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RAX - Q4 2013 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting's Q4 2013 earnings call. As a reminder, this call is being recorded. At this time all lines are in 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 Jason Luce, Vice President of Finance for Rackspace. Mr. Luce, you may begin.

Jason Luce - *Rackspace Hosting Inc - VP of Finance*

Hello everyone. Welcome to Rackspace's fourth-quarter and fiscal-year 2013 earnings conference call. We hope you've had a chance to read our press release, which we issued earlier today. If you don't have a copy of the press release, please visit our Investor Relations page of our website at IR.Rackspace.com.

This call is also being webcast online and can be accessed through our Investor Relations site. For Rackspace on the call today will be Lanham Napier, Rackspace's Retiring Chief Executive Officer; Graham Weston, our Chairman and CEO; Taylor Rhodes, our President; and Karl Pichler, Rackspace's Chief Financial Officer.

I need to remind you that some of the comments we will make today are forward-looking statements, including statements regarding expected operations and business results, our growth plans and expectations, the impact of new platforms, products, or services, and our expected level of capital expenditures. These statements involve a number of risks and uncertainties that could cause actual results to differ materially.

These risks and uncertainties include things like: one, continued market acceptance of our public cloud platform and products; two, the continued adoption of OpenStack as the open source cloud computing platform standard; three, increasing competition in our industry; four, unfavorable economic conditions; and last, other risks that are described in our SEC filings. Please note that these forward-looking statements reflect our opinions only as of the date of this presentation, and we undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events.

Please also note that certain financial measures will be used during this call, such as adjusted EBITDA are expressed on a non-GAAP basis and that our GAAP results and GAAP to non-GAAP reconciliation can be found in our Earnings Release, which is currently posted on the investor page of our website at www.rackspace.com.

After our prepared remarks this afternoon we will be happy to take your questions. In the interest of time we'd be grateful if you would limit your questions to one.

With that, I'll turn the call over to Lanham. Lanham?

Lanham Napier - *Rackspace Hosting Inc - Retiring CEO*

Good afternoon everyone. Thank you for joining us today.

At the beginning of 2013, we said that our number-one financial objective for the year was to accelerate our growth rate. We got off to a slow start to the year but we battled back and made good progress toward this objective in the second half, culminating with revenue growing 5% sequentially in the fourth quarter. We're looking forward to executing on the 2014 strategic and financial plan that we'll share with you on this call.

In 2013, we made great progress toward our goal of being the best at serving the lucrative part of the cloud market that cares most about high technical service and performance outcomes. I am proud that we were able to end 2013 on a strong note, especially because today I'm announcing that I'm retiring from my role as CEO of Rackspace.

Let me take a few moments to explain the thinking behind my decision and how to think about what comes next. First, I want you to know that my decision was a difficult one. It required much soul searching and a thoughtful process with the Board, and I'm confident that it's the right choice. The truth is there's no perfect time for a transition like this one, but I believe now is as good a time as any, and there are number of reasons why.

Beginning with the launch of OpenStack, which is now the de facto standard for open-source cloud software, we embarked on the largest transition in our history. While there is still work to do, I am pleased with the progress we have made, the increased capability of our hybrid cloud offering, and the way that it qualifies us to compete for much larger opportunities. Our OpenStack public cloud now is competitive for workloads of any size, while our OpenStack private cloud is winning accelerated adoption from some of the world's biggest enterprises.

The transition has been challenging and has taken longer than we anticipated. But our ambitions for this game-changing transition are massive. I wanted to stay at the Company long enough to see the transition through, and I feel like we're finally over the hump.

Most of the heavy lifting has been accomplished, so the Company is positioned to continue forward. With the Board and Management team aligned around our strategy and financial plan heading into 2014, I believe now is a natural transition point and the right time for our leaders to advance the mission of making Rackspace a much larger and more powerful Company.

It makes it easier to step aside knowing that we have continuity within our team. Graham is stepping back in as CEO. A role that he held from 1999 until 2006 when he handed the CEO role over to me and focused on his role as Executive Chairman of the Board. From the time Graham co-founded the Company, he has been an active leader in Rackspace's growth and development.

It's great to see Taylor stepping into the President role. He's been an accomplished and inspirational leader in sales, support, and international operations. Graham and Taylor bring a deep knowledge of our Company and our industry. They have been intimately involved in the formation of our strategy and our 2014 financial plan, and our Rackers and customers hold them in the highest regard.

And on a personal level, I think it's time for me to make the transition. Along side an army of Rackers, I pulled this wagon with great pride for many years. We've exceeded the world's expectations and I'm proud of our accomplishments so far.

Now I need to move on and our team will guide Rackspace through the next stage of its journey. In thinking about that and reflecting on the other passions in my life that have taken a back seat to running this great Company, I decided that I'm now ready to make the transition. I intend to explore new things, both professionally and personally, and get back to my entrepreneurial roots.

These last 14 years have been the highlight of my professional career. I will stick around as long as I'm needed to help ensure a smooth transition. I'd also like to thank all of the investors and analysts on the call. You guys have done lots of work to understand our Company and I've enjoyed the process of working with you and I appreciate all the efforts you've gone through to understand Rackspace.

With that, I would like to turn the call over to our new CEO, Graham Weston.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Thank you Lanham. Let me start by saying that I'm personally grateful to Lanham for 14 years of partnership and friendship as we worked side-by-side to build this Company. Lanham led us from a tiny San Antonio startup to a global leader in the cloud computing, with more than $1.5 billion in annual sales, more that 5,000 Rackers working on five continents, an award winning, Fanatical Support culture, and more than 200,000 customers in 120 countries.

Every Racker has contributed to those accomplishments, but this level of success would not have been possible without Lanham. We all owe him a debt of gratitude for his leadership. While we will miss seeing him in the halls each day, we respect his decision to step down and turn his attentions to other interests and new ventures.

I'm honored to step back in as CEO while the Board conducts a thorough search for a long-term CEO. I'm confident that we will find strong candidates internally and externally. In the meantime, I plan to aggressively push Rackspace into our future, as one of the clear leaders in the emerging cloud market, an opportunity that I view as one of the biggest in the history of business.

I'm confident that our best days lie ahead, and I'm excited by the opportunity to lead the Company toward its bright future. I'm also excited to partner with Taylor Rhodes in his new role as President. Taylor is a proven leader who has led his teams to achieve impressive results through a variety of assignments at Rackspace in the US and abroad.

With the leadership team and the strategy we have in place, the powerful position we have established in the marketplace, I'm confident that we can make 2014 one of the best years of Rackspace's history. We will adapt our strategy to take advantage of opportunities as they arrive during the year.

We are quite clear on you how we will win. We will establish ourselves as the leading service specialist in the hybrid cloud, with clear differentiation from the do-it-yourself approach of the industry giants.

In 2014 we will continue to invest in our strategy of differentiating based on three core pillars. First, Fanatical Support, which positions us as the trusted choice for large and lucrative market segment that wants exceptional service and values performance, in contrast to the DIY, do-it-yourself approach. Secondly, hybrid cloud. Hybrid cloud leverages our leadership position in OpenStack and our heritage as the inventor of the managed hosting industry to offer each customer the right combination of the public cloud, private cloud, and dedicated hardware.

Finally, our position as the leading specialist in running open and standard technologies that our customers must use to achieve their performance requirements. We will invest in deepening our expertise and expanding our innovative offerings in rapidly-growing technologies such as modern data engines and eCommerce platforms.

We believe that this differentiation will position us well for the huge shift that is beginning to take place in the cloud marketplace. The early adopters of cloud computing were primarily do-it-yourself tech enthusiasts who were content with essentially renting access to raw IT infrastructure. Rather than focusing on software development at the core of their business, they also took on operational burdens of making that infrastructure work.

Today, a much larger wave of adoption is forming around a very different type of customer. Pragmatic businesses, millions of them around the world, these businesses will want software engineers to focus on developing work that differentiates them and drives their core business, rather than operating infrastructure and learning the endless succession of complex new tools. These customers will want a trusted partner to keep their IT operations running smoothly.

They will want expert advice as they move to a hybrid cloud architecture, and they will want specialists to help them leverage the latest tools to exploit big data and digital marketing.

One reason I'm so excited to step back in as CEO is that as I look at the coming wave of adoption by pragmatic business customers, I see an even larger opportunity for Rackspace than I saw when we launched the Company 15 years ago. This new wave of customers will need the right portfolio of cloud alternatives because they have a portfolio of applications and many of them have different needs. This is why the hybrid cloud model makes so much sense to them.

They will also need to rely on our expertise in the ever-changing landscape of open technologies that are being invented to make cloud architectures work. Unlike the early cloud adopters, the main stream market doesn't have this type of expertise in-house.

The 200,000-plus customers we have -- we serve today know that they can find cheaper do-it-yourself hosting with a few keystrokes, but they choose Rackspace because they know that our services and expertise deliver extra value for them. We believe the customers in the coming wave of the mainstream cloud adoption will discover the same value proposition.

At Rackspace, we are a Company of specialists. We specialize in helping customers find the best fit for their IT needs on the hybrid cloud. We specialize in deploying and running OpenStack private clouds, in the customers' data center or in ours. We also specialize in managing complex applications for big data, digital marketing, collaboration, et cetera, that our customers must leverage to be successful in their businesses.

Our foundation as a Company of specialists is built on our cultivation of a strong and innovative work culture, which enables us to attract and retain the best experts in key hybrid cloud technologies and applications. This is part of our secret sauce and one of the main reasons that we have staying power in our rapidly-changing market.

I am thrilled that Rackspace placed number 29 on this year's Fortune Magazine list of 100 Best Companies to Work For. We made the list seven years ago, and this year we jumped closer to the top number by five spaces.

We've won similar honors at Glassdoor.com, which by the way is a Rackspace customer, and from business publications in the UK. Thank you Rackers for all you're doing to make us great.

I'll now turn over the call to Taylor Rhodes, our President, to give a detailed overview of our plan for 2014.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Thank you, Graham. First I am honored to be Rackspace's new President, and I am very excited about the opportunities ahead of us. I'm confident that we have a very large opportunity and I am eager to get after it.

In 2013, we got off to a slow start, but we learned a lot and made key investments and our execution improved in the second half of the year. We focused on playing our game, targeting customers who value Fanatical Support, who need the performance that a hybrid cloud provides, and who choose to leverage our specialist expertise in running technologies that are critical to their business.

As a result, we began seeing a fatter sales pipeline build. We made important progress in leveraging the power of OpenStack as part of our hybrid cloud portfolio. One of our key milestones was surpassing 100 Rackspace private cloud customers in the back half of the year.

Many of those customers are large enterprises and they include some of the world's best known brands. This positions us as the leader in OpenStack private cloud, and proves the market demand for the hybrid cloud model. All of this activity is reflected in our strong results for the fourth quarter.

We are working to build on our success as the leading service specialist in an attractive and growing industry. As Graham discussed, we see a big wave of adoption building from companies who are just starting their move toward a hybrid cloud world. These customers will need a hybrid portfolio of services as they gradually move more workloads to the cloud.

They want to focus on their core business. They choose not to do everything on their own so that they can focus on what they do best. They want a partner who delivers Fanatical Support every step of the way, and they want specialist expertise in running the ever-expanding set of open technologies that are at the heart of cloud scale applications.

These customers are a great fit for us. Let me share with you three examples of recent customer wins. I'll start with DirecTV, which is one of the many customers who use the Rackspace hybrid cloud to achieve the performance they need and couldn't get at a public cloud-only vendor.

DirecTV as you know is a leading direct broadcast satellite service provider. It needed an infrastructure platform to test and develop a new generation of applications that must scale quickly while meeting stringent security requirements. Using our hybrid cloud solution, DirecTV deployed its security-sensitive workloads on dedicated infrastructure while using the public cloud for workloads with high-scaling requirements.

Our second example of a customer win illustrates one of the most exciting areas of specialization that we are building upon in big data solutions such as Cassandra, Hadoop, and MongoDB. Customers have told us that these databases are critical to their business but can be very hard to run at scale in a cloud world, so they're seeking our expertise and support. One such customer is SumAll, which provides real-time analytics for marketers.

SumAll integrates data from multiple sources Including Facebook, Twitter, Google, and PayPal, so its customers can see what matters all in one place. Today, SumAll tracks more than $4 billion in revenue, 290 billion social actions, and 190 billion sites for more than 100,000 businesses. SumAll started out running its critical open source MongoDB database on a large public cloud-only provider, but soon realized it could not optimize the performance of that database on the public cloud.

SumAll needed a purpose-built solution to enable performance and cost scaling, so it migrated its big data environment to Rackspace's ObjectRocket solution for MongoDB. The deployment, which began at two terabyte's has more than tripled and is continuing to grow. SumAll's leaders tell us that they love the value of Fanatical Support compared to the do-it-yourself approach they encountered at their former hosting provider.

Our final customer example, Swatch, is a customer that values performance, reliability, and security of our dedicated offerings, as well as our deep expertise in complex applications that are critical to its business. The Swiss watch maker is one of the world's most recognizable brands.

One of Swatch's most important applications is its eCommerce property, Swatch.com. This site utilizes a complex configuration of a Magento eCommerce engine with a MySQL database backend, two open technologies where Rackspace is a leader and can provide specialist expertise on top of the right infrastructure solution.

The customers we've mentioned here are pulling Rackspace toward our future as a Company. We are innovating in our portfolio and service levels to deliver powerful results for customers who value our specialist approach.

Other segments do exist in the market but we don't plan to pursue them. For example, when a customer wants to handle all of the tasks associated with operations and staying abreast of the rapidly-changing tools and technologies in the cloud world, while also working on software development, then Rackspace is not the right fit.

When unit price is the most important attribute in the customer's choice of a vendor we may not be the right fit for them. We understand that economics will always impact the performance to total cost equation, so we will remain competitive on total cost, but we will key in on the segment of the market that values support, specialist expertise, and performance more than anything else.

For 2014, we think successful execution will result in the following financial performance. We expect revenue growth for the full year to range between 15% and 18%. Given that much of our business operates on a recurring revenue model, we'll measure improvement in our revenue acceleration on a quarter-over-quarter basis throughout the year.

Our goal is to show improvement coming off of what we expect to be a seasonally lower Q1. Recall that our sequential growth in the first quarter of each year is typically lower than in subsequent quarters given cloud workloads spinning down after the holiday months and the usual reallocation of IT budgets starting a new year.

For Q1 we expect revenue to grow between 2% and 3.5%, as compared to 2.6% in Q1 of 2013. We will continue to invest in innovation through our technical engineering capabilities, software platform, and systems to enhance our overall power in the face of this huge market opportunity. With that in mind, our adjusted EBITDA margins are expected to range between 32% and 35% for the full year. This range includes all of the major operational investments contemplated in our 2014 plan.

We want to be clear that we have a lot of leverage in the cost side of our model, so unless we make all of the strategic investments in our plan, there's still plenty of upside to the margin profile. Due to seasonally-higher expenses in the first quarter each year, we expect adjusted EBITDA margins to range between 31% and 33% in Q1. Margins will likely improve in subsequent quarters.

We expect to demonstrate higher capital efficiency in 2014, with CapEx trending closer to 25% of revenue. This level of spending should be more consistent with 2012 and below the 30% of revenue level in 2013, which was a big investment year for us as we expanded our infrastructure footprint around the globe.

With those financial goals in mind, we want to express our absolute confidence in executing and delivering on our 2014 plan. We like our position in the market and we ended 2013 on a high note. We look forward to coming back in May to share our Q1 results with you.

With that, I will hand the call over to Karl Pichler, our Chief Financial Officer, to go through the financial details for the fourth quarter and full year of 2013. Karl?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Taylor.

For the fourth quarter of 2013, total revenue was $408 million, representing 5% growth from the third quarter of 2013, and 16% growth compared to the fourth quarter of 2012. Revenue from our dedicated business increased to $291 million in the fourth quarter, representing 3.9% sequential growth, compared to 1.2% sequential growth in the third quarter. Public cloud revenue for the fourth quarter was $117 million, representing 7.8% sequential growth, compared to 9.5% sequential growth in the third quarter.

Exchange rates had a positive impact on revenue of approximately $4.2 million, compared to the third quarter of 2013, and $0.8 million compared to the fourth quarter of 2012. On a constant currency basis, revenue grew 3.9% sequentially and 15% year over year. For the full year of 2013, total revenue was $1.53 billion, representing an annual growth rate of 17.2%, and 17.6% on a constant currency basis.

Moving on to profitability. Adjusted EBITDA grew to $132 million, representing 5.2% sequential growth and the margin of 32.4% in the fourth quarter, which was up from 32.3% in the third quarter, and down from 36.8% in the fourth quarter of 2012. Depreciation and amortization expense came to $88 million in the quarter, representing 21.5% of revenue, compared to 19.5% in the fourth quarter of 2012. Net income came in at $21 million for the fourth quarter, representing growth of 27.5% over the third quarter, and the margin of 5.1%, up from 4.2% in the third quarter.

Capital expenditures totaled $116 million for the quarter; of this amount we spent $65 million on customer gear, $23 million on data center build-out, $8 million on our office facility, and $20 million on capitalized software development and other projects. For the full year of 2013, total capital expenditures were $466 million, representing approximately 30% of revenue.

As Taylor mentioned in his prepared remarks, one of our goals this year is to improve capital efficiency by monetizing the infrastructure capacity that we put online in 2013. Specifically, our goal is to drive capital expenditures toward 25% of revenue by utilizing capacity we have built up this past year.

Adjusted free cash flow came in at $15 million for the quarter, and $34 million for the full year. Return on capital came to 9.6% in the fourth quarter and 11% for the full year, compared to 8% in the third quarter and 15.9% in 2012. We ended the year with a total cash balance of $260 million. Our total debt outstanding including capital leases was $58 million, which translates to a net cash position of approximately $202 million.

Let me take a step back and summarize what happened in the last year from a financial perspective. During 2013, we invested heavily in a business that we believe has large and long-term growth opportunities. Specifically, during 2013 we expanded our data center footprint domestically and internationally, we deployed large capacities in new geographies and some new products, we continued building out our software engineering and development capabilities, we acquired three companies, and we ran a branding campaign around OpenStack.

As a simple reflection of those investments, our margins and other key metrics are lower in 2013 than they were in 2012. However, our unit economics are intact, our growth is profitable, our balance sheet is strong, and the revenue opportunity is very large. As we leverage our assets and capabilities on a growing revenue base, our margin profile and key metrics will revert back to what we lay out in our target model, which we still consider to be relevant and accurate from a long-term perspective.

With respect to 2014, Taylor gave you specific pointers. For the first quarter, we expect seasonal revenue growth -- sequential revenue growth to be between 2% and 3.5%, or $416 million to $422 million in revenue. Adjusted EBITDA margins for the first quarter are expected to be in the range of 31% to 33%.

For the full year, revenue is expected to grow between 15% and 18%, or $1.765 billion to $1.8 billion in revenue. Adjusted EBITDA margin is expected to be between 32% and 35%. We expect capital efficiency to improve with CapEx to revenue trending towards 25%.

Two final comments on our cost structure for the year. One, please note that our current D&A charge of 21.5% of revenue reflects a good estimate of the D&A charges in the near future. Over time, when utilizing the capital base we've built up; this percentage is coming down.

Two, in keeping with our confidence in the market opportunity ahead of us, we will continue to use equity and option grants to attract and retain key talent for our business. As a result, share-based compensation expense can be expected to approach approximately 5% of revenue during 2014.

With this, I would like to conclude our prepared remarks. We are now ready for Q&A. Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We'll take our first question from Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thank you very much, and Lanham, best of luck for your future endeavors. Graham, if I could ask you to go through some of your key priorities for the Company over the next several months, and is there any change in strategy? Obviously the strategy's evolved here. Is there anything that you're really going to prioritize versus what perhaps the Company's been focused on over the last couple of years? And maybe you can provide a little bit more clarity over expected timing on the CEO search. Thanks.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Thank you. First, as we said during the prior part of the call, expect a continuation of the strategy that we've had in place this last year. I think it's important to understand that Rackspace has always targeted and served the pragmatist customers in the market. Not always the leading-edge customers, not the do-it-yourself customers.

This is what our core competency has always been and this allows companies to focus on what really matters in their businesses. That is our target market and it will continue to be so. That's really what Fanatical Support has always wanted to accomplish, and we'll deepen Fanatical Support by specializing on technologies where our customers need help in the cloud. And that's especially these emerging and new technologies.

Secondly, our hybrid cloud runs many applications better than the clouds that are multi-tenant only. So we'll continue to build our capability in the software, build more software that helps our hybrid cloud operate better, and help customers applications perform better. We're also going to capitalize even more in the coming year on our expertise around OpenStack. We're going to continue to run more and more private clouds for companies on-premise, and also deepen our expertise around open technologies.

So I think as far as the CEO search goes, I think one of the advantages of -- the fact that I've been Executive Chairman throughout this time and one of the founders of the Company, this allows us to do the CEO search in a -- with as much diligence as possible. We're not in a hurry to find a successor to Lanham; I'll remain in this role as long as necessary. We do have some candidates inside the Company that are very good candidates.

We also know that there are outside candidates that need to be considered, so a search has not really gotten under way yet. We're just at the beginning of that. I don't expect to make an announcement any time soon. We're going to take our time.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thanks a lot.

Operator

We'll go next to James Breen from William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Just two questions. One, to Lanham and Taylor. Given this transition of the Management, do you think there's increased execution risk here, given some of the troubles you had or challenges you had in late 2012 into 2013?

And then secondly, on the enhanced guidance now giving an annual number, what's your view on the risk side? Does this make it more manageable given it seems like we've had a lot of news flow by Google cutting pricing and Amazon cutting pricing. How do you relate some of that to where the guidance range is? Thanks.

Lanham Napier - *Rackspace Hosting Inc - Retiring CEO*

This is Lanham, I'll handle the first part of that with respect to the transition and what do we see in terms of any risk associated with it. I would say we have a lot of confidence around our team and it enables us to handle this transition smoothly and handle this announcement today in the manner that we're doing it.

If you look at our results last year, we brought Taylor back in the middle of the year. We gave him a larger role, and we all witnessed an improvement in our execution, culminating in the numbers we just turned in in the fourth quarter. And I think Taylor in his -- the team he's built around him get a lot of credit for that.

So I feel like as we went through that process of bringing Taylor back and parallel with that we worked on our strategy and financial planning for 2014, and it's arrived at a point where we are darn confident about where we are as a Company today. And so it's a pretty I think rare moment and opportunity here that we have Taylor as well as Graham. Graham being an Executive Chairman and co-founder of the Company, his fingerprints are all over this Company. So I think with the two of them in place we don't see the transition imposing a big risk on the Company.

Taylor Rhodes - *Rackspace Hosting Inc - President*

James, this is Taylor, I'll take the second part. I think you asked a question about how do we feel about the giants in the industry having a declared race-to-the-bottom pricing war, is that putting pressure on us, and therefore is that really driving our guidance range?

I would tell you that I think the way to think about us and always we've said this is, is every industry has large-scale players who are generalists and every industry has specialists who seek customers where we can solve more complex and more valuable problems, and therefore they're willing to pay us more. So you won't see any deviation from that thesis in our execution in 2014. In fact, I think some of the reason that we turned in stronger results in the back half of the year is we really got reoriented around that mission, playing our game, not playing the game against the large players in the head-on to their strength and scale.

So for us, we are going to continue to find those seams in the market where customers say, I have hard problems to solve. I need your expertise. I need a hybrid portfolio, not just one option, because I have a whole portfolio of applications. They're not all created equal. And we feel very comfortable, and the reason we provided the guidance we gave you, it's our best estimate of what we're going to go execute this year.

James Breen - *William Blair & Company - Analyst*

Great. Thanks.

Operator

We'll take our next question from Gray Powell from Wells Fargo.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Hi, thanks for taking the question, and Lanham, congratulations on your retirement. Been great working with you the last few years.

Lanham Napier - *Rackspace Hosting Inc - Retiring CEO*

Thank you.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

So I guess, a bigger-picture question. What do you see as the long-term return on invested capital for your business? Obviously the metric used to be around 20%, 2013 was a pretty big investment year. So I guess my question is, do you see the potential for returns to get back north of 20%?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes, Karl speaking. Hi. Thank you for the question. The short answer is yes, absolutely.

And let me elaborate a little bit on how we think about the creation of shareholder value here in this Company and what we mean when we say we're an [EVA] shop. So when you operationalize the concept into business, it's really about two core components. One is an opportunity to generate excess return on the business, and excess return is defined as returns that are exceeding your cost of capital.

And then number two is really applying that on as much business volume as possible, which is simply a reflection of growth. Those are the two components that we are constantly working on, in combination of the two, actually.

The excess return question is really a question of strategy, and our strategy has always been the one like Graham pointed out before, a strategy of specialists that provide the highest customer value, and that attracts the deepest profit pools in the industry. And we've been very successful at that throughout our history and we've, time over time, proven that we can actually tap into those profit pools and generate those excess returns.

When you take a step back and apply this whole concept then on the level of the Corporation, there are many costs on top of the unit costs that are incurred to build up capacity, to expand the reach of those products that are inherently very profitable, and to basically drive the long-term growth. And this is what we've seen specifically in 2013.

So the 2013 year was a year of trade-offs where we make a lot of investments that affect short-term ROC on a Company basis, but that drive huge growth opportunities going forward. And that's really what happened in the year, which is like an investment year where we built up capacity, where we built up capabilities that we can then leverage on a very, very large market.

So we certainly think that filtering out the impact -- the timing impact of these investments out of the numbers, we're still seeing return potential of 20% to 30%, and we are certainly not happy with the growth potential that we -- or the growth, actual growth that we see right now. So exit growth in excess of 20% is our next milestone that we're going after. So think about it as 2020, as a short hand for where we are, where we want to go back to very soon.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Got it. You actually touched on my next question. So if I look at the absolute dollar amount of sequential revenue growth, and I back out foreign exchange, this quarter was the best quarter you've seen all year, and it's the biggest change in the pace of growth that you've seen since 2010. So I guess -- I know you've done it, but can you talk about the main drivers and how sustainable you see that being in 2014?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Thanks, Gray, this is Taylor. I think we talked openly in the middle of the year about the fact that we needed to get reoriented toward our strategy. We spent a lot of time in 2012 and early 2013 doing lots of work to re-factor our product platform, retrain Rackers about hybrid cloud and public cloud, and some of those things impacted our pipeline generation, as humans can only do so many things. So we talked openly about that.

And in the middle of the year we really had a refresh and a honing and sharpening of our strategy around hybrid cloud and Fanatical Support and solving customers' hardest problems. We got the sales teams and the support teams reoriented toward that mission. It works, it developed greater pipeline depth.

We also brought in some new talent in Todd Cione to lead our America sales organization, and Rick Jackson as our Chief Marketing Officer. We told you about those two adds. And so look, we feel like we got some of the pistons firing and we feel good about continuation of that strategy going into 2014.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Understood. That's very helpful. Thank you very much.

Taylor Rhodes - *Rackspace Hosting Inc - President*

You're welcome.

Operator

We'll go next to Jonathan Schildkraut from Evercore.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Great. I'd also extend my gratitude to Lanham for all of the work over the several years. My question's actually for Graham. Graham, I'd love to get your perspective on the development of the overall cloud space.

When you look at Rackspace's results for 2013, you grew cloud 36%, 37% -- public cloud, 36%, 37%, and I'm wondering how you feel about that growth rate relative to what you think is going on in the broader cloud ecosystem. One of the things you guys said during your prepared remarks was that there's a certain subsegment of this ecosystem that you're really shooting after. And if that's a more appropriate subsegment to talk about, I'd like to hear about your views on that group in particular.

And then one last question, which is tied to the private cloud, because it sounds like you're having some really good success there and we did see some strong improvement on the dedicated side. Just wanted to make sure that if the private cloud stuff was falling into the dedicated side, we appropriately reflected that. Thank you.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Thanks, Jonathan. I think as far as the 35% growth, I think that there -- of course, we always want it to grow faster, but I think that it's important to understand that all of our strength has always been around serving the pragmatist customer. I think that an awful lot of the growth of the cloud so far at other companies has been serving the do-it-yourself company, the company that loves the science project that the cloud has given them.

There's a big company out there that brags about having created 22 open source projects that help them run another company's cloud. This is not our customer. It's important to understand that so much of the [enthusiast] of the cloud growth that's happening right now is very early stage, that is our customers are people who are looking for us to help them.

This is the pragmatist customer, the customer that really does not want to enter into the cloud as a big science project. And then once they want to go to the cloud, that the public cloud-only approach is just not good enough for many applications. So I think that in order to make a multi-tenant public cloud work for broad applications, you're better off running it on a hybrid cloud where you can put the workload on the right kind of infrastructure.

And so I think that -- that to me is -- so I'm really talking about two aspects of a wave that is coming. One is the pragmatist, we've just started the very beginning of the cloud and the pragmatist buyer, the wave of pragmatists is ahead. And secondly, the first wave of the cloud has been the multi-tenant cloud. I'm proud of our multi-tenant cloud growth, but really I think our future, I think the future of the whole industry is the hybrid cloud.

So to me those are the two -- we're starting to see that happen where people are coming over from other clouds. And to me, the idea that the hybrid cloud is the next kind of cloud that's coming and that the -- and our specialization in helping people run these technologies for pragmatist buyer, to me that means that that's the massive amount of market that's ahead. I think that we're going to look back and say that that was a much bigger percentage of the total cloud market in a decade than the early adopters. And the last question -- ?

Jonathan Schildkraut - *Evercore Partners - Analyst*

Was just the private cloud stuff, is that in your dedicated revenue line or is that also in the cloud?

Karl Pichler - *Rackspace Hosting Inc - CFO*

I'll take that, Jonathan. This is Karl. Yes it is, and for the following reason. This distinction is really a product distinction, and as Graham said, the best way to think about this is multi-tenant versus single tenant. And so the public cloud revenue is really that multi-tenancy and the private cloud is a single tenant thing, so it is listed in dedicated.

Jonathan Schildkraut - *Evercore Partners - Analyst*

But if we're really talking about a hybrid cloud going forward, and that being the right metric to analyze how you guys are executing, then maybe these historical distinctions are no longer meaningful in letting us have insight into the Company's execution.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

You're right, Jonathan, so many of our dedicated customers, in fact, a large percentage of them are running hybrid clouds now, and so you're right, those labels -- I think we're going to revisit those categories in the future.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thank you for taking the questions. I'll circle back in the queue.

Operator

(Operator Instructions)

We'll take our next question from Sterling Auty from JPMorgan.

Sterling Auty - *JPMorgan Chase & Co. - Analyst*

Yes, I wanted to follow up on that line of thinking. As you take a look at the guidance that you've given here for 2014, with the split and all the descriptions that you just made, how should we think about the reacceleration? Should it be reacceleration in both dedicated and cloud? Or will the mix skew to one versus the other?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Look, I think -- thanks, Sterling, this is Taylor. Look, we intend to use the whole portfolio. So we aren't going to break down for you today between the public and the dedicated in terms of our guidance. However, part of what makes this work for us is using the whole portfolio.

As Graham said, part of our advantage in the market is applications benefit from being able to leverage both multi-tenancy and single tenancy. We will use the whole portfolio. And as Graham said, we will revisit some of our thinking about our metrics and reporting in future Qs, and we'll have a dialogue with you about that.

Sterling Auty - *JPMorgan Chase & Co. - Analyst*

Because I think the big challenge that investors have had is you started off 2013 with a fall-off in dedicated because of the focus on the cloud. And given the back and forth, I think investors are just struggling in terms of how to really take a look at whether you're being more successful or struggling in the marketplace, so anything that you can do to help on that would be great. Thanks.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Sure. Thank you.

Operator

We'll take our next question from Siti Panigrahi from Credit Suisse.

Siti Panigrahi - *Credit Suisse - Analyst*

Hi, guys. Thanks for taking my question. I'm looking at the installed base growth. It has again decelerated to 1.1% this year. Just wondering what are the factors impacting that? And could you give some color in terms of enterprise adoption of the hybrid cloud and how is that going to help drive this particular line item going forward?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Sure. Thank you for the question. This is Taylor again. I think the way to think about that is with the addition of Todd Cione and Rick Jackson, again, our Head of Sales and our Chief Marketing Officer, in the middle of the year, my return from our international business, we really executed an acquisition strategy, a new customer acquisition strategy in the back half of the year.

So you saw growth and execution in the acquisition. I think you're seeing that the installed base growth declined from Q3 to Q4. But the way our model works is, as we feed more new customers into the base and deliver the Fanatical Support, that translates into healthier installed base growth and that upgrades, et cetera, in future quarters.

So we feel that also that things move around a bit as well as more of our business becomes a utility-based business with the cloud components, and so that's another factor.

Siti Panigrahi - *Credit Suisse - Analyst*

All right. Thank you.

Operator

We'll take our next question from Kash Rangan from Merrill Lynch.

Kash Rangan - *BofA Merrill Lynch - Analyst*

Hi Lanham, it was great working with you. Congratulations as well. Question for you, Karl. I think you said that 2020 plan, several years back at your Analyst Day at the NYSE, I think you talked about a combination of revenue growth rate, returns on capital at which you'd be self-sufficient, that is you would be able to generate all the cash and be able to fund your CapEx. Can you recapture for us in light of the changing business dynamics, how the tradeoff between an acceptable revenue growth rate, an acceptable EBITDA margin, return on capital, how those three metrics will triangulate. Thank you very much.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. Okay. So you're asking about the relationship between growth and returns and cash, right?

Kash Rangan - *BofA Merrill Lynch - Analyst*

Correct.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay. So basically, the underlying core relationship is that your ROC is basically determining the breakeven growth rate at which you start to burn cash. Very simply speaking it will be the equivalent rate. However, if you have a significant amount of excess capacity and your marginal rate of return is higher, that is really the one that you have to focus on.

So we may show returns at 10% level right now, but if our incremental flow-through is basically at 20%, 25%, 30% that is really what determines the cash flow breakeven rate. So the more accurate number is really what the marginal profitability or marginal returns is for that and if that is in excess of 20%, 25%, 30%, that's what basically is our growth rate, our breakeven growth rate from a cash flow perspective.

Kash Rangan - *BofA Merrill Lynch - Analyst*

Got it Karl. If it's okay, any color on number of OpenStack customers you have and how much revenue you're getting, that would be great? Thank you very much.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Hey Kash, this is Taylor. We're not going to break that out on this call. Thanks.

Operator

We'll take our next question from Tim Horan from Oppenheimer.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thanks, guys. Related to the OpenStack question, could you talk about customer adoption or roughly is that accelerating? Or with the pragmatist, what are the concerns now versus six months ago, what do you expect those concerns to be six months from now? Just an idea how things are going, what the main concerns are, what the adoption rate is? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Okay, thanks. Look, we're seeing really exciting trends with our Rackspace private cloud offer, which is an OpenStack-based private cloud. And you can think about that being driven by a couple of things. First off is many medium and large size enterprises still run almost all of their IT within their own corporate data centers. They are historically running on proprietary stacks like VMware, or a Windows stack or what have you.

So the traction we're seeing is, in 2012 and the first part of 2013, was very much a lot of proof of concept action. It was I know that I feel compelled to evaluate an open strategy for a cloud architecture. If I'm a CIO I want to become much more of a service provider myself to my internal business customers, and I need a cloud architecture to do that.

I also want an alternative to a very expensive solution, which is VMware or Windows stack forever. And so we saw a lot of proof of concept action in 2012 and early 2013, and now we're very happy to see that those proofs of concept are moving into production, and projects with companies like Fidelity and Workday and others who are working with us to design and deploy and provide support to the OpenStack cloud in their data center.

We think it's a wonderful market expansion opportunity for us. Historically, if you wanted to work with Rackspace you had to work within our data center. This gives us an opportunity to enter the customer's data center, help them with OpenStack, and then begin to create an interoperability between their OpenStack-based private cloud and our multi-tenant public cloud also built on OpenStack. So that's what we're seeing.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

We'll take our next question from Frank Louthan from Raymond James.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you. Could I clarify one thing quickly? You said in the guidance that -- is the capital intensity going to be closer to 25% or trending towards that through the year? And then on the sales side, what percentage of your salesforce is hitting quota currently in the quarter? Where was that compared to a year ago?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay, I'll take the capital question. So basically we have in the past given fairly explicit guidance around CapEx for the year, and for this year we've basically made a different choice. We've given you very specific guidance on revenue ranges, and so we've narrowed down on the CapEx, the extent to which we are explicit about CapEx.

But I think a good way to think about capital deployment is really, number one it's largely success-based and continues to be success-based. And two, there is a -- you can express this is as a simple relationship to revenue, and then recognize the fact that as we grow faster the percentage has to be higher and vice versa.

But what we've seen over the years is that we've basically fluctuated between 25% and 30%, given the pace of revenue or given the pace of capacity build-out, and 2013 was a year in which we built up more capacity than we've consumed. That's what drives the behavior of the metrics. And for the coming year or for this year we're in, 2014, we expect to basically burn off some of that capacity again.

So we're trending towards that 25%. Capital is kind of a lumpy thing. So it's not just going to fall back to 25% down, but we're basically improving that ratio towards that 25% number.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

And on the second part of that question, which was about salesforce hitting quota, look, I would characterize us as doing better in the second half of the year. Clearly, we added more dollars of revenue in the second half of the year than we did in the first half of the year. And so, look, our effectiveness of our marketing with Rick Jackson leading us to more targeted marketing, as well as sales execution was better. We still have room to improve. We've still got leverage on that cost base that we feel excited about going and getting in 2014.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay, great. Thank you.

Operator

We'll take our next question from Colby Synesael from Cowen & Company.

Colby Synesael - *Cowen and Company - Analyst*

Great. Thank you. My question just has to do with the revenue guidance, comparing -- and I guess EBITDA margin guidance, comparing the first quarter versus 2014. If you look at the guidance you gave for the first quarter relative to what you're expecting for the year, it does look like you're expecting both an improvement in revenue growth as well as margins.

I'm just curious if that's just the seasonality aspect that we see in the first quarter and the seasonality we typically see in the fourth quarter when both those metrics are also stronger, or is there something else there in the pipeline that's giving you the conviction that you will see that acceleration in growth through the course of the year?

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Thanks for the question. I think you can look at Q1 for the past couple of years and you can see that we've got some seasonal drivers in the revenue line, which is what we are guiding you for, as well as some cost reset in the EBITDA line that I think hit all companies, these are around employee-related expenses. So those are what is driving our guidance for Q1. And clearly if that is seasonal effect, then your geometric math is right and it suggests improvement after Q2.

Colby Synesael - *Cowen and Company - Analyst*

Okay, and then if I could add a quick follow-up. Taylor, as it relates to managed hosting you guys had called out going into fourth quarter that the third-quarter sequential growth was a trough and we obviously saw a nice improvement in the fourth quarter. Do you believe that that was in fact a trough now looking backwards and you would expect to see continued improvement in that metric?

Taylor Rhodes - *Rackspace Hosting Inc - President*

I think the way to think about it is as we said in our prepared remarks, we're going to measure success in driving improved sequential revenue growth. However, it is important to note that this will not be a pure linear equation. The cloud is a utility-based business, and as it becomes a bigger part of our revenue you'll see ups and downs, so I wouldn't say it's a pure linear equation.

Colby Synesael - *Cowen and Company - Analyst*

Great. Thank you.

Operator

We'll go next to Barry McCarver from Stephens.

Barry McCarver - *Stephens Inc. - Analyst*

Hey, guys. Good quarter. I guess I want to revisit Lanham's decision, given that the stock is in aftermarket trading off pretty steeply. Can you once again go over your thoughts on why now is the right time for you to step away and why as an investor should you not be worried about the timing and the decision to move on?

Lanham Napier - *Rackspace Hosting Inc - Retiring CEO*

Okay. This is Lanham. I think anytime we make this decision, I can at least give you the insights into how I made it. For me there are two dimensions, two primary considerations.

One is the Company itself, which gets to your investor question. And so when I look at the Company and its position in the marketplace, based on the comments that we prepared for the call and our answers here in this session, it was really important to me that the Company be in a good place as I contemplate stepping away. And so when I look at the Company being in a good place I think about the OpenStack transition that we've been through as a Company.

I think about the hybrid cloud portfolio and our opportunity in the marketplace. I think about Graham and Taylor and their role here. And so I look at those dimensions and the customer feedback we get every day from our net promoter scores, and I think the Company's in a good spot.

I think the Company has a good powerful place in the market. I think it's got a good future, I think Rackers are engaged. We just turned in 29 on the Best 100 Places to Work For list.

So when I look from a Company dimension, I feel like it's pretty strong and the transition we have in place is pretty darn seamless, because Graham and Taylor have been here a long time, and Graham's been Executive Chairman since the Company was founded, and CEO. So I think all that from a Company point of view looks pretty darn formidable to me, and I think from an investor point of view, you have those sort of qualitative factors. And then you have the communication we've provided on this call around the quarter we just turned in, and our outlook for the year as a Company and how we feel about that and where we have confidence in it, and why we have confidence. So I think from an investor point of view evaluating the Company itself, that's the first level.

I think then I got to a dimension around me personally, okay. And as I looked at that, this was a difficult decision for me. I mean, I've been here now about 14 years. I'm grateful for all the time I've had here.

This has been a business dream to get to join a Company when it was a $1.5 million startup, and now we just turned in $1.5 billion of revenue. That's a pretty darn special ride. And so when I ask myself will I ever want to do another CEO gig, I'm not sure I'd ever find another CEO gig as cool as the one I was just on where I got to work with people I cared about in a mission that I believed in that I think makes a dent in the universe. So that's a pretty tough thing to think about personally.

But the stuff that opened my mind to it is number one, it's been a 14-year climb, that's been a difficult climb, that being CEO of this Company is a 24/7 gig, whether it's a customer escalation on Easter Sunday, or something else going on, it's a 24/7 gig. And after a period of time that wore on me.

So I think where I am personally, is I'm passionate about funding education for first-generation Americans. I've got a foundation that does that. I'm going to go spend some time on that. I'm going to take a break for a while. And then I'm wired to build things, so I imagine I'll turn up some place building something else, probably here in San Antonio, Texas.

So that's how I see things and I think as an investor evaluating it, I'd look at the merits of the Company, the opportunity ahead, the power of the business model. When I think about on a personal basis I think about my family and where I'm needed and the blessing of having been here 14 years, and I think now's as good a time as any.

Barry McCarver - *Stephens Inc. - Analyst*

That's good info. Thanks a lot.

Operator

And we'll take our final question from Louis Miscioscia from CLSA.

Louis Miscioscia - *CLSA Limited - Analyst*

Thank you. You all signed up a lot of customers to consult, build, and run their data centers. I recently spoke to one that was very happy. I guess the question I would have is that can you repeat your long-term growth target, when do you think you might give us some color on the size of this business or when it might become a separate P&L? And is there a concern that this type of business is very people-intensive and will actually be a slower growth opportunity, and as you get to one of the out years will obviously impact your revenue growth? Thank you.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Okay. Thanks. I think you're referring to our Rackspace private cloud business, and I want to just clarify our business model so there's no misunderstanding. This is not that we go and build or take over and run entire data centers for our customers. So this is not the sort of legacy IBM global services or HP model, that is we take over data centers and we run them for you.

This is truly us providing expertise around OpenStack software and how it works and management layers, around hardware, et cetera, to be able to run an OpenStack-based private cloud inside of a customer's data center. Those customers who choose that model, which is the on-premise model inside of their data center, they are going to continue to manage the capital-intensive part of that relationship, i.e., the hardware and the break/fix, and things like that. Our job is to provide them with support of the software, and that's really the business model around the Rackspace private cloud. So I wanted to make sure we clarified that.

I think you also asked some questions about the overall growth target and when are we going to break this out as a separate P&L. I would just say those are future conversations that we're not ready to share right now. But I would tell you that we feel very, very energized about the part that the Rackspace private cloud and OpenStack play in our overall portfolio play. Again, think about this as the large wave of mainstream cloud adopters who are just getting started, and the logic that it makes to them to invite somebody into their existing capacity and to help them leverage the power of OpenStack within that existing capacity, and then ultimately be able to interoperate that cloud if it's the right fit for them into an OpenStack-based public cloud.

And it is also an attractive business model in a sense for us as well because of the capital that belongs to somebody else. This is attractive to us for a number of different reasons.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Also, this is Graham Weston, I'll be surprised if we break it out as a separate P&L because these customers tend to buy more than one service from us. And so we may be running their OpenStack private cloud in their data center, but we may also include running a private cloud from them in our data center.

Taylor Rhodes - *Rackspace Hosting Inc - President*

It's really a product being sold to the same customer.

Louis Miscioscia - *CLSA Limited - Analyst*

And the question on the targets was for the total Company, you may have given it the last analyst meeting that you reiterated earlier, but you just didn't actually give the actual numbers, if you happen to have it.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Are you talking about our annual revenue guidance?

Louis Miscioscia - *CLSA Limited - Analyst*

No. Your long-term growth targets, I guess top, bottom line margins, whatever, you mentioned them earlier.

Bryan McGrath - *Rackspace Hosting Inc - Director of Finance*

This is Bryan McGrath. We were referring to the target model slide, which is in our Investor Relations deck, which is available on our website. You can go download it and check it out.

Louis Miscioscia - *CLSA Limited - Analyst*

Great, I'll pick it up there. Thank you.

Operator

With no further questions in the phone queue, I'd like to turn the call back over to Graham Weston for any additional or closing remarks.

Graham Weston - *Rackspace Hosting Inc - Chairman and CEO*

Well, I just want to thank everyone for taking the time to be on the this call. I'm really excited to be back as CEO for as long as it takes, and I'm excited about the year ahead of us. We look forward to updating you on our progress in 90 days. And with that, we will adjourn the meeting. This concludes this call.

Operator

This does conclude today's conference. We thank you for your participation.
