

VMWARE, INC.

Form 10-Q

August 08, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2016

OR

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

For the transition period from to

Commission File Number 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

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

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

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

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

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

Large accelerated filer  Accelerated filer

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

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

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

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## PART I

## FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

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

(unaudited)

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

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

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

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

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VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

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

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

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VMware, Inc.

## CONDENSED CONSOLIDATED BALANCE SHEETS

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

(unaudited)

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

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

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VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

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

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Supplemental disclosures of cash flow information:

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

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

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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 (“IT”) resources in a manner that is based on their specific needs. VMware’s virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, run on industry-standard desktop computers, servers and mobile devices and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

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

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

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

Principles of Consolidation

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



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

Use of Accounting Estimates

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

Estimates are used for, but

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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

**New Accounting Pronouncements**

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

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

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

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

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

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

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

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Definite-Lived Intangible Assets, Net

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

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

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

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

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

## Goodwill

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

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Joint Venture

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

## C. Realignment Charges

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

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

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

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

## D. Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the

period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, including performance stock units, and stock options, including purchase options under VMware's employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

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VMware, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

The following table sets forth the computations of basic and diluted net income per share during the three and six months ended June 30, 2016 and 2015 (net income in millions, shares in thousands):

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Net income	\$265	\$ 172	\$426	\$ 368
Weighted-average shares, basic for Class A and Class B	425,104	24,169	424,164	26,055
Effect of dilutive securities	1,995	2,628	1,560	2,717
Weighted-average shares, diluted for Class A and Class B	427,102	26,797	425,724	28,772
Net income per weighted-average share, basic for Class A and Class B	\$0.62	\$ 0.41	\$ 1.00	\$ 0.86
Net income per weighted-average share, diluted for Class A and Class B	\$0.62	\$ 0.40	\$ 1.00	\$ 0.86

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the three and six months ended June 30, 2016 and 2015, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
Anti-dilutive securities:				
Employee stock options	2,065	2,100	2,207	2,206
Restricted stock units	3,315	90	9,512	399
Total	5,380	2,190	11,719	2,605

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## E. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of June 30, 2016 and December 31, 2015 consisted of the following (tables in millions):

	June 30, 2016			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$542	\$ —	\$ —	\$ 542
Cash equivalents:				
Money-market funds	\$2,374	\$ —	\$ —	\$ 2,374
Time deposits	13	—	—	13
Municipal obligations	62	—	—	62
Total cash equivalents	\$2,449	\$ —	\$ —	\$ 2,449
Short-term investments:				
U.S. Government and agency obligations	\$956	\$ 5	\$ —	\$ 961
U.S. and foreign corporate debt securities	3,936	24	(1 )	3,959
Foreign governments and multi-national agency obligations	29	—	—	29
Municipal obligations	500	—	—	500
Asset-backed securities	8	—	—	8
Mortgage-backed securities	216	1	—	217
Total short-term investments	\$5,645	\$ 30	\$ (1 )	\$ 5,674
Other assets:				
Marketable available-for-sale equity securities	\$15	\$ 2	\$ —	\$ 17
	December 31, 2015			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$725	\$ —	\$ —	\$ 725
Cash equivalents:				
Money-market funds	\$1,763	\$ —	\$ —	\$ 1,763
Time deposits	5	—	—	5
Total cash equivalents	\$1,768	\$ —	\$ —	\$ 1,768
Short-term investments:				
Time deposits	\$12	\$ —	\$ —	\$ 12
U.S. Government and agency obligations	753	—	(3 )	750
U.S. and foreign corporate debt securities	3,263	1	(12 )	3,252
Foreign governments and multi-national agency obligations	35	—	—	35
Municipal obligations	705	1	—	706
Asset-backed securities	20	—	—	20
Mortgage-backed securities	243	—	(2 )	241
Total short-term investments	\$5,031	\$ 2	\$ (17 )	\$ 5,016
Other assets:				
Marketable available-for-sale equity securities	\$15	\$ 3	\$ —	\$ 18

Refer to Note F for further information regarding the fair value of VMware's cash equivalents and investments.





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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

VMware evaluated its available-for-sale investments as of June 30, 2016 and December 31, 2015 to determine whether or not any security had experienced an other-than-temporary decline in fair value. As of June 30, 2016 and December 31, 2015, VMware did not consider any of its available-for-sale investments to be other-than-temporarily impaired. The realized gains and losses on investments during the three and six months ended June 30, 2016 and 2015 were not material.

Unrealized losses on cash equivalents and available-for-sale investments as of June 30, 2016 and December 31, 2015, which have been in a net loss position for less than twelve months, were classified by asset class as follows (table in millions):

	June 30, 2016		December 31, 2015	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	\$24	\$ —	\$657	\$ (3 )
U.S. and foreign corporate debt securities	385	(1 )	2,564	(11 )
Mortgage-backed securities	67	—	171	(1 )
Total	\$476	\$ (1 )	\$3,392	\$ (15 )

As of June 30, 2016 and December 31, 2015, 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 material. 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 material as of June 30, 2016 and December 31, 2015.

**Contractual Maturities**

The contractual maturities of short-term investments held at June 30, 2016 consisted of the following (table in millions):

	Amortized	Aggregate
	Cost Basis	Fair Value
Due within one year	\$ 1,947	\$ 1,947
Due after 1 year through 5 years	3,427	3,453
Due after 5 years through 10 years	109	111
Due after 10 years	162	163
Total short-term investments	\$ 5,645	\$ 5,674

**F. 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 which are classified as Level 1. Additionally, VMware's Level 2 classification includes forward contracts and notes payable to EMC. At June 30, 2016 and December 31, 2015, VMware's Level 2 securities were generally priced using non-binding market consensus prices that are 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 material assets or liabilities that fell into Level 3 of the fair value hierarchy as of June 30, 2016 and December 31, 2015, and there have been no transfers between fair value measurement levels during the three and six months ended June 30, 2016 and 2015.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables set forth the fair value hierarchy of VMware's cash equivalents, available-for-sale securities, and forward contracts that were required to be measured at fair value as of June 30, 2016 and December 31, 2015 (tables in millions):

	June 30, 2016		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$2,374	\$—	\$2,374
Time deposits	—	13	13
Municipal obligations	—	62	62
Total cash equivalents	\$2,374	\$75	\$2,449
Short-term investments:			
U.S. Government and agency obligations	\$667	\$294	\$961
U.S. and foreign corporate debt securities	—	3,959	3,959
Foreign governments and multi-national agency obligations	—	29	29
Municipal obligations	—	500	500
Asset-backed securities	—	8	8
Mortgage-backed securities	—	217	217
Total short-term investments	\$667	\$5,007	\$5,674
Other assets:			
Marketable available-for-sale equity securities	\$17	\$—	\$17
Other current assets:			
Forward contracts	\$—	\$2	\$2
	December 31, 2015		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$1,763	\$—	\$1,763
Time deposits	—	5	5
Total cash equivalents	\$1,763	\$5	\$1,768
Short-term investments:			
Time deposits	\$—	\$12	\$12
U.S. Government and agency obligations	543	207	750
U.S. and foreign corporate debt securities	—	3,252	3,252
Foreign governments and multi-national agency obligations	—	35	35
Municipal obligations	—	706	706
Asset-backed securities	—	20	20
Mortgage-backed securities	—	241	241
Total short-term investments	\$543	\$4,473	\$5,016
Other assets:			
Marketable available-for-sale equity securities	\$18	\$—	\$18
Accrued expenses and other:			
Forward contracts	\$—	\$(1 )	\$(1 )

VMware has elected not to record its notes payable to EMC at fair value, but has measured the notes at fair value for disclosure purposes. As of June 30, 2016, the fair value of the notes payable to EMC approximated its carrying value due to the minimal difference between the fair market interest rate as of June 30, 2016 and the fixed interest rate for

the notes payable to

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VMware, Inc.

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(unaudited)

EMC. As of December 31, 2015, the fair value of the notes payable to EMC was approximately \$1,474 million. Fair value was estimated primarily based on observable market interest rates (Level 2 inputs).

VMware offers a deferred compensation plan for eligible employees that allows participants to defer payment for part or all of their compensation. The net impact to the condensed consolidated statements of income is not material 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 both approximately \$27 million and \$20 million as of June 30, 2016 and December 31, 2015, 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 has strategic investments in its portfolio accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. VMware evaluates these investments to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding 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 investments to their fair value.

During the six months ended June 30, 2016, VMware recognized charges of approximately \$5 million, as a result of determining that certain strategic investments were considered to be other-than-temporarily impaired. There was no impairment charge during the three months ended June 30, 2016 and the three and six months ended June 30, 2015. All other realized gains and losses on investments during the three and six months ended June 30, 2016 and 2015 were not material. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments accounted for under the cost method was \$125 million and \$103 million as of June 30, 2016 and December 31, 2015, respectively.

**G. Derivatives and Hedging Activities**

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate 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 agreement. VMware manages counterparty risk by seeking counterparties of high credit quality, by monitoring credit ratings and credit spreads of, and other relevant public information about its counterparties. VMware does not, and does not intend to, use derivative instruments for trading or speculative purposes.

**Cash Flow Hedges**

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into forward contracts. The Company designates these forward contracts 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 hedges 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 June 30, 2016 and 2015, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not material. 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.

VMware enters into forward contracts annually, which have maturities of twelve months or less. As of June 30, 2016 and December 31, 2015, VMware had forward contracts designated as cash flow hedges with a total notional value of \$109 million and \$213 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 June 30, 2016 and 2015, 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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

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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.

VMware enters into forward contracts on a monthly basis, which typically have a contractual term of one month. As of June 30, 2016 and December 31, 2015, VMware had outstanding forward contracts with a total notional value of \$641 million and \$721 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 June 30, 2016, VMware recognized a gain of \$11 million and a loss of \$12 million, respectively, relating to the settlement of forward contracts. During the three and six months ended June 30, 2015, VMware recognized a loss of \$20 million and a gain of \$21 million, respectively. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

The combined gains and losses derived from the settlement of forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of \$1 million and \$3 million, respectively, during the three and six months ended June 30, 2016. The combined gains and losses derived from the settlement of forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of \$3 million and \$9 million during the three and six months ended June 30, 2015, respectively. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

**H. Unearned Revenues**

Unearned revenues as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	June 30, December 31,	
	2016	2015
Unearned license revenues	\$ 455	\$ 428
Unearned software maintenance revenues	4,189	4,174
Unearned professional services revenues	478	474
Total unearned revenues	\$ 5,122	\$ 5,076

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or are 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 such time as all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenues 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 software maintenance revenues are attributable to VMware’s maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at June 30, 2016 was approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

Unearned license and software maintenance revenues 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 revenues derived from transactions denominated in a foreign currency is impacted by fluctuations in the foreign currencies in which VMware invoices.

**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. In the lawsuit, Phoenix is seeking injunctive relief and monetary damages. Trial is currently scheduled for November 2016. VMware believes that it has meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

On March 4, 2015, Christoph Hellwig, a software developer who alleges 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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

alleging copyright infringement for failing to comply with the terms of an open source General Public License v.2 (“GPL v.2”) and seeking an order requiring VMware 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 Mr. Hellwig’s lawsuit because he failed to show that his protectable software code had been used in VMware’s product.

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, alleging that the directors 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 does not assert claims directly against VMware, but purports to bring class claims on behalf of other VMware Class A stockholders and derivative claims on behalf of VMware. In addition, on November 10, 2015, David Jacobs, also a VMware stockholder, filed an action in Massachusetts Superior Court against, among others, EMC and four directors who serve on both the EMC board and the VMware board, setting forth similar allegations to those in the Ford matter. While VMware does not believe that the cases represent material adverse exposures, no assurances can be given that the litigation will not have any adverse consequences for the company or the directors named in the suits.

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 June 30, 2016, amounts accrued relating to these other matters arising as part of the ordinary course of business were not considered material. VMware does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on its condensed consolidated financial statements.

**J. Stockholders’ Equity**

**VMware Stock Repurchases**

During April 2016, VMware’s board of directors authorized the repurchase of up to an aggregate of \$1,200 million of VMware’s Class A common stock through the end of 2016. The aggregate authorized stock repurchase amount of \$1,200 million includes the amount remaining from VMware’s previous stock repurchase authorization announced on January 27, 2015, which was \$835 million as of June 30, 2016. Stock will be purchased from time to time, in the open market or through private 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. All shares repurchased under VMware’s stock repurchase programs are retired.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

There were no repurchases of our Class A common stock during the three and six months ended June 30, 2016. The following table summarizes stock repurchase activity during the three and six months ended June 30, 2015 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended June 30, 2015	Six Months Ended June 30, 2015
Aggregate purchase price	\$ 412	\$ 850
Class A common shares repurchased	4,750	10,116
Weighted-average price per share	\$ 86.71	\$ 84.02

The aggregate purchase price of repurchased shares includes commissions and is classified as a reduction to additional paid-in capital.

## VMware Stock Options

Stock option activity was not material during the six months ended June 30, 2016. As of June 30, 2016, there were 2.6 million stock options outstanding. The stock options outstanding as of June 30, 2016 had an aggregate intrinsic value of \$37 million based on VMware's closing stock price as of June 30, 2016.

## VMware Restricted Stock

VMware's restricted stock primarily consists of restricted stock unit ("RSU") awards granted to employees. RSUs are valued 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 of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award 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 target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued.

The following table summarizes restricted stock activity since January 1, 2016 (units in thousands):

	Number of Units	Weighted- Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2016	18,693	\$ 77.29
Granted	9,974	56.28
Vested	(3,719 )	80.94
Forfeited	(2,310 )	79.31
Outstanding, June 30, 2016	22,638	67.22

The total fair value of VMware restricted stock that vested during the six months ended June 30, 2016 was \$113 million. As of June 30, 2016, restricted stock representing 22.6 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of \$1,295 million based on VMware's closing stock price as of June 30, 2016.

As of June 30, 2016, the total unrecognized compensation cost for stock options and restricted stock was \$1,197 million and will be recognized through 2020 with a weighted-average remaining period of 1.5 years.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Accumulated Other Comprehensive Income (Loss)

The changes in components of accumulated other comprehensive income (loss) during the six months ended June 30, 2016 and 2015 were as follows (tables in millions):

	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, January 1, 2016	\$ (7 )	\$ (1 )	\$(8 )
Unrealized gains (losses), net of taxes of \$15, \$0 and \$15	24	—	24
Amounts reclassified from accumulated other comprehensive income (loss) to the consolidated statement of income, net of taxes of \$2, \$0 and \$2	3	1	4
Balance, June 30, 2016	\$ 20	\$ —	\$20

	Unrealized Gain (Loss) on Available-for-Sale Securities	Unrealized Gain (Loss) on Forward Contracts	Total
Balance, January 1, 2015	\$ —	\$ (1 )	\$(1 )
Unrealized gains (losses), net of taxes of \$0	1	(3 )	(2 )
Balance, June 30, 2015	\$ 1	\$ (4 )	\$(3 )

Unrealized gains 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 are realized.

The effective portion of gains (losses) resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments are reclassified to its related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense functional line items on the condensed consolidated statements of income during the three and six months ended June 30, 2016 and 2015 were not material to the individual functional line items.

## K. Related Parties

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

## Transactions with EMC

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

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end users.

- EMC purchases products and services from VMware for internal use.

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

- 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 EMC, 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.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Information about VMware's revenues and receipts from such arrangements during the three and six months ended June 30, 2016 and 2015 and unearned revenues from such arrangements as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	Revenues and Receipts		Unearned Revenues	
	Three Months Ended	Six Months Ended	As of	As of
	June 30, 2016	June 30, 2015	June 30, 2016	December 31, 2015
Reseller revenues	\$85	\$69	\$163	\$131
Internal-use revenues	14	6	19	9
Professional services revenues	26	24	51	48
Agency fee revenues	1	3	2	4
Reimbursement for services to Pivotal	—	1	1	2
			n/a	n/a

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

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

• From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and VMware pays EMC for services provided to VMware by EMC related to such projects.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC personnel who are managed by VMware. The costs incurred by EMC 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 rent expenses. EMC also incurs certain administrative costs on VMware's behalf in the U.S. that are recorded as expenses on VMware's condensed consolidated statements of income.

• From time to time, VMware invoices end users on behalf of EMC for certain services rendered by EMC. Cash related to these services is collected from the end user by VMware and remitted to EMC.

Information about VMware's costs from such arrangements for the three and six months ended June 30, 2016 and 2015 consisted of the following (table in millions):

	Three Months Ended	Six Months Ended	Three Months Ended	Six Months Ended
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Purchases and leases of products and purchases of services	\$17	\$12	\$34	\$31
Collaborative technology project costs	—	1	—	3
EMC subsidiary support and administrative costs	21	26	44	54

VMware also purchases EMC products through EMC's channel partners. Purchases of EMC products through EMC's channel partners were not material during the three and six months ended June 30, 2016. Purchases of EMC products through EMC's channel partners were \$18 million and \$26 million during the three and six months ended June 30, 2015, respectively.

**Tax Sharing Agreement with EMC**

VMware has made payments to EMC pursuant to a tax sharing agreement. The following table summarizes the payments made during the three and six months ended June 30, 2016 and 2015 (table in millions):

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Three	Six
Months	Months
Ended	Ended
June 30,	June 30,
2016	2015

Payments from VMware to EMC \$54 \$ 43 \$95 \$ 92

Payments from VMware to EMC under the tax sharing agreement relate to VMware's portion of federal income taxes on EMC's consolidated tax return as well as the state payments for combined states. The amounts that VMware pays to EMC for

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

its portion of federal income taxes on EMC's consolidated tax return differ from the amounts VMware would owe on a separate return basis and the difference is presented as a component of stockholders' equity. During the three and six months ended June 30, 2016, the difference between the amount of tax calculated on a separate return basis and the amount of tax calculated per the tax sharing agreement was \$14 million and \$15 million, respectively. During the three and six months ended June 30, 2015, the difference was not material.

**Due To/From Related Parties, Net**

As a result of the related party transactions with EMC described above, amounts due to and from related parties, net as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	June 30, 2016	December 31, 2015
Due (to) related parties	\$(49)	\$ (68 )
Due from related parties	145	142
Due (to) from related parties, net	\$96	\$ 74

Income tax due (to) from related parties \$10 \$ (18 )

Balances due to and from related parties, which are unrelated to tax obligations, are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from related parties is governed by the tax sharing agreement with EMC.

**Notes Payable to EMC**

VMware and EMC entered into a note exchange agreement on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The total debt of \$1,500 million includes \$450 million that was exchanged for the \$450 million promissory note issued to EMC in April 2007, as amended and restated in June 2011.

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 three and six months ended June 30, 2016, \$7 million and \$13 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2015, \$7 million and \$13 million, respectively, of interest expense was recognized.

**Pivotal**

During 2013, VMware transferred certain assets and liabilities to Pivotal in exchange for preferred equity interests in Pivotal's outstanding shares. As of December 31, 2015, VMware's ownership interest in Pivotal was 28%.

In April 2016, VMware contributed \$20 million in cash to Pivotal in exchange for additional preferred equity interests in Pivotal. As of June 30, 2016, VMware's ownership interest in Pivotal was 17% and continued to be accounted for under the cost method. The decrease in VMware's ownership interest was a result of investments made by other investors.

**L. Segment Information**

VMware operates in one reportable operating segment, thus all required financial segment information can be found on 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.

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VMware, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

Revenues by geographic area for the three and six months ended June 30, 2016 and 2015 were as follows (table in millions):

	Three Months Ended June 30, 2016		Six Months Ended June 30, 2015	
United States	\$870	\$742	\$1,671	\$1,504
International	823	779	1,611	1,528
Total	\$1,693	\$1,521	\$3,282	\$3,032

Revenues by geographic area are based on the ship-to addresses of VMware's customers. No individual country other than the United States accounted for 10% or more of revenues for the three and six months ended June 30, 2016 and 2015.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of June 30, 2016 and December 31, 2015 were as follows (table in millions):

	June 30, December 31, 2016		2015	
United States	\$ 817	\$ 831		
International	134	148		
Total	\$ 951	\$ 979		

No individual country other than the United States accounted for 10% or more of these assets as of June 30, 2016 and December 31, 2015, respectively.

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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 June 30, 2016 should be read in conjunction with our consolidated financial statements for the year ended December 31, 2015 contained in our Form 10-K filed on February 25, 2016.

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. We develop and market our product and service offerings within three main product groups, which are discussed in more detail below and allow organizations to leverage synergies and manage IT resources across complex multi-cloud, multi-device environments.

Our three main product groups are:

SDDC or Software-Defined Data Center

Hybrid Cloud Computing

End-User Computing

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.

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. Historically, the majority of our license sales have been from VMware vSphere, which is included in our compute product category within our SDDC product group. However, the market for our compute products is reaching maturity, and VMware vSphere license sales have been declining. As the transformation of the IT industry continues, we expect that our growth of license sales within the SDDC product group will be increasingly derived from sales of our newer products and services solutions across our SDDC portfolio. We have experienced continued growth in sales volume of VMware NSX ("NSX"), our network virtualization solution, through the first half of 2016. We also continue to see growth in sales volume of our Virtual SAN ("VSAN") products as well as other newer offerings.

Hybrid Cloud Computing

Our cloud strategy has three 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.

Hybrid cloud computing is comprised of VMware vCloud Air Network ("vCAN") Service Providers Program and VMware vCloud Air ("vCloud Air") offerings. Revenues derived from vCAN continued to grow during the second quarter of 2016. We have narrowed the focus of vCloud Air to provide specialized cloud software and services unique to VMware that are distinct from those offered by other cloud providers.

End-User Computing

End-user computing includes VMware Workspace ONE, which consists primarily of VMware AirWatch ("AirWatch") and Horizon desktop and application virtualization ("Horizon"). Our AirWatch business model includes an on-premise solution that we offer through the sale of perpetual licenses and an off-premise solution that we offer as software-as-a-service ("SaaS"). AirWatch products and services continued to contribute to the growth of our end-user computing product group during the three and six months ended June 30, 2016.

Business Realignment Plan

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. We eliminated approximately 800 positions and personnel and recognized \$52 million of realignment charges during the six months ended June 30, 2016. Actions associated with this plan were substantially completed as of June 30, 2016.

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## Dell and EMC Merger

We are a majority-owned and controlled subsidiary of EMC Corporation (“EMC”). As of June 30, 2016, EMC held 80.6% of our outstanding common stock and 97.4% of the combined voting power of our outstanding common stock, including 43 million shares of our Class A common stock and all of our Class B common stock.

On October 12, 2015, Dell Inc. (“Dell”), Denali Holding Inc. (“Denali”) and EMC entered into a definitive merger agreement under which Denali has agreed to acquire EMC (the “Dell Acquisition”). Under the terms of the agreement, we will continue to operate as a publicly traded company. Upon closing of the transaction, a portion of the merger consideration that EMC shareholders will receive will include shares of Class V common stock that will be registered with the Securities and Exchange Commission and issued by Denali. Pursuant to the terms of the agreement, it is expected that approximately 0.111 shares of Class V common stock will be issued by Denali for each EMC share. Denali has also disclosed that the Class V common stock will be a publicly traded tracking stock that, upon issuance, is intended to track the performance of an approximately 53% economic interest in our business. On July 19, 2016, EMC shareholders approved the Dell Acquisition. The closing of the transaction remains subject to certain regulatory approvals.

## Results of Operations

Approximately 70% of our sales are denominated in the U.S. dollar, however, we also invoice and collect in the euro, the British pound, the Japanese yen, the Australian dollar and the Chinese renminbi in their respective regions. In addition, we incur and pay operating expenses in currencies other than the U.S. dollar. As a result, our financial statements, including our revenues, operating expenses, unearned revenues, and the resulting cash flows derived from the U.S. dollar equivalent of foreign currency transactions are impacted by foreign exchange fluctuations.

## Revenues

Our revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended					Six Months Ended						
	June 30,		\$	%	Constant	June 30,		\$	%	Constant		
	2016	2015	Change	Change		Currency	2016	2015	Change		Change	Currency
Revenues:												
License	\$644	\$638	\$ 6	1	% 1	%	\$1,216	\$1,214	\$ 2	—	% 1	%
Services:												
Software maintenance	915	829	86	10			1,806	1,641	165	10		
Professional services	134	130	4	3			260	253	8	3		
Total services	1,049	959	91	9			2,066	1,894	173	9		
GSA settlement	—	(76)	) 76	(100)			—	(76)	) 76	(100)		
Total revenues	\$1,693	\$1,521	\$ 172	11	11		\$3,282	\$3,032	\$ 250	8	9	

## Revenues:

United States	\$870	\$742	\$ 128	17	%		\$1,671	\$1,504	\$ 167	11	%
International	823	779	44	6			1,611	1,528	84	5	
Total revenues	\$1,693	\$1,521	\$ 172	11	11		\$3,282	\$3,032	\$ 250	8	9

In order to provide a comparable framework for assessing how our business performed, adjusted for the impact of foreign currency fluctuations, management analyzed year-over-year license and total revenue growth on a constant currency basis. License and total revenue growth in constant currency are non-GAAP financial measures that are calculated by converting license and total revenues recognized during the current period derived from non-U.S. dollar based transactions into U.S. dollars using the exchange rates that were effective in the comparable prior year period. The calculated current period license and total revenues, adjusted for foreign currency fluctuations, is compared to the license and total revenues of the comparable prior year period, as reported, in calculating license and total revenue growth in constant currency. We believe this information is useful to investors to facilitate comparisons of operating

results and better identify trends in our business. These constant currency performance measures should be viewed in addition to, and not in lieu of or superior to, our operating performance measures calculated in accordance with GAAP.

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Hybrid cloud, including vCAN and vCloud Air, and our SaaS offerings, including our AirWatch mobile solutions, increased to approximately 8% of our total revenues during the three and six months ended June 30, 2016. vCAN revenues are generally included in license revenues and our SaaS revenues, including vCloud Air and our AirWatch mobile solutions, are included in both license and services revenues.

While we are seeing strong growth across our portfolio of emerging products, our compute products are reaching maturity and the sales of these products are expected to represent a decreasing percentage of our total business going forward. Taking this into account, we expect our total revenue growth in 2016 to slow as sales transition to our emerging products.

**License Revenues**

Overall license revenues during the three and six months ended June 30, 2016 increased slightly when compared with the same periods in 2015. While we experienced increased sales in our emerging products, including NSX and VSAN, as well as our vCAN offering, our license revenue growth rate was negatively impacted by certain factors, including lower license sales of our core compute products and increased growth derived from our hybrid cloud and SaaS offerings. Perpetual license revenues that are part of a multi-year arrangement are generally recognized upon delivery of the underlying license using the residual method, whereas revenues derived from our hybrid cloud and SaaS offerings are recognized over a period of time.

During 2016, we expect sales of our emerging products to continue to increase as a percentage of total revenues, and we expect overall license revenue growth in 2016 to be flat when compared with 2015.

**Services Revenues**

During the three and six months ended June 30, 2016, software maintenance revenues benefited from renewals of our software maintenance contracts sold in previous periods and additional maintenance contracts sold in conjunction with new software license sales. In each period presented, customers bought, on a weighted-average basis, more than 24 months of support and maintenance with each new license purchased.

Professional services revenues increased slightly during the three and six months ended June 30, 2016 when compared to the same period in 2015. As we continue to invest in our partners and expand our ecosystem of third-party professionals with expertise in our offerings to independently provide professional services to our customers, our professional services revenues will vary based on the delivery channels used in any given period as well as the timing of engagements.

**GSA Settlement**

During June 2015, we reached an agreement with the Department of Justice (“DOJ”) and the General Services Administration (“GSA”) to pay \$76 million to resolve allegations that our government sales practices between 2006 and 2013 had violated the federal False Claims Act. The settlement was paid and recorded as a reduction of our total revenues during the three months ended June 30, 2015.

**Unearned Revenues**

Our unearned revenues as of June 30, 2016 and December 31, 2015 were as follows (table in millions):

	June 30, December 31,	
	2016	2015
Unearned license revenues	\$ 455	\$ 428
Unearned software maintenance revenues	4,189	4,174
Unearned professional services revenues	478	474
Total unearned revenues	\$ 5,122	\$ 5,076

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or are 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 such time as all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenues 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 software maintenance revenues are attributable to our maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at June 30, 2016 was approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

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Unearned license and software maintenance revenues 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 revenues derived from transactions denominated in a foreign currency is impacted by fluctuations in the foreign currencies in which we invoice.

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

Our cost of services revenues and operating expenses were primarily impacted by increasing employee-related expenses including salaries, bonuses, commissions and stock-based compensation across most of our income statement expense categories, net of realignment activities, when compared to the same period in 2015. We expect this trend to continue. As part of the realignment plan approved in January 2016, we expect to reinvest the associated savings primarily in research and development as well as sales and marketing.

In calculating the impact of foreign currency fluctuations on cost of license revenues, cost of services revenues and operating expenses, we converted expenses recognized during the current period derived from non-U.S. dollar based transactions into U.S. dollars using the exchange rates that were effective in the comparable prior year period and compared the calculated amount to the amount, as reported, in the comparable prior year period.

**Cost of License Revenues**

Our cost of license revenues principally 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.

Our cost of license revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Cost of license revenues	\$40	\$46	\$ (6 )	(13 )%	\$80	\$95	\$ (16 )	(17 )%
Stock-based compensation	—	—	—	4	1	1	—	5
Total expenses	\$40	\$46	\$ (6 )	(12 )	\$81	\$96	\$ (16 )	(16 )
% of License revenues	6	% 7	%		7	% 8	%	

Cost of license revenues decreased during the three and six months ended June 30, 2016 compared to the same periods in 2015 primarily due to a decrease in royalty costs of \$3 million and \$9 million, respectively. In addition, amortization of intangible assets decreased by \$3 million and \$5 million during the three and six months ended June 30, 2016, respectively.

**Cost of Services Revenues**

Our cost of services revenues 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, our cost of services revenues includes depreciation on equipment supporting our service offerings.

Our cost of services revenues during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Cost of services revenues	\$208	\$194	\$ 15	8 %	\$407	\$375	\$ 31	8 %
Stock-based compensation	13	10	2	21	25	22	3	15

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Total expenses	\$221	\$204	\$ 17	8	\$432	\$397	\$ 34	9
% of Services revenues	21	% 21	%		21	% 21	%	

Cost of services revenues increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. The increase was primarily due to growth in cash-based employee-related expenses of \$11 million and \$29 million during the three and six months ended June 30, 2016, respectively. Additionally, during the six months ended June 30, 2016,

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equipment and depreciation increased by \$9 million. These increases were partially offset by the favorable impact of \$6 million during the six months ended June 30, 2016 resulting from fluctuations in the exchange rates between the U.S. dollar and the foreign currencies in which we incur expenses.

**Research and Development Expenses**

Our research and development expenses include the personnel and related overhead associated with the development of our product software and service offerings.

Our research and development expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Research and development	\$289	\$269	\$ 20	7 %	\$576	\$520	\$ 56	11 %
Stock-based compensation	74	53	21	39	144	107	37	35
Total expenses	\$363	\$322	\$ 41	13	\$720	\$627	\$ 93	15
% of Total revenues	21	% 21	%		22	% 21	%	

Research and development expenses increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. These increases were primarily driven by growth in cash-based employee-related expenses of \$21 million and \$48 million during the three and six months ended June 30, 2016, respectively. In addition, stock-based compensation increased by \$21 million and \$37 million during the three and six months ended June 30, 2016, respectively, primarily driven by an increase in restricted stock awards granted to existing employees. Equipment and depreciation costs also increased by \$7 million during the six months ended June 30, 2016.

**Sales and Marketing Expenses**

Our 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. Sales commissions are generally earned and expensed when a firm order is received from the customer.

Our sales and marketing expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Sales and marketing	\$533	\$522	\$ 10	2 %	\$1,049	\$1,019	\$ 30	3 %
Stock-based compensation	47	43	5	12	95	81	14	17
Total expenses	\$580	\$565	\$ 15	3	\$1,144	\$1,100	\$ 44	4
% of Total revenues	34	% 37	%		35	% 36	%	

Sales and marketing expenses increased during the three and six months ended June 30, 2016 compared to the same periods in 2015. These increases were primarily driven by growth in cash-based employee-related expenses of \$24 million and \$57 million during the three and six months ended June 30, 2016, respectively, due primarily to higher commission expense resulting from increased sales volume. In addition, stock-based compensation increased by \$14 million during the six months ended June 30, 2016 primarily driven by an increase in restricted stock awards granted to existing employees. These increases were partially offset by the favorable impact of \$4 million and \$17 million during the three and six months ended June 30, 2016, respectively, resulting from fluctuations in the exchange rates between the U.S. dollar and the foreign currencies in which we incur expenses, as well as decreases in costs incurred for marketing programs and related initiatives of \$4 million and \$12 million during the three and six months ended June 30, 2016, respectively. Equipment, depreciation and facilities-related costs also decreased by \$4 million during the three months ended June 30, 2016.



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## General and Administrative Expenses

Our general and administrative expenses include personnel and related overhead costs to support the overall business. These expenses include the costs associated with our finance, human resources, IT infrastructure and legal, as well as expenses related to corporate costs and initiatives.

Our general and administrative expenses during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
General and administrative	\$ 149	\$ 163	\$ (14 )	(8 )%	\$ 302	\$ 336	\$ (33 )	(10 )%
Stock-based compensation	18	17	—	2	36	31	5	16
Total expenses	\$ 167	\$ 180	\$ (13 )	(7 )	\$ 338	\$ 367	\$ (28 )	(8 )
% of Total revenues	10 %	12 %			10 %	12 %		

General and administrative expenses decreased during the three and six months ended June 30, 2016 compared to the same periods in 2015. These decreases were primarily driven by a decrease in installment payments to certain key employees of AirWatch subject to the achievement of specified employment conditions. Compensation expense relating to these installment payments decreased by \$41 million and \$68 million during the three and six months ended June 30, 2016. The final payment was made during the first quarter of 2016. These decreases were partially offset by an increase in charitable donations of \$9 million and \$14 million and an increase in equipment and depreciation-related costs of \$8 million and \$15 million during the three and six months ended June 30, 2016, respectively. Cash-based employee-related expenses also increased by \$8 million during the three and six months ended June 30, 2016.

## Realignment Charges

Our realignment charges during the three and six months ended June 30, 2016 and 2015 were as follows (dollars in millions):

	Three Months Ended June 30,				Six Months Ended June 30,			
	2016	2015	\$ Change	% Change	2016	2015	\$ Change	% Change
Realignment charges	\$(1)	\$(2)	\$ 1	(57 )%	\$ 52	\$ 21	\$ 32	154 %
% of Total revenues	— %	— %			2 %	1 %		

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 charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. Additionally, we are in the process of consolidating certain facilities as part of this plan, which resulted in the recognition of \$3 million of related charges during the six months ended June 30, 2016 on the condensed consolidated statements of income. As of June 30, 2016, \$5 million remained in accrued expenses and other on the condensed consolidated balance sheets, which is generally expected to be paid during 2016. Actions associated with the plan were substantially completed by June 30, 2016.

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

## Income Tax Provision

Our quarterly effective income tax rate is based on our estimated annual income tax rate forecast and discrete items. Our quarterly effective income tax rate was 21.4% and 20.7% during the three and six months ended June 30, 2016, respectively. For the three and six months ended June 30, 2015, our effective tax rate was 19.3% and 15.5%, respectively. Our estimated annual effective tax rate increased primarily as a result of the shift in the mix of our earnings from our lower tax non-U.S.

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jurisdictions to the U.S. During the three and six months ended June 30, 2015, discrete items included a \$19 million benefit recognized in connection with the GSA settlement which occurred during the second quarter of 2015.

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 impacted by the composition of our earnings in the U.S. and non-U.S. jurisdictions.

We are included in the EMC consolidated group for U.S. federal income tax purposes, and expect to continue to be included in such consolidated group for periods in which EMC 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 EMC 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 EMC'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 EMC consolidated group for U.S. federal income tax purposes, and our U.S. federal income tax would be reported separately from that of the EMC consolidated group.

Although our results are included in the EMC 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 EMC are parties to are assessed using consolidated tax return rules.

The EMC consolidated group is routinely under audit by the Internal Revenue Service ("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 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.

Our future effective tax rate may be affected by such factors as changes in tax laws, changes in our business, regulations, or rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations and shifts in the amount of earnings in the U.S. compared with other regions in the world as well as the expiration of statute of limitations and settlements of audits.

**Our Relationship with EMC**

As of June 30, 2016, EMC owned 43 million shares of Class A common stock and all 300 million shares of Class B common stock, representing 80.6% of our total outstanding shares of common stock and 97.4% of the combined voting power of our outstanding common stock. For a description of related risks, refer to "Risks Related to Our Relationship with EMC and the Dell Acquisition" 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 EMC and EMC's consolidated subsidiaries (collectively "EMC").

**Transactions with EMC**

We and EMC engaged in the following ongoing intercompany transactions, which resulted in revenues and receipts and unearned revenues for us:

• Pursuant to an ongoing reseller arrangement with EMC, EMC bundles our products and services with EMC's products and sells them to end users.

• EMC purchases products and services from us for internal use.

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

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 EMC, 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.

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Information about our revenues and receipts from such arrangements during the three and six months ended June 30, 2016 and 2015 and unearned revenues from such arrangements as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	Revenues and Receipts		Unearned Revenues	
	Three Months Ended	Six Months Ended	As of	As of
	June 30, 2016	June 30, 2015	June 30, 2016	December 31, 2015
Reseller revenues	\$85	\$69	\$163	\$131
Internal-use revenues	14	6	19	9
Professional services revenues	26	24	51	48
Agency fee revenues	1	3	2	4
Reimbursement for services to Pivotal	—	1	1	2
			n/a	n/a

We and EMC engaged in the following ongoing intercompany transactions, which resulted in costs to us:

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

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

• In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC 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 rent expenses. EMC also incurs certain administrative costs on our behalf in the U.S. that are recorded as expenses on our condensed consolidated statements of income.

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

Information about our costs from such arrangements for the three and six months ended June 30, 2016 and 2015 consisted of the following (table in millions):

	Three Months Ended	Six Months Ended	Three Months Ended	Six Months Ended
	June 30, 2016	June 30, 2015	June 30, 2016	June 30, 2015
Purchases and leases of products and purchases of services	\$17	\$12	\$34	\$31
Collaborative technology project costs	—	1	—	3
EMC subsidiary support and administrative costs	21	26	44	54

We also purchase EMC products through EMC's channel partners. Purchases of EMC products through EMC's channel partners were not material during the three and six months ended June 30, 2016. Purchases of EMC products through EMC's channel partners were \$18 million and \$26 million during the three and six months ended June 30, 2015, respectively.

#### Tax Sharing Agreement with EMC

We have made payments to EMC pursuant to a tax sharing agreement. The following table summarizes the payments made during the three and six months ended June 30, 2016 and 2015 (table in millions):

	Three Months Ended	Six Months Ended



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June 30, June 30,  
2016 2015 2016 2015

Payments from us to EMC \$54 \$43 \$95 \$92

Payments from us to EMC under the tax sharing agreement relate to our portion of federal income taxes on EMC's consolidated tax return as well as the state payments for combined states. The amounts that we pay to EMC for our portion of federal income taxes on EMC's consolidated tax return differ from the amounts we would owe on a separate return basis and the difference is presented as a component of stockholders' equity. During the three and six months ended June 30, 2016, the

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difference between the amount of tax calculated on a separate return basis and the amount of tax calculated per the tax sharing agreement was \$14 million and \$15 million, respectively. During the three and six months ended June 30, 2015, the difference was not material.

## Due To/From Related Parties, Net

As a result of the related party transactions with EMC described above, amounts due to and from related parties, net as of June 30, 2016 and December 31, 2015 consisted of the following (table in millions):

	June 30, 2016	December 31, 2015
Due (to) related parties	\$(49)	\$ (68 )
Due from related parties	145	142
Due (to) from related parties, net	\$96	\$ 74

Income tax due (to) from related parties \$10 \$ (18 )

Balances due to and from related parties, which are unrelated to tax obligations, are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from related parties is governed by the tax sharing agreement with EMC.

## Notes Payable to EMC

We and EMC entered into a note exchange agreement on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The total debt of \$1,500 million includes \$450 million that was exchanged for the \$450 million promissory note issued to EMC in April 2007, as amended and restated in June 2011.

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 three and six months ended June 30, 2016, \$7 million and \$13 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2015, \$7 million and \$13 million, respectively, of interest expense was recognized.

## Pivotal

During 2013, we transferred certain assets and liabilities to Pivotal in exchange for preferred equity interests in Pivotal's outstanding shares. As of December 31, 2015, our ownership interest in Pivotal was 28%.

In April 2016, we contributed \$20 million in cash to Pivotal in exchange for additional preferred equity interests in Pivotal. As of June 30, 2016, our ownership interest in Pivotal was 17% and continued to be accounted for under the cost method. The decrease in our ownership interest was a result of investments made by other investors.

## Liquidity and Capital Resources

At June 30, 2016 and 2015, we held cash, cash equivalents and short-term investments as follows (table in millions):

	June 30, 2016	June 30, 2015
Cash and cash equivalents	\$2,991	\$1,791
Short-term investments	5,674	5,205
Total cash, cash equivalents and short-term investments	\$8,665	\$6,996

As of June 30, 2016, we held a diversified portfolio of money market funds, time deposits and fixed income securities totaling \$8,123 million. 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 domestic and international 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 June 30, 2016, our total cash, cash equivalents and short-term investments were \$8,665 million, of which \$6,599 million was held outside the U.S. 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.

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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 meet normal operating requirements for at least the next twelve months. While we believe our existing cash and cash equivalents and cash to be generated by operations will be sufficient to meet our normal operating requirements, our overall level of cash needs may be impacted by the number and size of acquisitions, investments and stock repurchases. Should we require additional liquidity, we may seek to arrange debt financing or enter into credit facilities.

Our cash flows summarized for the six months ended June 30, 2016 and 2015 were as follows (table in millions):

	Six Months Ended June 30, 2016		2015
Net cash provided by (used in):			
Operating activities	\$1,297		\$999
Investing activities	(776 )	(404 )	
Financing activities	(23 )	(875 )	
Net increase (decrease) in cash and cash equivalents	\$498		\$(280)

**Operating Activities**

Cash provided by operating activities increased \$298 million during the six months ended June 30, 2016 as compared to the same period in 2015, driven by changes in accounts receivable resulting from increased cash collections during the six months ended June 30, 2016. Additionally, cash provided by operating activities during the six months ended June 30, 2015 reflects payments for legal settlements, primarily \$76 million for the GSA settlement. These increases were partially offset by an increase in cash payments for employee-related expenses including salaries, bonuses and commissions, resulting primarily from growth in headcount, and increased severance payments as part of our realignment plan.

During the first quarter of 2016, we made our final installment payment of \$29 million to certain key employees of AirWatch.

**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 impacted by the sales and maturities of our available-for-sale securities.

Cash used in investing activities increased \$372 million during the six months ended June 30, 2016 as compared to the same period in 2015 primarily as a result of the increase in net cash used related to net purchases of our available-for-sale securities and an increase in cash used in business acquisitions of \$38 million. These increases were partially offset by a decrease in additions to property and equipment.

**Financing Activities**

Cash used in financing activities decreased \$852 million during the six months ended June 30, 2016 as compared to the same period in 2015 primarily because we did not execute any repurchases of shares of our Class A common stock during the six months ended June 30, 2016 due to legal and regulatory constraints resulting from the proposed Dell Acquisition.

**Notes Payable to EMC**

As of June 30, 2016, \$1,500 million remained outstanding on notes payable to EMC, with interest payable quarterly in arrears.

In connection with our acquisition of AirWatch, we entered into a note exchange agreement with EMC on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The total debt of \$1,500 million included \$450 million that was exchanged for the \$450 million promissory note issued to EMC in April 2007, as amended and restated in June 2011.

The three notes issued have the following principal amounts and maturity dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022.

The notes bear interest at the annual rate of 1.75%. Interest is payable quarterly in arrears. The notes may be prepaid without penalty or premium. We drew down on all three notes in late January 2014.

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### Stock Repurchase Program

From time to time, we repurchase stock pursuant to authorized stock repurchase programs in open market transactions or privately negotiated 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. All shares repurchased under our stock repurchase programs are retired. During the six months ended June 30, 2016, we did not repurchase any shares of our Class A common stock as we were subject to a number of legal and regulatory constraints resulting from the proposed Dell Acquisition, which impacted the timing and ability to execute repurchases of our shares.

During April 2016, our board of directors authorized the repurchase of up to an aggregate of \$1,200 million of our Class A common stock through the end of 2016. The aggregate authorized stock repurchase amount of \$1,200 million includes the amount remaining from our previous stock repurchase authorization announced on January 27, 2015, which was \$835 million as of June 30, 2016. Refer to Note J of the “Notes to Condensed Consolidated Financial Statements” for further discussion. We expect to repurchase the authorized \$1,200 million of our Class A common stock during the remainder of 2016, following the EMC shareholder vote on the proposed Dell Acquisition which occurred on July 19, 2016.

### 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 2015 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, including, without limitation, statements regarding expectations of, or our plans for: the IT industry transformation and our related strategic positioning; expected benefits to customers of our product and service offerings; sales growth in our newer products and services solutions; reinvestment of realignment-related savings; the impact of Denali’s proposed acquisition of EMC; slowing of total revenue growth in 2016 as sales transition to emerging products; the level of overall license revenues growth in 2016; impact on professional services revenues of expanding our ecosystem of third-party professionals with expertise in our offerings; impacts of employee-related expenses; continuing to be included in the consolidated tax group of EMC; indefinitely reinvesting our overseas earnings outside of the U.S. and not repatriating them to the U.S.; the sufficiency of our liquidity and capital reserves to fund our normal operating requirements; our ability to generate positive cash flows from operations; our ability to obtain liquidity, arrange debt financing or enter into credit facilities, should additional liquidity be required; the effect on us of the resolutions of pending claims, legal proceedings and investigations and other matters described in Note I of the “Notes to Condensed Consolidated Financial Statements”; and the level of expected stock repurchases in 2016.

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.

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### 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 June 30, 2016. See Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk” of our 2015 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.

#### Changes in Internal Controls Over Financial Reporting

During the second quarter of 2016, we completed the first phase of a new enterprise resource planning system implementation which included the general ledger, asset accounting, accounts payable, cash management and purchasing modules.

There were no other changes in our internal control over financial reporting during the most recent fiscal quarter ended June 30, 2016 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 EMC Corporation (“EMC”), including, among other things, Denali’s proposed acquisition of EMC (the “Dell Acquisition”), overlapping business opportunities, EMC’s ability to control certain transactions and resource allocations and related persons transactions with EMC and its other affiliated companies, are set forth below under the heading “Risks Related to Our Relationship with EMC and the Dell Acquisition.”

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-premise data center servers, which form the foundation for private cloud computing. As the market for server virtualization continues to mature, sales of our vSphere hypervisor product have begun to decline, and 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, our AirWatch mobile device management offerings and VMware Virtual SAN (“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. 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 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. The large majority of our revenues 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 has matured. 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 and network virtualization 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 inter-related and rapidly evolving, and we face intense competition across all the markets for our products and services. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do.

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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 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 and that complement and or compete with off-premises compute resources offered by competitors, 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 and certain vCloud Air offerings may compete directly with infrastructure-as-a service ("IaaS") offerings from various public cloud providers such as Amazon and Microsoft. 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 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 and OpenStack provide significant 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 significant 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 HP, IBM and Cisco.

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.

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

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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. 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 information technology (“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 addition, recent economic instability in Brazil, China and Russia has adversely affected our operating results in these countries, and our operating results may be further adversely affected if this economic instability continues or spreads to neighboring markets. 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. 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 revenues or recognize revenues from these customers until we receive payment, which could adversely affect the amount of revenues we are able to recognize and our cash flows in a particular period.

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 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 revenues 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.

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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 June 30, 2016, 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 revenues in 2015 and early 2016 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 revenues.

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 revenues or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our Class A common stock would likely decline substantially.

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

- fluctuations in demand, adoption rates, sales cycles (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 revenues 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 revenues and accounts receivable;
- our ability to process sales at the end of quarter;
- 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; and
- our ability to accurately predict the degree to which customers will elect to purchase our subscription-based offerings in place of licenses to our on-premises offerings.

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,

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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 significantly 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.

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

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

- difficulties in enforcing contracts and collecting accounts receivable and longer payment cycles, especially in emerging markets;
- difficulties in delivering support, training and documentation in certain foreign markets;
- tariffs and trade barriers and other regulatory or contractual limitations on our ability to sell or develop our products and services in certain foreign 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.

For example, recent economic instability in Brazil, China and Russia has adversely affected our operating results in these countries, and our operating results may be further adversely affected if this economic instability continues or spreads to neighboring markets. Additionally, the Chinese government is working to implement new network security standards that will require IT systems being sold into certain key sectors to be certified as “secure and controllable.” As part of that effort, in December 2014, standards were implemented in the banking sector requiring IT companies selling to Chinese banks to submit their software and other technology to intrusive security testing, include indigenous Chinese intellectual property and encryption technology in their software and disclose source code and other proprietary information to the Chinese government. Implementation of these standards was subsequently suspended in light of concerns communicated by banks and other parties. However, in 2015 and 2016, the government

has continued to enact or propose additional laws and regulations to address information and network security. For example, in July 2015, China enacted a State Security Law authorizing the government to implement a system for maintaining the security of networks and information, and it also published a draft cyber security law that proposed various specific information security and network security measures to enhance “cyber sovereignty.” In

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November 2015, the insurance regulator in China issued draft insurance cyber rules that would require insurance companies to have compliant encryption tools, secure and compliant hardware and software products, and data storage. 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. In June 2016, China's legislature tabled a second draft of a Network Security Law that contemplates data localization measures and other network security measures relevant to a vaguely defined scope of "key information infrastructure." 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.

Our current research and development efforts may not produce significant revenues 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 and VSAN virtual storage 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 revenues than we anticipate. Our research and development expenses were approximately 22% of our total revenues during the six months ended June 30, 2016. 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 revenues from these investments for several years, if at all.

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.

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

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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 an open source license 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 that is subject to possible appeal. 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, vCloud Air Network and integrated virtual desktop and mobile device) 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 revenues could be negatively impacted. Certain of our new product initiatives, such as our vCloud Air 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 revenues from subscriptions are 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.

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.

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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, EMC or Dell Inc. (“Dell”), which is in the process of completing its acquisition of EMC, 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 revenues during the six months ended June 30, 2016. 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 revenues 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 vCloud Air and SaaS offerings rely on third-party providers for data center space and colocation services.

Our vCloud Air and 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 vCloud Air and SaaS offerings would be impaired.

Joint ventures may not yield expected benefits and outcomes.

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



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

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

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

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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.

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 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 the merit of 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 of the "Notes to Condensed Consolidated Financial Statements" for a description of certain claims and litigation.

Improper disclosure of personal data could result in liability and harm our reputation.

Our business is subject to a wide variety of federal, state and international laws and regulations regarding privacy and protection of personal data. 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. The application of U.S. and international data privacy laws 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 who we may partner with. Any 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 or compromise of our security that results in the release of our customers' and employees' data could (i) subject us to substantial damage claims, (ii) expose us to costly regulatory remediation and (iii) harm our reputation and brand.

Proposed legislation and regulations could also significantly affect our business. There currently are a number of proposals pending before federal, state and foreign legislative and regulatory bodies, including a data protection regulation being considered by the European Commission that may include operational requirements for companies that receive or process personal data that are different than those currently in place in the European Union, and that may also include significant penalties for non-compliance. In addition, some countries are considering or have passed

legislation implementing data protection requirements or requiring local storage and processing of data or particular restrictions on the transfer of that data that could increase the cost and complexity of delivering our services.

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

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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. In June 2015, we reached an agreement with the Department of Justice (“DOJ”) and the General Services Administration (“GSA”) to pay \$76 million to resolve allegations that our government sales practices between 2006 and 2013 had violated the federal False Claims Act. As set forth in the settlement agreement, VMware denied the allegations and did not admit liability. 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 dispositions 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, and from time to time we dispose of businesses, products and technologies. These transactions 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 revenues, 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, 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;
- unidentified issues not discovered during the diligence process, including issues with the acquired business’s intellectual property, product quality, security, privacy practices, accounting practices, regulatory compliance or legal contingencies;
- maintaining or establishing acceptable standards, controls, procedures or policies with respect to an acquired business;
- risks relating to the challenges and costs of closing a transaction; and
- the need to later divest acquired assets at a loss if an acquisition does not meet our expectations.

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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 June 30, 2016, goodwill and amortizable intangible assets were \$4,031 million and \$577 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 customers, fulfilling contractual obligations 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. For example, we are in the midst of a multi-year project to replace 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. Any disruptions relating to our systems enhancements, particularly any disruptions impacting our operations during the implementation period, could adversely affect our business in a number of respects. Additionally, 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 United States and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues 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 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 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, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations, changes in the composition of global earnings, the expiration of statute of limitations, settlements of audits, changes in our international organization and changes in overall levels of income before tax.

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 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 regulations in Ireland beginning in 2021, and we may proactively make structural changes that impact our tax rates prior to that date. The Organisation for Economic Cooperation and Development issued guidelines and proposals during October 2015 that

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also may change how our tax obligations are determined in many of the countries in which we do business. These potential changes could also adversely affect our effective tax rate.

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 revenues 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 significant 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 ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated standard is effective for us in the first quarter of 2018 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. We have not selected a transition method and are currently evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures.

**Risks Related to Our Relationship with EMC and the Dell Acquisition**

Our stock price has fluctuated significantly since the announcement of the Dell Acquisition, and its expected completion may adversely impact our business and stock price in the future.

On October 12, 2015, EMC and Dell announced the Dell Acquisition, pursuant to which Dell's parent company, Denali, would acquire EMC while maintaining VMware as an independent publicly traded company and issuing a tracking stock, Class V common stock, intended to reflect VMware's economic performance as partial consideration to the EMC shareholders. On July 19, 2016, EMC's shareholders voted to approve the acquisition, but the transaction has not yet closed. Upon issuance, the Class V common stock is expected to track the performance of an approximately 53% economic interest in the VMware business.

Our stock price has fluctuated significantly since the announcement of the Dell Acquisition. A number of factors relating to the Dell Acquisition could adversely affect our business or our stock price during the pendency or following the closing of the Dell Acquisition, including:

Once the Dell Acquisition is completed, Denali will be able to control matters requiring our stockholders' approval, including the election of a majority of our directors and the other matters over which EMC currently has control, as described in the risk factors below.

Following the closing of the acquisition, Denali could implement changes to our business, including changing our commercial relationship with EMC or taking other corporate actions that our other stockholders may not view as beneficial.

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

During the pendency of the Dell Acquisition, Denali has a right of consent to matters requiring EMC's approval under our certificate of incorporation, including acquisitions or investments in excess of \$100 million, and Denali may choose not to consent to matters that our board of directors and EMC believe 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 to be issued by Denali, while not a VMware issued security, would increase the supply of publicly traded securities that track VMware's economic performance and could create the perception that the Class V common stock dilutes the holdings of our public stockholders, both of which could put downward pressure on our



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stock price. The price of Class V common stock may be volatile immediately following its issuance as investors in EMC adjust their holdings and 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. Following the closing of the Dell Acquisition, Denali will be highly leveraged and may be required to commit a substantial portion of its cash flows to servicing its indebtedness. While Denali has publicly stated that it plans to leave VMware free to use its cash to invest in the VMware business, Denali's significant debt could create the perception that Denali may exercise its control over us to limit our growth in favor of its other businesses or cause us to transfer cash to Denali. In addition, if Denali defaults, or appears in danger of defaulting, on its indebtedness, the trading price of the Class V common stock issued by Denali 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 during or following the expected closing of the Dell Acquisition.

The pendency and expected consummation of the Dell Acquisition creates uncertainty for our employees, which could make it difficult to attract and retain employees.

The pendency and expected consummation of the Dell Acquisition could distract management's focus from executing on other strategic initiatives.

The Dell Acquisition creates potential litigation risk. Various lawsuits have been filed against EMC and others in connection with the Dell Acquisition, including two in which the Company and our directors are named as defendants. It is possible that we or our Company's directors may be named in other lawsuits.

Holders of our Class A common stock have limited ability to influence matters requiring stockholder approval.

As of June 30, 2016, EMC owned 43,025,000 shares of our Class A common stock and all 300,000,000 shares of our Class B common stock, representing 80.6% of the total outstanding shares of common stock or 97.4% of the voting power of outstanding common stock. Through its ownership of the Class B common stock, which is generally entitled to 10 votes per share, EMC 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 EMC 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 (such as Denali, after the Dell Acquisition is completed) or a subsidiary of EMC automatically convert into Class A common stock. EMC's voting control over VMware will continue so long as the shares of Class B common stock it owns continue to represent at least 20% of our outstanding stock. If EMC's 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 EMC effects a 355 Distribution at a time when it holds shares of Class B common stock, its shareholders 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.

EMC or, following the expected close of the Dell Acquisition, Denali, 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 or its successor-in-interest (including Denali, when the Dell Acquisition is completed), 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 (including Denali, after the Dell Acquisition is completed) 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 Denali, after the Dell Acquisition is completed) to undertake a tax-free spin-off. Denali, after the Dell Acquisition is completed, or another acquirer or successor, if the Dell Acquisition is not completed and EMC is subsequently acquired or otherwise

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undergoes a change of control, will be 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 EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed) 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.

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.

EMC or, following the expected close of the Dell Acquisition, Denali has the ability to prevent a change in control transaction and may sell control of VMware without benefiting other stockholders.

EMC's voting control and its additional rights described above gives EMC (or Denali, after the Dell Acquisition is completed) 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, EMC (or Denali, after the Dell Acquisition is completed) 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 EMC. Accordingly, shares of Class A common stock may be worth less than they would be if EMC did not maintain voting control over us or if EMC did not have the additional rights described above.

If EMC's level of ownership significantly increases, EMC (or Denali, after the Dell acquisition is completed) could unilaterally effect a merger of VMware into EMC 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 June 30, 2016, EMC held approximately 80.6% of VMware's outstanding common stock, and EMC's percentage ownership of VMware common stock could increase as a result of repurchases by VMware of our Class A common stock or purchases by EMC (or Denali, after the Dell Acquisition is completed). 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 EMC or Denali (after the Dell Acquisition is completed) 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 Denali (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. Denali has publicly stated that from the completion of the Dell Acquisition through the two-year anniversary of its completion, it will not acquire 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 Denali.

We engage in related persons transactions with EMC and, following the expected close of the Dell Acquisition, we expect to 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 EMC (and, after the Dell Acquisition is completed, we expect in the future to engage in related persons transactions with Dell) that include joint product development, go-to-market, branding, sales, customer service activities, real estate and various support services. Additionally, we contributed technology and transferred employees to Pivotal Software, Inc. ("Pivotal") in 2013 and

continue to hold a significant ownership interest in Pivotal. For more information, refer to Note K of the “Notes to Condensed Consolidated Financial Statements” and “Our Relationship with EMC” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this periodic report and “Transactions with Related Persons” in the proxy statement for our 2016 annual meeting of stockholders.

We believe that these related persons transactions provide us a unique opportunity to leverage the respective technical expertise, product strengths and market presence of EMC 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 (or other transactions we may enter into with Dell after the Dell Acquisition is completed) may prove not to be successful and may

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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 EMC (or other transactions we may enter into with Dell after the Dell Acquisition is completed), 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 EMC and its subsidiaries (or, after the Dell Acquisition is completed, Denali 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.

Our business and EMC's and Dell's businesses overlap, and EMC and Dell may compete with us, which could reduce our market share.

We and EMC are IT infrastructure companies providing products and services that overlap in various areas, including software-based storage, hyper-converged infrastructure products and cloud computing services. Dell, which will indirectly control our company after the Dell Acquisition is completed, also provides products and services that overlap with ours in various areas, including in management and hyper-converged infrastructure products. EMC and Dell compete 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 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.

EMC or, after the Dell Acquisition is completed, Denali 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, EMC or, after the Dell Acquisition is completed, Denali 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 EMC and Dell in markets where we compete with them. In addition, EMC and Dell maintain significant partnerships with certain of our competitors, including Microsoft.

EMC's and 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 EMC and by the Dell Acquisition. We partner with a number of companies that compete with EMC or Dell in certain markets in which EMC or Dell participate. EMC's majority ownership in us, and Denali's majority ownership in us when the Dell Acquisition is completed, may affect our ability to effectively partner with these companies. These companies may favor our competitors because of our relationship with EMC and our potential relationship with Dell.

EMC and Dell compete 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, after the Dell Acquisition is completed, Dell may have the ability to impact our relationship with those of our partners that compete with EMC or Dell, which could have a material adverse effect on our operating results and our ability to pursue opportunities which may otherwise be available to us.

We could be held liable for the tax liabilities of other members of EMC's consolidated tax group.

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. Pursuant to our agreement with EMC, we and EMC 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 EMC's consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation 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. When we become subject to federal income tax audits as a member of EMC's consolidated group, the tax sharing agreement provides that EMC has authority to control the audit and represent EMC and VMware's interests to the IRS. Accordingly, if we and EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed) 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 EMC effects a 355 Distribution or other transaction that is subsequently determined to be taxable, VMware 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.

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We have been included in the EMC consolidated group for U.S. federal income tax purposes since our acquisition by EMC, and expect to continue to be included in such consolidated group for periods in which EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed) 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 EMC consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation 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.

We are still evaluating the potential impact of the pending Dell Acquisition on our tax sharing agreement with EMC and expect to amend the agreement following or in conjunction with the completion of the acquisition. Once the pending Dell Acquisition is completed, if it is subsequently determined that the tracking stock issued in connection with the Dell Acquisition constitutes a taxable distribution, VMware 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 EMC.

Disputes may arise between EMC and us in a number of areas relating to our ongoing relationships, including our reseller, technology and other business agreements with EMC, 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 EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed), and even if we do, the resolution may be less favorable than if we were dealing with an unaffiliated party.

The agreements we enter into with EMC may be amended upon agreement between the parties, and then in some cases only with the consent of Denali under the terms of the Dell Acquisition Agreement. While we are controlled by EMC and after the closing of the Dell Acquisition, Denali, 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 EMC.

Our CEO, our CFO and some of our directors own EMC common stock or equity awards to purchase EMC common stock that will accelerate upon completion of the Dell Acquisition and will receive shares of Denali Class V common stock in partial consideration for their EMC common stock when the Dell Acquisition closes. In addition, some of our directors are executive officers or directors of EMC, and EMC, as the sole holder of our Class B common stock, is entitled to elect 8 of our 9 directors. Ownership of EMC common stock and equity awards to purchase EMC common stock by our directors and the presence of executive officers or directors of EMC on our board of directors could create, or appear to create, conflicts of interest with respect to matters involving both us and EMC that could have different implications for EMC than they do for us. Under certain circumstances, ownership of Denali Class V common stock could also create, or appear to create, conflicts of interest with respect to matters involving us and Denali. Provisions of our certificate of incorporation and the master transaction agreement between EMC and us address corporate opportunities that are presented to our directors or officers that are also directors or officers of EMC. 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 EMC or, after the Dell Acquisition is completed, Denali, and we may be precluded from pursuing certain growth initiatives.

EMC's ability to control our board of directors may make it difficult for us to recruit independent directors.

So long as EMC or, after the Dell Acquisition is completed, Denali 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, EMC or, after the Dell Acquisition is completed, Denali can effectively control and direct our board of directors. Further, the interests of EMC, Denali 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 of EMC 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 EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC 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



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for such services with an unrelated third party. These costs are included as expenses on our condensed consolidated statements of income. Additionally, we and EMC engage in intercompany transactions, including agreements regarding the use of EMC's and our intellectual property and real estate, agreements regarding the sale of goods and services to one another and to Pivotal, and an agreement for EMC to resell our products and services to third party customers. If EMC 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 VMware, including the fact that VMware could lose the benefit of these arrangements with EMC. There can be no assurance that VMware would be able to renegotiate these arrangements with EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed) 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 EMC. Moreover, our historical financial information is not necessarily indicative of what our financial condition, operating results or cash flows will 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 EMC. During the three and six months ended June 30, 2016, we recognized revenues of \$126 million and \$236 million, respectively, and as of June 30, 2016, \$331 million of sales were included in unearned revenues from such transactions with EMC. For additional information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our condensed consolidated financial statements and notes thereto.

### 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. In particular, our stock price has fluctuated significantly following the announcement of the Dell Acquisition. Future announcements concerning these matters, the issuance of Denali Class V common stock upon the expected 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.

EMC, which holds 80.6% of our outstanding stock 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 EMC 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 EMC'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 issuance and trading of Denali Class V common stock, which will represent approximately 53% of the economic interest in VMware, will have on the volatility and the liquidity of VMware Class A common stock and how the Denali Class V common stock will trade in relation to the VMware Class A common stock. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted, including against us, and, if not resolved swiftly, can result in substantial costs and a diversion of management's attention and resources.

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

The trading market for our Class A common stock is influenced by the research and reports that industry or securities analysts publish about us, our business, our market or our competitors. If any of the analysts who cover us or who will cover the Denali 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, EMC (and after the expected close of the Dell Acquisition, Denali) 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;

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following a 355 Distribution of Class B common stock by EMC 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 EMC or its successor-in-interest (including Denali, after the Dell Acquisition is completed) no longer owns shares of our common stock representing at least a majority of the votes entitled to be cast in the election of directors, stockholders may not act by written consent and may not call special meetings of the stockholders.

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

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

(a) Sales of Unregistered Securities

None.

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

None.

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

In April 2016, VMware's board of directors authorized the repurchase of up to an aggregate of \$1,200 million of VMware's Class A common stock through the end of 2016. The April 2016 stock repurchase authorization includes the amount remaining from VMware's previous stock repurchase authorization announced in January 2015, which was \$835 million as of June 30, 2016. VMware's Class A common stock has been, and may in the future be, purchased pursuant to our stock repurchase authorizations, from time to time, in the open market or through private transactions, subject to market conditions. We are not obligated to purchase any shares under our stock repurchase program. Subject to applicable laws, repurchases under our stock repurchase program may be made at such times and in such amounts as we deem appropriate. 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 and regulatory requirements and other market and economic conditions. Purchases under our stock repurchase program can be discontinued at any time that we feel additional purchases are not warranted. VMware did not repurchase any shares of its Class A common stock as part of its publicly announced share repurchase program during the six months ended June 30, 2016.

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: August 8, 2016 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		
		Filed Herewith	Form/ File No.	Date
3.1	Amended and Restated Certificate of Incorporation		S-1/A-2	7/9/2007
3.2	Amended and Restated Bylaws		8-K	3/8/2011
10.28+	Consulting Agreement between VMware, Inc. and Carl Eschenbach effective as of April 11, 2016	X		
10.29+	Executive Retention Plan, adopted June 15, 2016		8-K	6/17/2016
10.30+	Letter Agreement between VMware, Inc. and Maurizio Carli effective as of April 1, 2016	X		
31.1	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	X		
31.2	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	X		
32.1	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	X		
32.2	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	X		
101.INS	XBRL Instance Document	X		
101.SCH	XBRL Taxonomy Extension Schema	X		
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	X		
101.DEF	XBRL Taxonomy Extension Definition Linkbase	X		
101.LAB	XBRL Taxonomy Extension Label Linkbase	X		
101.PRE	XBRL Taxonomy Extension Presentation Linkbase	X		
	+ Management contract or compensatory plan or arrangement			