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RAX - Q1 2014 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting's Q1 2014 Earnings 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.

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

Hello, everyone. Welcome to Rackspace's Q1 2014 Earnings Conference Call. We hope you 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. On the call today will be Graham Weston, our Chief Executive Officer; and Karl Pichler, our Chief Financial Officer.

I need to remind you that some of the comments we may 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, including continued market acceptance of our hybrid cloud platform and products, increased competition in our industry, and 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 call, 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 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. After our prepared remarks this afternoon, we'll be happy to take your questions. I will now turn the call over to Graham. Graham?

Graham Weston - *Rackspace Hosting Inc - CEO*

Good afternoon, and thank you for joining us today. Let's talk about some of the recent developments in our industry and what they mean in the context of our strategy. At the end of March, Amazon, Google, and Microsoft, the unmanaged cloud providers, sharply cut prices. This attracted a ton of publicity within our industry. But it's important to remember that this is just the latest iteration for the longstanding trend for those players, a service that only covers a fraction of the real cost of transitioning, running, and scaling on the cloud.

Rackspace's strategy is to be the leader of the managed cloud category, the higher-value alternative to the unmanaged cloud approach. We will continue to differentiate through Fanatical Support, and by providing a customer experience that the unmanaged cloud vendors do not provide.

Our business has always been about more than just renting out access to infrastructure. We add value by managing that infrastructure, as well as specializing in the complex tools and applications that run on top. While the other providers add value through economies of scale that yield low unit prices, we add value through economies of expertise, allowing customers to leverage the specialized expertise of our cloud engineers and architects.

Just as Rackspace created and dominated the managed hosting market years ago, our strategy today is to dominate the managed cloud market. We will do that by continuing to increase the value of the solutions we run for our customers on top of our hybrid cloud system. We will continue to focus on solving complex technology challenges for our customers so they can focus on their businesses. With that, I'd like to hand the call over to Taylor Rhodes, our President of Rackspace.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Thank you, Graham. I think the managed cloud opportunities before us make this a really exciting time to be at Rackspace. Many businesses want and will require an expert service provider that can deliver the best-fit infrastructure for their specific applications. Whether that requires multi-tenant, single-tenant, or hybrid architecture using VMware or OpenStack in our data centers or in theirs or in those of a third party, those customers are the segment of the market that we are focused on. None of our larger competitors offer the selection of hybrid solutions we include in our portfolio, and none of them offer the level of service that we provide.

During the first quarter, thousands of new and existing customers chose Rackspace to run their important applications, including companies like AppBoy, Under Armour, SunPower, Clarks, and Alex and Ani. One of our new customers that chose us for our DevOps service model is AppBoy. AppBoy is the leading platform for application marketing automation. After outgrowing EngineYard and Amazon Web Services, AppBoy selected Rackspace for our ablity to support its agile application development practices, and high scaling requirements. AppBoy leverages other Rackspace products in its hybrid cloud solution, including our multi-tenant performance cloud servers, and our object rocket service for running MongoDB.

Under Armour is a long-time and very large Rackspace customer who embraces the value of our hybrid solutions. Under Armour is an innovative athletic performance brand whose products are worn by athletes in the NFL, the Olympics, top universities, and all levels of sport around the world. In addition to hosting their website, large e-commerce platform and a disaster recovery site with Rackspace, they also utilize high-availability firewalls and load balancers with direct-attach storage arrays. Most recently, Under Armour has selected ObjectRocket for its MongoDB environment, and signed on to take full advantage of our managed virtualization solution.

Another customer win is SunPower, a global solar energy solutions leader. With residential, business, and government customers all over the world, SunPower is using our hybrid cloud in order to quickly scale its growing business, while ensuring a world-class experience for its customers.

Clarks is a shoe manufacturer based in the UK, with more than 1,000 company-owned stores and franchises around the world, and more than GBP1.4 billion in annual scales. Clarks selected Rackspace to run its new global e-commerce platform. This complex deployment consists of dedicated servers running the Hybris e-commerce application, VMware, and an Oracle database. In addition, the deployment is fully redundant in two of Rackspace's data centers, one in the UK and one in the US.

Alex and Ani makes a popular brand of wire bangle bracelets, and is one of the fastest-growing retailers in the world. It came to Rackspace from a competing hosting provider because of our expertise in the Magento e-commerce platform, the SharePoint collaboration suite, and for our ability to guide and help manage their rapidly growing business requirements. Alex and Ani trust Rackspace to architect a hybrid environment that is capable of managing explosive growth through major marketing events like its 2014 Super Bowl ad campaign.

In addition to these examples, we also welcomed one of the largest new customers in Rackspace's history. This leading global enterprise customer chose Rackspace to run a complex hybrid environment for a highly sensitive mission-critical application. The hybrid solution includes both our managed virtualization service and our dedicated VMware vCenter offering.

The customer demanded strong service-level agreements to guarantee up-time and performance from Rackspace. It required close collaboration with partners in areas including complex security solutions, high-speed file transfer, and storage. Rackspace was able to deliver on every front, and won the business against two much larger competitors.

This new deal is notable not only for its size and complexity, but also because the customer is moving its workload out of one of its own data centers. This customer is emblematic of the new wave of cloud-adopters among sophisticated mainstream companies that don't want to do everything themselves in IT, but instead seek a trusted partner with specialized expertise, and the right portfolio of managed cloud options, who can help them gain the benefits of the cloud era without having to own and run it all by themselves.

Our job is to move the industry conversation beyond unit prices for infrastructure toward total cost and value. In the coming months, you will see us getting more aggressive as we educate the market on the important choice between unmanaged cloud and managed cloud. We are addressing these issues with more aggressive marketing, including a headline sponsorship at the OpenStack summit that kicked off today in Atlanta, with more than 4,500 developers and users in attendance. Rackspace is extremely proud to be the founder of OpenStack, and we will continue to contribute to and leverage the power of OpenStack in our managed cloud model.

We will also be present at a keynote speech during the Gigaom structure conference in June. Beginning in July, we will be hosting one-day conferences in major cities around the world to directly communicate our messages to the market. You can find out more information about these conferences at www.Rackspacesolve.com. We will also announce some important additions to our product and support portfolio in the coming months that will extend our capability advantage over the unmanaged cloud alternatives in the market.

Now on to the guidance update. At the beginning of the year, we provided high-level financial goals for 2014, including our expectation that year-over-year revenue growth would range between 15% and 18%, and adjusted EBITDA margins would range between 32% and 35%. With the first quarter behind us, we feel good about those goals, and we believe we are on track to deliver results within those ranges. As we've mentioned before, the first quarter is typically our slowest quarter because of seasonality, and our goal is to improve from here. With that, I'll hand the call over to Karl Pichler, our CFO. Karl?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Revenue for the first quarter grew 3.2% sequentially to $421 million. On a constant-currency basis, sequential revenue growth was 2.6%. As we discussed on our last call in February, revenue growth in the first quarter of each year is typically lower than the fourth quarter, due to a number of seasonal factors, including fewer billing days, cloud workloads spinning down after the holiday months, and the reallocation of IT budgets starting in a new year. Our goal continues to be to improve our revenue growth, and we do expect growth to improve in the second quarter.

Adjusted EBITDA for the first quarter was $140 million, reflecting a margin of 33.2%. Net income was $25 million, reflecting a margin of 6%. As in prior years, first-quarter profit margins were negatively impacted by seasonal costs, including higher payroll taxes and employee-benefit-related expenses. In addition to the normal seasonal expenses, first-quarter margins were also negatively impacted by higher software license and data center costs. However, these outlays were offset by lower head-count-related expenses, and the retirement of unvested stock options compensation, primarily relating to the departure of our previous CEO, Lanham Napier.

Recall that one of our stated goals for 2014 is to improve capital efficiency by driving capital expenditures down towards 25% of revenue. In the first quarter, total capital expenditures came to $101 million in the quarter, representing 24% of revenue. Obviously, this is a good start, and we feel good about delivering on our goal to improve capital efficiency for the year.

As a result of improved margins and tighter capital expenditures, our cash flow improved significantly. Adjusted free cash flow in the first quarter came to $40 million, which was a record high for the Company. Average revenue per server came to $1,336 in the quarter, representing another Company record. Looking ahead to the second quarter, we are forecasting sequential revenue growth of 3% to 4.5%, resulting in total revenue in the range of $434 million to $440 million. From a profitability standpoint, we expect adjusted EBITDA margins to be in the range of 32% to 34%.

The guidance ranges that we provided reflect our best estimates as to where revenue and expenses will fall for the second quarter, based on all the information available to us today. We are obviously aware of the price cuts that our competitors made at the end of March, and that took effect on April 1. Any immediate impact that they might have is reflected in our guidance considerations.

Also, it is important to remember that a large portion of revenue is derived from product that are distinctly different than the offerings from the unmanaged cloud providers. Dedicated single-tenant hosting represents more than 70% of our revenue, and within our multi-tenant cloud revenue base, a meaningful portion is generated by our e-mailing the application product.

Finally, we are evaluating how to best report our business progress to you in the future. We have historically stated that our preference is not to give specific financial guidance, especially on a quarterly basis. While we provided quarterly guidance on this call, we will continue to evaluate whether we will provide both quarterly and annual guidance in the future.

We also believe that our historical reporting of the business broken into cloud and dedicated revenue components is becoming less relevant. Our customers want to consume multi-tenant and single-tenant product in hybrid solutions, and the lines between the different products continue to blur. We will update you on our latest thinking on our next earnings call. This is the end of our prepared remarks. Operator, please open the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

Certainly.

(Operator Instructions)

Our first question comes from the line of Barry McCarver. Please go ahead, sir. Your line is open.

Barry McCarver - *Stephens Inc. - Analyst*

Hey, good afternoon, guys. Good quarter and thanks for taking my questions.

First off, could you speak just to Rackspace's offering of OpenStack in the market place? I know you've spent a lot of time last year billing that out, continue to bill that out. Can you just speak to how competitive you are versus some of the other providers out there that are also offering OpenStack, where you stand in the market place?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Sure, Barry. This is Taylor. I'll take that question.

Look, the way to think about OpenStack for us is that it helps us in a couple of ways. The first is that our public multi-tenant cloud is built on OpenStack. We are running by far the world's largest instantiation of an OpenStack public cloud. The ability to leverage the OpenStack community to continue to help us to develop new capabilities within the public cloud is one way that we leverage OpenStack.

The other way it's an important part of our hybrid cloud system is that OpenStack is the basis for our private cloud offering, which allows us to design, deploy, and operate private clouds for our customers within their own data centers or within a Rackspace data center. We are very competitive. We told you on the last call we did over 100 of those private cloud deals in 2013 alone. We are the leader in the market there.

We continue to believe that the ability to help customers really run a hybrid cloud system with certain environments running in their data center, being able to work synchronously with OpenStack clouds running in our data centers is an important differentiator for us in the market. That's how we feel about the OpenStack story for us.

Barry McCarver - *Stephens Inc. - Analyst*

If I may, growth from the installed base was pretty light again this quarter. Churn looks great, but net upgrades are still pretty low. Your thoughts on how that's going to affect the year? Really good guidance for revenue for the year, but can you tell us what's going to come from the installed base?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Sure. Yes, if you look back at past first quarters, right? Last year, year before, et cetera, you see more of the utility nature of our business model kicking in, in Q -- in the first quarter of the year.

Obviously people go and take the holiday off and spend projects down. January is often a point in time when it takes our customers the first half of the month to get back off of vacation, particularly in Europe, and certainly in other parts of the world.

We see the ability for our customers to use the cloud as it was intended, which usually means we get off to a slow start in January. That's the primary effect. That's why we guided it to be lower for Q1. We generally pick up steam from here, and we have confidence that we guided you toward higher growth in Q2.

Barry McCarver - *Stephens Inc. - Analyst*

Fair enough. Graham, one question for you. With the stock downward, it is very close to the 52-week low. Any thoughts on using that great balance sheet to maybe buy back stock? Thanks a lot, guys.

Graham Weston - *Rackspace Hosting Inc - CEO*

I think at this time we have lots of opportunities to use our cash. We have no plans of buying back our stock at this time.

Operator

Our next question comes from the line of Pat Walravens. Please go ahead, sir. Your line is open.

Pat Walravens - *JMP Securities - Analyst*

Great, thank you. Congratulations, you guys.

Graham, like you, the biggest question I get is still how can Rackspace compete against Amazon, Microsoft, and Google. You addressed that at the beginning when you talked about the managed cloud versus the unmanaged cloud. But I think most people would agree that message hasn't really gotten out there.

I have two questions. One, why do you think that your message got lost over the last year or two? Two, how are you going to fix that?

Graham Weston - *Rackspace Hosting Inc - CEO*

Actually Pat, I think I'm going to ask Taylor to field this one. He has a great update for you.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Hi, Pat. This is Taylor. Thank you for that question. I appreciate it.

Look, I think many of you all have attended our Investor Days, and you've heard our customers talk on our behalf, right? You hear guys like Zack from Pantheon and others talk about the fact that they use Rackspace despite the fact that they could get cheaper infrastructure pricing elsewhere. Really, the reason is they understand it's not -- the infrastructure is merely a component -- an important component, but just a component of really managing and getting the value out of the cloud. It's really about how many talented engineers and architects and operators you would have to hire yourself in order to really manage the cloud 24 by 7.

The first era of cloud -- of the cloud era, the first phase -- is really driven by early adopters, who were mostly developer-oriented, technologically savvy, and do-it-yourself types. The public cloud offered such a compelling difference to them that it was okay that it was limited to public only, and not hybrid. It was okay that it was a do-it-yourself model instead of a supported model. It was okay that there was really no service levels available instead of getting service level guarantees.

But we really see now that the cloud is transitioning into this thing called the managed cloud. For businesses to really get value, they will expect hybrid options, because they've got a portfolio of applications that aren't all created equal. They will have limited capability to deploy and hire the skills at scale that are required to keep up with the proliferation of tools and software and things that are required to make a hybrid cloud work globally.

We are entering a new phase where it's not just about economies of scale and infrastructure. It's about economies of expertise. Rackspace has always been in the business not to sell raw infrastructure, but to provide the economies of expertise required to make it work, and produce real value for businesses.

We're going to get on the road starting right after this. In fact, at OpenStack this week you'll see us being very active. We have got a keynote spot at Gigaom Structure in June, and we've got our own city -- multi-city road show coming in July, starting in San Francisco on July 28.

You all are invited to that. I would love to have you there. We'll have our customers up there talking about why they choose Rackspace over buying raw infrastructure from somebody else, and the value we add into that equation. We would love to see you there.

Also, just one last note on this. We have a great blog by our CTO John N. Gates out today on our website, along with a customer testimonial from an amazing customer called SumAll. I'd encourage you to go check those out, because they really tell the story about managed versus unmanaged clouds well.

Pat, thanks for the question. I hope that helps.

Pat Walravens - *JMP Securities - Analyst*

Thank you.

Operator

Our next question comes from the line of Simon Flannery. Please go ahead, sir. Your line is open.

Louise Singlehurst - *Morgan Stanley - Analyst*

Hi. This is actually Louise for Simon. Thanks for taking the question. Congrats on the quarter.

Can you provide a bit of color on the bookings that you saw in this quarter? You had some good customer wins in the quarter, so can you talk a little bit more about the timing of those with respect to how they should appear in revenue growth in the fourth?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure, yes, thank you for the question.

Look, we have a lag in bookings to revenue, like most companies do, obviously. Our timing on bookings to revenue really depends on the size and scale of the opportunity of the deal. For the very large -- one of the largest new customers we've ever signed, those are one of those complex deployments, but we'll still get it online and convert it to revenue inside of 90 days. We would really expect that the impact from the strong bookings in Q1 will really help Q2, and start to show up in the quarter.

Louise Singlehurst - *Morgan Stanley - Analyst*

Okay. Do you have a sense of how bookings grew in this quarter relative to 4Q and so forth?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. We don't disclose bookings metrics.

The best thing I can tell you is that we feel good about our bookings performance in Q1. This really -- it helps us because obviously at this point in the quarter we have good visibility into how those bookings are materializing into revenue. That's a good tail wind for us.

Louise Singlehurst - *Morgan Stanley - Analyst*

Okay, great. Thank you.

Operator

Our next question comes from the line of Gray Powell. Please go ahead, sir. Your line is open.

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

Hi. Thanks for taking the questions.

With the new high-performance server offering in the market for just over six months now, have you seen increased volumes of new business and any improved traction on larger work loads than what you were seeing on the old platform?

Taylor Rhodes - *Rackspace Hosting Inc - President*

Yes. Thanks, Gray. This is Taylor.

Look, I think the performance cloud server has done well for us. Obviously, it got us very competitive in the market space for the Compute offer, and also when we combine it with our cloud block storage and our 10-gig networking, you have a really competitive, compelling compute storage and networking offer. It is growing faster than our previous generations ever grew.

The ARPU of our customers, or the revenue of the customers, you'll notice that we set a new record for revenue per server in this quarter. You're starting to see the evidence that we are getting larger production, great work loads from customers, because we have a production-grade offer for them. That's kind of the best characterization I can give you on that, Gray.

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

Got it. Just one follow up, if I may.

Return on invested capital improved nicely this quarter. How should we think about the pace of continued improvements over the course of 2014. Then, do you continue to see sort of a high teens or 20% return on invested capital profiles as a potential target at some point?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes, this is Karl speaking.

Okay, I think the two components that drive ROC at the end of the day are capital turnover and our margin profile. To pick up on the guidance that Taylor provided in his prepared remarks and that I've continued in my prepared remarks is that we have -- we basically continue margins to be flat in the 32% to 34% for the year, 35% range.

Capital turnover is just a measure that shows how we monetize our capital investments, which average revenue per server is another corresponding metric. You see we have fairly constant performance there. For the short term next six to nine months, we think that ROC, absent quarter-to-quarter fluctuations that are normal, should roughly stay the same.

The margin profile -- the target margin profile remains unchanged. Our unit economics are fairly intact the way that they've always been. We call it the 20/20 plan. At a moderate growth rate off that and in the 20% range, we can deliver 20% ROC before taking into account large investment opportunities that we have, and that we're pursuing at times.

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

Got it. All right, thanks a lot. Nice work this quarter.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Thanks, Gray.

Operator

(Operator Instructions)

Our next question comes from the line of Frank Louthan.

Alex Sklar - *Raymond James & Associates - Analyst*

Thanks. This is Alex Sklar here for Frank.

Can you talk about the trend in running off-prem enterprise deployments, and how these deployments are comparing in size to your other deployments? And maybe the margin profiler -- any other color on the differences there? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Well, I'll tell you about the trend, and we don't disclose specific data points around those deals. But the trend is very strong. I think if you think about, again, this emergence of the cloud era into a new phase -- phase one of it was really early-adopter driven and public cloud only. But for the mainstream to adopt, they're really going to want a hybrid model, which means I want to use some of the capability I have within my own data center, but I'm looking for an alternative to expensive VMware or Microsoft stacks. OpenStack is the leading contender to become the cloud architecture for those companies considering those options.

We continue to feel strong pull from medium and large enterprises, particularly to work with them with private clouds. Clearly those are different models for us.

We use OpenStack software rather than owning all of the infrastructure on those deals. They are lower revenue but less capital-intensive deals for us. We feel good about this continuing to be a differentiated part of our offering.

Alex Sklar - *Raymond James & Associates - Analyst*

Great. Thank you.

Operator

Our next question comes from the line of James Breen. Please go ahead, sir.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Just to -- the price cuts that Amazon and Google put in place at the end of March were pretty large. I was just wondering how you see that sort of impacting the business, and how you think about the evolution of that cloud business going forward?

Secondly, maybe for Taylor, you talk about going to market in different ways. Can you give us some more color on how you're thinking about from a sales perspective and sales engineering perspective how you're going to go to market with some of these new products? Thanks.

Graham Weston - *Rackspace Hosting Inc - CEO*

Sure. Thanks, Jim.

First of all, I think that the main thing to note is that the price cuts really affect the unmanaged infrastructure portion of the market. If you hear one thing from us today, we really do believe that we have to deal with the fact that Amazon and Google are clearly in the cloud market. But we are competing for a very different segment of the market. Customers who are going to choose not just infrastructure, but also the skills we can provide and the guarantees we can provide and the hybrid options to fit their portfolio, they're just shopping for different things.

For us, being able to clearly state today that we believe we are competing in a different segment, which is the managed cloud segment is the main message we want to get across today. Clearly, the price cuts cause people to think about their options. They create the compelling question of should I go with the unmanaged cloud option, and is that the best path for me?

For some customers it will be, because they will choose for whatever purposes to manage clouds themselves. But the point here is they will manage it.

A cloud infrastructure must be managed. The question we want to pose to the market is who is going to manage that for you? Are you going to keep up with the skill requirements and the proliferation of software and tools that will come with ever-cheaper infrastructure, or are you going to invest in the things that help you run your business better? We offer the clear alternative in the market as the market sorts itself into undifferentiated, low-cost infrastructure, which is unmanaged cloud, and into managed cloud. We actually feel good this gives us a chance to separate even further.

On the go to market, this is what we do, right? We go out and we hire talented sales and technical sales people who really understand key critical work loads, like e-commerce and SaaS applications, and big-data applications that all of our customers are trying to solve for. They can come with authoritative reference architectures and use cases, and really importantly, reference customer who will say I've chosen Rackspace. Help me feel good about choosing Rackspace over what might seem to be a cheaper alternative at Amazon or Google or somewhere else.

That's the go-to-market. We're strengthening our sales and technical sales teams by investing and training current rackers in our focus areas around big data and e-commerce and SaaS, et cetera, and we're deploying more resources there. We feel good about our credibility and experience in the past that selling hybrid cloud, managed cloud, Fanatical Support.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Our next question comes from the line of Tim Horan. Please go ahead, sir. Your line an open.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thanks, guys. Great quarter. Sorry to harp on the pricing, but it seems to be such an issue with the investors at this point.

Obviously you've been facing price declines from the infrastructure providers for quite a number of years. Can you maybe just talk about how this round of price cut is going to compared so what you've seen in the past?

Also, how much of a premium can you really charge, do you think, for your services versus unmanaged infrastructure? Has that premium been increasing or decreasing at this point? Thanks.

Graham Weston - *Rackspace Hosting Inc - CEO*

Sure. My simple answer to the first part of your question is they're bigger, right? These are bigger price cuts.

Google coming out and cutting prices to the extent they did is clearly a very aggressive move, clearly aimed at AWS and Microsoft. Again, I think that what this does is it -- I'm not being flippant about this. It simply says they're intent on racing, and racing to the bottom in a very undifferentiated approach, which is to go try to compete primarily for developer-driven decisions, with technology and low prices.

We believe that what's going to happen in the market is, again, this bifurcation will become more stark. We will continue to emphasize the alternative that we provide. And also that we have this firm conviction that the further they cut prices, it becomes very difficult for them to try to add more value or expertise on top, even if they want to. Right?

First of all, I would make the point that's not their business. Never has been. They are not in the support and services business. But as they go deeper and deeper and deeper down the price curve, it will get more difficult for them to add more valuable expertise on top.

I think the second thing is we have an infrastructure component to our business, as well. Look, we ride cost curves and experience curves now with every data center we deploy. We are investing in open computes and open-compute servers. We'll continue to make investments that allow us to ride the experience curve down and the scale curve down on the infrastructure components of our business, too.

Tim Horan - *Oppenheimer & Co. - Analyst*

Do you think this has helped driving elasticity, the price cuts, for cloud adoption?

Graham Weston - *Rackspace Hosting Inc - CEO*

Sure. For customers who are really comfortable with selecting a self-service unmanaged model with very little SLAs and price is their number one factor, absolutely. Yes, it will.

But for what we believe is the main market, which is really more of the mainstream business market that has a scarcity of access to the skills and capabilities to run clouds at scale, it's not about necessarily just the price. Price is always a factor in every deal we do. It's really about what application are you solving for me and running better. How do you use a hybrid cloud architecture to create better performance and economics for me, and what can your people do for me so I don't have to go hire that engineer. I can go run my business.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

Our next question comes from the line of Siti Panigrahi. Please go ahead. Your line is open.

Siti Panigrahi - *Credit Suisse - Analyst*

Hey, guys. Congrats on a good quarter.

Graham Weston - *Rackspace Hosting Inc - CEO*

Thank you.

Siti Panigrahi - *Credit Suisse - Analyst*

I want to dig a little bit into the dedicated Cloud business. It had a better than expected revenue. Wondering could you discuss the pipeline in this business, and how should we think about the potential for growth to improve in the coming quarters?

Graham Weston - *Rackspace Hosting Inc - CEO*

Sure. I'd say the first thing I want to make sure that we cover on this is that dedicated is really a feature of a managed cloud, okay? We don't think of our dedicated business as our old business. What we have discovered over time is that having the experience we have at running dedicated solutions at scale and being able to connect them into a public cloud multi-tenant environment really makes for a -- it makes dedicated a killer feature of a hybrid managed cloud.

As we are going to market and selling the value of Rackspace, it's very much selling division not only of Fanatical Support and us running things. But really thinking about the value that the dedicated component of our business brings to customers who are concerned about performance, security, and the ability for us to use it as a part of the business that helps our customers have the right fit choice for the infrastructure they're solving for.

It's also super important for us because our competitors have a multi-tenant public cloud. They do not have the capability to use dedicated as a solution option for our customers. We find that to be a very important aspect of our ability to solution for the mainstream market that's just beginning to adopt cloud.

Siti Panigrahi - *Credit Suisse - Analyst*

Do you feel confident that you can get back the segment back to that high-teen cycle growth in the future at some point?

Graham Weston - *Rackspace Hosting Inc - CEO*

Yes, we're working on it. I think you can do the math on what we guided for Q2.

But look, I will tell you the biggest -- the large deal we talked about signing in Q1 was mostly a dedicated deal. A lot of our big, new customers, a significant portion of their footprints are dedicated. That's because at this point in the market evolution they value that, and they connecting it to a multi-tenant public cloud hybrid solution.

We feel like as the main market moves out of its own data centers, the first stop for them often times is going to be a dedicated portion of their solution connected to a multi-tenant cloud. We feel good about it as a valuable part of our differentiation.

Siti Panigrahi - *Credit Suisse - Analyst*

That's great. Thank you.

Graham Weston - *Rackspace Hosting Inc - CEO*

Thank you.

Operator

Our next question comes from the line of Jonathan Schildkraut. Please go ahead, sir. Your line is open.

Jonathan Schildkraut - *Evercore Partners - Analyst*

I'm wondering as you talk about really emphasizing the folks who want a managed experience, if this is a new strategy, or a return to your old strategy. Because it sounds like maybe you're articulating something different than what I've heard from the Company over the last 12 months. What I've been hearing is that you wanted to go after the developers and the IT architects, and you were going to work with them in customizing the OpenStack architecture to meet the application resource need.

What I'm hearing today is that sort of moved back towards your roots of really helping those folks who need more help. Maybe I just didn't understand the subtleties in how you guys were previously describing your strategies. My real question here is, is this a change in direction, is it just a pivot, or is this where you were going, and you're just articulating it somewhat differently? Then I have a follow-up, thanks.

Graham Weston - *Rackspace Hosting Inc - CEO*

Thank you, Jonathan. Really, we are catering to developers just as much as ever, because they actually need specific services that we provide.

There are DIY developers that we don't serve as well, that we don't target, but I think there are many developers out there -- the big companies, dot coms alike -- that can utilize our services. Our MongoDB service, for example, is a really leading way that many of our most advanced customers, most technically savvy customers come to us.

What we're saying is that we're really here to serve businesses that need our help. We're here to serve businesses that need our help. That is what Fanatical Support has been about for our entire history.

I think what you're seeing is that as the unmanaged guys cut price and basically lean out their model, it means that we are differentiating ourselves even more. It's even clearer today that we're the managed alternative in the cloud. I think that it's -- it just clarifies what our capabilities are, where we want to focus, and really how we pull away to be different from them.

Taylor Rhodes - *Rackspace Hosting Inc - President*

I would -- just to amplify real quickly. I think Graham said it well. We are here to serve customers whether they are developer oriented or business oriented or CIO oriented who choose not to go run clouds themselves, right?

Two of our biggest areas of investment are around big data solutions and dev ops. Those are clearly developer-oriented offers. The distinction you have to make in your head is we aren't looking for it to be the best solution for developers who say just give me the raw stuff and I'll take it from here. We are trying to create irresistible offers that solve problems that are important to developers, but then also help them getting back to writing more code. That's what they really want.

When you spend an incremental dollar of your budget on hiring a developer, the more of a problem you have with cloud-oriented infrastructure operations. The more of a bottleneck that effective infrastructure operations can become for your developer spend. We want to solve hard problems for devs that let them get back to writing code. We want to attract business buyers and CIOs who are saying I want to be there, as well. I've got a scarcity of skill set and budget, and I'm going to leverage your scale to go do it. I think that's the best way to characterize it.

Jonathan Schildkraut - *Evercore Partners - Analyst*

That's very helpful. I have two follow-up questions, then.

One, who is your competition then in this world? Secondly, how is your cost for that raw infrastructure stuff relative to those outside competitors, because I imagine there's some threshold that customers will be willing to pay on the Fanatical Support side relative to that base infrastructure cost? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Okay. I think the first question was who are our competitors. I think about people like IBM, who historically served the Fortune 500 well, but clearly with their SoftLayer acquisition are trying to broaden their appeal.

When we're competing today for the types of deals that we featured here for the mainstream, we are seeing IBM. We are going to play to our strength there. We are really a clear-service differentiator. We're more nimble. We have much more experience truly in running hybrid clouds than IBM does, so we feel good about that.

Then there are other traditional what I would call hosters. They might be the folks like CenturyLink and Teramark inside of Verizon, et cetera. But if you look across the spectrum at our ability to do the dedicated component of managed cloud, the multi-tenant component to add valuable services on top for apps that really are born on the web, and require web speed, web scale, web nimbleness, we are really the only specialist that covers that spectrum. We feel pretty good about it.

We think that really if you think about our core competitor, our core competitor is really do-it-yourself. Most of the infrastructure in the world is still managed inside of a corporate data center. We feel super good that the trends towards as-a-service models means more and more of those work loads will be under evaluation.

One of the biggest trends in the industry right now is that CIOs spent the last decade virtualizing their apps inside of their own data centers, and now they are saying I need to get those out. I want to put them in a managed services model. I need to create space in my own budget and my own data center, my own staff, for innovation -- that's important. They want to bring it to somebody like Rackspace they can trust with up time and performance, but also who can connect it right next into a multi-tenant public cloud.

We think really this is sort of inning two of a seven-game series of the cloud era. It's early days, and we feel like we're going to be the natural heir for the mainstream market that is really deciding not to go invest in running and owning everything. We're excited about that, and I hope that answers your question.

Operator

Our next question comes from the line of Colby Synesael. Please go ahead. Your line is open.

Colby Synesael - *Cowen and Company - Analyst*

Great. Two questions, if I may.

Given today how important culture is and how important your employees are to the model, I was just wondering if you could give us your update how employee retention has done, and how your ability to hire may have changed, if at all, since Lanham left.

The second question has to go back to install base drip. I guess if someone was negative on the Company, they would point to that metric as an area of issue. Can you just explain to us in maybe a little more specificity why that metric, at least the way you guys look at the Company, isn't as important perhaps today as it was maybe a year or two ago? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc - President*

Sure. Two parts, two different questions. First about employee retention, ability to hire.

Look, Lanham is a dearly beloved figurehead iconic leader here at Rackspace. He left in good graces. He's still in San Antonio. He's still part of our culture here.

The team that worked with him has worked with him for a very long time. You look around the table here, you see Karl Pichler, you see Graham, me, et cetera. We all had year and years of experience with Lanham. The continuity was very strong.

There was an article out this morning, actually a new list yesterday, that talked about the top 10 companies -- tech companies to work for who are not in Silicon Valley, and how they fare. We made number 10 on that list.

We continue to be very highly regarded. We're number 29 on the Fortune 100 Best list this year. Forbes recently published its list of most trusted big-cap Companies in America, and we were in the top 10 on that list.

We haven't found that our retention has -- pardon me, our turnover has spiked. Clearly we're under pressure. Clearly there is this notion in the market that people who know how to do cloud things are very scarce and hot resources.

We're competing every single day to make Rackspace a great place to work for them. We're competing every day to draw new talent in. We feel pretty good, right?

Geeks want to work at Rackspace because they get a chance to develop cool and interesting things here. They're not confined to working in sort of a black box proprietary stack. A lot of geeks in the world want to work on open-source projects. That's an important draw for us, as well.

Then I think your question was around install base growth metrics. Karl, do you want to talk about install base growth as a metric, and why it changes over time?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes, sure, I can. Basically, look, traditionally our managed hosting business on the dedicated side was all contractually based. You had a solution that was configured to your specific needs, and then you can have -- you basically have a contractually stipulated monthly bill, and you basically pay that bill.

When everything's changed, you upgrade with us which is another contractual change, which requires an additional fee to be invoiced and then paid for on a recurring basis, or a downgrade or a defection, ultimately. You basically have recurring revenue layers that go up and down depending on net upgrades and churn and the addition of new business, and so everything is highly recurring.

On the cloud side, on the utility side, it's a little bit more complicated than that. On the overall business, it is still a fairly stable amount of revenue and a fairly high degree of recurring nature, even on the compute side, which is if you want the least recurring one. I'm going to add some color in a minute.

But you have two effects. One is you have a pure utility consumption model from a customer's point of view, which basically means there's no recurring nature in general. Variable work loads will lead to variable revenue, which is one of the key features of the cloud utility nature of billings.

The second piece is you also bill by time unit. When you look at periods -- when you compare periods that have different days, it actually creates volatility that is not really reflective of what our customer base is doing from a work load perspective. So while the number conceptually, or the concept conceptually is very important, it's numerical relevane, software's a little bit from the volatile nature of the consumption of utility-based product.

We still have way more than 50% of our business is attached to the recurring nature, the truly recurring nature that's contractual based. It is not completely useless as a metric, but it loses its relevance over time a little bit.

Colby Synesael - *Cowen and Company - Analyst*

What about -- I'm sorry to interrupt you. Is there any other correlation or tie in there to the shift from SMB to enterprise? Or more from utilizing OpenStack opposed to your legacy technology, which a lot of your legacy customers by definition may still be on?

Karl Pichler - *Rackspace Hosting Inc - CFO*

No. Not really.

Colby Synesael - *Cowen and Company - Analyst*

Okay, thank you.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay.

Operator

That does conclude our Q&A session. Speakers, I'll turn the call back to you for any closing remarks.

Taylor Rhodes - *Rackspace Hosting Inc - President*

No, thank you. This is Taylor. Thank you for joining us today. We appreciate the opportunity to answer your questions, and we'll look to meeting with many of you over the coming months.

Thank you. Goodbye.

Operator

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