

VMWARE, INC.

Form 10-Q

September 07, 2017

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 August 4, 2017

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 September 1, 2017, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 408,947,278, of which 108,947,278 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 (LOSS)

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

(unaudited)

	Three Months Ended		Six Months Ended		Transition Period
	August 31, 2017	June 30, 2016	August 31, 2017	June 30, 2016	January 1 to February 3, 2017
Revenue:					
License	\$732	\$644	\$1,342	\$1,216	\$125
Services	1,168	1,049	2,294	2,066	371
Total revenue	1,900	1,693	3,636	3,282	496
Operating expenses <sup>(1)</sup> :					
Cost of license revenue	39	40	78	81	13
Cost of services revenue	231	221	481	432	80
Research and development	428	363	849	720	150
Sales and marketing	668	580	1,255	1,144	231
General and administrative	160	167	311	338	63
Realignment and loss on disposition	36	(1)	86	52	—
Operating income (loss)	338	323	576	515	(41)
Investment income	25	19	48	35	8
Interest expense with Dell	(7)	(7)	(13)	(13)	(2)
Other income (expense), net	51	2	54	—	1
Income (loss) before income tax	407	337	665	537	(34)
Income tax provision (benefit)	73	72	99	111	(26)
Net income (loss)	\$334	\$265	\$566	\$426	\$(8)
Net income (loss) per weighted-average share, basic for Class A and Class B	\$0.82	\$0.62	\$1.39	\$1.00	\$(0.02)
Net income (loss) per weighted-average share, diluted for Class A and Class B	\$0.81	\$0.62	\$1.37	\$1.00	\$(0.02)
Weighted-average shares, basic for Class A and Class B	408,399	425,107	408,415	424,169	408,625
Weighted-average shares, diluted for Class A and Class B	412,768	427,102	413,920	425,729	408,625

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

Cost of license revenue	\$—	\$—	\$1	\$1	\$—
Cost of services revenue	12	13	25	25	5
Research and development	89	74	170	144	31
Sales and marketing	48	47	98	95	19
General and administrative	20	18	37	36	7

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 (LOSS)

(in millions)

(unaudited)

	Three Months Ended		Six Months Ended		Transition Period
	August 2017	June 30, 2016	August 2017	June 30, 2016	January 1 to February 3, 2017
Net income (loss)	\$334	\$ 265	\$566	\$ 426	\$ (8 )
Other comprehensive income:					
Changes in market value of available-for-sale securities:					
Unrealized gains, net of tax provision of \$5, \$6, \$9, \$15 and \$1	8	10	15	24	2
Reclassification of losses realized during the period, net of tax benefit of \$—, \$—, \$1, \$2, and \$—	—	—	2	3	—
Net change in market value of available-for-sale securities	8	10	17	27	2
Changes in market value of effective foreign currency forward contracts:					
Unrealized gains (losses), net of tax provision of \$3, \$—, \$3, \$—, and \$—	(5 )	(3 )	1	—	3
Reclassification of losses realized during the period, net of tax benefit of \$— for all periods	2	1	2	1	—
Net change in market value of effective foreign currency forward contracts	(3 )	(2 )	3	1	3
Total other comprehensive income	5	8	20	28	5
Total comprehensive income (loss), net of taxes	\$339	\$ 273	\$586	\$ 454	\$ (3 )

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)

	August 4, 2017	December 31, 2016	Transition Period February 3, 2017
<b>ASSETS</b>			
Current assets:			
Cash and cash equivalents	\$ 3,552	\$ 2,790	\$ 3,220
Short-term investments	5,350	5,195	5,173
Accounts receivable, net of allowance for doubtful accounts of \$2, \$2 and \$2	1,189	1,856	1,192
Due from related parties, net	207	132	93
Other current assets	173	362	173
Total current assets	10,471	10,335	9,851
Property and equipment, net	1,005	1,049	1,042
Other assets	262	248	249
Deferred tax assets	691	462	716
Intangible assets, net	476	517	507
Goodwill	4,270	4,032	4,032
Total assets	\$ 17,175	\$ 16,643	\$ 16,397
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Current liabilities:			
Accounts payable	\$ 116	\$ 125	\$ 53
Accrued expenses and other	1,016	898	887
Note payable to Dell	680	—	—
Unearned revenue	3,464	3,531	3,349
Total current liabilities	5,276	4,554	4,289
Notes payable to Dell	820	1,500	1,500
Unearned revenue	2,040	2,093	1,991
Other liabilities	440	399	401
Total liabilities	8,576	8,546	8,181
Contingencies (refer to Note I)			
Stockholders' equity:			
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 109,651, 108,351 and 110,060 shares	1	1	1
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3	3
Additional paid-in capital	1,640	1,721	1,843
Accumulated other comprehensive income (loss)	16	(9	) (4
Retained earnings	6,939	6,381	6,373
Total stockholders' equity	8,599	8,097	8,216
Total liabilities and stockholders' equity	\$ 17,175	\$ 16,643	\$ 16,397

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)

	Six Months Ended August 4, 2017	June 30, 2016	Transition Period January 1 to February 3, 2017
Operating activities:			
Net income (loss)	\$566	\$426	\$ (8 )
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	165	174	29
Stock-based compensation	331	301	62
Excess tax benefits from stock-based compensation	—	(1 )	(5 )
Deferred income taxes, net	35	(5 )	(254 )
Loss on disposition	79	—	—
(Gain) loss on Dell stock purchase	2	—	(1 )
Impairment of strategic investments	2	5	—
Gain on disposition of strategic investments	(38 )	(1 )	—
Other	1	5	—
Changes in assets and liabilities, net of acquisitions:			
Accounts receivable	4	417	664
Other assets	(27 )	(23 )	190
Due to/from related parties, net	(114 )	(18 )	39
Accounts payable	60	(10 )	(68 )
Accrued expenses	122	18	(41 )
Income taxes payable	8	(36 )	38
Unearned revenue	199	45	(284 )
Net cash provided by operating activities	1,395	1,297	361
Investing activities:			
Additions to property and equipment	(105 )	(79 )	(18 )
Purchases of available-for-sale securities	(2,152 )	(2,211 )	(38 )
Sales of available-for-sale securities	1,253	979	43
Maturities of available-for-sale securities	770	619	20
Proceeds from disposition of assets	—	3	—
Purchases of strategic investments	(32 )	(27 )	—
Proceeds from sales of strategic investments	6	1	—
Business combinations, net of cash acquired	(236 )	(59 )	—
Net cash paid on disposition of business	(41 )	—	—
Increase in restricted cash	—	(2 )	—
Net cash provided by (used in) investing activities	(537 )	(776 )	7
Financing activities:			
Proceeds from issuance of common stock	76	52	61
Payment to acquire non-controlling interests	—	(4 )	—
Repurchase of common stock	(425 )	—	—
Excess tax benefits from stock-based compensation	—	1	5
Shares repurchased for tax withholdings on vesting of restricted stock	(177 )	(72 )	(4 )

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Net cash provided by (used in) financing activities	(526 )	(23 )	62
Net increase in cash and cash equivalents	332	498	430
Cash and cash equivalents at beginning of the period	3,220	2,493	2,790
Cash and cash equivalents at end of the period	\$3,552	\$2,991	\$ 3,220
Supplemental disclosures of cash flow information:			
Cash paid for interest	\$16	\$14	\$ —
Cash paid for taxes, net	63	135	3
Non-cash items:			
Changes in capital additions, accrued but not paid	\$6	\$(19 )	\$(6 )

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

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

Change in Fiscal Year End

Effective January 1, 2017, VMware’s fiscal year changed from a fiscal year ending on December 31 of each calendar year to a fiscal year consisting of a 52- or 53-week period ending on the Friday nearest to January 31 of each year. The period that began on January 1, 2017 and ended on February 3, 2017 is reflected as a transition period (the “Transition Period”). VMware’s first full fiscal year 2018 under the revised fiscal calendar is a 52-week year that began on February 4, 2017 and will end on February 2, 2018.

The Company has included its unaudited condensed consolidated financial statements for the Transition Period in this report on Form 10-Q. As permitted under SEC rules, prior-period financial statements have not been recast, as management believes (i) the three and six months ended June 30, 2016 are comparable to the three and six months ended August 4, 2017 and (ii) recasting prior-period results was not practicable or cost justified.

Accounting Principles

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

Unaudited Interim Financial Information

The accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full fiscal year 2018. 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 2016 Annual Report on Form 10-K.

Effective September 7, 2016, Dell Technologies Inc. (“Dell”) (formerly Denali Holding Inc.) acquired EMC Corporation (“EMC”), including EMC’s majority control of VMware (the “Dell Acquisition”). As a result of the Dell Acquisition, EMC became a wholly-owned subsidiary of Dell and VMware became an indirectly held, majority-owned subsidiary of Dell. As of August 4, 2017, Dell controlled 81.4% of VMware’s outstanding common stock and 97.5% of the combined voting power of VMware’s outstanding common stock, including 33 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 (“Parent”).

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 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.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Principles of Consolidation

The unaudited condensed consolidated financial statements include the accounts of VMware and its subsidiaries. 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.

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.

New Accounting Pronouncements

Topic 606, Revenue from Contracts with Customers

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 provide interpretive clarifications on the new guidance in Topic 606 (collectively, “Topic 606”). The updated revenue standard replaces all existing revenue recognition guidance under GAAP and establishes common principles for recognizing revenue for all industries. It also provides 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. The updated standard is effective for interim and annual periods beginning after December 15, 2017 and permits the use of either the full retrospective or cumulative effect transition method.

VMware plans to adopt Topic 606 using the full retrospective transition method when it becomes effective for the Company in the first quarter of fiscal 2019. While the Company is continuing to assess the potential impacts of Topic 606, VMware currently expects unearned license revenue related to the sale of perpetual licenses will decline significantly upon adoption. Currently, VMware defers all license revenue related to the sale of its perpetual licenses in the event certain revenue recognition criteria are not met. However, under Topic 606, the Company would generally expect that substantially all license revenue related to the sale of its perpetual licenses will be recognized upon delivery. Topic 606 is also expected to impact the timing and recognition of costs to obtain contracts with customers, such as commissions. Under the new standard, incremental costs to obtain contracts with customers are deferred and recognized over the expected period of benefit. As a result, VMware expects deferred commission costs to increase. The Company is continuing to evaluate the effects that Topic 606 will have on its consolidated financial statements and related disclosures, and its preliminary assessments are subject to change.

ASU No. 2016-02, Leases

During February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires a lessee to recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. 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. The Company 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.

ASU No. 2016-16, Income Taxes

During October 2016, the FASB issued ASU No. 2016-16, Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory (Topic 740), which requires entities to recognize at the transaction date the income tax consequences of intra-entity asset transfers. Previous guidance required the tax effects from intra-entity asset transfers to be deferred

until that asset is sold to a third party or recovered through use. The updated standard is effective for annual and interim periods beginning after December 15, 2017 and requires a modified retrospective transition method. The Company is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

ASU No. 2016-09, Compensation

VMware adopted ASU No. 2016-09, Compensation—Stock Compensation (Topic 718), on a prospective basis, effective February 4, 2017. Prior periods have not been reclassified to conform to the fiscal 2018 presentation. Net excess tax benefits

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

recognized in connection with stock-based awards are now included in the income tax provision on the condensed consolidated statements of income. Net excess tax benefits recognized during the three and six months ended August 4, 2017 were \$13 million and \$44 million, respectively. Prior to adopting the updated standard, such amounts were recognized in additional paid-in capital on the Company's consolidated balance sheets.

Additionally, all tax-related cash flows resulting from stock-based awards are reported as operating activities in the statements of cash flows. Prior to adopting the updated standard, excess tax benefits were reported as a cash inflow from financing activities in the statements of cash flows.

**B. Related Parties**

The information provided below includes a summary of the transactions entered into with Dell and Dell's consolidated subsidiaries, including EMC. Transactions prior to September 7, 2016 reflect transactions only with EMC and its consolidated subsidiaries.

**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 ongoing reseller arrangements with Dell, Dell bundles VMware's products and services with Dell's products and sells them to end users. Reseller revenue is presented net of related marketing development funds and rebates paid to Dell.

Dell purchases products and services from VMware for internal use.

VMware provides professional services to end users based upon contractual agreements with Dell.

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.

VMware provides various services to Pivotal. Support costs incurred by VMware are reimbursed to VMware and are recorded as a reduction to the costs incurred by VMware.

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				Unearned Revenue			
	Three Months Ended		Six Months Ended		Transition Period January 1 to February 3, 2017	As of		Transition Period February 3, 2017
	August 4, 2017	June 30, 2016	August 4, 2017	June 30, 2016		August 4, 2017	December 31, 2016	
Reseller revenue	\$282	\$ 85	\$505	\$ 163	\$ 44	\$806	\$ 637	\$ 616
Internal-use revenue	4	14	9	19	7	9	15	18
Professional services revenue	26	26	55	51	3	—	—	—
Agency fee revenue	—	1	1	2	—	—	—	—
Reimbursement for services to Pivotal	—	—	—	1	—	n/a	n/a	n/a

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.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with Dell subsidiaries for support services and 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 United States 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	Three Months Ended	Six Months Ended	Six Months Ended	Transition Period January 1 to February 3, 2017
	August 4, 2017	June 30, 2016	August 4, 2017	June 30, 2016	
Purchases and leases of products and purchases of services	\$32	\$ 17	\$68	\$ 34	\$ 14
Dell subsidiary support and administrative costs	33	21	62	44	13

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.

During the second quarter of fiscal 2018, VMware acquired Wavefront, Inc. ("Wavefront"). Upon closing of the acquisition, Dell was paid \$20 million in cash for its ownership interest in Wavefront.

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 \$7 million and \$9 million during the three and six months ended August 4, 2017, respectively. Financing fees during the Transition Period were not significant.

Tax Sharing Agreement with Dell

VMware has made payments to Dell pursuant to a tax sharing agreement. The following table summarizes the payments made during the periods presented (table in millions):

	Three Months Ended	Three Months Ended	Six Months Ended	Six Months Ended	Transition Period January 1 to February 3, 2017
	August 4, 2017	June 30, 2016	August 4, 2017	June 30, 2016	
Payments from VMware to Dell	\$12	\$ 54	\$12	\$ 95	\$ —

The timing of the tax payments due to and from related parties is governed by a tax sharing agreement. 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 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 presented as a component of stockholders' equity. The difference between the amount of tax calculated on a separate return basis and the amount of tax calculated pursuant to the tax sharing agreement was not significant during the three and six months ended August 4, 2017 and the Transition Period, and was \$14 million and \$15 million during the three and six months ended June 30, 2016, respectively.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## 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):

	Transition Period		
	August 4, 2017	December 31, 2016	February 3, 2017
Due (to) related parties	\$ (67 )	\$ (71 )	\$ (85 )
Due from related parties	274	203	178
Due from related parties, net	\$ 207	\$ 132	\$ 93
Income tax related asset, net	\$ —	\$ 181	\$ —
Income tax due (to) related parties	(14 )	—	(21 )

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

## Stock Purchase Agreements with Dell

On March 29, 2017, VMware entered into a stock purchase agreement to purchase \$300 million of VMware Class A common stock from Dell. During the first quarter of fiscal 2018, VMware paid Dell \$300 million in exchange for an initial delivery of 2.7 million shares, or approximately 80% of the expected total shares to be received and retired under the arrangement. On May 10, 2017, the stock purchase agreement with Dell was completed and VMware received an additional 0.7 million shares. The aggregate number of 3.4 million shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

On December 15, 2016, VMware entered into a stock purchase agreement to purchase \$500 million of VMware Class A common stock from Dell. VMware purchased 4.8 million shares for \$375 million through December 31, 2016. On February 15, 2017, the stock purchase agreement with Dell was completed. A total of \$500 million was paid in exchange for 6.2 million shares. The aggregate number of shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

On August 23, 2017, VMware entered into a stock purchase agreement to purchase \$300 million of VMware Class A common stock from Dell. Purchases under this agreement are expected to occur during fiscal 2018. The aggregate number of shares purchased will be determined based upon a volume-weighted average price during a defined period, less an agreed upon discount.

## Notes Payable to Dell

VMware entered into a note exchange agreement with its Parent on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022. As of August 4, 2017, \$680 million was classified as a current liability.

The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and six months ended August 4, 2017, \$7 million and \$13 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2016 and the Transition Period, \$7 million, \$13 million and \$2 million, respectively, of interest expense was recognized.

On August 21, 2017, VMware repaid certain of the notes payable to Dell in the aggregate principal amount of \$1,230 million. The aggregate principal amount included repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount. Refer to Note N for further information regarding subsequent events.

## C. Business Combinations, Definite-Lived Intangible Assets, Net and Goodwill

## Business Combinations



During the second quarter of fiscal 2018, VMware completed the acquisitions of Wavefront and Aptelligent, Inc., which were not material to the condensed consolidated financial statements. These acquisitions are part of a strategy to accelerate the development of VMware's Cloud services and other technologies. The aggregate purchase price for the two acquisitions was \$238 million, net of cash acquired of \$35 million. The aggregate purchase price included \$36 million of identifiable intangible

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

assets and \$238 million of goodwill that is not expected to be deductible for tax purposes. The identifiable intangible assets primarily relate to purchased technology, with estimated useful lives of five years. The fair value of assumed unvested equity attributed to post-combination services was \$37 million and will be expensed over the remaining requisite service periods on a straight-line basis. The estimated fair value of the stock options assumed by the Company was determined using the Black-Scholes option pricing model.

Prior to the closing of the acquisition, VMware held an ownership interest in Wavefront. Upon completion of the step acquisition, VMware recognized a gain of \$34 million in other income (expense), net for the remeasurement of its ownership interest to fair value, which was \$49 million. The gain recognized on the step acquisition is not expected to be taxable and resulted in a discrete tax benefit of \$13 million during the second quarter of fiscal 2018. Upon closing of the acquisition, Dell was paid \$20 million in cash for its ownership interest in Wavefront.

The pro forma financial information assuming the acquisition had occurred as of the beginning of the fiscal year prior to the fiscal year of acquisition, as well as the revenue and earnings generated during the current fiscal year, were not material for disclosure purposes.

## Definite-Lived Intangible Assets, Net

As of the periods presented, definite-lived intangible assets consisted of the following (amounts in tables in millions):  
August 4, 2017

	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	\$ 663	\$ (412 )	\$ 251
Leasehold interest	34.9	149	(26 )	123
Customer relationships and customer lists	8.2	135	(71 )	64
Trademarks and tradenames	8.5	63	(27 )	36
Other	5.7	5	(3 )	2
Total definite-lived intangible assets		\$ 1,015	\$ (539 )	\$ 476

December 31, 2016

	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$ 641	\$ (358 )	\$ 283
Leasehold interest	34.9	149	(24 )	125
Customer relationships and customer lists	8.3	132	(62 )	70
Trademarks and tradenames	8.7	61	(23 )	38
Other	5.7	4	(3 )	1
Total definite-lived intangible assets		\$ 987	\$ (470 )	\$ 517

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	Transition Period February 3, 2017			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	\$ 641	\$ (366 )	\$ 275
Leasehold interest	34.9	149	(24 )	125
Customer relationships and customer lists	8.3	132	(64 )	68
Trademarks and tradenames	8.7	61	(23 )	38
Other	5.7	4	(3 )	1
Total definite-lived intangible assets		\$ 987	\$ (480 )	\$ 507

Amortization expense on definite-lived intangible assets was \$34 million and \$66 million during the three and six months ended August 4, 2017, respectively, and \$32 million and \$65 million during the three and six months ended June 30, 2016, respectively. Amortization expense on definite-lived intangible assets was \$10 million during the Transition Period.

Based on intangible assets recorded as of August 4, 2017 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 2018	\$67
2019	124
2020	100
2021	46
2022	31
Thereafter	108
Total	\$476

**Goodwill**

The following table summarizes the changes in the carrying amount of goodwill during the six months ended August 4, 2017 (table in millions):

Balance, February 3, 2017	\$4,032
Increase in goodwill related to business combinations	238
Balance, August 4, 2017	\$4,270

**D. Realignment and Loss on Disposition****Disposition of VMware vCloud Air Business**

During the second quarter of fiscal 2018, VMware completed the sale of its VMware vCloud Air business (“vCloud Air”) to OVH US LLC (“OVH”). Losses recognized in connection with this transaction were \$36 million and \$86 million during the three and six months ended August 4, 2017, respectively, and were recorded in realignment and loss on disposition on the condensed consolidated statements of income. Losses recognized on the disposition of vCloud Air include the impairment of fixed assets identified as part of the sale, as well as the costs associated with certain transition services, which primarily include 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. The losses recognized on the disposition of vCloud Air are deductible for tax purposes and resulted in a discrete tax benefit of \$12 million during the second quarter of fiscal 2018.

In connection with the disposition of vCloud Air, approximately \$35 million of total unearned revenue, including \$18 million of unearned license revenue, was transferred to OVH during the second quarter of fiscal 2018.

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## Realignment

On January 22, 2016, VMware approved a plan to streamline its operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the six months ended June 30, 2016. VMware recognized \$49 million of severance-related realignment expenses during the six months ended June 30, 2016 on the condensed consolidated statements of income. Additionally, VMware consolidated certain facilities as part of this plan, which resulted in the recognition of \$3 million of related expenses during the six months ended June 30, 2016. Actions associated with this plan were substantially completed by December 31, 2016.

The following table summarizes the activity for the accrued realignment expenses for the period presented (table in millions):

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

## E. Net Income (Loss) per Share

Basic net income (loss) per share is computed by dividing net income (loss) 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 computations of diluted net income (loss) per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate net income (loss) 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 (loss) per share during the periods presented (table in millions, except per share amounts and shares in thousands):

	Three Months Ended		Six Months Ended		Transition Period
	August 31, 2017	June 30, 2016	August 31, 2017	June 30, 2016	January 1 to February 3, 2017
Net income (loss)	\$334	\$ 265	\$566	\$ 426	\$ (8 )
Weighted-average shares, basic for Class A and Class B	408,399	25,107	408,413	24,169	408,625
Effect of other dilutive securities	4,369	1,995	5,505	1,560	—
Weighted-average shares, diluted for Class A and Class B	412,768	27,102	413,920	25,729	408,625
Net income (loss) per weighted-average share, basic for Class A and Class B	\$0.82	\$ 0.62	\$ 1.39	\$ 1.00	\$ (0.02 )
Net income (loss) per weighted-average share, diluted for Class A and Class B <sup>(1)</sup>	\$0.81	\$ 0.62	\$ 1.37	\$ 1.00	\$ (0.02 )

(1) During the Transition Period, VMware incurred a net loss. As a result, all potentially dilutive securities were anti-dilutive and excluded from the computation of diluted net loss per share.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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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 (loss) per share calculations during the periods presented, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended		Six Months Ended		Transition Period
	August 4, 2017	June 30, 2016	August 4, 2017	June 30, 2016	January 1 to February 3, 2017
Anti-dilutive securities:					
Employee stock options	845	2,065	870	2,207	2,353
Restricted stock units	499	3,315	250	9,512	3,259
Total	1,344	5,380	1,120	11,719	5,612

## F. Cash, Cash Equivalents and Investments

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

	August 4, 2017			Aggregate
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Cash	\$473	\$ —	\$ —	\$ 473
Cash equivalents:				
Money-market funds	\$2,848	\$ —	\$ —	\$ 2,848
U.S. Government and agency obligations	45	—	—	45
U.S. and foreign corporate debt securities	183	—	—	183
Foreign governments and multi-national agency obligations	3	—	—	3
Total cash equivalents	\$3,079	\$ —	\$ —	\$ 3,079
Short-term investments:				
U.S. Government and agency obligations	\$940	\$ —	\$ (2 )	\$ 938
U.S. and foreign corporate debt securities	4,170	8	(5 )	4,173
Foreign governments and multi-national agency obligations	74	—	—	74
Mortgage-backed securities	134	—	(1 )	133
Marketable available-for-sale equity securities	15	17	—	32
Total short-term investments	\$5,333	\$ 25	\$ (8 )	\$ 5,350

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	December 31, 2016			Aggregate
	Cost or	Unrealized	Unrealized	Fair
	Amortized	Gains	Losses	Value
	Cost			
Cash	\$512	\$ —	\$ —	\$ 512
Cash equivalents:				
Money-market funds	\$2,235	\$ —	\$ —	\$ 2,235
Time deposits	26	—	—	26
Municipal obligations	17	—	—	17
Total cash equivalents	\$2,278	\$ —	\$ —	\$ 2,278
Short-term investments:				
U.S. Government and agency obligations	\$734	\$ —	\$ (3 )	\$ 731
U.S. and foreign corporate debt securities	3,885	2	(18 )	3,869
Foreign governments and multi-national agency obligations	32	—	—	32
Municipal obligations	365	—	—	365
Asset-backed securities	4	—	—	4
Mortgage-backed securities	196	—	(2 )	194
Total short-term investments	\$5,216	\$ 2	\$ (23 )	\$ 5,195
Other assets:				
Marketable available-for-sale equity securities	\$15	\$ 7	\$ —	\$ 22
	Transition Period February 3, 2017			
	Cost or	Unrealized	Unrealized	Aggregate
	Amortized	Gains	Losses	Fair
	Cost			Value
Cash	\$720	\$ —	\$ —	\$ 720
Cash equivalents:				
Money-market funds	\$2,471	\$ —	\$ —	\$ 2,471
Time deposits	26	—	—	26
Municipal obligations	3	—	—	3
Total cash equivalents	\$2,500	\$ —	\$ —	\$ 2,500
Short-term investments:				
U.S. Government and agency obligations	\$733	\$ —	\$ (3 )	\$ 730
U.S. and foreign corporate debt securities	3,884	3	(16 )	3,871
Foreign governments and multi-national agency obligations	32	—	—	32
Municipal obligations	350	—	—	350
Asset-backed securities	4	—	—	4
Mortgage-backed securities	188	—	(2 )	186
Total short-term investments	\$5,191	\$ 3	\$ (21 )	\$ 5,173
Other assets:				
Marketable available-for-sale equity securities	\$15	\$ 7	\$ —	\$ 22

VMware evaluated its available-for-sale investments as of August 4, 2017, December 31, 2016 and February 3, 2017 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 and six months ended August 4, 2017 and June 30, 2016 and the Transition Period were not significant.





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Unrealized losses on cash equivalents and 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):

	August 4, 2017		December 31, 2016		Transition Period February 3, 2017	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	\$720	\$ (2 )	\$608	\$ (3 )	\$527	\$ (3 )
U.S. and foreign corporate debt securities	1,587	(5 )	2,595	(18 )	2,287	(16 )
Mortgage-backed securities	102	(1 )	164	(2 )	151	(2 )
Total	\$2,409	\$ (8 )	\$3,367	\$ (23 )	\$2,965	\$ (21 )

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

**Contractual Maturities**

The contractual maturities of fixed income securities included in short-term investments on the condensed consolidated balance sheets and held as of August 4, 2017, consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	\$ 1,990	\$ 1,989
Due after 1 year through 5 years	3,138	3,140
Due after 5 years through 10 years	95	95
Due after 10 years	95	94
Total fixed income securities	\$ 5,318	\$ 5,318

**G. 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 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

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 are primarily classified as Level 2, with the exception of some of the U.S. Government and agency obligations that are classified as Level 1. Additionally, VMware's Level 2 classification includes forward contracts and notes payable to Dell. As of August 4, 2017, December 31, 2016 and February 3, 2017, 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 fell into 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.



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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):

	August 4, 2017		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$2,848	\$—	\$2,848
U.S. Government and agency obligations	—	45	45
U.S. and foreign corporate debt securities	—	183	183
Foreign governments and multi-national agency obligations	—	3	3
Total cash equivalents	\$2,848	\$231	\$3,079
Short-term investments:			
U.S. Government and agency obligations	\$659	\$279	\$938
U.S. and foreign corporate debt securities	—	4,173	4,173
Foreign governments and multi-national agency obligations	—	74	74
Mortgage-backed securities	—	133	133
Marketable available-for-sale equity securities	32	—	32
Total short-term investments	\$691	\$4,659	\$5,350
Other current assets:			
Forward contracts	\$—	\$10	\$10
	December 31, 2016		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$2,235	\$—	\$2,235
Time deposits	—	26	26
Municipal obligations	—	17	17
Total cash equivalents	\$2,235	\$43	\$2,278
Short-term investments:			
U.S. Government and agency obligations	\$441	\$290	\$731
U.S. and foreign corporate debt securities	—	3,869	3,869
Foreign governments and multi-national agency obligations	—	32	32
Municipal obligations	—	365	365
Asset-backed securities	—	4	4
Mortgage-backed securities	—	194	194
Total short-term investments	\$441	\$4,754	\$5,195
Other current assets:			
Derivative due to stock purchase with Dell	\$—	\$8	\$8
Other assets:			
Marketable available-for-sale equity securities	\$22	\$—	\$22

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	Transition Period		
	February 3, 2017		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$2,471	\$—	\$2,471
Time deposits	—	26	26
Municipal obligations	—	3	3
Total cash equivalents	\$2,471	\$29	\$2,500
Short-term investments:			
U.S. Government and agency obligations	\$445	\$285	\$730
U.S. and foreign corporate debt securities	—	3,871	3,871
Foreign governments and multi-national agency obligations	—	32	32
Municipal obligations	—	350	350
Asset-backed securities	—	4	4
Mortgage-backed securities	—	186	186
Total short-term investments	\$445	\$4,728	\$5,173
Other current assets:			
Derivative due to stock purchase with Dell	\$—	\$9	\$9
Other assets:			
Marketable available-for-sale equity securities	\$22	\$—	\$22

During the first quarter of 2018, marketable available-for-sale equity securities were reclassified to short-term investments on the condensed consolidated balance sheets, as restrictions on the Company's ability to sell the common stock lapse within twelve months of the balance sheet date. As of December 31, 2016 and February 3, 2017, these securities were classified as other assets.

Notes payable to Dell are not adjusted to fair value. The fair value of the notes payable to Dell was approximately \$1,477 million, \$1,489 million and \$1,492 million as of August 4, 2017, December 31, 2016 and February 3, 2017, respectively. Fair value 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 and liabilities associated with this plan were the same at approximately \$48 million, \$35 million and \$36 million as of August 4, 2017, December 31, 2016 and February 3, 2017, respectively, and are included in other assets and other liabilities on the condensed consolidated balance sheets.

#### Assets Measured and Recorded at Fair Value on a Non-Recurring Basis

VMware holds strategic investments in its portfolio accounted for using the cost method. These strategic investments are periodically assessed for other-than-temporary impairment. VMware uses Level 3 inputs as part of its impairment analysis, including pre- and post-money valuations of recent financing events, the impact of financing events on its ownership percentages, and other available information relevant to the issuer's historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value. If VMware determines that an other-than-temporary impairment has occurred, VMware writes down the investment to its fair value.

Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments was \$151 million, \$139 million and \$139 million as of August 4, 2017, December 31, 2016 and February 3, 2017, respectively.

H. 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

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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 have been 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 income (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 and six months ended August 4, 2017 and June 30, 2016 and the Transition Period, 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.

These forward contracts have contractual maturities of twelve months or less, and as of August 4, 2017, December 31, 2016 and February 3, 2017, outstanding forward contracts had a total notional value of \$134 million, \$22 million and \$250 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 and six months ended August 4, 2017 and June 30, 2016 and the Transition Period, 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 August 4, 2017, December 31, 2016 and February 3, 2017, outstanding forward contracts had a total notional value of \$854 million, \$875 million and \$834 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 and six months ended August 4, 2017, VMware recognized losses of \$27 million and \$35 million, respectively, relating to the settlement of forward contracts. During the three and six months ended June 30, 2016 and the Transition Period, VMware recognized a gain of \$11 million, and losses of \$12 million and \$18 million, respectively. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

The combined gains and losses related to forward contracts and the underlying foreign currency denominated assets and liabilities resulted in net gains of \$10 million and \$13 million during the three and six months ended August 4, 2017, respectively. Net losses during the three and six months ended June 30, 2016 and the Transition Period were not significant. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

I. Contingencies

Litigation

On March 27, 2015, Phoenix Technologies (“Phoenix”) filed a complaint against VMware in the U.S. District Court for the Northern District of California asserting claims for copyright infringement and breach of contract relating to a version of Phoenix’s BIOS software that VMware licensed from Phoenix. Following trial, the jury issued its verdict on June 12, 2017, finding that VMware did not infringe on any of the four bases asserted by Phoenix. The Court entered

judgment in VMware's favor, and the parties are in the post-trial briefing stage. The Company intends to continue vigorously defending itself against this lawsuit.

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 the Regional Court's decision. No hearing schedule has yet been set by the appellate court.

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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.

On November 17, 2015, Francis M. Ford, a VMware Class A stockholder, filed an action in the Delaware Chancery Court against certain current and former VMware directors, among others (collectively, the "Defendants"), alleging that the Defendants breached their fiduciary duties in connection with the Dell Acquisition, and the proposed issuance of tracking stock that is intended to track the performance of VMware. The plaintiff did not assert claims directly against VMware, but purported to bring class claims on behalf of other VMware Class A stockholders and derivative claims on behalf of VMware. On May 2, 2017, the Delaware Chancery Court granted Defendants' motion to dismiss without leave to amend, dismissing all claims against all Defendants. The time limitation for the plaintiff to file an appeal lapsed on June 1, 2017.

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 August 4, 2017, amounts accrued relating to these other matters arising as part of the ordinary course of business were considered immaterial. 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.

**J. Unearned Revenue**

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

	Transition Period		
	August 4, 2017	December 31, 2016	February 3, 2017
Unearned license revenue	\$ 519	\$ 503	\$ 484
Unearned software maintenance revenue	4,522	4,628	4,405
Unearned professional services revenue	463	493	451
Total unearned revenue	\$ 5,504	\$ 5,624	\$ 5,340

Unearned license revenue is generally recognized upon delivery of existing or future products or services, or is otherwise recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence ("VSOE") of fair value cannot be established, the revenue for the entire order is deferred until all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenue may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist.

Unearned license revenue derived from commitments to future products that have not been delivered represents a



significant portion of total unearned license revenue as of August 4, 2017. VMware expects unearned license revenue to substantially decline upon the adoption of Topic 606.

Unearned software maintenance revenue is attributable to VMware's maintenance contracts and is generally recognized ratably over the contract period. The weighted-average remaining term as of August 4, 2017 was approximately two years. Unearned professional services revenue results primarily from prepaid professional services, including training, and is generally recognized as the services are delivered.

Unearned license and software maintenance revenue will fluctuate based upon a variety of factors including sales volume, the timing of both product promotion offers and delivery of the future products offered, and the amount of arrangements sold

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

with ratable revenue recognition. Additionally, the amount of unearned revenue derived from transactions denominated in a foreign currency is affected by fluctuations in the foreign currencies in which VMware invoices. In connection with the disposition of vCloud Air, approximately \$35 million of total unearned revenue, including \$18 million of unearned license revenue, was transferred to OVH during the second quarter of fiscal 2018. Refer to Note D for further information.

## K. Stockholders' Equity

## VMware Stock Repurchases

During January 2017, VMware's board of directors authorized the repurchase of up to \$1,200 million of VMware's Class A common stock through the end of fiscal 2018. Subsequent to the fiscal quarter ended August 4, 2017, VMware's board of directors authorized the repurchase of up to an additional \$1,000 million of Class A common stock through August 31, 2018. The \$1,000 million authorization is in addition to VMware's ongoing \$1,200 million stock repurchase program authorized in January 2017, of which \$900 million remained available for repurchase as of August 4, 2017.

Stock will be purchased 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.

The following table summarizes stock repurchase activity, including shares purchased from Dell, during the period presented (aggregate purchase price in millions, shares in thousands):

	Three Months Ended August 4, 2017	Six Months Ended August 4, 2017
Aggregate purchase price <sup>(1)(2)(3)</sup>	\$ 60	\$ 425
Class A common shares repurchased	666	4,827
Weighted-average price per share	\$ 90.04	\$ 88.05

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

(2) The aggregate purchase price of \$60 million during the three months ended August 4, 2017 includes the purchase price associated with the final delivery of 0.7 million shares under the March 29, 2017 agreement with Dell.

(3) The aggregate purchase price of \$425 million during the six months ended August 4, 2017 includes the purchase price associated with the final delivery of 1.4 million shares under the December 15, 2016 agreement with Dell, as well as the delivery of 3.4 million shares under the March 29, 2017 agreement with Dell.

During the three and six months ended June 30, 2016 and the Transition Period, VMware did not repurchase any shares of its Class A common stock.

## VMware Restricted Stock

VMware's restricted stock primarily consists of restricted stock unit ("RSU") awards 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 will 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 individual award. If minimum performance thresholds are not achieved, then no shares will be issued.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table summarizes restricted stock activity since January 1, 2017 (units in thousands):

	Number of Units	Weighted-Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2017	20,866	\$ 67.54
Vested	(256 )	77.07
Forfeited	(159 )	68.11
Outstanding, February 3, 2017	20,451	67.41
Granted	6,474	89.15
Vested	(5,191 )	66.16
Forfeited	(1,056 )	71.00
Outstanding, August 4, 2017	20,678	74.43

The total fair value of VMware restricted stock that vested during the six months ended August 4, 2017 and the Transition Period was \$488 million and \$21 million, respectively. As of August 4, 2017, restricted stock representing 20.7 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of \$1,925 million based on VMware's closing stock price as of August 4, 2017.

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, January 1, 2017	\$ (8 )	\$ (1 )	\$(9 )
Unrealized gains, net of tax provision of \$1, \$— and \$1	2	3	5
Balance, February 3, 2017	\$ (6 )	\$ 2	\$(4 )
Unrealized gains, net of tax provision of \$9, \$3, and \$12	15	1	16
Amounts reclassified from accumulated other comprehensive income (loss) to the consolidated statements of income, net of tax provision of \$1, \$— and \$1	2	2	4
Other comprehensive income, net	17	3	20
Balance, August 4, 2017	\$ 11	\$ 5	\$ 16
	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, January 1, 2016	\$ (7 )	\$ (1 )	\$(8 )
Unrealized gain, net of tax provision of \$15, \$—, and \$15	24	—	24
Amounts reclassified from accumulated other comprehensive income (loss) to the consolidated statements of income, net of tax provision of \$2, \$—, and \$2	3	1	4
Balance, June 30, 2016	\$ 20	\$ —	\$ 20

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

functional line items on the condensed consolidated statements of income were not significant to the individual functional line items during the periods presented.

## L. 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 geographic area during the periods presented was as follows (table in millions):

	Three Months Ended	Six Months Ended	Transition Period January 1 to	
	August 4, 2017	August 4, 2016	August 4, 2017	February 3, 2017
United States	\$963	\$ 870	\$1,823	\$ 248
International	937	823	1,813	248
Total	\$1,900	\$1,693	\$3,636	\$ 496

Revenue by geographic area is based on the ship-to addresses of VMware's customers. No individual country other than the United States accounted for 10% or more of revenue during the three and six months ended August 4, 2017 and June 30, 2016 and the Transition Period.

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

	August 4, 2017	December 31, 2016	Transition Period February 3, 2017
United States	\$ 727	\$ 784	\$ 777
International	123	132	131
Total	\$ 850	\$ 916	\$ 908

No individual country other than the United States accounted for 10% or more of these assets as of August 4, 2017, December 31, 2016 and February 3, 2017.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## M. Transition Period

## Comparable Financial Information

In conjunction with VMware's change in fiscal year end, the Company had a Transition Period of 34 days that began on January 1, 2017 and ended on February 3, 2017. The most comparable prior-year period, the one month ended January 31, 2016, had a duration of 31 days.

The following table presents certain financial information during the periods presented (table in millions, except per share amounts and shares in thousands):

	Transition Period January 1 to February 3, 2017	Comparable Period January 1 to January 31, 2016
Total revenue	\$ 496	\$ 470
Operating income (loss)	(41)	) 22
Income tax provision (benefit)	(26)	) 4
Net income (loss)	(8)	) 22
Net income (loss) per weighted-average share, basic for Class A and Class B	\$ (0.02)	) \$ 0.05
Net income (loss) per weighted-average share, diluted for Class A and Class B	\$ (0.02)	) \$ 0.05

Weighted-average shares, basic for Class A and Class B	408,625	422,067
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Weighted-average shares, diluted for Class A and Class B <sup>(1)</sup>	408,625	423,092
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<sup>(1)</sup> During the Transition Period, VMware incurred a net loss. As a result, all potentially dilutive securities were anti-dilutive and excluded from the computation of diluted net loss per share.

## Income Taxes

The Company's net deferred tax assets were \$462 million and \$716 million as of December 31, 2016 and February 3, 2017, respectively. The increase from December 31, 2016 to February 3, 2017 primarily resulted from higher deferred tax assets related to unearned revenue which were \$324 million and \$566 million as of December 31, 2016 and February 3, 2017, respectively. The increase in deferred tax assets was a result of the Dell Acquisition and VMware's new fiscal year calendar. VMware believes it is more-likely-than-not that the net deferred tax assets as of December 31, 2016 and February 3, 2017 will be realized in the foreseeable future as VMware believes that it will generate sufficient taxable income in future years. VMware's ability to generate sufficient taxable income in future years in appropriate tax jurisdictions will determine the amount of net deferred tax asset balances to be realized in future periods.

## N. Subsequent Events

## Debt Offering

On August 21, 2017, VMware issued three unsecured senior notes pursuant to a public debt offering in the aggregate amount of \$4,000 million, consisting 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, at annual rates of 2.30%, 2.95% and 3.90%, respectively, and contain 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.

Upon closing, a portion of the net proceeds from the offering was used to repay certain promissory notes previously issued to the Company's Parent in the aggregate principal amount of \$1,230 million. The aggregate principal amount

included repayment of the note due May 1, 2018 at par value and the repayment of the note due May 1, 2020 at a discount. The Company intends to use the remaining net proceeds to fund additional repurchases of up to \$1,000 million of its Class A common stock through August 31, 2018 and for general corporate purposes, including mergers and acquisitions and repaying other indebtedness. Refer to Note B for further information regarding notes payable to Dell and Note K for further information regarding VMware common stock repurchases.

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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 ("MD&A") 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 August 4, 2017 should be read in conjunction with our consolidated financial statements for the year ended December 31, 2016 contained in our Form 10-K filed on February 24, 2017.

Period-over-period changes are calculated based upon the respective underlying, non-rounded data. 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

The information technology ("IT") industry is transforming, moving from a hardware-based traditional model to one of a software-defined infrastructure. We are a leader in virtualization and cloud infrastructure solutions utilized by organizations to help transform the way they build, deliver and consume IT resources.

Over the years, we have increased our product 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. 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 are the basis for the private cloud environment 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. While overall sales of our VMware vSphere ("vSphere") offerings have remained strong, the majority of our license sales originate from products and services solutions across our portfolio beyond our compute products. We continue to experience growth in sales of VMware NSX ("NSX"), our network virtualization solution, and VMware vSAN ("vSAN") products. We expect compute license sales to remain stable, while total compute sales are expected to grow slightly over the next few years.

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 first half of fiscal 2018, hybrid cloud computing was comprised of VMware vCloud Air Network ("vCAN") and VMware vCloud Air ("vCloud Air") offerings. During the second quarter of fiscal 2018, we completed the sale of our vCloud Air business to OVH US LLC ("OVH"). We continue to see revenue growth derived from our vCAN offering.

End-User Computing

Our End-User Computing solution consists of VMware Workspace ONE ("Workspace ONE"), our digital workspace platform, which includes VMware AirWatch ("AirWatch") and VMware Horizon ("Horizon"). Our AirWatch business model includes an on-premises solution that we offer through the sale of perpetual licenses and an off-premises solution that we offer as software-as-a-service ("SaaS"). Our mobile and desktop products and services within Workspace ONE continued to contribute to the growth of our End-User Computing product group during the first half of fiscal 2018.

Change in Fiscal Year End

As a result of the change to our fiscal year from a fiscal year ending on December 31 of each calendar year to a fiscal year ending on the Friday nearest to January 31 of each year, the period that began on January 1, 2017 and ended on February 3, 2017 was a transition period (the "Transition Period"). Our first full fiscal year 2018 is a 52-week year that

began on February 4, 2017 and will end on February 2, 2018. As permitted under SEC rules, prior-period financial statements have not been recast as we believe (i) the three and six months ended June 30, 2016 are comparable to the three and six months ended August 4, 2017; and (ii) recasting prior-period results was not practicable or cost justified. We have included certain unaudited condensed consolidated financial statements for the Transition Period in this Form 10-Q and will include audited financial statements for the Transition Period in the Form 10-K filed for the fiscal year ended February 2, 2018.

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## Results of Operations

Approximately 70% of our sales are denominated in the 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 August 4, 2017				Six Months Ended August 4, 2017				
	2017	2016	\$ Change	% Change	2017	2016	\$ Change	% Change	
Revenue:									
License	\$ 732	\$ 644	\$ 88	14 %	\$ 1,342	\$ 1,216	\$ 125	10 %	
Services:									
Software maintenance	1,015	915	100	11	1,988	1,806	182	10	
Professional services	153	134	19	14	306	260	47	18	
Total services	1,168	1,049	119	11	2,294	2,066	229	11	
Total revenue	\$ 1,900	\$ 1,693	\$ 207	12	\$ 3,636	\$ 3,282	\$ 354	11	

## Revenue:

United States	\$ 963	\$ 870	\$ 93	11 %	\$ 1,823	\$ 1,671	\$ 152	9 %
International	937	823	114	14	1,813	1,611	202	13
Total revenue	\$ 1,900	\$ 1,693	\$ 207	12	\$ 3,636	\$ 3,282	\$ 354	11

Hybrid cloud, including vCAN and vCloud Air, and our SaaS offerings, which include our AirWatch mobile solutions, increased to approximately 9% of our total revenue during the three and six months ended August 4, 2017 from approximately 8% during the three and six months ended June 30, 2016. vCAN revenue is included in license revenue, and SaaS revenue, including vCloud Air and our AirWatch mobile solutions, is included in both license and services revenue. We completed our sale of vCloud Air business during the second quarter of fiscal 2018.

License revenue relating to the sale of perpetual licenses that are part of a multi-year arrangement is generally recognized upon delivery of the underlying license, whereas revenue derived from our hybrid cloud and SaaS offerings is recognized based on consumption or over a period of time.

## License Revenue

During the three and six months ended August 4, 2017, license revenue benefited from balanced performance in all major geographies and broad strength across our product portfolio. License revenue growth during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016 continued to be driven by sales of our NSX and vSAN offerings, as well as growth in our End-User Computing and vCAN offerings. Strength in renewals of our EAs also contributed to license revenue growth during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016.

## Services Revenue

During the three and six months ended August 4, 2017, software maintenance revenue benefited 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, more than two and a half years of support and maintenance with each new license purchased.

Professional services revenue increased 14% and 18% during the three and six months ended August 4, 2017, respectively, as compared to the three and six months ended June 30, 2016. We have continued our focus on solution deployments, including our products such as NSX and vSAN, which attributed to the increase in professional services revenue. Our professional services revenue will vary based on the delivery channels used in any given period as well

as the timing of service engagements.

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## Unearned Revenue

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

	August 4, December 31,	
	2017	2016
Unearned license revenue	\$ 519	\$ 503
Unearned software maintenance revenue	4,522	4,628
Unearned professional services revenue	463	493
Total unearned revenue	\$ 5,504	\$ 5,624

Unearned license revenue is generally recognized upon delivery of existing or future products or services, or is otherwise recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence (“VSOE”) of fair value cannot be established, the revenue for the entire order is deferred until all product delivery obligations have been fulfilled. If the arrangement does not include professional services, unearned license revenue may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Unearned license revenue derived from commitments to future products that have not been delivered represents a significant portion of total unearned license revenue as of August 4, 2017. We expect unearned license revenue to substantially decline upon the adoption of Topic 606.

Unearned software maintenance revenue is attributable to our maintenance contracts and is generally recognized ratably over the contract period. The weighted-average remaining term as of August 4, 2017 was approximately two years. Unearned professional services revenue results primarily from prepaid professional services, including training, and is generally recognized as the services are delivered.

Unearned license and software maintenance revenue will fluctuate based upon a variety of factors including sales volume, the timing of both product promotion offers and delivery of the future products offered, and the amount of arrangements sold with ratable revenue recognition. Additionally, the amount of unearned revenue derived from transactions denominated in a foreign currency is affected by fluctuations in the foreign currencies in which we invoice.

In connection with the disposition of vCloud Air, approximately \$35 million of total unearned revenue, including \$18 million of unearned license revenue, was transferred to OVH during the second quarter of fiscal 2018. Refer to Note D to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion.

## 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 headcount and increasing compensation across most of our income statement expense categories during the three and six months ended August 4, 2017. We expect increases in cash-based employee-related expenses to continue.

## 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 August 4,				Six Months Ended August 4,			
	June 30,		June 30,		June 30,		June 30,	
	2017	2016	\$	%	2017	2016	\$	%
			Change	Change			Change	Change
Cost of license revenue	\$ 39	\$ 40	\$ (1 )	(2 )%	\$ 77	\$ 80	\$ (3 )	(3 )%

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Stock-based compensation	—	—	—	1	1	1	—	(1 )
Total expenses	\$39	\$40	\$ (1 )	(2 )	\$78	\$81	\$ (3 )	(3 )
% of License revenue	5 %	6 %			6 %	7 %		

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Cost of license revenue was flat during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016.

**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 to provide professional services. Additionally, cost of services revenue includes depreciation on equipment supporting our service offerings.

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

	Three Months Ended August 4, 2017				Six Months Ended August 4, 2017			
	2017	2016	\$ Change	% Change	2017	2016	\$ Change	% Change
Cost of services revenue	\$219	\$208	\$ 11	5 %	\$456	\$407	\$ 49	12 %
Stock-based compensation	12	13	(1 )	(9 )	25	25	—	2
Total expenses	\$231	\$221	\$ 10	5	\$481	\$432	\$ 49	11
% of Services revenue	20 %	21 %			21 %	21 %		

Cost of services revenue increased during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016. The increase was primarily due to growth in cash-based employee-related expenses of \$23 million and \$46 million during the three and six months ended August 4, 2017, respectively, driven by incremental growth in headcount and salaries, as well as increased IT development costs of \$11 million during the six months ended August 4, 2017. These increased costs were offset in part by a decrease in equipment, depreciation and facilities-related costs of \$15 million and \$16 million during the three and six months ended August 4, 2017, respectively.

**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.

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

	Three Months Ended August 4, 2017				Six Months Ended August 4, 2017			
	2017	2016	\$ Change	% Change	2017	2016	\$ Change	% Change
Research and development	\$339	\$289	\$ 50	17 %	\$679	\$576	\$ 103	18 %
Stock-based compensation	89	74	15	20	170	144	26	18
Total expenses	\$428	\$363	\$ 65	18	\$849	\$720	\$ 129	18
% of Total revenue	23 %	21 %			23 %	22 %		

Research and development expenses increased during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016. The increase was primarily due to growth in cash-based employee-related expenses of \$69 million and \$114 million during the three and six months ended August 4, 2017, respectively, driven by incremental growth in headcount and salaries. In addition, stock-based compensation increased by \$15 million and \$26 million, respectively, primarily driven by an increase in restricted stock unit awards granted after the second quarter of 2016. These increases were partially offset by an increase in capitalized internal-use software development costs of \$18 million and \$34 million during the three and six months ended August 4, 2017, respectively.

**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. Sales commissions for our license offerings are generally earned and expensed when a firm order is received from the customer. In the event of a multi-year EA or our SaaS offerings, sales commissions are generally expensed over the term of the arrangement.





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

	Three Months Ended				Six Months Ended			
	August 4,		June 30,		August 4,		June 30,	
	2017	2016	\$	%	2017	2016	\$	%
		Change	Change			Change	Change	
Sales and marketing	\$620	\$533	\$ 86	16 %	\$1,157	\$1,049	\$ 109	10 %
Stock-based compensation	48	47	1	3	98	95	2	2
Total expenses	\$668	\$580	\$ 87	15	\$1,255	\$1,144	\$ 111	10
% of Total revenue	35	% 34	%		35	% 35	%	

Sales and marketing expenses increased during the three and six months ended August 4, 2017 compared to the three and six months ended June 30, 2016. The increase was primarily due to growth in cash-based employee-related expenses of \$92 million and \$122 million during the three and six months ended August 4, 2017, respectively, driven by incremental growth in headcount and salaries, as well as higher commission expense resulting from increased sales volume.

**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 VMware's Foundation.

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

	Three Months Ended				Six Months Ended			
	August 4,		June 30,		August 4,		June 30,	
	2017	2016	\$	%	2017	2016	\$	%
		Change	Change			Change	Change	
General and administrative	\$140	\$149	\$ (9 )	(6 )%	\$274	\$302	\$ (29 )	(10 )%
Stock-based compensation	20	18	2	12	37	36	1	4
Total expenses	\$160	\$167	\$ (7 )	(4 )	\$311	\$338	\$ (28 )	(8 )
% of Total revenue	8	% 10	%		9	% 10	%	

General and administrative expenses were relatively flat during the three months ended August 4, 2017 compared to the three months ended June 30, 2016. During the six months ended August 4, 2017, general and administrative expenses decreased compared to the six months ended June 30, 2016. The decrease was primarily driven by decreased contractor spending of \$15 million, as well as decreased IT development costs of \$20 million. These decreases were partially offset by decreased capitalization of internal-use software development costs of \$24 million, as well as increased cash-based employee-related expenses of \$18 million, resulting primarily from incremental growth in headcount and salaries during the six months ended August 4, 2017.

**Realignment and Loss on Disposition**

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

	Three Months Ended			Six Months Ended		
	August 4,		June 30,	August 4,		June 30,
	2017	2016	\$	2017	2016	\$
		Change	Change		Change	Change
Realignment and loss on disposition	\$36	\$ (1 )	\$ 37	\$86	\$ 52	\$ 34
% of Total revenue	2	% —	%	2	% 2	%

During the second quarter of fiscal 2018, we completed the sale of vCloud Air to OVH. Losses recognized in connection with this transaction were \$36 million and \$86 million during the three and six months ended August 4, 2017, respectively. Losses recognized on the disposition of vCloud Air include the impairment of fixed assets identified as part of the sale, as well as the costs associated with certain transition services, which primarily include

employee-related expenses and costs associated

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with data-center colocation services. Transition services are to be provided over a period of 18 months, starting from the date of the sale.

On January 22, 2016, we approved a plan to streamline our operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the six months ended June 30, 2016. We recognized \$49 million of severance-related realignment expenses during the six months ended June 30, 2016 on the condensed consolidated statements of income. Additionally, we consolidated certain facilities as part of this plan, which resulted in the recognition of \$3 million of related expenses during the six months ended June 30, 2016. Actions associated with this plan were substantially completed by December 31, 2016.

**Interest expense with Dell**

On August 21, 2017, we issued three unsecured 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 certain promissory notes payable to Dell in the aggregate principal amount of \$1,230 million. We expect interest expense to increase by approximately \$50 million during the second half of fiscal 2018 compared to the second half of 2016 due to the issuance of public debt, partially offset by a reduction in interest expense with Dell.

**Other Income (Expense), net**

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

	Three Months Ended			Six Months Ended		
	August 4, 2017	June 30, 2016	\$ Change	August 4, 2017	June 30, 2016	\$ Change
Other income (expense), net	\$51	\$2	\$ 48	\$54	\$—	\$ 54
% of Total revenue	3 %	— %		1 %	— %	

During the second quarter of fiscal 2018, we acquired all of the outstanding shares of Wavefront, Inc. (“Wavefront”). Prior to the closing of the acquisition, we held an ownership interest in Wavefront. Upon completion of the step acquisition, we recognized a gain of \$34 million in other income (expense), net for the remeasurement of our ownership interest to fair value.

**Transition Period**

In conjunction with our change in fiscal year end, we had a Transition Period of 34 days that began on January 1, 2017 and ended on February 3, 2017. The most comparable prior-year period, the one month ended January 31, 2016, had a duration of 31 days.

The following table presents certain financial information during the periods presented (table in millions, shares in thousands):

	Transition Period	Comparable Period
	January 1 to February 3, 2017	January 1 to January 31, 2016
Total revenue	\$ 496	\$ 470
Operating income (loss)	(41 )	22
Income tax provision (benefit)	(26 )	4
Net income (loss)	(8 )	22

During the Transition Period, total revenue increased and license sales declined when compared to the one-month period ended January 31, 2016. Operating loss during the Transition Period reflected costs related to our global sales event, as well as increases in employee-related expenses compared to the one month ended January 31, 2016. Factors

contributing to the increase in employee-related expenses include both incremental headcount and costs associated with three additional days of expense included in the Transition Period.

The income tax benefit recognized during the Transition Period was driven by the pre-tax loss incurred during the period and our Internal Revenue Code Section 199 deduction (“Deduction”), which reflected the impact of claiming a higher Deduction for two of our U.S. tax return periods compared to the Deduction for the year ended December 31, 2016, which was calculated on a stand-alone basis. We were required to file two U.S. tax returns covering the period prior to the Dell Acquisition from January 1, 2016 to September 7, 2016 and the period following the Dell Acquisition through Dell’s fiscal year ended

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February 3, 2017. The Deduction was greater during the two U.S tax return periods due to higher taxable income resulting from the acceleration of income recognized from unearned revenue for tax purposes.

### 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 effective income tax rate was 17.9% and 14.9% during the three and six months ended August 4, 2017, respectively. For the three and six months ended June 30, 2016, our effective tax rate was 21.4% and 20.7%, respectively. Our estimated annual effective income tax rate for fiscal 2018 decreased slightly when compared to the annual effective tax rate for the year ended December 31, 2016.

Our effective income tax rate for the three and six months ended August 4, 2017 declined primarily due to certain discrete tax items, including \$25 million related to a non-taxable gain recognized on the step acquisition of one of our strategic investments and deductible losses from the disposition of vCloud Air during the second quarter of fiscal 2018. In addition, we recognized excess tax benefits of \$13 million and \$44 million for the three and six months ended August 4, 2017, respectively, in connection with our adoption of Accounting Standards Update (“ASU”) No. 2016-09, Compensation-Stock Compensation (Topic 718) during the first quarter of fiscal 2018. Prior to adopting the updated standard, such amounts were recognized in additional paid-in capital on the condensed consolidated balance sheets. We expect upcoming reductions in unrecognized tax benefits resulting from expiration of statutes of limitation during fiscal 2018, which would reduce our fiscal 2018 annual income tax rate.

Our rate of taxation in non-U.S. jurisdictions is lower than our U.S. tax rate. Our non-U.S. earnings are primarily earned by our subsidiaries organized in Ireland, 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.

We have historically been included in EMC’s consolidated group for U.S. federal income tax purposes, and with the closing of the Dell Acquisition, we are now included in Dell’s consolidated tax group. We 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 is calculated primarily as though we were a separate taxpayer. However, certain transactions that we and Dell are parties to are assessed using consolidated tax return rules.

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 United States 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 August 4, 2017, Dell controlled 33 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 97.5% 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. Transactions prior to September 7, 2016 reflect transactions only with EMC and its consolidated subsidiaries (“Parent”).



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## 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 ongoing reseller arrangements with Dell, Dell bundles our products and services with Dell's products and sells them to end users. Reseller revenue is presented net of related marketing development funds and rebates paid to Dell.

Dell purchases products and services from us for internal use.

We provide professional services to end users based upon contractual agreements with Dell.

Pursuant to an ongoing distribution agreement, we act 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 us and remitted to Pivotal, net of the contractual agency fee.

We provide various services to Pivotal. Support costs incurred by us are reimbursed to us and are recorded as a reduction to the costs incurred by us.

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				Transition Period January 1 to February 3, 2017	Unearned Revenue		
	Three Months Ended		Six Months Ended			As of		Transition Period February 3, 2017
	August 2017	June 30, 2016	August 2017	June 30, 2016		August 2017	December 31, 2016	
Reseller revenue	\$282	\$ 85	\$505	\$ 163	\$ 44	\$806	\$ 637	\$ 616
Internal-use revenue	4	14	9	19	7	9	15	18
Professional services revenue	26	26	55	51	3	—	—	—
Agency fee revenue	—	1	1	2	—	—	—	—
Reimbursement for services to Pivotal	—	—	—	1	—	n/a	n/a	n/a

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.

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 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 United States 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.

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

	Three Months Ended August 4, 2017	Six Months Ended August 4, 2016	Transition Period January 1 to February 3, 2017
Purchases and leases of products and purchases of services	\$32	\$ 17	\$ 14
Dell subsidiary support and administrative costs	33	21	13

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.

During the second quarter of fiscal 2018, we acquired Wavefront. Upon closing of the acquisition, Dell was paid \$20 million in cash for its ownership interest in Wavefront.

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 \$7 million and \$9 million during the three and six months ended August 4, 2017, respectively. Financing fees during the Transition Period were not significant.

Tax Sharing Agreement with Dell

We have made payments to Dell pursuant to a tax sharing agreement. The following table summarizes the payments made during the periods presented (table in millions):

	Three Months Ended August 4, 2017	Six Months Ended August 4, 2016	Transition Period January 1 to February 3, 2017
Payments from us to Dell	\$12	\$ 54	\$ 95

The timing of the tax payments due to and from related parties is governed by a tax sharing agreement. 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 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 presented as a component of stockholders' equity. The difference between the amount of tax calculated on a separate return basis and the amount of tax calculated pursuant to the tax sharing agreement was not significant during the three and six months ended August 4, 2017 and the Transition Period, and was \$14 million and \$15 million during the three and six months ended June 30, 2016, respectively.

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):

	August 4, 2017	December 31, 2016	Transition Period February 3, 2017
Due (to) related parties	\$ (67 )	\$ (71 )	\$ (85 )
Due from related parties	274	203	178



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Due from related parties, net	\$ 207	\$ 132	\$ 93
Income tax related asset, net	\$ —	\$ 181	\$ —
Income tax due (to) related parties	(14 )	—	(21 )

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

Stock Purchase Agreements with Dell

On March 29, 2017, we entered into a stock purchase agreement to purchase \$300 million of our Class A common stock from Dell. During the first quarter of fiscal 2018, we paid Dell \$300 million in exchange for an initial delivery of 2.7 million shares, or approximately 80% of the expected total shares to be received and retired under the arrangement. On May 10, 2017, the stock purchase agreement with Dell was completed and we received an additional 0.7 million shares. The aggregate number of 3.4 million shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

On December 15, 2016, we entered into a stock purchase agreement to purchase \$500 million of our Class A common stock from Dell. We purchased 4.8 million shares for \$375 million through December 31, 2016. On February 15, 2017, the stock purchase agreement with Dell was completed. A total of \$500 million was paid in exchange for 6.2 million shares. The aggregate number of shares purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

On August 23, 2017, we entered into a stock purchase agreement to purchase \$300 million of our Class A common stock from Dell. Purchases under this agreement are expected to occur during fiscal 2018. The aggregate number of shares purchased will be determined based upon a volume-weighted average price during a defined period, less an agreed upon discount.

Notes Payable to Dell

We entered into a note exchange agreement with our Parent on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022. As of August 4, 2017, \$680 million was classified as a current liability.

The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and six months ended August 4, 2017, \$7 million and \$13 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2016 and the Transition Period, \$7 million, \$13 million and \$2 million, respectively, of interest expense was recognized.

On August 21, 2017, we repaid certain of the notes payable to Dell in the aggregate principal amount of \$1,230 million. The aggregate principal amount included repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount. Refer to Note N in Part I, Item 1 of this Quarterly Report on Form 10-Q for further information regarding subsequent events.

Liquidity and Capital Resources

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

	Transition Period		
	August 4, 2017	December 31, 2016	February 3, 2017
Cash and cash equivalents	\$ 3,552	\$ 2,790	\$ 3,220
Short-term investments	5,350	5,195	5,173
Total cash, cash equivalents and short-term investments	\$ 8,902	\$ 7,985	\$ 8,393

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.

As of August 4, 2017, our cash, cash equivalents and short-term investments held outside the United States were \$7,967 million. If these overseas funds were needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes on substantially all of the undistributed earnings to repatriate these funds. However, our intent is to

indefinitely reinvest our non-U.S. earnings in our foreign operations and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

We expect that cash generated by operations will be our primary source of liquidity. We also believe that existing cash and cash equivalents, together with any cash generated from operations, will be sufficient to fund our operations for at least the next

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twelve months. While we believe these cash sources will be sufficient to fund our operations, our overall level of cash needs may be affected by the number and size of acquisitions, investments and stock repurchases.

On August 21, 2017, we issued three unsecured senior notes pursuant to a public debt offering in the aggregate amount of \$4,000 million, consisting 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, at annual rates of 2.30%, 2.95% and 3.90%, respectively. In aggregate, the 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, including mergers and acquisitions and repaying other indebtedness.

Our cash flows summarized for the periods presented were as follows (table in millions):

	Six Months Ended August 4, 2017	2016	Transition Period January 1 to February 3, 2017
Net cash provided by (used in):			
Operating activities	\$1,395	\$1,297	\$ 361
Investing activities	(537 )	(776 )	7
Financing activities	(526 )	(23 )	62
Net increase in cash and cash equivalents	\$332	\$498	\$ 430

#### Operating Activities

Cash provided by operating activities increased \$98 million during the six months ended August 4, 2017 compared to the six months ended June 30, 2016. Cash provided by operating activities benefited from a net increase in cash collections due to increased sales, a decrease in federal tax payments and the absence of severance payments related to the January 2016 realignment plan. These positive impacts were partially offset by an increase in cash payments for employee-related expenses, including salaries, bonuses and commissions, resulting primarily from growth in headcount.

Cash provided by operating activities of \$361 million during the Transition Period primarily reflected cash provided by cash collections, partially offset by cash payments for employee-related expenses.

#### 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 used in investing activities decreased \$239 million during the six months ended August 4, 2017 compared to the six months ended June 30, 2016, driven primarily by the increase in net cash provided by our available-for-sale securities, partially offset by the increase in cash used in business combinations, as well as the disposition of vCloud Air.

#### Financing Activities

Cash used in financing activities increased \$503 million during the six months ended August 4, 2017 compared to the six months ended June 30, 2016, primarily as a result of the increase in our repurchase of common stock. During the first half of 2016, we did not repurchase any shares of our common stock.

Cash provided by financing activities of \$62 million during the Transition Period was driven by cash proceeds from the issuance of common stock of \$61 million, resulting primarily from our employee stock purchase plan.

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### Disposition of our vCloud Air Business

As a part of the sale of vCloud Air, we agreed to provide certain transition services to OVH. Transition services consist primarily of payroll-related support services covering the migration of our vCloud Air customers to OVH. We expect to continue to make payments related to these transition services over the next 18 months from the date of the sale. In addition, we expect to make payments associated with the settlement of certain leases related to vCloud Air. Costs associated with transition services were included in the losses recognized in connection with the sale of vCloud Air recorded in realignment and loss on disposition on the condensed consolidated statements of income during the three and six months ended August 4, 2017.

### Notes Payable to Dell

We entered into a note exchange agreement with our Parent on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the six months ended August 4, 2017 and June 30, 2016, \$16 million and \$13 million, respectively, was paid for interest related to these notes. As of August 4, 2017, \$680 million was classified as a current liability.

On August 21, 2017, we repaid certain of the notes payable to Dell in the aggregate principal amount of \$1,230 million. The aggregate principal amount included repayment of the note due May 1, 2018 at par value and repayment of the note due May 1, 2020 at a discount.

### 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 January 2017, our board of directors authorized the repurchase of up to \$1,200 million of our Class A common stock through the end of fiscal 2018. Subsequent to the fiscal quarter ended August 4, 2017, our board of directors authorized the repurchase of up to an additional \$1,000 million of Class A common stock through August 31, 2018. The authorization is in addition to our \$1,200 million stock repurchase program authorized in January 2017, of which \$900 million remained available for repurchase as of August 4, 2017. Refer to Note K to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion.

On August 23, 2017, we entered into a stock purchase agreement to purchase \$300 million of our Class A common stock from Dell. Purchases under this agreement are expected to occur during fiscal 2018. The aggregate number of shares purchased will be determined based upon a volume-weighted average price during a defined period, less an agreed upon discount.

### 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 2016 Annual Report on Form 10-K 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.

#### 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

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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; plans for and anticipated benefits of VMware products, services and solutions and partner and alliance relationships; plans for and anticipated benefits of corporate transaction 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.

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

There were no material changes to our market risk exposures during the six months ended August 4, 2017 or the Transition Period. See Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" of our 2016 Annual Report on Form 10-K 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.

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Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting during the most recent fiscal quarter ended August 4, 2017 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. 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 I 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, 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 emerging 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 our vSphere hypervisor product 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 management and automation and network virtualization (“NSX”) offerings, our Horizon client virtualization offerings, VMware AirWatch (“AirWatch”) mobile device management offerings and VMware vSAN (“vSAN”) storage virtualization offerings. 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 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 emerging 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 and more businesses achieve high levels of virtualization in their data centers, the market for our VMware 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 may also shift some of their existing workloads to public cloud providers, thereby limiting growth, and potentially reducing, the market for on-premises deployments of VMware vSphere. Although sales of VMware vSphere have declined as a portion of our overall business, and we expect this trend to continue, VMware vSphere remains key to

our future growth, as it serves as the foundation for our newer SDDC, network virtualization and our planned new cloud offerings. Although we are developing 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.

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

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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 we fail to develop products and services that address evolving customer requirements for hybrid cloud computing, the demand for VMware’s virtualization products and services may decline, and we could experience lower growth. Additionally, vCloud Air Network 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 October 2016, we announced a strategic alliance with AWS to deliver a vSphere-based cloud service running on AWS. Although we expect our strategic alliance to provide significant advantages to customers when it is generally available, our strategic alliance with Amazon and our vCloud Air Network offerings from our other partners may not prevent or completely offset a decline in demand for our virtualization products and services. Our strategic alliance with Amazon may also be seen as competitive with vCloud Air Network offerings and adversely affect our relationship with vCloud Air Network partners.

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, and Microsoft offers its own server, network and storage virtualization software packaged with its Windows Server product and offers built-in virtualization in the client version of Windows. 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 Photon OS™ and vSphere Integrated Containers 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.

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.

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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.

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 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 vote by the United Kingdom to exit the European Union or that region’s failure to recover 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 historically 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. Even if customers are willing to purchase our products and services, if they do not meet our credit requirements, we may not be able to record accounts receivable or unearned revenue or recognize revenue from these customers until we receive payment, which could adversely affect the amount of revenue we are able to recognize and our cash flows in a particular period. 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 existing notes payable to Dell, 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 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

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the increasingly sophisticated needs of our customers or that interoperate with new or updated operating systems and hardware devices.

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, introduce them into product suites and maintain their compatibility with multiple IT resources utilized by our customers, which can significantly increase the development time and effort necessary to achieve the interoperability of product suite components while maintaining product quality. 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 VMware 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 VMware 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 could seriously harm our business.

We increasingly depend upon our IT systems 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 have penetrated our network security and our website in the past and may do so in the future. These cyberattacks threaten to misappropriate our proprietary 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 we store increasing amounts of customer data and host or manage parts of customers’ businesses in cloud-based IT environments.

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, 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, we could be subject to significant claims for liability from our customers, we could face regulatory actions 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 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

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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 (which have been increasing in length) 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 recognizing revenue in any given quarter, which can be affected by a number of factors, including product announcements, beta programs and product promotions that can cause revenue recognition of certain orders to be deferred until future products to which customers are entitled become available;
- 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;
- 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;
- the impact of new accounting pronouncements, for example, the adoption of Accounting Standards Update ("ASU") 2016-09, which will likely result in increased volatility in the provision for income taxes because excess tax benefits and tax deficiencies are now recognized within the income tax provision in the period in which they occur;
- 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; and
- to the extent that we buy back shares of our common stock in private transactions with Dell or other third parties through arrangements that are accounted for as derivative instruments, fluctuations in our stock price during the pricing reference periods of such arrangements may result in gains or losses in our quarterly earnings.

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 six months ended August 4, 2017, 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 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 further 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:

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difficulties in enforcing contracts and collecting accounts receivable and longer payment cycles, especially in emerging markets;

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- difficulties in delivering support, training and documentation in certain foreign markets;
- tariffs and trade barriers 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. A new Cyber Security Law was enacted in November 2016 and came into effect on June 1, 2017, which 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. 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 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 prohibit the provision of 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.

On August 21, 2017, 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 plan to enter into a \$1,000 million unsecured revolving credit facility during fiscal 2018. Our 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.

Our unsecured notes impose restrictions on us and require us to maintain compliance with specified 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, changes by any rating agency to our credit rating 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

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taken, the interest rate payable by us under our revolving credit facility could increase. Downgrades in our credit ratings could also affect the terms of any such financing and restrict our ability to obtain additional financing in the future.

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.

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 VMware 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 six months ended August 4, 2017. 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.

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 I 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 United States. 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.

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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;
- 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, vCloud Air Network-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. Additionally, the duration of sales cycles for our offerings has increased as our customers’ purchasing decisions become more complex and require additional levels of approval. 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 new product initiatives, such as our vCloud Air Network 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 arrangements 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.

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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. We may also inherit unknown security vulnerabilities when we integrate the products or services of other companies into VMware products or services. 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.

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.

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 intend 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, which completed its acquisition of EMC in September 2016, 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 six months ended August 4, 2017. 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

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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 will also require 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.

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 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. In the course of providing employee compensation and benefits, we also maintain personal data of our employees and share that information with third party payroll and benefits providers. Our hybrid cloud computing service offerings, pursuant to which we offer hybrid cloud services and enable third-party service providers to offer hybrid 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.

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 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.

The European Union data protection law, the General Data Protection Regulation ("GDPR"), which will become effective in May 2018, is wide-ranging in scope. In order to meet the new EU requirements, we will have to invest resources necessary to implement policy changes across our business units and services relating to how we collect and use personal data relating to customers, employees and vendors. Failure to comply may lead to sizable fines. EU data protection regulators are expected to publish guidance for compliance with the law which may further impact our information processing activities. In parallel, the European Commission has published a new draft Regulation on Privacy and Electronic Communications which is designed to align with the GDPR and certain other EU privacy rules like e-marketing, the use of cookies on websites, and preserving the confidentiality of communications. In order to adapt to these new requirements, we will likely have to invest resources necessary to implement internal and policy changes across our business units and services. 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. 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 also need to continue to adapt to future judicial decisions and future rulemaking activity as laws on privacy and the protection of personal data continue to evolve in the countries in which we do business.

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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 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

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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 acquisitions of other companies, which could result in an impairment of goodwill or intangibles. As of August 4, 2017, goodwill and amortizable intangible assets were \$4,270 million and \$476 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 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. In addition, in connection with our adoption of ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606), we plan to implement new revenue accounting software, utilizing internal and third party resources. Delays in adapting our information systems to address new business models could limit the success or result in the failure of such initiatives and impair the effectiveness of our internal controls. Even if we do not encounter these adverse effects, the implementation of these enhancements may be much more costly than we anticipated. If we are unable to successfully implement the information systems enhancements as planned, our operating results could be negatively impacted.

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 Internal Revenue Service (the "IRS"). All U.S. federal income tax matters have been concluded for years through 2010, except for any matters under appeal. The IRS is currently auditing the Dell-owned EMC consolidated group's federal tax returns for tax year 2011. 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 United States 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 rate of taxation in foreign jurisdictions is lower than our U.S. tax rate. Our international income is primarily earned by our subsidiaries organized in Ireland, and, as such, our effective tax rate can be impacted by the composition of our earnings in

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the U.S. and foreign 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.

The current U.S. administration has made public statements indicating that tax reform is a priority. Any significant change to U.S. tax laws could have a material impact on our financial condition and operating results.

In addition, numerous other countries have recently enacted or are considering enacting changes to tax laws, administrative interpretations, decisions, policies and positions. The Organisation for Economic Cooperation and Development issued guidelines and proposals during October 2015 that may change how our tax obligations are determined in many of the countries in which we do business. 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 United States. These principles are subject to interpretation by the SEC 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 May 2014, the Financial Accounting Standards Board issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). We plan to adopt Topic 606 using the full retrospective transition method when it becomes effective for us in the first fiscal quarter of 2019, under the Company's new fiscal calendar. While we are continuing to assess the potential impacts of Topic 606, we currently expect unearned license revenue related to the sale of perpetual licenses will decline significantly upon adoption. Currently, we defer all license revenue related to the sale of perpetual licenses in the event certain revenue recognition criteria are not met. However, under Topic 606, we would generally expect that substantially all license revenue related to sale of perpetual licenses will be recognized upon delivery. Topic 606 is also expected to impact the timing and recognition of costs to obtain contracts with customers, such as commissions. Under the new standard, incremental costs to obtain contracts with customers are deferred and recognized over the expected period of benefit. As a result, we expect deferred commission costs to increase. We are continuing to evaluate the effect that Topic 606 will have on our financial statements and related disclosures, and preliminary assessments are subject to change.

**Risks Related to Our Relationship with Dell**

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

Dell acquired EMC on September 7, 2016. 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.

Our stock price fluctuated significantly following the announcement of the Dell Acquisition. A number of 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.

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We have arrangements with a number of companies that compete with Dell, and the completion of the Dell Acquisition could adversely affect our relationship 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.

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

The Class V common stock issued by Dell on September 7, 2016, 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. While the price of Class V common stock has initially been relatively stable, it may be volatile from time-to-time as a consistent trading market in Class V common stock is established. Any volatility in the market for Class V common stock could contribute to volatility in the price of VMware Class A common stock.

With the closing of the Dell Acquisition, Dell has become more highly leveraged and may be required to commit a substantial portion of its cash flows to servicing its indebtedness. While Dell has publicly stated that it plans to leave VMware free to use its cash to invest in the VMware business, 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.

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 August 4, 2017, Dell controlled 33,423,000 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 97.5% 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 August 4, 2017, 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 Software, Inc. ("Pivotal"). We continue to hold a significant ownership interest in Pivotal after contributing \$20 million in cash to Pivotal during 2016, in exchange for additional preferred equity interests in Pivotal.

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, if Pivotal requires additional funding, we may be asked to contribute capital resources to Pivotal or accept dilution in our ownership interest, and we may be unable to realize any value from the technology and resources that we contributed to Pivotal.

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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.

The realignment of our fiscal calendar to coincide with Dell's and Dell's reporting on our financial results may make it more difficult to compare our year-over-year performance and identify changes in business trends and conditions.

Dell provides segment reporting on VMware in its public reports on financial results. However, prior to February 2017, the fiscal calendars for Dell and VMware did not align. VMware reported on a calendar year basis through December 31, 2016, whereas Dell reports on a 52- or 53-week fiscal year basis ending on the Friday nearest to January 31 of each year. Effective January 1, 2017, our fiscal calendar changed to align with Dell's.

The period beginning on January 1, 2017 and ending on February 3, 2017 is being reported as a transition period (the "Transition Period"). Accordingly, our first full fiscal year under our revised fiscal calendar began on February 4, 2017 and will end on February 2, 2018.

We are including certain unaudited condensed consolidated financial statements for the Transition Period in this Form 10-Q and will include audited financial statements for the Transition Period in the Form 10-K for the fiscal year ended February 2, 2018. Following the change in our fiscal calendar and for the first fiscal year, we will compare results from each fiscal period under our new fiscal calendar to the corresponding period under our prior calendar. For example, this Form 10-Q compares the results of the first and second quarter of our 2018 fiscal year running from February 4, 2017 through August 4, 2017 to the results of the first and second quarter of our 2016 fiscal year which ran from January 1, 2016 through June 30, 2016, and in accordance with generally accepted accounting practices, we will not denote any full fiscal quarters or a fiscal year as a "2017" fiscal period.

Our fiscal year transition may also distort the impact of seasonal factors that we have observed in our business, such as the end of fiscal period budget expenditures by our customers and the timing of holiday and vacation periods on our quarterly results. Consequently, it may be difficult to accurately determine the extent to which year-over-year changes in our financial results represent actual changes to business conditions and trends or are instead artifacts of our fiscal period transition.



Additionally, the financial results for Dell's VMware business segment may differ from the financial results reported by us due to the impact of intercompany transactions, purchase accounting, and reporting practices. These differences in the reporting of VMware's financial results by us and Dell could result in volatility and fluctuations in the price of our Class A common stock.

Further, the process of implementing a fiscal calendar transition required us to make adjustments to many of the critical business processes and data systems that our management and personnel rely upon to conduct our business operations and coordinate our worldwide activities. Although we believe that we have successfully managed the transition of our processes and

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systems to the new fiscal calendar, there can be no assurance that errors and failures will not occur that could impact comparisons of our year-over-year results.

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 with the closing of the Dell Acquisition, we are now 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 stand alone liability may increase, vary more widely from period to period and be less predictable.

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, 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 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 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 8 of our 9 directors. 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

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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.

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 interests of Dell and our other stockholders may diverge. Under these circumstances, persons who might otherwise accept our invitation to join our board of directors may decline.

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 and six months ended August 4, 2017, we recognized revenue of \$312 million and \$570 million, respectively, and as of August 4, 2017, \$815 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 B to the 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 August 4, 2017, 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.

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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.

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.

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## 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

Purchases of equity securities during the three months ended August 4, 2017:

	Total Number of Shares Purchased <sup>(1)</sup>	Average Price Paid Per Share <sup>(2)</sup>	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>(1)</sup>	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Publicly Announced Plans or Programs <sup>(3)</sup>
May 6 – June 2, 2017	666,354	90.04	666,354	900,000,000
June 3 – June 30, 2017	—	—	—	—
July 1 – August 4, 2017	—	—	—	—
	666,354	\$ 90.04	666,354	900,000,000

<sup>(1)</sup> During January 2017, VMware's board of directors authorized the repurchase of up to \$1,200 million of VMware's Class A common stock through the end of fiscal 2018.

On March 29, 2017, VMware entered into a stock purchase agreement with Dell to purchase \$300 million of VMware Class A common stock. During the first quarter of fiscal 2018, VMware paid Dell \$300 million in exchange for an initial delivery of shares of 2.7 million shares, or approximately 80% of the expected total shares to be received and retired under the arrangement. On May 10, 2017, the stock purchase agreement with Dell was completed and VMware received an additional 0.7 million shares. The aggregate number of shares of 3.4 million purchased was determined based upon the volume-weighted average price during a defined period, less an agreed upon discount.

<sup>(2)</sup> The average price paid per share excludes commissions.

<sup>(3)</sup> Represents the amounts remaining in the VMware stock repurchase authorizations.

Subsequent to the fiscal quarter ended August 4, 2017, VMware's board of directors authorized the repurchase of up to an additional \$1,000 million of Class A common stock through August 31, 2018. The authorization is in addition to VMware's \$1,200 million stock repurchase program authorized in January 2017, of which \$900 million remained available for repurchase as of August 4, 2017.

## 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: September 7, 2017 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
10.10+*	<u>Form of Restricted Stock Unit Agreement, as amended June 2017</u>				
10.16+*	<u>Form of Performance Stock Unit Agreement, as amended June 2017</u>				
10.30+*	<u>Form of Restricted Stock Unit Agreement for U.K. Participants, as amended June 2017</u>				
10.34+*	<u>Form of Performance Stock Unit Agreement for Non-U.S. Participants</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					