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PRESENTATION

Operator

Please stand by for realtime captions. Good afternoon, ladies and gentlemen and welcome to Rackspace earnings release call. As a reminder this call is being recorded. At this time all lines are in a listen only mode to prevent background noise. After the prepared remarks there will be a question-and-answer session. (Operator Instructions) It is now my pleasure to introduce Bryan McGrath, Director of Finance for Rackspace. Mr McGrath, you may now begin.

Bryan McGrath - *Director Finance - Analyst*

Thank you. Good afternoon and thank you for joining Rackspace's first quarter 2011 earnings call. I am here today with Lanham Napier, our Chief Executive Officer, and Karl Pichler, our interim Chief Financial Officer. We issued a press release at the close of the market today with our unaudited financial results for the first quarter of 2011. If you do not have a copy, please visit the investors section of our website at rackspace.com where this call is also being webcast.

The primary purpose of today's call is to discuss the first quarter 2011 results. However, some of our comments today are forward-looking statements that involve risks, uncertainties and assumptions. If the risks or uncertainties materialize or assumptions prove incorrect, our results could differ materially from those expressed or implied by the forward-looking statements and assumptions. All statements other than historical facts are statements that could be deemed forward-looking statements. These risks, uncertainties and assumptions are described in Rackspace Hosting's Form 10-K for the year ended December 31, 2010 as filed with the SEC on February 22, 2011 and in Rackspace Hosting's Form 10-Q for the quarter ended March 31, 2011, expected to be filed this week. These forward-looking statements speak as of today. Except as required by law, we assume no obligation to update these forward-looking statements publicly even if new information becomes available in the future.

During today's discussion we will be using GAAP as well as non-GAAP financial measures such as adjusted EBITDA. Our GAAP results and GAAP to non-GAAP reconciliations can be found in the earnings release we issued earlier today, which is posted on our website as mentioned previously. Following our prepared remarks today, we will the open call for your questions. Okay let's get started. Lanham?

Lantham Napier - *Rackspace Hosting Inc - CEO*

Good afternoon and thank you for joining us today. In February, we outlined our plans to increase share in the massive hosting and cloud competing market while also improving business model to deliver better returns. During the first quarter, we made good progress on improving our business and on accelerating our growth trajectory compared to last year. Let's start with some of the highlights.

Number 1, revenue growth accelerated on a year-over-year basis to 29%, representing the highest growth rate since the fourth quarter of 2008 and grew 7.1% sequentially. Number 2, Cloud revenue, which now represents more than 16% of total revenue, grew faster in the first quarter on both a year-over-year and sequential basis. First quarter Cloud revenue of $37 million grew 93% compared to the first quarter of last year and 18% compared to the fourth quarter of last year. More and more of our customers are using both our virtualized and dedicated infrastructure offerings and we're changing the way we deliver our services as a result.

Number 3. Monthly installed base growth at 0.9% per month for the quarter is the highest level since the second quarter of 2008, right before the recession started to affect our customers and our business. This is a proof point that Fanatical Support has never been more important than during the economic downturn. When we serve our customers well they stick with and buy more. Number 4, we are also happy to announce that we added over 12,000 new customers in the quarter, a new record for us. Number 5, we recorded 230 new rackers to the team which is the highest number of new rackers since the first quarter of 2008 and deployed a record number of new servers in the first quarter. Last, we accomplished these growth milestones while also improving capital efficiency and our unit economics. Both revenue per server and capital turns improved for the seventh consecutive quarter.

As you can see, many of our most important growth metrics have returned to levels we haven't experienced since the recession began in mid 2008. We are a stronger and more profitable business today as we close the gap on $1 billion of run rate revenue. We have got that milestone in our sights and we're already laying the foundation for continued growth as we build the service leader in cloud computing. And for a comment about the atmosphere here at Rackspace, the energy level is the highest it's been in years. Rackers and our customers are the reason we are growing at a level we haven't experienced since the recession hit in mid '08. What's even more exciting is that our future has never looked brighter. We are making the right strategic investments to improve growth and maximize our long-term opportunity. And as always, we will remain disciplined about our approach to growth and investments.

As you all know, cloud computing represents a massive, essentially untapped, multi-billion dollar revenue opportunity for Rackspace. Our goal was to be the dominant service leader in the cloud computing market. The rest of this call is about what we are doing to get there.

Today, according to force research, only 13% of surveyed North American enterprises are currently outsourcing their entire IT infrastructure. That is changing. Thanks to the cost savings and agility that companies achieve when they move to cloud computing. Broadly defined as the delivery of IT as a service over the Internet. Forester predicts that the cloud market estimated $38 billion today will almost double to$73 billion by 2013. We believe this global shift of cloud computing represents the biggest market opportunity in all of technology. Within the broad market for cloud computing and hosting, we believe the most profitable segment will be the one that emphasizes high service levels. For business customers who want a trusted partner to guide them and take accountability for delivering a great outcome. Rackspace's mission is to dominate that segment.

In the last 2 quarters we have grown revenue at an annualized rate that is well above the 24% growth we generated in 2010. If we maintain this pace throughout the year, we would exceed the growth rate we delivered in 2010. Which is one of our primary goals for 2011. While we are encouraged by our initial progress towards achieving this goal, our growth rate is just one of the many aspects of our business that we are investing in to improve. Rackspace's value proposition continues to reside in providing customers with optimum technology outcomes and we do this through our culture of customer service called Fanatical Support. Running mission critical IT systems involves a very complex fusion of computing resources, software platforms and management tools. As well as a strong technical staff fluent in a diverse range of disciplines. Fanatical Support abstracts all the complexity is making these domains work together and combines them into a world class experience for our customers. In short, Rackspace's Fanatical Support leverages both the strengths of our systems and that of our employees to create the best technology service outcomes in our industry.

This service delivery strategy is the core of our differentiation and competitive advantage. We will continue to invest in this core and improve the value we deliver to customers because we believe the investments we make today are paramount to leading us towards our long-term goal of owning this huge market opportunity. In order to provide for faster growth, higher returns and maximize our long-term potential, we are making investments to, number 1, increase service levels in our portfolio. Number 2, increase the capital efficiency of the services we deliver. Number 3, build new capabilities to address new demand. And number 4, increase the capacity and capabilities of our sales organization.

Let's review the progress we've made in the first quarter across these four areas. RackConnect, which is a networking product that enables hybrid hosting service customers to link legacy applications to our cloud, its a new capability that makes us more competitive in the market and improve capital efficiencies. Over 20% of our customers with dedicated infrastructure are using one of our cloud services. In a significant portion of new dedicated infrastructure customers chose Rackspace for this unique capability. Demand for our managed cloud product continues to be strong. Over 160 customers adopted the new service in the two weeks available in 2010. By the end of April, there were over 1,100 customers.

Crocs Incorporated, a world leader in innovative casual footwear, and Stussy, a global branded apparel company, are two of the newest managed cloud customers. This product represents a new capability that should address new demand while providing a higher service level that generates more revenue per compute input with good margins, without requiring additional capital. So, from an economic standpoint, the result is improved capital efficiency and higher returns. To date, the average revenue per customer is more than twice as large for cloud server customers without this initial managed service level.

Critical Sites is an example of a new service that enhances our service levels. Critical Sites represents our most comprehensive SLA. Which involves extensive application monitoring and is designed for applications that require the highest levels of performance. Like other offerings of enhanced service levels, Critical Sites generates higher revenue with similar margins, but is not required incremental capital to be deployed. The net result is improved capital efficiency and thus higher returns. We now have over 15 Critical Sites customers, many of which are enterprise sized organizations. Our most recent new product introduction is Rackspace Cloud Load Balancers. With this offering, businesses of all sizes can now have access to a new cloud-based load balancing solution that gives them the ability to scale applications or quickly build high availability configurations. Rackspace customers benefit from being able to intuitively set up a load balancer in minutes, while cost-effectively providing application fault tolerance. Introducing Cloud Load Balancers should help us both address new areas of demand, as well as improve capital efficiency. Almost 300 new customers adopted Cloud Load Balancers in the first two weeks the product was available and we are optimistic that demand will continue to be strong.

In January, we launched our cloud service in Europe. Like its US counterpart, the European cloud is intended to increase capital efficiency and make us more competitive in the market. Since the launch of the European cloud infrastructure service in January, over 3,000 customers have adopted the offering, including system tracking experts, Phantom, and content management specialists, Juicy Media. Over time, the European cloud will serve as the foundation for us to layer on higher service levels to further improve capital efficiencies and returns.

OpenStack, the open source cloud project launched by Rackspace and NASA, achieved a number of important milestones in the quarter. At last count, there were more than 20,000 downloads of the software platform in 60 participating partners with Cisco, [Kanautical], Korea Telecom and others joined the community in the first quarter. In March, we launched Rackspace Cloud Builders. A new business that offers training certification, deployment and ongoing support services for organizations running the OpenStack platform. This new service offering will enable Rackspace to extend Fanatical Support beyond the Company's data centers to any OpenStack cloud deployment. This capability is squarely aimed at improving capital efficiency as it enables Rackspace to generate support revenue without deploying capital. Cloud Builders is just the first of many new innovations planned around the OpenStack platform in 2011, so expect to hear more as the year progresses.

And finally, let's review some of the progress we have made with enhancing our sales organization. Our enterprise traction continued this momentum during the first quarter with both new customers and upgrades. Two of the new enterprise customers added in the quarter are Mazda USA and Sylvania. Mazda is using Rackspace's private cloud and SAN managed storage services and Sylvania is leveraging Rackspace to run a SharePoint 2010 configuration. We also performed a significant upgrade to one of our enterprise customers, Aon Corporation. In order to meet the needs of one of Aon's key strategic clients, Aon needed Rackspace to re-architect their network and deploy visible service rapidly. This is something that we are purpose built to deliver.

With regard to our channel sales group, in March we launched an enhanced partner program that combined all Rackspace offerings into one unified partner program. This change is aimed at significantly increasing across selling opportunities by making it simple for all of our channel partners to offer all of our product lines under one agreement. We have over 4,500 partners participating in the new program. And March was a record bookings for our partner sales channel.

In summary, we made good progress on improving our business and accelerating our growth profile during the quarter. All of this is due to the hard work that rackers due to earn our customers trust. I want to thank rackers for their commitment to our cause and thank our customers for placing their trust in ours. Now I will hand the call over to Karl who will take us through our financials. Karl has successfully stepped into the interim CFO role and is off to a great start. Karl?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Thank you, Lanham. As we highlighted earlier this year, our goal for 2011 is to improve our business model and to become more competitive to seize the massive market opportunity ahead of us. While also improving the economics of our model by becoming more capital efficient. We will do this by making the right investments to further increase our service level capability and to enhance our product portfolio by rolling out new products. We also told you that successful execution of our 2011 business plan should result in one, revenue growing at a faster rate than the 24% annual growth rate that we delivered in 2010. And two, maintaining our 2010 margin profile by reinvesting incremental profits into the areas that we just discussed. With the first quarter behind us, I am pleased to say that we are on track to hit these 2011 goals.

We also explained that in our model we do not expect to burn cash with annual revenue growth rates below 35%. That relationship still holds true, however, in 2011 we may burn a minimum amount of cash even if we grow slower than 35% because we are building out the final phase of our data center we own in the UK and we are consolidating our San Antonio headquarters.

Moving onto the detailed financial results. For the first quarter, total revenue was $230 million, representing 7.1% growth from the fourth quarter and 29% growth compared to the first quarter of 2010. Change in currency exchange rates quarter-over-quarter had positive impact on revenue of approximately $700,000 sequentially and a positive impact of $1.4 million on a year-over-year basis. On a constant currency basis, revenue grew 6.8% quarter-over-quarter and 28% year-over-year. Total installed base growth was 0.9% in the quarter, which is an improvement from 0.6% in the fourth quarter and the highest rate we have generated since second quarter of 2008. Managed hosting revenue increased to $193 million, representing 5.2% sequential growth and 21% growth on a year-over-year basis. Growth in managed hosting was driven by continued traction with enterprise customers and demand for our higher service level offerings.

Cloud revenue for the quarter was $37 million representing18.1% sequential growth and 93% growth on year-over-year basis. As in prior periods, Cloud growth was driven by a combination of new customer options and higher usage from existing customers, as well as the first full quarter of the managed Cloud services and contribution of UK Cloud business. We continue to see more of our customers adopt services across both of our dedicated and Cloud infrastructure offerings. As more and more of our customers leverage RackConnect and draw a mix of managed and Cloud services, the line separating the two services will continue to blur. This trend is changing the way we deliver services to the customers, the way we measure performance and, therefore, the metrics we track to manage the business. In total, we added over 12,000 new customers in the quarter, bringing our total installed base to more than 142,000. As Lanham indicated, this is the largest number of new customers Rackspace has ever added on an organic basis in one quarter.

Moving on to profitability. Adjusted EBITDA grew to $76 million in the quarter, representing 5.4% sequential growth and 28% growth on a year-over-year basis. Adjusted only for non-cash stock based compensation, adjusted EBITDA margin was 33% in the first quarter. Adjusted EBITDA and adjusted EBITDA margin were negatively impact by a non-cash charge of $3 million for the quarter relating to data center operating leases. Depreciation and amortization expense came to $44 million in the quarter. As a percent of revenue, depreciation and amortization represented approximately 19% of revenue in the quarter, which is consistent with the range it has been over the last two years of 19% to 21% of revenue. Net income came to $13.8 million in Q1, for a 6% margin, representing growth of 2.1% sequentially and 41% from the first quarter of 2010. Capital expenditures totaled $77 million in the quarter. Of this amount, we spent $46 million on customer gear, $9 million on data center build out, $3 million on our office facility and $18 million on capitalized software development and other projects.

Looking ahead for the full year of 2011, we continue to expect total capital expenditures to be in the range of $275 million to $335 million, although we expect to end up in the upper range of the -- upper end of the range if we continue to grow at the rate consistent with the last two quarters. Adjusted free cash flow came in at negative $3 million in the quarter and we ended the quarter with a total cash balance of $134 million., up from $105 million at the end of 2010. Our total debt outstanding, including capital leases, was $135 million, which translates to a net debt position of approximately $1 million or net leverage of essentially zero.

In summary, during the first quarter, we invested across the organization to drive higher growth as well as increase our service level capability and enhance our product portfolio. We also made good progress toward our goal of accelerating revenue growth in the year. While we still have a lot to accomplish throughout the year, we are on the right track to deliver on our goals for 2011. With that, I will turn it over to the operator and open up for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will be from Jonathan Schildkraut with Evercore.

Jonathan Schildkraut - *Evercore - Analyst*

I have 2 questions here, and then I'll circle back into the queue. The first is, you did add a lot of rackers this quarter, 320. That was a very big acceleration looking back over a number of quarters. You did signal prior to this quarter that you'd be making investments into people to support the service levels and to grow sales. Could you tell us where you are in that process relative to this 320 rackers? And I guess that will give us some sort of view as to incremental costs as we go through the year.

The second question has to do with Cloud Builders. If you could dive a little bit deeper into maybe an example of a customer deployment around that, and how big the market opportunity you see there is? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. Let's start with the number of rackers we added. Jonathan, I think the real number was 230. In your question you said 320, so I think you just got those digits transposed. As we worked on our plan this year, like prior periods, we focus on the investments, and a big driver of the investments comes down to the people we hire. The largest investment here in our Company literally is in human capital across Rackspace.

So when we look at some of the areas we are investing in right now, there are areas in our product development team, specifically around some of the higher service levels we want to build out for Cloud. There are areas in our enterprise service capability as we look to improve the way we serve enterprise customers and really add new muscles to how we serve them. Additionally, we focus on customer acquisition capability in our sales and marketing teams for enterprise customers as well.

So when we build the plans, we focus on what type of roles do we have to fill, and we are more worried about what type of role we have to fill and being opportunistic about getting an A player into that role, than we are about the timing of it. So the way we run the recruiting for these critical jobs, is we look at it in terms of what are the most important roles we have to fill in order to execute on our plans. As we talked in the previous call, I was asked a question about what's the number one risk to our Company and executing our plan, and I think it is just flat-out us. I think it's execution risk at this point. One way we believe we can mitigate execution risk out there is to rapidly assemble the right players on the team for those critical spots.

There is a tension here as we do this, around doing it in a way that is sustainable for the culture. We think our culture is absolutely a competitive advantage here at Rackspace. We have to make sure we hire people that share our values, that we can assimilate them properly, and we can get them rapidly up to speed with respect to performing their job and adding value.

What you see in the first quarter was some really good work by our recruiting teams specifically, and by the hiring managers to be able to opportunistically identify the right folks and get them on board. We are pleased with what we have been able to do in the first quarter from a talent acquisition perspective. And believe that those talents will impact our ability to perform at an even better level as the year progresses. That is my answer to question number one.

The second question was about Rackspace Cloud Builders. Rackspace Cloud Builders is a relatively new addition here at the Company, and the thesis around Rackspace Cloud Builders is we want to enable OpenStack adoption. We believe that OpenStack is going to rapidly emerge as the open standard platform for cloud computing. It was a thrill for us to get to launch this project with NASA. And what Rackspace Cloud Builders is doing is helping us enable the deployment of OpenStack, specifically for enterprise customers. We have a number of customers and prospects that are talking to us about OpenStack. They want us to deploy OpenStack for them, and so we have to invest in this capability in order to that in a fanatical fashion for these customers.

Jonathan Schildkraut - *Evercore - Analyst*

Okay, great. If I could squeeze one more in. I also noticed that for the second quarter in a row, the percent of customer gear that you financed has been low relative to historical standards; this quarter it was at 41%. Does this underlie a shift more towards Cloud-focused business where maybe you can move away from branded boxes?

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Lanham Napier - *Rackspace Hosting Inc - CEO*

If you look at the form factor, in terms of our boxes, whether it is a branded box that we've consumed historically or more white box that we are getting straight from the factory. Across our compute platform, we are shifting into the more white box form factors, specifically when it comes to Cloud. Looking at the growth numbers we just posted, we talked about our Cloud business from a revenue perspective growing 93% year over year. So obviously that's the fastest growing form factor inside of our Company.

And so what you're seeing in a capital turns and business model point of view is the impact of our rapidly growing Cloud, and Cloud has some wonderful attributes to it with respect to the model. Okay, and so what we want to do at this basic compute layer is it has to be web scale, it has to be reliable, and it has to be at a great value. So far in the evolution of our Cloud, we have been able to do this by buying commodity gear, which you are seeing in some of these CapEx numbers.

Jonathan Schildkraut - *Evercore - Analyst*

Thank you for taking the questions.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure.

Operator

And the next question will be from James Breen with William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Just a couple of questions. One, with respect to the embedded base growth that came up again this quarter at 0.9%. Where can you see that going? I think the highest it had gotten was 1.5%, which would imply almost 40% growth as a company. Over time, sort of on the heels of Jonathan's question, you are building the team there. It seems like growth is accelerating, or accelerating again. Can you talk about those trends, and then also the relation to that to your margins going forward. Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. Let's start with install base. We will just do these one at a time. First of all, we are thrilled that it's up. Less than a minute just talking contextually about install base growth, how we measure it, and what it means to our Company. Installed base growth for us is basically comp sales for a retailer. This is a measure of are customers consuming more services that we provide net of churn. When we have an installed base growth of 0.9%, on an annualized basis we have current customers growing our Company about 10% a year, almost 11%.

If we look at the key metrics page in our release, we can see how this has trended up here lately. That most of last year we were at 0.5%, 0.6%, now we've taken a step forward at 0.9%. And previous calls we have talked about how the install base growth is an indicator of what's going on inside of our customer base, it's an indicator for the strength and demand that our customers have for our services. It's also our most profitable source of growth. So the most profitable customers around here are ones we already serve that buy more from us.

So one of the nice things about install base growth is it has positive impacts in a couple of areas. It's growth that can come in big chunks because you're talking about 140,000 customers in our base now. It also is growth that comes in a way that we are able to serve these customers well because we already serve them today. They are purchasing more as an indicator of their loyalty that we have with them. We're trying to build a customer loyalty advantage here at Rackspace, so installed base growth in many ways affirms the fact that our strategy is working.

With respect to how high can it go? Pre-recession, we had installed base growth of 1.5%, in some quarters. That is significantly higher than where we are today. During the depth of the recession, it basically almost went to zero. It was at 0.1% during some time periods. We've already seen it recover quite a bit. I think could it get back to pre-recession levels? Yes, we believe it could. That depends on our ability to execute our road map, and the macroeconomic strength around us. But we feel like it has that type of potential. Getting it back to 0.9% is something that we are thrilled about. We look forward to working on this, and seeing if we can get it to continue.

Your next question was the trade-off between growth and margin, and what do those trends look like. As we think about this issue today and where we are as a Company, when we think about the growth, the number one thing we want to satisfy is our making the investments to realize our dream of becoming a service leader in cloud computing. We think there is a massive opportunity in front of us, we believe the most valuable segment in the cloud market is going to be that service segment, the customer that wants a trusted partner to deliver these services to them, and we feel like Fanatical Support and Rackspace ought to be that Company. That is our number one objective, which is why we are very conscious about growth.

Now that being said, we don't want growth at all costs. And we don't want out-of-control growth. We want to build a good book of business here. It's about having customers that select us for Fanatical Support, that we can serve well so we can earn their trust and they can stick around for a long time.

As we grow faster, there are pressures on margins. We've talked about this in some of our prior calls, around the fact that as we make investments for growth, some of these investments are front loaded. And you've seen some of that in our numbers now. So when we talk about the previous question of making some of the product development hires, and the sales capability hires, that has an immediate impact on the margin.

And the reality today, we don't have all of those people up to speed and carrying their full quota yet. We certainly do have some margin pressure as we grow a little bit faster. What we hang our hat on and think about a lot is basically -- are we getting high-quality growth? Is this growth consistent with our model? Do we understand what is happening in the unit economics, and are we maintaining a disciplined approach?

James Breen - *William Blair & Company - Analyst*

Great, thank you.

Operator

Moving along, we will hear from Mitesh Dhruv with BoA.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Thank you for taking my questions. Two questions, one for Lanham and one for Karl. First for Lanham, since you have one full quarter of the managed Cloud under your belt, I was curious to hear from you any specific use cases that is driving that growth versus the base cloud?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. In general, the way I'd frame it for you is that these are customers that needed a higher service level for the app that they are running with us. I think what we are seeing here really is the first step down a long path to be able to increase our service levels on the Cloud form factor to run complex web apps. The load balancing service we just announced and talked about in our prepared remarks is another indicator of that. We have other items on our road map that will further bolster this. I think really what we are seeing in general is this is the first step along that path. These are customers that want more help from a partner taking accountability for the performance of the infrastructure.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Are these new customers who are porting to the managed cloud, or are these existing customers who are moving along and you are able to upsell them to the managed cloud?

Lanham Napier - *Rackspace Hosting Inc - CEO*

These are new customers to us.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Okay, and just for Karl. Karl, can you talk about what really changed in terms of your CapEx guidance, more specifically in terms of the cash burn to the extent that what really surprised you from last quarter that now we are seeing that if you, even if you don't grow above 35%, you may burn cash?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Yes, those are not really for prices. We talked about this extensively over the years, actually. That depending on how we finance our data center build out, that we have different break-even rates of growth with respect to free cash flow. And so we have in this first quarter and the second quarter, we're going to have some impact of the [Lonetree] data center build out. Lonetree is the last facility of all the facilities that we have where we spend a significant amount of our capital to build it out, whereas in the newer models that we have here in the US, we actually have a bigger proportion leased rather than spend on a CapEx perspective. So, I wouldn't call this a surprise, it's just the nature of the build-out spend that we have at different data center facilities.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Thank you. That's it for me.

Operator

Moving along we will go to Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks very much. A couple for Lanham. Lanham, we have seen a lot of consolidation in the industry with major carriers buying Terremark and Savvis. How do you expect that to change the nature of competition? Do you think there's an opportunity for

Rackspace here as these merger integration take place? Do you think the -- perhaps just give us a sense of the overall level of competition.

Then, staying on that theme, we had an outage at AWS recently. There has been some concern in the media about, is there more risk in cloud than maybe people had thought. Are you seeing any hesitation from your customers, or are they asking more questions post the Amazon issues? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, sure, let's talk about consolidation first. The landscape, from a competitive perspective, is certainly changing. The deals that have been announced here recently have absolutely changed our industry. To me it is very similar to what we went through in the hosting industry post 9/11 in tech rec, when our industry went through a wave of consolidation. I think it is happening again now. And what is driving it, from my perspective, is the market is realizing how big this opportunity is in cloud. I think they are also realizing it is hard to build one of these companies. And so people are trying to acquire assets in order to accelerate their progress.

From Rackspace's perspective, I generally think this stuff is clarifying and good opportunity. What I mean by that, I think it's clarifying because it sets forth what the differences are between companies, it makes our differentiation around Fanatical Support and Service Leader more distinct as these other companies get consolidated. I think it reinforces our commitment as a long-term player to this space. So that when customers sign up with us, they know we are going to be here. They trust us to run their mission-critical applications. I think in many ways it reinforces our leadership in the industry because at this point, of the pure plays out there, we are the last ones standing. The other folks have been consolidated. I think this opens the marketplace more for Rackspace.

With respect to the AWS outage. Yes, that was certainly big news. I think that we've, as a Company, had some communication with some of the press about this. Our perspective on it, I thought, was really well articulated by Lew Moorman, our President and Chief Strategy Officer. When he used the analogy of this outage for the industry is like an airplane crash. It is a tragic event. But airplane travel is still the fastest, safest, most efficient way to get there. The savings and the performance that people get from the cloud, we believe will continue to propel the industry forward. We think the cloud delivers better value and performance versus companies doing it themselves.

The reality is, I think, every day -- right now as we are on this call, there are many internal data centers having some sort of service disruption. But those never get reported. Right? But the cloud, because it is a high-profile hub, does get reported upon. From our perspective, I think the outage is a tragic event, okay? But I think that the industry will go on. We haven't felt any hesitation in customer conversations about doing it. So I think things from here will continue to march forward and the cloud will be adopted.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Okay, thank you.

Operator

And the next question will be coming from Chris Larsen with Piper Jaffray.

Chris Larsen - *Piper Jaffray - Analyst*

Hi, and thanks for taking the questions. I wanted to circle back to the internal growth rate that you talked a little bit about earlier. For clarification, does that include, if I begin to shift over to the managed cloud and other cloud services, was that captured in there as I'm a customer of both dedicated and then cloud services? And then in terms of what's driving this higher. I want to get a sense for, is it the mix of customers because we really haven't seen economic levels in the US tick up, and it seemed like the small businesses didn't really want to do anything. Is this a function of a good benefit here having moved into the larger customers?

And then, Karl, great to speak with you again. Question for you. The $3 million of difference between the cash and non-cash on the rent for the data centers, is that a good rate to carry forward into the second quarter?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, why don't I start with the install base growth, and what is taking place there and what is driving it. The short answer to your question specifically is yes. As customers buy more services from us, all of that is incorporated into this metric. So I don't remember your example specifically, Chris, but if you are a regular cloud customer and you upgrade to a managed layer of service in cloud, this is going to count in this metric. The metric really captures, if you look at our existing customers today, how much more are they buying today net of churn.

What is driving this, number one, I think we have a low share of wallet in our enterprise customers. So as we win more enterprise customers and earn their trust, they tend to have an accelerated adoption rate of install base growth for us. Number two, the new products we've launched are also driving this. We just talked about managed cloud in our prepared remarks, we talked about some others that we've launched. These new products and services enable our customers to spend more with us. One way to think about that is our share, as we roll out new services, our share of our customers' IT spend increases. Each new service basically increases our addressable market within our customers.

As we look more broadly, your comments about the macroeconomic strength, it is still a bit choppy. Yes, I think what is happening is the SMB part of our customer base is still a bit choppy relative to enterprise. Some of the fastest upgrade activity, some of the fastest installed base growth that we are seeing is taking place inside of our enterprise customer set.

Karl do you want to handle the next one?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Yes. Okay, Chris, good talking to you as well. The accounting expense actually, the way that this works is from a cash perspective we pay for the data center space that we need, which is actually great from an accounting perspective. What happens is the free periods and the build up over time is actually all taken into an overall spend for the lease period, and then straightlined over the lease period.

From an accounting OpEx perspective, you have more expenditures, more OpEx in the early years relative to the cash expense, and then vice versa on the back end of the lease duration. The good thing from a modeling perspective, is you can just take it forward because it's basically -- everything is straightlined, it just goes through.

Chris Larsen - *Piper Jaffray - Analyst*

Great, and then another quick follow-up. The $18 million on the software CapEx, is that a good rate to kind of think about $76 million for the full year, or anything that would make this quarter different than other quarters?

THOMSON REUTERS

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Sorry, I did not hear what you said. Can you ask the question again?

Chris Larsen - *Piper Jaffray - Analyst*

Sure, the $18 million you spent on software CapEx. Is that a good rate for the full year, or should we be thinking anything different 1Q versus other quarters?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Yes, the total range that we have communicated for the software expense is $50 million to $60 million.

Chris Larsen - *Piper Jaffray - Analyst*

Okay, so 1Q tracking a little bit ahead than the average?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Yes. That goes back to Lanham's point. There is the expense on the front end of the year. Also, the same argument applies a little bit to rent expense as we start utilizing that space, we actually have a leverage effect on that, because the rent is fixed but we generate more and more revenue off of it.

Chris Larsen - *Piper Jaffray - Analyst*

Absolutely. Thanks a lot. I appreciate it.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure.

Operator

Moving along, we will go to Gray Powell with Wells Fargo.

Gray Powell - *Wells Fargo Securities - Analyst*

Just had a few quick questions. So, touching on Chris's point. You guys have seen a good pick up in revenue growth over the last 2 quarters from the first 3 quarters of 2010. Can you just dig in a little bit more into the main drivers? Is it more of your new product offerings that is driving the improvement, or is it just sort of an improvement macroenvironment and enterprise customers getting more comfortable with your cloud type offerings?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes, this is Lanham. I think it's really a mix. What we have is, on the sales capability point of view, our ability to win larger enterprise opportunities is certainly better than it was a year ago. That has definitely increased. I think the new service capabilities we've rolled out dramatically expand our addressable market, and so having that opportunity out in the marketplace also drives our growth. I think the macro stuff is better today than it was a year ago, so that helps. I think the growth that we're seeing today is really more about the capabilities that Rackspace has added on a micro basis than it is about the macro recovery.

I think it's more about our strategy working as opposed to a broad macroeconomic recovery on a global basis. What we are seeing in the business today is, the cloud is growing at a high rate. Our service levels around the cloud are growing at a high rate. Our ability through RackConnect to stitch together hybrid offerings for legacy applications to tap into some of the performance promise of the cloud is something that's getting a lot of attention.

We talked on the call about our load balancing service that we just launched, and the traction that it got, literally in a 2-week period. What we are finding here I think is really more about the road map, the product road map that we are executing against, and the target segments we have identified within our enterprise opportunity. I think that's really what is making it happen today.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay. Then on the UK Cloud offering, it sounds like it is off to a good start. Just doing a quick analogy, if my math is correct, Cloud in the US, it's about 20% of US revenue in about 3 years. How should we think about the adoption in the UK tracking relative to that of the US?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Here's how we think about it internally. Obviously the UK market is significantly smaller than the US. If you just look at population or economic size. Based on our experience with the US market and the adoption curve for cloud technologies, we anticipate and are shooting for a similar adoption in the UK from a growth rate perspective that we experienced in the US. The thing that I like a lot more about the UK, given our -- is driven by our state of maturity as a Company, in that we will be able to follow up with managed cloud over there at a much faster rate than we could here in the states.

So by having the experience we have in the US with the cloud offering, already adding Windows and already adding the first managed service layer to it, we will be able to execute the road map in the UK much faster because the reality today is we are almost to the point where we have a global road map. So that when we roll things out, we are rolling it out for each market. So our expectation and hope for the UK Cloud business is that it will track to something similar to what we experienced here in the US.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay, thank you very much.

Operator

Next in queue will be from Scott Goldman with Goldman Sachs.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Are you still there?

Operator

We are not getting a response from that line. I will move to Colby Synesael with Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

First question has to do with the margins. Obviously, you are assuming some margin growth, obviously, in the back half since you are maintaining your guidance. I was wondering if you could talk about where that margin growth is going to come from. Is it simply just leveraging the sales hires that you made this quarter, and finally as you've said getting them to quota? Or is there something else there, perhaps product mix?

And then the second question has to do with M&A. I think going into 2011 you guys had noted that you would be more perhaps focused on M&A than we had seen in the last few years. Clearly you made the acquisition of Cloudkick at the end of fourth quarter of 2010, but I would have thought at this point you would've made 1 or 2 additional tuck-in acquisitions, and we haven't seen that. Just a little bit of commentary on what you're seeing out there in terms of your interest level.

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

Thanks. Okay, let me take the margin question first. As we repeatedly said, this year is a year of accelerating growth and building out our service capabilities. So the way that we are going to do this is basically take the incremental profit from the growth, and reinvest it in the business, and that is why we would certainly expect our margins to be not higher than in 2010.

Colby Synesael - *Cowen and Company - Analyst*

Did you say not higher than in 2010?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

That's correct.

Colby Synesael - *Cowen and Company - Analyst*

I thought the guidance was for essentially flat margin?

Karl Pichler - *Rackspace Hosting Inc - interim CFO*

That's correct. That's what we said last call as well.

Colby Synesael - *Cowen and Company - Analyst*

Okay.

Lanham Napier - *Rackspace Hosting Inc - CEO*

On the M&A perspective, we are absolutely looking at things. We just haven't found the right thing to do a transaction with. We will continue to be opportunistic in the marketplace. The types of things we are interested in are really around increasing our capability with a toolkit or a specific technology that we need to execute our road map. We are not interested, at this point, in large-scale acquisitions. So you referenced Cloudkick in the question. So something like Cloudkick we would love to do again. That has been a great addition of talent and technology. It is right in the center of our road map. We will look to do more like that, we just haven't found the right one yet.

Colby Synesael - *Cowen and Company - Analyst*

And is that just because you simply haven't found the right company, or because the companies you are finding, the price tags they are asking for are higher than what you think they are worth?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Good question. I think that there are some technologies out there we're stress testing quite a bit. For us, it is one part technology and one part people, in that the technology has to be good, but we have to feel really good about the people wanting to volunteer for our cause. We just haven't found that right combination. And sure, I'd reinforce your comment that there seem to be some valuation prices going on in the start-up world out there. That start-ups in the Valley are fetching high prices. We have certainly seen that as well, but that hasn't been the driver for us. The deals we are looking at relative to the rest of our Company, or Company value are actually pretty small transactions. So for us it's more about the capability, the technology capability, and the human capability that drives the deal for us.

Colby Synesael - *Cowen and Company - Analyst*

Okay, great. Thank you, guys.

Operator

The last question for today is from Scott Goldman with Goldman Sachs.

Scott Goldman - *Goldman Sachs - Analyst*

Hi, guys. Thank you for throwing me back on. I apologize for dropping off there. A couple of questions. I guess going back to a question earlier on revenue growth. Lanham, I'm just wondering what your thoughts were in terms of whether you need to introduce additional products in the pipeline this year in order to maintain your current level of growth, or whether the managed cloud, the Critical Sites, the UK Cloud, so forth and so on provide sort of the ARPU lift in demand to help you maintain the current level of growth? Then wondering if maybe you could talk a little bit about the collaboration you have with Equinix and Dell in terms of promoting the OpenStack, how the early reaction has been to that, and whether there is other channel opportunities to expand awareness of that going forward?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, great. In terms of the growth, when we outlined our plans for this year, we talked about growing at a faster rate. And what is driving this revenue growth, on the one hand, is executing the road map around the products we launched last year. So last year we had a number of products that hit the market, and the way it fell, we really did not get all the benefit we could from them. This year we have a full year with some of those products.

We also have a road map this year of products that we are going to execute and launch. One of them being, we already talked about, being the load balancing as a service product.

Now if you look at our business model, the vast majority of our revenue we are at 99% recurring revenue model. So the marginal growth we have been achieving provides pretty darn good analytical visibility into what is happening inside the Company. So as we think about our growth today, we think that we have a good base as a result of the growth we generated last year, the new products we launched last year, and the products we have already in the pipe this year and recently launched.

I think we also have, as we look at this growth and what is driving it, I think the new products that we provide from here on out will be sort of incremental to what we can do. We talked on the call already about install base growth. That is a tremendous tailwind for our growth. When we get installed base growth climbing like it had, like it did this past quarter, that really helps in future periods.

Our perspective right now is, the number one risk in our growth is our ability to execute. Based on the work we did last year, we like our chances, growing faster this year than we did this last year. We have more stuff to do this year with respect to our product road map that are also important things, and it's not just, from our perspective, about this year's revenue growth. It's really about our competitiveness in the market, and our ability to win the right customers, and build the service leader on cloud computing.

The revenue growth this year is important, I think, for investors as they evaluate us, but the real driver here for our economics and market value of our Company is getting competitive in the marketplace. If we successfully build the service leader on cloud computing, this is going to be a Company worth 10X where we are today. From this type of change, a web giant ought to emerge, and so this is a tremendous opportunity for us. And our ability to seize this entirely resides around our ability to build the right products, serve customers well, and generate incredible customer outcomes that drive loyalty. From our perspective, it's not as much about the revenue growth right now as it is about our ability to build a service leader on cloud computing, and pursue this dream about building a web giant that is significantly larger than we are today.

Scott Goldman - *Goldman Sachs - Analyst*

And on OpenStack?

Lanham Napier - *Rackspace Hosting Inc - CEO*

On the OpenStack collaboration, what you are seeing here is our ability to interact with technology thought leaders and enterprise technology providers in a new fashion. Historically, as a Company, we have integrated technology created from others and bundled it together into a seamless service experience for customers. This is still an important part of our model, but what we also have going for us now with OpenStack is customers and prospects are looking at us as a technology thought leader about how to best utilize and adopt this technology.

The announced collaboration with Equinix and Dell is really about putting together some of these basic building blocks for these prospects to start to experience, adopt, and test OpenStack environments. It is incredible to think about the ability in any Equinix facility around the world to deploy a box from Dell that is a special custom box from Dell for an OpenStack platform that Rackspace could serve remotely for any prospect that wants it. This is the kind of stuff that when we talk about extending the tentacles of Fanatical Support into on-premise computing, it's a partnership like this that has some of the building blocks to enable us to do that.

The level of excitement we have with OpenStack is that we believe OpenStack is going to emerge as the open standards based platform for cloud computing. We are a thought leader in that, we are an active participant in that community. Equinix and Dell are members of that 60 number we talked about in terms of other companies that are jumping on the bandwagon to support the movement. We feel like we have a lot of the right resources lining up around OpenStack, and our mission and purpose here inside of this technology category is to build services around it. As the market adopts OpenStack as the open source standard for cloud computing, for those customers that adopt it that want a world-class service level, we want to provide Fanatical Support to them.

So this is what we are after in the OpenStack marketplace. I think the collaboration with Dell and Equinix reinforce the fact that there is real traction and real interest in this. I was out at our OpenStack design summit just a couple of weeks ago out in California, and it was sold out, we had hundreds of people on the waiting list. There's real traction around this movement.

Scott Goldman - *Goldman Sachs - Analyst*

Great, and if I could just follow up with one other quick question. Just in terms of pricing of the services, I think maybe 6 months, 9 months ago we were talking about managed cloud being 2X on the ARPU side. I think Critical Sites is maybe 10%, 15% premium over its base product. Can you help us think about it? Sounds like managed cloud may be getting a little bit more than 2X, and how you think about how we should think about that. And then in terms of the load-balancing, what sort of benefits are you able to get on the ARPU front from these incremental services you are wearing on?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure, let's talk from a business model point of view. The basic driver here is the higher service level we can provide, the more value we deliver to customers and the higher price a customer is willing to pay. It comes down to fundamental price/value relationship. With respect to managed cloud, the 2X metric around a managed cloud customer's paying us 2X what a core cloud customer is paying us, that is still holding true today. Our belief is that our current service level on cloud is really just the first step of many steps to follow.

Similar thinking around Critical Sites, in that Critical Sites, the premium you talked about is still in place today, as we add more value, customers are willing to pay us more for those service outcomes. So we believe that construct and model still works. As we think about how this plays out going forward and what's going on with pricing, and such, our feeling is that so long as we focus on delivering incredible customer outcomes through these different service levels, that customers will reward us for that.

So far the ratios are holding, we believe we have more investment to do in here to actually try to add more value and capture more of that value, as we serve customers better. A lot of the road map that we work on, and the comments earlier when I talked about competitiveness, and it's not just about revenue growth, it's about competitiveness for us. Ultimately, competitiveness ought to show up in the revenue growth that we deliver for stockholders.

I think that what is happening with the road map is we have to maintain our focus and increase our service level capability because as we do that, it enables us to build a service leader on cloud computing. I think we are off to a good start. We love our position around it. We believe we can continue to invest and add more value for customers.

Scott Goldman - *Goldman Sachs - Analyst*

Great. Thanks, Lanham.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure.

Operator

Ladies and gentlemen, this does conclude the Q&A portion of the call. At this time, I will turn it back over to our host for any additional or closing remarks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, this is Lanham. To all of the investors and analyst community that tuned into the call, we want to say thanks for your interest. We will continue to execute our plan. For the rackers that are listening in, I want to thank you for all of your hard work. You continue to keep your head down, deliver incredible customer outcomes, and really set the right bar in our industry for providing Fanatical Support. Thanks, everybody, for listening and we will keep working. Goodbye.
