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RAX - Q3 2013 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to Rackspace Q3 earnings release 2013 conference call. As a reminder, this call is being recorded.

(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 third quarter 2013 earnings conference call.

We hope that you have 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 www.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, Chief Executive Officer, and Karl Pichler, 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 we will use during this call, such as adjusted EBITDA, are expressed on a non-GAAP basis and that our GAAP results and GAAP to non-GAAP reconciliations can be found on our earnings release, which is currently posted on the Investor page of our website. After our prepared remarks this afternoon, we will be happy to take your questions. I will now turn the call over to Lanham.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Good afternoon, and thank you for joining us today. Let's start the call by reviewing the path we've traveled towards building Rackspace into one of the greatest cloud computing companies in the industry.

Just a few short years ago, we made the decision to open source our cloud technology and create the OpenStack project alongside our friends at NASA. Initially, creating OpenStack was a move to create an open source cloud operating system, to speed innovation and allow customers to ensure that their data would remain their data, free from vendor lock-in. We felt such an open system would compete well against the proprietary alternatives in the market.

Open sourcing our cloud and launching OpenStack was a bold move because there was no guarantee that a critical mass of developers and companies would join the movement, participate in the project or adopt the technology for production use. As it turned out, thousands of them did. At the latest count, the OpenStack foundation has attracted more than 9,500 individual members from 850 different organizations. At last count, the OpenStack technology is approaching 2 million lines of code.

OpenStack created a new technology to provide a powerful and innovative alternative to established technology such as VMware, Eucalyptus and CloudStack. For about 12 to 18 months after its inception, it was unclear which project was going to emerge as the dominant open source cloud platform. As it turned out, OpenStack did. Now that the success of OpenStack is widely understood in the market, the question is whether Rackspace will benefit from the technology. Within the four walls of Rackspace, there is no doubt that OpenStack is a game changer for our business. However, we don't believe we have yet proven this to the market.

We began addressing the issue roughly 12 months ago, when we completed the rollout of our OpenStack public cloud products. The completion of this project represented the largest, most strategic technology investment that Rackspace has ever made. By the time the rollout was complete, our strategy had shifted from simply minimizing our deficiencies to expanding our addressable market by competing for large, complex workloads. This is an important segment of the market that is growing rapidly, and at the time, a segment in which Rackspace wasn't competitive given the limitations or our prior software platform. We believe OpenStack changed that dynamic, and we said that if we successfully executed our strategy, we would be able to serve these larger customer workloads and ultimately improve our growth rate.

In the first quarter, we talked about HubSpot, as a customer with multiple large and complex workloads. In the second quarter, we talked about CERN, Emerson Electric, Fidelity, Mazda and Sony Playstation. We have had more good wins in the third quarter, including Cloudant, MapMyFitness, Sherry-Lehmann Wine and Spirits, Spencer Gifts, TheCHIVE.com, Zero, and Yeti Coolers.

We've said throughout 2013 that our number one financial objective has been to accelerate our growth rate. We believe we are making significant progress toward this objective. We guided to sequential growth of 2% to 3.5% for the third quarter, and we were able to grow 3.4%. Based on what we know today, we believe revenue will grow between 3% and 5% sequentially in the fourth quarter. Although the data points we study indicate the trajectory of our business has begun to turn around, there's no guarantee that the revenue growth rate improvement will be a step function.

Let's touch on some of the areas driving the improved traction in the business and that give us confidence heading into next year. As discussed on prior calls, we have made a number of investments that we believe will pay off in future periods, but not all these investments have delivered growth in the short term. We also told you about a series of organizational leadership changes we've made, and we feel these changes are beginning to reinvigorate the business. Market awareness of our OpenStack capabilities, including our public cloud products, continue to gain momentum. And the pipeline of our managed sourcing services, largely driven by enterprise demand and installed base growth, is rebuilding nicely.

One new public cloud customer that we would like to highlight is Xero. Xero is a fast-growing accounting software and service company. Rackspace provides the critical infrastructure necessary to deliver 24 by 7 global application uptime, which is fundamental for their SaaS business model. Xero is adding roughly 200 customers a day, and by leveraging the capabilities of our public cloud, Xero is able to handle this rate of growth while scaling its operations team and maintaining availability of its application to its installed base.

As we continue to hone our strategy, and through continued work with some of the largest and fastest growing web companies, one common theme that has emerged is the importance of world-class performance. The combination of our hybrid cloud portfolio and suite of managed services delivers powerful performance to our customers. When customers select Rackspace, they have a specific application in mind that needs to perform to a high spec. And the deciding framework skews to the provider who can run the customer's application with the highest performance capability, not just for today, but also for the next 10 million or 100 million users that will demand even greater performance.

For some workloads, unit price will be the most important attribute in selecting that company's cloud provider. Rackspace does not intend to pursue markets with a cloud provider strategy to lead with unit price,. Instead, our strategy is to serve customer workloads when performance is the most important attribute in the decision-making process. We understand that economics will always impact the performance to total cost equation, so we will remain competitive on total costs while keying in on the segment of the market that values performance derived from infrastructure and services more than anything else. Delivering optimum performance through the right combination of software platforms, hardware platforms, and the best technical expertise with fanatical support creates great outcomes for customers.

As the technology adoption cycle continues to develop rapidly, our work to innovate is ongoing. Focusing on innovating around world-class performance is an advantage we hold today and that we are building upon. Earlier this year, we re-emphasized the benefits of our hybrid cloud capabilities and the way in which Rackspace is able to help customers optimize performance by finding the best fit for each of their workloads on hybrid architecture. As you know, Rackspace is a customer-centric company, and we have learned from our customers that they architect their applications in two distinct ways. Many new applications are architected at inception to take advantage of the public cloud, using APIs and open technologies, including dynamic languages like Python and Ruby.

Other customer applications, including many of our Fortune 1000 customers, are architected in a more traditional client server manner. We have a managed hosting offer that is ideal for traditional client server applications and a hybrid cloud offer that is targeted to new cloud applications. These two offers form the foundation of our portfolio. We are uniquely positioned in the market because we have the capability to manage traditional client server apps and public cloud apps. The technology market is going through a big shift, and it is to our advantage that we can manage so many different types of applications for our customers.

One new hybrid cloud customer example is MapMyFitness. MapMyFitness provides a group of websites that make up the world's largest community for fitness content -- interactive tools, calculators and mapping technologies for personal athletic pursuits. By leveraging that Rackspace's hybrid cloud solutions, MapMyFitness was able to capture and process the data in real time, analyze trends and ultimately deliver a more compelling user experience. The company uses our cloud servers product to host a database that processes more than 200,000 transactions per day for more than 16 million registered members.

A few eCommerce customer examples include Spencer's Gifts, Yeti Coolers, and Sherry-Lehmann Wine and Spirits. Spencer Gifts relies on Rackspace's hybrid cloud service to handle its eCommerce storefront. Online sales are growing at a much quicker rate than its brick and mortar establishments. The company leverages our hybrid architecture to handle day-to-day traffic and uses our public cloud for bursting during high-traffic periods such as Halloween and the holiday season. Servers and site traffic can reach 1,000 times the chain's normal activity, and our infrastructure provides Spencer Gifts with the flexibility to meet the varying demands.

Yeti Coolers manufactures the highest quality coolers on the market, providing unsurpassed durability and insulation. Yeti utilizes the Rackspace hybrid cloud offering to run its implementation of e-based Magento -- software-based eCommerce platform. Sherry-Lehmann Wine and Spirits, the renowned wine and spirits retailer and iconic name within the wine industry, has partnered with Rackspace for our hybrid cloud solution. Sherry-Lehmann has been a customer of Rackspace since 2008, utilizing the private cloud for their eCommerce site. In 2013, Sherry Lehman, with the support of Rackspace, successfully migrated to a hybrid cloud. The hybrid cloud allowed Sherry-Lehman to immediately gain the flexibility of the cloud while maintaining a secure environment for credit card transactions and realizing significant cost savings.

Another hybrid example is Resignation Media, a family of web properties including their flagship website, TheCHIVE.com. For those of you not familiar, TheCHIVE happens to be the world's largest photo entertainment website. TheCHIVE uses both our public and dedicated cloud servers to support its mobile properties that receive more than 15 million visitors per month. Lastly, we would like to highlight Cloudant, a Y Combinator funded next-generation database provider and new Rackspace customer. Cloudant runs a database-as-a-service offering and is using Rackspace as bare metal infrastructure to help support its application in a large scale distributed system.

Our hybrid cloud offer is aimed at customers who take an API-driven utility-billing approach to IT. We have learned that public cloud has its limitations, particularly with large complicated apps running at scale. While many new applications start out on the public cloud, as the applications grow, customers have to engage in costly over-provisioning to achieve the level of performance they need. That is when the benefits of a hybrid cloud becomes compelling.

Another strategic step aimed at delivering superior performance was our recent launch of the Rackspace performance cloud servers product. By improving architecture of the hardware infrastructure layer, including the use of solid state drives,10 gigabit Ethernet and powerful Intel Xeon processors, performance cloud servers delivers up to 5000% higher disc IO performance than the standard cloud servers with spinning discs. Our performance cloud servers are designed to deliver enhanced levels of application performance with greater speed, throughput and reliability. This capability makes our cloud offering extremely attractive for a variety of workloads, ranging from high-traffic websites to large-scale NoSQL data stores like MongoDB, Hadoop and Cassandra.

Our customers benefit from the increased efficiency and performance of their applications and ultimately greater revenue for their businesses. By offering performance cloud servers across every flavor and configuration of cloud server we sell, we have redefined the standard of performance. Performance cloud servers are currently available out of our Northern Virginia data center. In the coming weeks, we plan to make performance servers available in our Dallas/Fort Worth, Chicago and London data centers, as well.

This new offering strengthens our hybrid cloud capabilities, and as the name suggests, it is all about performance. With our hybrid cloud offer super charged by performance cloud servers, we are able to offer the best value in the industry for customers who demand consistent, high performance. We can also improve performance in our hybrid cloud through the optimization of open technologies on our platform, net speed innovation, avoid vendor lock-in and ensure the customer maintains ownership of their data. And of course, we will layer on fanatical support, enabling customers to benefit from our superior technical expertise. The combination of our unmatched portfolio of hybrid cloud services, our commitment to open technologies and our technical service expertise is what differentiates us from the rest of the technology industry. We intend to pursue this strategy relentlessly.

In closing, I would like to take a moment to thank all of the Rackers for their hard work this year. We got off to a difficult start this year, but we stayed in the battle and all those efforts are beginning to bear fruit. I am proud of the way Rackers respond to adversity. The work we're doing to refine our strategy in hybrid cloud offers a once in a lifetime opportunity for all of us, and I'm excited about changing the world with all of you. I will turn the call over to Karl to review our detailed financial statements.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Lanham. Despite revenue growth in the third quarter falling within the range of our guidance, our aspiration is to grow at a higher rate, and that continues to be our primary focus. As Lanham indicated in his prepared remarks, for the fourth quarter, we expect our sequential revenue growth to range between 3% and 5%, which would result in revenues between $400 million and $408 million, with $404 million falling in at the mid point of the range. We are currently working through our 2014 growth plans and will share those with you on the February call next year.

Now let's move on to the specific results. Total revenue for the quarter was $389 million, representing 3.4% sequential growth and 16% growth compared to the third quarter of 2012. Exchange rates had a positive impact on the revenue by approximately $900,000 compared to the second quarter of 2013 and a negative impact of $1.8 million compared to the third quarter of 2012. Dedicated revenue increased to $280 million in the third quarter, representing 1.2% sequential growth and 9.2% growth on a year-over-year basis. Public cloud revenue for the quarter was $108 million, representing 9.5% sequential and 36.5% growth on a year-over-year basis. Install based growth was 0.7% in the quarter, just the same as the prior quarter. We have talked about our work on rebuilding the dedicated pipeline for several months now, and we expect for the dedicated growth rate to rebound. The pipeline rebuilding is going well, and we have factored that into our total revenue guidance for the fourth quarter.

Moving on to profitability, adjusted EBITDA for the quarter was $125 million, a 1.9% increase compared to the second quarter and a 3% increase compared to the third quarter of 2012. The adjusted EBITDA margin for the quarter was 32.3% compared to 32.8% in the previous quarter and 36.2% for the third quarter of 2012. Consistent with our goal to reaccelerate revenue growth, our decision to invest aggressively in hiring technical talent and in research and development have depressed margins this year compared to 2011 and 2012. Even though our growth estimates for the fourth quarter are slightly higher than the past few quarters, we expect margins to remain near the 30% range for the time being. Depreciation and amortization expense came to $81 million in the quarter, representing 20.8% of revenue. Net income was $16 million for the quarter, down 27% from the previous quarter and down 40% from the third quarter of 2012. Net income margin for the quarter was 4.2% compared to 6% for the previous quarter and 8.1% in the third quarter of 2012. Earnings per share came to $0.11 on a fully diluted basis in the quarter.

Capital expenditures totaled $118 million for the quarter. Of this amount, we spent approximately $74 million on customer gear, $12 million on data center buildout, $7 million on our office facility and $25 million in capitalized software development and other projects. Total server count increased to 101,967 in the quarter, up from 98,884 servers in the previous quarter. Adjusted free cash flow for the quarter was $8 million. Return on capital was 8.0% in the third quarter compared to 11.9% in the prior quarter and 16% in the third quarter of 2012. Capital turnover in the third quarter slightly decreased to 1.89 from 1.93 in the prior quarter. Our returns are similarly being depressed while we invest ahead of our ambition to achieve higher growth rates.

This concludes the review of our third-quarter results. Operator, please open up the call to questions.

QUESTIONS AND ANSWERS

Operator

Certainly.

(Operator Instructions)

We will go first to James Breen with William Blair & Company.

James Breen - *William Blair & Company - Analyst*

Thank you for taking my question. Around the revenue trajectory, when I look at the guidance for the fourth quarter, this is the first time the guidance range has ticked up. We have 5% at the high end of the range. It seems like you are seeing some form of reacceleration back toward the 20% level you targeted.

What gives you confidence in that? What can you point to that is going well that makes you believe that the top end of that range is achievable now? Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

This is Lanham. I will take this one.

When we work on our guidance, we try to take into account everything we know about the business. The process we follow looks at what is going on in our existing customer base. It looks at what is going on in the market around us. It looks at what is happening internationally and new initiatives we have coming up.

As we looked at it here recently to provide this guidance range, there are a few things that I'd highlight that are giving us confidence. I think the first is that we feel the results improving in our traditional managed hosting business, that when we look at the trajectory there, we see our pipeline rebuilding. We think things are firming up there based on some of the investments we made, so we feel good about that dedicated business, that managed hosting business improving.

As you look across that, I would say our churn is pretty darn stable. Historically when you look at our company, churn will bounce around a little bit. When you look at the metrics we just published, it is pretty stable right now, so that is another thing that gives us confidence.

We also believe our Cloud is advancing. When we look at the results we are delivering for customers, we believe the customer outcomes we are delivering are better today in the cloud than they were a year ago.

We think the new performance server launch is the next advance in those customer outcomes that we generate. We like the traction we are receiving in hybrid.

In the prepared remarks, many of those examples were hybrid Cloud customers utilizing multiple form factors here at Rackspace. So I guess I would say hybrid has good traction, and we like the product advances that we have.

OpenStack had a big summit last week over in Hong Kong. We recently launched a Hadoop service here, we just launched performance servers, and we're making additional investments in our products in our managed hosting business.

So I think we see things firming in managed hosting, we see improved results in our Cloud, and we believe we have more interesting offers in customer outcomes coming in the future. That is why we are ticking it up a little bit.

James Breen - *William Blair & Company - Analyst*

Thank you. And on the cost side of the equation, margins did come down a little bit as you led people to talk about in the second quarter call. You hired another 200 or so employees this quarter.

Can you talk about the trends there as revenue? Are you setting up for that revenue growth, and what is the reasoning?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Well, this is Lanham again, by the way. The way to think about what we are doing right now as a company is that we are in an investment phase.

The ultimate outcome of these investments is to accelerate our growth. We are making those investments ahead of the growth today.

So, as we look at our business internally, we go through the thought exercise I just described on the forecast, the guidance itself here going forward. Then we look at the investments we need to make to accelerate from there.

If you look at our margins, what is driving it, it is all the investment that we are doing right now that is the timing that it is coming ahead of the growth. If you look at the investments we made this year, we made investments around data centers, we made investments in a complete platform which we just launched here recently called performance servers.

We made investments in new offers that haven't yet launched. We also made investment in human capital, which is representative in the question of the people we hired.

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As we distill all that down, I think some of the hires we made here specifically in sales and marketing with Rick Jackson, those are having an impact on the company now. We also think the offers and investments we've made around the technology capabilities and the offers from customers are having an impact. You see some of that in a cost today before we have all the growth from it.

I think back to your previous question, the confidence and visibility we have in the pipeline is making us feel better about the guidance range. And what you are seeing in the cost bar that you are asking about now is really the aggregate impact of all the investments we made, and now we will push real hard moving forward around the growth.

James Breen - *William Blair & Company - Analyst*

Great. Thank you.

Operator

Our next question will come from Gray Powell with Wells Fargo.

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

Hi. Thank you for taking the question. A couple if I may.

Cloud revenue growth reaccelerated back to 9.5% sequentially, which was good to see. Can you talk about what the main driver was there, and just what needs to happen for cloud to get back to sort of the 10% to 12% quarter-over-quarter growth that we saw back in 2012?

Lanham Napier - *Rackspace Hosting Inc - CEO*

The way you started the question, I thought you had a couple comments. Is that the only one?

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

I have another one, too, but maybe I will go one a time if that is okay with you guys.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Thank you, Gray. First we'll deal with the cloud revenue growth rate.

The question about what does it take to get back to 10% to 12%, what's causing the reacceleration. Here we are sitting at 9.5%.

So I would say we're chipping away at it. Our mental attitude is we will keep pounding the rock. The rock with respect to Cloud growth comes down to really a simple thing, and that is the job we do for customers.

When we look at the job we do for customers, we think there are a few areas there to go down. One is just a base infrastructure performance. And another is the value of the services that we put on top of the infrastructure.

As we have discussed in prior calls, we've made investments in managed services, like managed cloud. On the last call we talked about some of our debt lodge thinking. These are examples of moving up the stack which we continue to invest in which will have a positive impact on the sequential growth rate you just mentioned.

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The other thing we've done here recently with the performance servers launch is deepen the focus at the infrastructure layer itself in terms of the capability and job it can do for customers. Specifically we want the infrastructure to be able to run larger, more complicated workloads. Larger, more complicated workloads have a higher performance specification and tend to come in larger chunks, therefore larger revenue.

So, when we think about the job to be done by customers, how do we improve that infrastructure and performance itself and how do we add more value in the service layer. Then we end up targeting customers in particular segments where we can do a great job.

When we think about customer segments that we can do a great job, we think about people that value performance with respect to the infrastructure and the service. We talked about that in prepared remarks.

We also look for those customer that are in a high growth area. The customers we mentioned on the call today were all customers growing at a pretty darned good rate in their businesses.

In our mind, if we get the job, if we do a great job for customers at the infrastructure and service level and we do a great job and go to market around targeting customers with a high growth rate, this is how we ultimately continue to drive higher and higher performance out of our cloud offer. The greatness here is that we are playing in a category in the cloud computing category that is growing at a really fast rate, so it is on us to execute well.

We made steps there, and we just have more steps to go to level our position. Our confidence is increasing, and we can see what we have to do.

We just have to go do it. It is a combination of doing the right job for customers and targeting customers that have a good growth rate themselves.

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

Okay, that makes sense. You actually hit on my second question.

Specifically, can you talk about the new high performance server offerings? What do you expect to see from initial customer demand standpoint, and is there even a way to ballpark how it increases your addressable market?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Well, sure. Let's talk about that a little bit.

In terms of ballparking the addressable market, I think everybody here on the call and listening in that will review the transcript is buying into the fact that the cloud is a big addressable market. I would say we have pretty high confidence in that dimension in that we are fishing in a pond with a whole lot of fish that we have a great opportunity ahead of us.

When we think about the workloads and the type of performance we get out of this offer and what customers should be doing it and how do we think about what customers will be taking this up, we had a pretty extensive and rigorous data program with customers for this offering, and we specifically wanted to push and understand the dimensions around more complex, high-performance workloads. That is why we put it in our prepared remarks.

If you go out to the website and you watch the video testimonials of some of the beta customers, you will see in that that they were running complex things. Historically, when we first launched our Cloud, our cloud was great for very simple workloads in use cases. What held us up in winning some of these larger Cloud customers was that the functionality and performance wasn't there in terms of getting the job done for customers with more complicated requirements.

Our open Cloud launch started the work last year. We believe the performance server this year is the next step in that. As we do more dev ops services capability, that is another step in it.

The great news here is that our market is dynamic and growing rapidly, so we have plenty of opportunity to roll out additional offers. What we are focused on is increasing our capability to serve more complex workloads with customers because they come with a higher RPU, they come with a higher revenue upside, particularly when we target high-growth customer segments in the marketplace.

What we are trying to do is skew to that edge of the market where we have a bigger revenue opportunity because we are doing a better job for customers. They value what we bring between infrastructure and services. They want Fanatical Support and they have high growth requirements themselves.

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

Got it. Okay. That is very helpful. Thank you very much.

Operator

Next we will hear from Jonathan Schildkraut with Evercore.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thank you for taking the question. Three questions.

First, in terms of the margin commentary from Karl, Karl, I think you said during your prepares remarks you expected margins to be in the 30% range. But the last two quarters, they have been in the 32% to 33% range. I want to make sure I understand what you meant about the 30% range versus what we have seen the last two quarters.

The second question is, just about new customer -- or revenue growth from new customers. It seems like you guys have done a really nice job sort of rebuilding the IBG pipeline, which was a little weak in the first quarter. But we also have seen revenue growth from new customers sort of slide down.

We are just trying to understand how those two dynamics play against each other. Last quarter you talked about a record number of new customer wins. I wonder if you can give some color commentary.

Finally, in terms of your prepared remarks today, you spent a lot of time really emphasizing the progress you made in the hybrid Cloud. I wonder, how far away are we from a point in time when you don't break out dedicated and Cloud based revenue because the solutions are reaching across both of those groups. Thank you.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay. Hi, Jonathan. This is Karl.

Let me take the first one around the way we think about margins. Thank you for the question. I think it is a good one for everybody on the call.

Basically there are two things going on at the same time. One is we are constantly working on making our core business more efficient. That is an ongoing operational requirement that we impose on ourselves.

Then the fund we generate through that are basically available to us for reinvestment. I think Lanham, through the prepared remarks, we have pointed out what those investment areas are.

When you boil it down to basically cost items, he was talking about head count and data center infrastructure and equipment, those are the two areas. You can basically see through all the P&L and key metrics how those investments are affecting those key metrics.

So we have an underlying margin uplift from operating at a higher scale and from delivering margin in our core business. Then we take those dollars and more this year and basically from those investment areas we have done.

On the data center side for example, we have built up more capacity, so our data center utilization has calmed down slightly. With those data center infrastructures, we have also invested into launch capital to launch performance cloud all over the place in Europe and in the US.

US already launched. Europe will launch in the next couple of days. Thereafter, we will launch Hong Kong and Sydney, as well.

All of these are the investments Lanham referred to that are being made ahead of the revenue. That is why you see these aberrations in the margins.

When we say 30% minimum, what we simply mean is even if we are super opportunistic and fund everything that is interesting to us, we still believe that we have enough power in down the line models to fund everything we want at a minimum margin of 30%. That doesn't mean that we just go out and spend it. That is why we are floating right now at around 32%.

Jonathan Schildkraut - *Evercore Partners - Analyst*

That is helpful color. Thank you.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure.

Lanham Napier - *Rackspace Hosting Inc - CEO*

So, let's talk about progress in the hybrid cloud and revenue growth from new customers. With respect to the revenue growth from new customers, I would just say it is sequential when we face things around here.

In your question, Jonathan, you referenced the IBG. You mentioned how that is improved. We had a low point of that earlier this year, and we rebounded nicely from that.

Clearly we made IBG an existing customers as a big focus because that is today's work. Ultimately the work of the Company going forward the driven more by the base today than it is by tomorrow's acquisition of a single customer.

Up to this point, we have done that work. I appreciate you recognizing that in the metrics.

Now the work we are talking about in terms of further acceleration, there is a lot of acquisition effort in there. I would say we are getting to that now. This is where in my remarks earlier I talked about the addition of Rick Jackson, other folks we hired into our sales and marketing efforts.

We have acquisition on our minds now. First things first was just the install base.

Now we are doing acquisition. We believe we have a lot of room for improvement and therefore a whole lot of opportunity to help ourselves.

THOMSON REUTERS

The last question you had was around progress in the hybrid Cloud, and at what point do the metrics here really blur between single tenant and multi-tenant architecture and form factors. Great observation.

We are getting there. It is something we have wrestled with internally about when we should think about changing those metrics or how we should communicate with people.

I don't think we have arrived there yet, but as the business progresses, we can all envision a world where through a control panel or series of commands, customers call on single tenant or multi-tenant architecture Particularly when you think about these customers running large, complex workloads. As people are running large workloads like that, they want to tap into different forms of architecture based on providing the best fit for their application performance.

With this in mind, it gets really hard to think about classifying revenue at a customer level when they use these form factors and how should we do that. Up to this point in our development, people tend to use -- the vast majority, one way or the other today.

Going forward at some point in time, I think that is much more of a mix. When it is more of a mix, we have to figure out how we want to convey that to investors so you guys can understand the results of the Company, know where we are headed and understand how we are performing.

I think that will be a conversation for future periods. I don't think it is something we have to delve into deeply today because right now the metrics today hold pretty well.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thank you for taking the time.

Operator

Next we will hear from Simon Flannery with Morgan Stanley.

Unidentified Participant - - *Analyst*

Hi, this is Lisa for Simon. Thank you for taking my call.

Can we talk a little more about the CapEX and how you're seeing that for the remainder of the year? I know CapEx this quarter ticked up a bit relative to the previous two quarters.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. Absolutely. This is Karl.

So, we have talked about these capital investments throughout the year, and we have shared with you the CapEx range in the past. We will come in about the high end of the range.

We will probably spend around $460 million to $510 million on total CapEx for the year. That's all inclusive, the year-to-date including the fourth quarter.

We basically have deviations on the high end for two reasons. They are on the customer gear side on the DC buildout side, and it's all related to the investment areas that is we talked about.

There are a couple of outliers that are worth mentioning. One, we bought a piece of land in the UK that is adjacent to the piece of land on which digital will build our data center.

We supply that land for flexibility and optionality purposes. That is north of a $10 million acquisition of land.

We have also spent more than we originally anticipated on accelerating and globalizing the launch of our performance Cloud, which had additional capital requirements on the equipment side and on the data center upgrade side. And those are the remain drivers why we have the range. On the office build out and software and other arrears, we're actually tracking along the original plans.

Unidentified Participant - - *Analyst*

Okay, thank you.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure.

Operator

Next we will go to Kash Rangan with Merrill Lynch.

Kash Rangan - *BofA Merrill Lynch - Analyst*

Hi, guys. Nice to see the stability in your business.

Karl, this goes back to several years back at the time of the IPO. We talked about the return on capital as a very important yardstick for the company.

Curious to get your thoughts on where do you think we should be thinking about the return on capital as your target as we emerge from this investment cycle since I remember for quite some time with the return on capital accelerating, you were able to grow the business sustainably at a higher pace. But if the capital were to go in another direction, I would imagine it takes a lot more capital to reaccelerate your revenue growth rate.

I guess the question for you is where do we get the acceptable cutoff point where the return of capital can start to expand and allow the company to grow without diluting its margins? Sorry for the financial questions, but that is all I had. Thank you very much.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure. Hi, Kash. I think it's worthwhile distinguishing between two things.

One is the economics on the unit perspective and the economics on a company perspective. The economics on the unit perspective continue to be very healthy. That is where all the analytical discipline goes into and where operationally we are executing along that discipline.

We are very confident that in all our product categories, whether they are growing very fast or very modestly, that they are generating healthy economics. When I say healthy economics what I specifically mean, given you are asking a finance question, a return profile that clearly covers any hurdle rates that we are applying ourselves.

So, that is kind of the economic engine that drives the business. My remark before too that we have uplift in our margin structure from our core business is related to that. That we have those unit economics that are very powerful, and that we are managing those very, very carefully and deliberately.

Then the second piece is, what do you do with those excess returns and how much do you take and reinvest in the business? If you look at our last five years, if you want to take the long term view, what you have seen is that we have invested along the way, all the time, and have built the business and have grown the business quite substantially.

This is kind of the first year, really, if you take that long term view where we have invested more than the underlying business has generated. This is what drives the wedge between the corporate economics and the unit economics, basically taking those margins and returns down.

If you decompose the return differential, they are really 80% due to the changes that happen in the margin. If you take the margin, it all happens in the area of really head count and people-related costs that is largely attributable to building the product development capabilities that we focused on over the last 12 to 18 months.

Then the small impact you have on the capital return side is all around infrastructure deployment and invests that we make there. You can also see that our utilization metrics, for example, they fluctuate a little bit. This year they are a little bit down.

From a raw perspective on the key metrics table at the very bottom, that is another indicator that we are investing ahead of our revenue, which driving the overall turn perspectives down. All this infrastructure is deployed that does not provide revenue yet and therefore depresses turns and margins. These revenue capacity to the tune that infrastructure gets monetized, we will basically have a very high flow-through, i.e. incremental revenue without any incremental cost.

Kash Rangan - *BofA Merrill Lynch - Analyst*

Thank you very much for that detailed answer, Karl. Take care.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure.

Operator

Next we will hear from Tim Horan with Oppenheimer.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thank you, guys. When do you expect the flow through to really start ticking in on the revenue front? Obviously it is a good quarter.

You are adding a huge amount of capacity in the front of that. Is it a year out, a quarter out? A little color on there would be great.

Then, maybe, what do you think the main kind of customer bottleneck is at this point? Why are they waiting to adopt them?

Lastly, can you talk about what you are paying on a per megawatt basis on the data center side? Is that changing all that much? Is it going up, squeezing margins or is it going down? Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

This is Lanham. I will start with the first couple, and Karl can address the dollar per megawatt question you have.

In terms of the -- I would categorize your question, really, around when will it accelerate and how will the acceleration take place, what is holding it back, and that leads to flow-through timing and customer bottleneck question, et cetera. As we think about it, we are sitting here today, and we think Q4 will be higher in terms of sequential growth for the first time in a year.

That basically with our guidance range we set forth, we feel like we are taking the first good step here. What has led to this has been a lot of work on the product side, which we've covered in the call, and some work in the sales and marketing side, which we covered in the call.

I think to continue the progress, we just have to keep that work going. The first half of this year was characterized with the product work we were doing, getting the right people on the bus in the sales and marketing moves that we made. We have now down that, and now it is more about accelerating the activity and getting it to work.

With respect to customer behavior and the bottlenecks we have seen, some of the bottlenecks we have seen, I touched on earlier about our ability to run more complex, larger workloads. When you envision Rackspace running the largest web properties in our cloud, up until recently we really weren't able to do that super effectively. And I think now the hybrid capability repositions us, and that is why we have the information on the call earlier today.

I believe one begets another, that it take as little time. As we continue to execute, you will see us do this faster than we have up to this point.

There is still plenty of work to do. I see it as there is product and service work that we have done a lot and will continue to do a lot more.

There is go to market work which we have done for the base. We have more work to do in the base, and we have more opportunity in the marketplace with new customers. As we do that work, I think you will see customer adoption increase.

We have become more valuable to customers, we can do a better job for customers, and the value of Fanatical Support increases as we move up the stack. I think all these things enhance our chances and give us a better opportunity.

I would also add to that, our viewpoint here is a long term view. When Karl talks about the investments we want to make, we think we have a tiger by the tail here, that we are operating in the intersection of an incredible opportunity in tech, that Cloud computing is changing the world, and we feel blessed to have an opportunity to participate in that as we build up this platform. Therefore, we want to make the investments that build long term power for the Company, and we want to prove it to you on a short term basis.

We believe the first step with Q4 guidance increasing is we are demonstrating to you the investments we made earlier this year are starting to bear fruit. We have other long term investments we think will bear fruit later on.

That is how I would incorporate the first two questions. We see the opportunity to do the work and have to keep after it. Karl, why don't you address the -- ?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Let me take a stab at addressing the other question. I think it is probably time to reeducate a little bit on what our data center strategy has in terms of implications on the cost structure.

So, I think traditionally what we have had, we have taken on a piece of data center facility, and we have an initial fit out that basically allowed us to take this facility life. This was traditionally in the range of $3 million to $5 million in terms of initial capital expenditures over and above the simple data center electricity kind of environment with cooling and power and connectivity.

So, what has happened over time, s that we have done two things. One, we have focused on operating larger and larger facilities. Most notably in the US we are building out more and more facilities, which means the buildout comes with different economics, in the millions of megawatts trunks. And at the same time we went from a lease and build out ourselves to basically wholesale lease call models which is much better for us as a company.

So, I think the simple rules of thumb, they just don't apply anymore. We basically, when you want to study our data center economics, you would have to look at the DC cost elements that are flowing through the P&L in the cost of revenue section with respect to the rent.

Then you have the capital that is associated with the DC buildouts that we break out as a category as well, and that gives you a complete cost picture in terms of what we incur. You have the megawattage as well listed on the key metrics, so you can infer and look at this how you want. Obviously as a company, our goal is by partnering with the right partners and by operating at a larger scale in concentrated and specialized facilites that we bring that TCO down over time in relation to the megawatts or the revenue we generate against it.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

We will hear next from Pat Walravens With JMP Securities.

Pat Walravens - *JMP Securities - Analyst*

Great, thank you. Lanham, I was surprised to see the dedicated Cloud decelerate to 1.2%. I think some investors probably are, too. Can you provide some deeper perspectives as to the challenges you are facing there?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. Thank you for the question, Pat.

I would not characterize it as deeper challenges so much as we feel like we have good visibility there, and we see the pipeline rebuilding. There is a longer sales cycle on these deals. They tend to skew more enterprise in nature.

I think we have touched on that in prior calls, so where we sit today, it is a matter of net upgrades. What are we doing to accelerate net upgrades in that business.

We made the sales and marketing investments in terms of human capital. We are also rolling out the sales and marketing investments in terms of programs and account management for those customers.

So, I guess to give you more color on the challenges, the challenges we have had at this point are getting all those things in place. We haven't -- we just didn't have all that in place earlier this year. I think what you are seeing here in Q3 is the low point in that business for the year.

We talked about it on calls earlier, we said we were getting to work on it, but we didn't have near term acceleration there. I think now we are at the point where when we look at our guidance range going forward, we are feeling better about that business, and that is contributing to that range changing.

Why do we feel better about the business? It is really a result of the investments we made, the sales and marketing investments in the human capital and program side.

There is also investment that we made in product work over there. We talked about hybrid traction, and hybrid does have a drag-along effect with dedicated gear as we make that business move more Cloud-like, if we can use that term.

I think we are now feeling better about it as we worked the first half of the year to get that turned around. We have pretty good visibility in that business, and today, we are feeling better about the growth of that business here over the next 90 days.

Pat Walravens - *JMP Securities - Analyst*

Great. Thank you.

Operator

Our next question comes from Frank Louthan with Raymond James.

Frank Louthan - *Raymond James & Associates - Analyst*

A couple of quick questions. First on the longer term vision of the business, this hybrid Cloud becomes much more of a focus and the original thought and intention, has that changed the long term trajectory of the CapEx and play any return of capital discussion from earlier?

And then looking at the new heads of sales and marketing, can you be more specific about what sort of changes you may have made in the last few months to the sales team and the process you are executing on to try to get the sales rebounding? Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. This is Lanham again. When you think about the business model of hybrid Cloud, the value prop here is really about providing best fit application for performance for customers. Hybrid is really powerful there.

Our ability to integrate single tenant and multi-tenant resources is pretty darn unique in the marketplace and provides a better application performance than either one of those resources on their own. A lot of the customer examples we provided to you this year basically demonstrate that performance attribute to the customers.

The next thing to talk about then, is -- okay, given that outcome for customers, what is the economic outcome for Rackspace stockholders? I think that what we are seeing and what we believe will continue is that hybrid Cloud positions us to handle larger, more complex workloads.

With larger, more complex workloads, there tends to be a higher SLA, a higher service content-- higher service requirement rather for those applications. Because it is a bigger, more valuable bundle, the Rackspace business model is better with those customers.

We have an opportunity to capture more mortgage and create more value with larger, more complex workload that has a higher service level and infrastructure performance requirement than we can be simple workload like a blog. When there is more at stake for a customer, when things are more mission critical, customers will set the bar on a higher performance level.

We can add more value in the level. Because we are integrating these different form factors, we can capture that value and deliver better outcome for customers and have pretty darn good economics for ourselves.

When you look at the micro economics which Karl touched on earlier, we believe hybrid cloud positions us very well to capture these economics going forward. If you take the view that Karl talked about, a five year view of the company's hybrid model, you can see how we have demonstrated a good ability to drive margin up. As we drive margin up, return on capital follows.

We're in an investment cycle right now where we deliberately pushed margin down to fund for these investments. Earlier on in the call, we had a question from Jonathan saying 30% of the numbers coming in, closer to 32%, how do we think about that?

I think Karl has a wonderful answer on that in that we have pretty darned good control over the investments we are making. We are thoughtful about those investments.

Not all those investments will pay off like we think. We do not bat 1000 around here, but we are very thoughtful about these investments, and we believe the investments position us for great long term growth. We think we demonstrate our ability in the past to increase margin, and we believe we can do it again.

Right now we are in a phase where -- man, we see an incredible opportunity coming our way, we have excellent opportunities around our hybrid cloud portfolio to drive better outcome for customers. We want to go do that stuff.

We are happy to describe micro economics for our investors so they can get a better comfort level for market improvement, but right now we think it is go time. We think the market is forming, that we are uniquely positioned with hybrid, so we want to make those investments going forward.

I think as you evaluate the business model and what happens with on return on capital, right now our capital returns are close to where they were a year ago. the difference is margin, and we demonstrated an ability to control margin going forward. Does that help you with that?

Frank Louthan - *Raymond James & Associates - Analyst*

That is great. Any thought on changes with the sale's force in that direction?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. I think that -- let's just break them down here a little bit.

With Rick Jackson joining us as chief marketing officer. Prior to Rackspace, he was chief marketing officer at VMware.

I think Rick brings an enterprise understanding to us that our company didn't have prior to his arrival. I also think he has a marketing focus and thought process around hitting the right segments in the marketplace that is superior to what we had before his arrival.

So, one thing that happened in our thinking around here, and I referenced this earlier in my remarks when I talked about high growth customer segments, combining that thinking with some of our product offer thinking, a lot of that is really Rick's voice. I am just taking credit for it on this call. All right?

That is what I would say is happening on marketing resource, our marketing thinking, rather. Rick is talented and has an enterprise perspective that is superior to what our company had before his arrival.

[Ahmet Tation] brings an enterprise perspective. Sales based on his experience at Microsoft. He also brings a nuts and bolts sales force understanding that is excellent, as well.

I think what Todd is doing in the sales force is getting people aligned and focused around customer targets, around specific offers in the marketplace, and increasing our game from an account management point of view in sales process with these customer, whether they are in an install base or in the acquisition side of things. Earlier we talked about our progress in install base.

I think we are feeling good there, but we also have upside in that number, and I think we have a lot of upside in our acquisition number right now. That is the stuff that is changing. It is a focused change, a depth of understanding change, a customer segmentation change, an organizational and execution change across our sales and marketing teams today.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you.

Operator

And with that we are out of time for today. We will take our final question from Colby Synesael with Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

Greatly. Thank you for taking my questions. I have two.

One, as it relates to hybrid, it seems like the focus is obviously in that area but taking a little bit to show up in the numbers. Is there anything you can do to accelerate the onboarding such as providing some type of framework that can be used from customer to customer to help in that direction?

Second question has to had with seasonality. Can you remind us how much seasonality you typically see in the business and how much of that is reflected in the fourth quarter guidance? Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

This is Lanham. I will take the first one, and Karl can take the second one.

With the question around what can we do to accelerate customer adoption, is there a framework we can utilize to help customers along the path? We are investing in a lot of these areas.

I will give you an example. If you go out to our developer, we are talking to developers about the best practice way to use the OpenStack power Cloud. There is a framework and reference architecture out there to do that.

When we talk about complex web apps and workloads and how they can utilize our infrastructure, through our SE efforts, we are providing best practices and reference architectures around how customers can utilize the infrastructure and make this happen sooner, make it easier for them to adopt what we are doing. The way we think about it, it is our job to deliver incredible outcomes for customers.

That is job number one. We have to get them to a point where it is easy for them to do that.

As we roll out these new products, we have a documentation strategy, a communication strategy with it, we update the way our SEs interact with customers, we update our training for our reps and account managers around the company. We will continue to do this because a big part of our job to help humanity and customers go through the technology shift is to educate them on the possibilities of it.

Therefore a lot of our investments are about how do we educate them on how to use these things is exactly I think the guts of your question around what framework and how do we help people accelerate their decisions. We are doing that. We are not doing it perfectly, but we are doing really good stuff, and I think we will invest more to keep it going.

Karl Pichler - *Rackspace Hosting Inc - CFO*

In regard to the seasonality, there is certainly from an activity standpoint, we do see seasonality around December and January traditionally. As you look at the number, I think the Q3 and Q4 quarters have traditionally been stronger than the first half of the year. Last year, for example, our Q4 quarter was a little slower than the Q3 quarter from a sequential growth perspective.

So, some times you see the seasonality, if it is affecting December, to kind of affect a little the Q4 number. As far as what we know, based on what we know, we factor in everything Lanham mentioned into the guidance range.

But the real impact, if any, of true seasonality year end cycle is really going to be in our first quarter number. We will certainly talk about that in our next call in February and factor it into the guidance then.

Colby Synesael - *Cowen and Company - Analyst*

Great. Thank you, gentlemen.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure.

Operator

With that, gentlemen, I would like to turn the call back over to you for any final and closing remarks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. This is Lanham. I want to thank everybody for tuning in.

Today also happens to be Veteran's Day. We have a number of Rackers that have served in the armed forces.

We want to thank the Rackers for their service and for all other active armed forces members for their service today. Thank you for what you are doing. We have a lot of work at Rackspace building out the hybrid cloud and high performance, so we will get back to work.

Operator

Once again, ladies and gentlemen, that does conclude today's call. Thank you for your participation, and have a great day.
