 5% of Class B common stock;
- the prohibition of cumulative voting in the election of directors or any other matters, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders' meeting;
- the ability of the board of directors to issue, without stockholder approval, up to 100,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock; and
- in the event that Dell or its successor-in-interest no longer owns shares of our common stock representing at least a majority of the votes entitled to be cast in the election of directors, stockholders may not act by written consent and may not call special meetings of the stockholders.

In addition, we have elected to apply the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation and bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock.

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

(a) Sales of Unregistered Securities

None.

(b) Use of Proceeds from Public Offering of Common Stock

None.

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchaser

From time to time, we repurchase stock pursuant to authorized stock repurchase programs in open market transactions as permitted by securities laws and other legal requirements. We are not obligated to purchase any shares under our stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased depends on a variety of factors, including our stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time we believe additional purchases are not warranted. From time to time, we also purchase stock in private transactions, such as with Dell. All shares repurchased under our stock repurchase programs are retired. During August 2017, our board of directors authorized the repurchase of up to \$1,000 million of Class A common stock through August 31, 2018, of which \$876 million remained available for repurchase as of May 4, 2018.

We did not repurchase any shares of our Class A common stock as part of our publicly announced share repurchase program during the three months ended May 4, 2018 due to the temporary suspension of our stock repurchase program in light of the 13D/A filed by Dell on February 2, 2018.

**ITEM 6. EXHIBITS**

See the Exhibit Index following the signature page of this Quarterly Report on Form 10-Q for a list of exhibits.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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.

VMWARE, INC.

Dated: June 11, 2018 By: /s/ Kevan Kryslar

Kevan Kryslar

Senior Vice President, Chief Accounting Officer

(Principal Accounting Officer)

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## EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date
		Form	File No.	Exhibit	
3.1	<u>Amended and Restated Certificate of Incorporation</u>	10-Q	001-33622	3.1	6/9/17
3.2	<u>Amended and Restated Bylaws</u>	8-K	001-33622	3.1	2/23/17
10.12+*	<u>Executive Bonus Program, as amended and restated April 16, 2018</u>				
10.23+*	<u>Letter Agreement between VMware, Inc. and Maurizio Carli effective as of May 1, 2018</u>				
31.1*	<u>Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>				
31.2*	<u>Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>				
32.1	<u>Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>				
32.2	<u>Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>				
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				
+ Indicates management contract or compensatory plan or arrangement					
* Filed herewith					
Furnished herewith					