

Red Hat, Inc. (RHT)

Leading Linux distributor; open-source software leader

SELL

Price: \$43.16 Price Target: \$25

Stock Summary

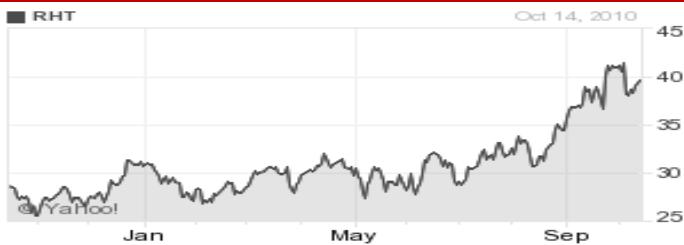
Market Cap (MM)	\$8.2B	52-week Range	\$25.45 - \$43.47
Historical P/E	95.45	1-yr Stock Return	65.22%
Forward P/E	47.96	1-yr S&P Return	13.57%
Cash Flow Yield	1.66%	Daily Volume	3.65m
Dividend Yield	N/A	Shares	191m
EV/EBITDA	41.20	Net Cash	\$669m

Company Summary

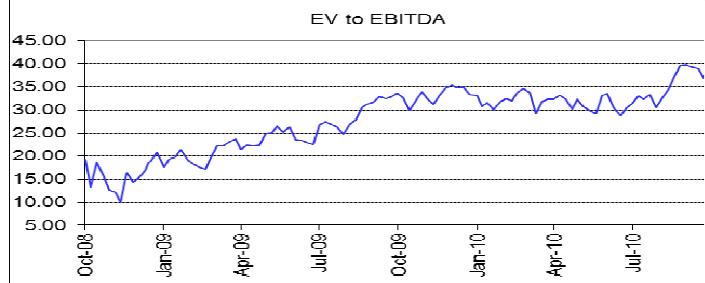
Red Hat is the largest distributor of enterprise Linux, commanding 70% of the market. It also offers JBoss—an application development software, which is an alternative to IBM's Websphere and Oracle's Weblogic. Linux and JBoss contribute about 80% and 10% to Red Hat's sales. These products are provided under open-source GNU General Public License, which means that Red Hat must offer the source code to public, thereby stripping RHT of any lasting competitive advantage.

Red Hat is aggressively diversifying into virtualization and cloud computing sectors to build differentiating products.

1 Year Price History for RHT



EV / EBITDA



200-day SMA and Bollinger Bands



Recommendation

Market has been bullish on Red Hat because of three key reasons—(1) likelihood of an imminent acquisition, (2) accelerating demand for Linux, (3) Red Hat's potential in application software and cloud computing sectors. I believe that an acquisition is unlikely, and competition in the product areas offered by Red Hat doesn't offer it the luxury of accelerating sales growth that seems to be priced in. Given these reasons, I believe that Red Hat is a compelling short candidate. My price target of \$25 represents about 40% return over a one-year horizon.

Key Reasons to stay away from Red Hat

1. Acquisition is unlikely

Ongoing consolidation in the technology sector seems to be the key driver of the stock for last 3 months, yielding returns of about 30% during the time period. An acquisition would make most sense for Oracle, as it is Red Hat's biggest channel partner. But, Oracle has focused on building its own version of Linux—Unbreakable Linux. This is the clearest indicator that an acquisition is not worth holding Red Hat for.

It is worth noting that Enterprise Linux, which constitutes more than 80% of its sales, is distributed under the GNU General Public License, which means that everyone can look at every line of source code. This lack of differentiation, combined with the low switching costs, means that an established company can simply rebuild Red Hat's business—calculations by analysts suggest that about \$2.5B would be sufficient to do this.

2. Linux's growth will not translate into Red Hat's growth

Much has been made about Linux's impressive sales growth, including IDC's forecast of 27% CAGR of Linux over next 3 years. Street is estimating that Red Hat's sales growth will track this statistic, given its dominant position. But, it is implausible to think that Red Hat will continue to maintain its 70% market share in a duopoly with Novell given the relative healthy margins of the business—85% gross, and 20% EBITDA margin, and the ease of upward integration by hardware vendors such as Oracle, HP and Dell, since Red Hat doesn't have a competitive moat.

3. Potential of new product areas are overstated

Street is excited about Red Hat's forays in application software, virtualization and cloud computing. JBoss, its application software indeed has a compelling value proposition, but it is worth remembering that, according to estimates, it contributes only about 10% of the overall sales. Its other forays—virtualization and cloud computing, are into crowded and competitive fields where the margins (10-12% EBIT margin) are well below Red Hat's (21% EBIT margin).

Valuation is over-stretched

Valuation is at a historic high with a forward P/E of 48, a meager cash-flow yield of 1.66%, and EV/EBITDA close to 41 (vs. historic average closer to 27 for last 2 years). It is one of the top 10 overbought stocks on NYSE and is trading well above its 200-day moving average, and in the top area of the Bollinger band. I did a DCF valuation assuming an average of 23% sales growth for next 5 years, a straight line decline to 4% for next 5 years, and 3% terminal growth rate—assumptions I believe to be sufficiently aggressive. This valuation suggests a share price of \$16, a 42% return based on the current share price.

Risks

1. Red Hat's brand as an open-source pioneer helps it retain clients
2. Oracle's increasing percentage of customers' purse (e.g. acquisition of Sun) forces customers to look for new vendors to avoid vendor lock-in
3. JBoss and DeltaCloud—Red Hat's cloud computing platform finds far more success than expected