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# EDITED TRANSCRIPT

RAX - Q2 2014 Rackspace Hosting Inc Earnings Call

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**Taylor Rhodes** *Rackspace Hosting Inc - President*

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting's Q2 2014 earnings conference call.

(Operator Instructions)

It is now my pleasure to introduce Jason Luce, Vice President of Finance for Rackspace. Mr Luce, you may begin.

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### Jason Luce - Rackspace Hosting - VP of Finance

Hello, everyone. Welcome to Rackspace's second quarter 2014 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](http://www.IR.Rackspace.com). This call is being webcast online and can be accessed through our investor relations site.

For Rackspace on the call today will be Graham Weston, chief executive officer and chairman of the board; Taylor Rhodes, president; and Karl Pichler, 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. That statements involve a number of risks and uncertainties that could cause actual results to differ materially.

Please note that these forward-looking statements reflect our opinions only as of the date of this call, and we under take 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 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 - Chairman & CEO*

Good afternoon and thank you for joining us today. Before I turn over the call to Taylor and Karl to review our second quarter results, I want to address the elephant in the room, the strategic options we're evaluating. As we discussed in an 8-K filing on May 15, our board hired Morgan Stanley to evaluate strategic proposals. At this point in time the evaluation is ongoing.

The board has not set a timetable for completion of this process, and there can be no assurance that any transaction or partnership arrangement will be reached. We do not intend to comment further on this issue at this time so we ask that you refrain from asking related questions so that we can focus our call on the operational results and the business opportunities. What we can talk about and what we're excited to share with you today are the results from our second quarter, the excellent progress we've made on our managed cloud strategy.

I am going to let Taylor review the details, but the long and short of it is that our strategy to be the leading managed cloud company is working. As customers gain production experience with the cloud, they're becoming increasingly savvy about the life cycle cost of this new way of leveraging IT. While early adopters of cloud shouldered the technical complexity and management responsibility themselves, mainstream customers are demanding services that Rackspace is world famous for providing.

We call it Fanatical Support, hybrid deployment models and value added solutions. These are the capabilities that make us highly differentiated from the large number of unmanaged cloud providers. We are playing a different game than they are, and this strategy is working. Industry research firm Gartner recently validated our strategy by publishing a report defining a new industry segment. Gartner calls it -- called it cloud enabled managed hosting.

We think managed cloud is a better name, but regardless the key point is that there is an emerging industry for service providers that offer value added services in conjunction with computing infrastructure. We think this industry will grow to be \$100 billion, and Gartner thinks Rackspace is the leader in this new category. In other words it's official, Rackspace is the number one managed cloud company.

We want to continue leading the market for businesses that want a trusted partner to manage their cloud rather than doing it all themselves, and we will continue to aggressively execute on that strategy. With that I'd like to hand over the call to our president, Taylor Rhodes.

**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Thank you, Graham. On last quarter's call we outlined our managed cloud positioning and strategy. We told you that we would get more aggressive with our marketing and that we would make some important additions to our product and support portfolio. Since then we've been hard at work executing our plan. With a few months under our belt we have some strong data points demonstrating that our strategy is working and that momentum is building. First Q2 was a company record for incremental net revenue added.

For the first time in Rackspace history we added more than \$20 million of new revenue in a single quarter. This record was driven by exceptionally strong sales performance in each month of the second quarter. To put that performance into perspective, we have not seen this level of sales trajectory since 2012 when we were growing at a much faster rate. Additionally, total sequential growth is re-approaching 2012 rates.

While GAAP growth of 4.8% was strong, on a constant currency basis, revenue growth of 4.3% in the second quarter was the highest rate of growth that we've generated since the fourth quarter of 2012. Another outstanding highlight is the performance of our cloud products in the second quarter. In the same period in which our competitors dramatically lowered prices, and the largest provider's cloud business decelerated, our revenue not only grew, but its growth rate accelerated to 7.5%.

At the same time that all of these revenue growth metrics improved, we were also able to improve capital efficiency. Capital turns improved to 1.94, and revenue per server grew to \$1,375 per month, which is another Rackspace record. The improvements in all of these growth drivers are a monumental achievement for Rackspace. They demonstrate that there is demand for our differentiated offerings. They demonstrate that Fanatical

Support and service levels matter in the cloud era, and they demonstrate the market is beginning to understand the difference between Rackspace's managed cloud and the unmanaged cloud alternatives.

In addition to the previously mentioned revenue growth and financial highlights, we operationalized our strategy by making a series of improvements and changes to the business. First we went live with a new version of our website with better descriptions of our managed cloud value proposition. Next we unbundled our pricing to highlight the value of Fanatical Support and allow a more accurate comparison of our offerings to the total cost of an unmanaged cloud.

Third we strengthened our service level agreements and guarantees to further emphasize the difference between Rackspace and the unmanaged clouds. Next we introduced our developer plus program to enhance our appeal to developers that want to focus on building new apps and shipping product rather than managing cloud operations. We launched OnMetal cloud servers which allow cloud users to spin up and spin down single tenant bare metal servers as quickly and easily as they spin up servers in our multi-tenant public cloud.

These servers deliver what our biggest and fastest growing customers have been asking for, the flexibility and utility building of a multi-tenant public cloud with the predictable performance and cost at scale of single tenant dedicated servers. We had standing room only attendance at our first ever Rackspace Solve event in San Francisco where innovative Rackspace customers showed more than 600 other business leaders, journalists and analysts how they are leveraging our managed cloud to grow their businesses. We are hosting additional Solve events in New York and Chicago in the coming months.

Finally, as Graham mentioned, we were recognized by Gartner as the number one managed cloud company in both North America and Europe. The overarching goal of all of our work is to create a clear differentiation between the Rackspace model and the unmanaged clouds through our messaging, service levels, application level expertise and clear simple pricing. The rationale for pursuing our strategy is simple.

None of our larger competitors offers the best fit for each customer's unique needs across the multi-tenant and single tenant options that we include in our hybrid portfolio. None of our larger competitors can come close to matching the levels of expertise and service that we provide.

No one in the industry can touch Rackspace when it comes to Fanatical Support, and as the cloud market moves from the early adopter to the mainstream phase, more and more companies of every size and technical sophistication level are realizing that there is a lot more to making the cloud produce value than getting a seemingly low price for unit hour of compute. Savvy buyers realize the power of renting the critical and expensive skills needed to operate cloud applications as a variable cost service so that they can stay fast and lean and focus their resources on what makes them special and unique in their industry.

And more and more of these mainstream cloud adopters realize that they need compelling service level agreements that actually align their designed business outcomes with their cloud provider's performance. This is the Rackspace target market, and it is large, and it is profitable. Thousands of new business customers from 75 different countries chose our managed cloud services in the second quarter. A few notable new customer wins in the quarter were WP Engine, WePay and Zulily, each selecting Rackspace because they recognize the difference in value in Fanatical Support and Rackspace's managed cloud offer.

Zulily, an innovative web 2.0 E-commerce leader with nearly \$1 billion in online revenue recently joined us on stage at Rackspace Solve to explain why they selected Rackspace over competing models. We are proud to welcome Zulily to the Rackspace family. I also want to briefly review the WePay customer example, because it perfectly illustrates how Rackspace is differentiated from the unmanaged cloud providers. WePay, an online payments company that handles massive transaction volume was having problems scaling its business by managing its infrastructure on a server by server basis. WePay needed to move to a cloud model, but it lacked the internal resources with the skills needed to manage and benefit from the cloud scaling capabilities.

They realized that getting value from the cloud required far more than simply buying unmanaged cloud infrastructure. The CEO faced a choice, attempt to hire, train and manage an expensive DevOps team in house, or leverage Rackspace's economies of expertise in DevOps scaling engineers on a utility basis. WePay chose the Rackspace managed cloud model so it could stay focused on growth and remain fast and lean. Our managed cloud positioning has helped us clarify who we are and how we are different from the other vendors in the market, but this is really just the start.



I look forward to updating you on our progress in November, and we hope to see many of you at our Rackspace Solve events in New York City on September 18 and in Chicago on October 20. Lastly at the beginning of the year we provided some high level financial goals for 2014 including our expectation that year-over-year revenue growth would range between 15% and 18% and that adjusted EBITDA margins would range between 32% and 35% for the full year.

With the first half of the year behind us, we continue to feel good about those ranges. Let me turn the call over to our chief financial officer, Karl Pichler, to review the financial details of the quarter and give you more specifics on our near term expectations. Karl.

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**Karl Pichler - Rackspace Hosting Inc - CFO**

Thank you, Taylor. Revenue for the second quarter grew 4.8% sequentially to \$441 million. On a constant currency basis sequential revenue growth was 4.3%. The sequential increase in revenue growth was largely driven by strong and consistent sales performance towards the end of Q1 and throughout the second quarter across both form factors dedicated and public cloud. Furthermore, we saw strong traction with new customers and had strong upgrades from our existing base. Down grades were low, and defection turn remains stable.

Adjusted EBITDA for the second quarter was \$142 million reflecting a margin of 32.1%. Net income was \$22 million reflecting a margin of 5%. Compared to the first quarter, second quarter profit margins were negatively impacted by higher head counts related costs, professional fees and software license expenses. These outlays were partially offset by a decrease in data center related expenditures as a percent of revenue. This also contributed to the gross margin improvement of 40 basis points to 67.1% for the second quarter.

As we stated at the beginning of the year, one of our goals for 2014 is to improve capital efficiency by driving capital expenditures down towards 25% of revenue. With the first half of the year complete we are on track to deliver on our goal. In the second quarter total capital expenditures came to \$112 million, representing 25% of revenue. Adjusted free cash flow in the second quarter came to \$26 million, average monthly revenue per server to \$1,375 in the quarter, surpassing last quarter and setting another Company record.

Looking ahead to the third quarter, we are forecasting sequential revenue growth of 3% to 4.5% resulting in total revenue in the range of \$454 million to \$461 million. From a profitability standpoint we expect adjusted EBITDA margins to be in the range of 31% to 33%. 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.

While we provided guidance on this call, we will continue to evaluate what 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 relative. Our customers want to consume multi-tenant and single tenant product in hybrid solutions, and the lines between the different products continue to blur.

Beginning in 2015, we do not plan to continue breaking out revenue into the dedicated and cloud segments as we do today. In addition, given the increased portion of revenue derived from products within our [rebell] model our install base growth metrics as currently defined is losing relevancy. We will continue evaluating alternative ways to measure and report on the activity of our install base and the traction we have with new customers.

Churn continues to be an important measure of the value that we provide our customers, and we expect to continue reporting monthly revenue churn. This is the end of our prepared remarks. Operator, please open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions)



Our first question comes from the line of Simon Flannery with Morgan Stanley. Please proceed.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Thanks very much. Good afternoon. Nice to see the accelerate in top line and the outlook. Can you give us a little bit more color on where the bookings are coming from? Is this existing customers, new customers, large customers, small customers, some color around the wins and to what extent they're hybrid? And then on the margins particularly, Karl, I guess with the new unbundled pricing model what are you assuming in terms of customer activity, just sort of optimize their pricing given some of the tweaks that you did recently? Thanks.

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Okay. Yes, so on number two, so we have -- the way that we structured our pricing we have unbundled the price tag so to speak for the support and then the infrastructure piece, and then we have also introduced a minimum for core services and then the managed cloud services. And so basically what that does for us is it creates a filter for companies to really pick up our services when they really need the support and when they can profit from it.

And so we expect that we will have fewer low paying customers than we currently have, and that is a trade that we are deliberately making. So we may lose a little bit of traction on the low end for customers that just want to consume a do it yourself model, and we are aiming for the high ARPU, high work load growing customer set that we serve exceptionally well.

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Simon, this is Taylor. I will take up the first part of your question and talk about where did the bookings come from. The good news is on the quarter we had a very balanced quarter both with strong new acquisition growth of new customers as well as our install base. And so it was a very balanced quarter in terms of strong performance on both of those.

On the new customer acquisition side we are very much finding customer who by definition buy into the managed cloud thesis and that say I'd rather rent these services than own them on my payroll. That might be out of necessity, meaning I have a hard time accessing these skills on my own, or it might be out of choice which is I could if I wanted to, but I rather trade you money from my most precious resource pack which is my software engineers who go write code instead of trying to manage cloud ops. That message is really resounding.

Again I'd just remind you as we've talked about before, the IT services market has always had large segments of do it yourselfers and large segments of I will buy this as a service. We don't believe cloud changes that. We just believe the industry went through a hype curve with cloud. It's now moving into mainstream adoption, and mainstream adopters are thinking about what they should do that is core to their business and what they should buy as a service that is context to their business.

Most of the customers we are signing these days as well are now hybrid by nature, so they are looking at multi tenant and single tenant options within the solutions they buy from us. That's how I would characterize the bookings momentum.

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**Simon Flannery** - *Morgan Stanley - Analyst*

And do you think you've with any early feedback from your sales force about the results of Solve, the results of the rebranding? Is that starting to generate more leads for you, or is it still a little bit early?



**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Early results are very good, high quality leads. Look at Solve, we had very compelling customers on stage like Docker and New Relic, Zulily, Alex and Ani, which is one of the largest, fastest growing e-commerce companies in the world. And so when these folks are willing without any incentive to get on stage with us and talk about why they chose Rackspace, you can imagine that that's the most credible marketing we can do. So we're very happy with the quality both in volume as well as quality of the leads coming out of Solve.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Great. Thank you.

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**Operator**

Our next question comes from the line of Pat Walravens with JMP group. Please go ahead.

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**Pat Walravens** - *JMP Securities - Analyst*

Great. Thank you. At this time last quarter the headlines were all about the pricing cuts from Amazon, and so just keeping it very simple for us, how is it that you are able to accelerate your growth despite 40% price cuts from your competitors?

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Hey, Pat, this is Taylor. I will take that one. Thanks. Look, I think that the market is going from hype to wisdom, and there is a couple things showing up in wisdom phase of the mainstream adoption. And that is first of all infrastructure is only a portion of the total cost of running cloud applications. In fact, it's the minority portion of the cost set. And you have this ability to start to have a conversation with people that says first of all choose multi-tenant cloud as a tool.

It's a good tool for some things in your App portfolio. It's not a good tool for all things. You need a single tenant capability as well as a multi-tenant capability. But also the most important and compelling part of making cloud produce value are the people with the skills that understand how to run and operate the applications and tools that sit on top of it. And especially as infrastructure gets cheaper those tools and applications are proliferating which creates complexity.

More and more companies are moving out of the notion of I should do all that myself and moving into the notion of I want to go to somebody who does that for a living who has expertise at scale to manage those for us. And I think also you are just seeing the evidence points shape up that there is a different market. There is a very different market between what AWS and Google are selling which is unmanaged cloud and what we're selling which is managed cloud. They have different customers who have different buying criteria. I think the proof points in our numbers are showing that the market is realizing there is a difference.

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

This is Graham Weston. Let me just add to that. I think the record revenues following the price -- our record revenue quarter following the price cuts by Amazon and Google is really a proof point that we are in a different business. We are in a different category, and customers are coming to us for a managed cloud offering. And I just think it really proves that categories have split and that the industry is evolving.

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**Pat Walravens** - *JMP Securities - Analyst*

And my follow up would be, because I get this question from investors all the time, do we need to worry about Amazon following you into the managed cloud side that is trying to offer this kind of expertise?

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

Yes, Pat I think -- could they? I think they probably could try. I think it's very counter to their culture. It's very counter to their model. They continue to say that that's not the direction they're heading. It is very difficult to build a successful service culture.

It's a very different economic model. I think also you have to question as they continue to drive the profit out of their infrastructure business can they afford to get into an expensive people oriented service based business. So could they? I guess they could. Do we think they would be successful at it? No.

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

We have been competing with companies that have support throughout our whole history. I don't think the question is whether they'll add it. The question is whether they'll become famous for it. I think that we've been competing on that turf for 15 years, and I think we'd fare very well.

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**Pat Walravens** - *JMP Securities - Analyst*

Thank you.

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**Operator**

Your next question comes from the line of Gray Powell with Wells Fargo. Please proceed.

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

Great. Thanks for taking the questions. I just had a few here. Maybe sticking with the top line theme, if I just look at the prior six quarters Rackspace has added about \$13 million in absolute sequential revenue growth on average give or take. If I back out foreign exchange number in Q2 is closer to \$18 million, so again nice step higher. Just looking into Q3 the guidance implies between \$13 million and \$20 million in new revenue growth. Can you talk about main driver between the high end and the low end of guidance and then just given that you are almost halfway through the quarter what is your confidence level?

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, look, our confidence level is fairly high at this point. There is variability really comes from on the one hand [cause] revenue which obviously materialized immediately. We have a very strong and high degree of visibility into our dedicated business which is closed -- which is where we have contractual revenue that is booked and that we bring online and then the big, big variable again of today is FX. That is factored in. We are expressing guidance range in terms of fully baked dollar revenue growth including FX. And that is always a little bit of a wild card.

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

Got it. One tougher question if I may. Obviously, there is disparity between public market's view of your valuation and obviously yours and the private market. Would you ever consider taking net leverage up to say half or a full turn and then using the proceeds to buy back stock?





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

This is Graham Weston. I will answer that. I think the board understands that buying back stock could be great way to increase shareholder value. We are open to consider a buyback that makes sense in the future including adding leverage.

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

Okay. Great. That's all I had.

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

Thanks, Gray.

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**Operator**

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

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**Colby Synesael** - *Cowen and Company - Analyst*

Great. Graham, I think in the past you have talked about dissatisfaction with the growth rate and a viewpoint that you thought growth should be accelerating. And I think some of the changes we have seen so far in 2014 around people and products and marketing message have been with the intention to help spur that. And I guess I'm curious are most of those changes now behind you, and to that point why would growth potentially slow down on a sequential basis in the third quarter when you're guiding 3% to 4.5% after doing about 4.3%?

And then my second question you mentioned professional services increased the cost base in the quarter. I would assume that's for the strategic review. I think it would be helpful if you were able to break out roughly speaking how much of the incremental cost in the second quarter came from the strategic review process. Thanks.

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

I think as far as the guidance range I just think we want to be conservative in setting a range we know that especially FX and revenue recognition can make those numbers swing a lot. I do feel that there is a lot of upside for faster growth, and I think that we've seen growth already accelerate. I think we've got -- there are new managed cloud strategies that's really only been in place a matter of weeks. We have a lot of plans that are -- surround that to execute more aggressively.

So I think that I am still very optimistic about being able to grow at a faster rate, lots of untapped market out there. And I think really the mainstream market of the cloud is going to want the managed cloud, and I think that's what's going to be evolving in the years to come. I think that at this time we're just not -- we're not going to split out the professional fees at this time. I just think we certainly hope they'll be lower in the future.

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**Colby Synesael** - *Cowen and Company - Analyst*

Okay. Thanks.

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**Operator**

Our next question comes from the line of Frank Louthan with Raymond James. Please proceed. Your line is now open.

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**Frank Louthan** - *Raymond James & Associates - Analyst*

Great. Thank you. I wanted to look at some of the CapEx. The data center build, what does that consist of? Are you -- it was accelerated a little bit more than we were looking for. Is that new data centers, or are you working on new customer equipment? On the cap software explain what that ramp was for in the quarter.

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, okay, so on the data center side you just have basically two major categories that come together. One is the build out for new stuff. We are constantly bringing on capacity that may be or may not be reflected in the key metrics at the bottom where you see the infrastructure capacities. All of that stuff happens in phases, and so we may spend money in advance of the actual bringing them online. The second piece is replacement. You have a combination of those two which really drives the data center CapEx. And on the capitalized software, basically we have made the purchase of a fairly large amount of internally used licenses for our back office systems that is reflected in that \$27 million number.

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**Frank Louthan** - *Raymond James & Associates - Analyst*

Okay. All right. Thank you.

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**Operator**

Our next question comes from the line of Jonathan Schildkraut with Evercore. Please proceed with your question.

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Great. Thank you for taking the questions. I guess I'd love to dive a little deeper into the competitive landscape and how you compete. I think you guys have done a very nice job of laying out where you want to play in the sandbox and who is not your competition.

I think when we talked about competition historically, let's go back more than two years ago. We talked about kind of really focused on getting people out of their own infrastructure and into Rackspace's infrastructure. Today as you look at the competitive landscape Amazon, Google would be outside of that, is it still mostly pulling people in from internal use, or are you competing with the soft layers and others out there in the world?

And then secondly just to get a sense how you go out and source your deals? Historically a lot of the business has been incoming calls and a high level of responsiveness from Rackspace. Could you talk to us a little bit about how you go out there and you generate demand at the large level? Are you responding to RFPs or is this sort of single source that come to you, and you work it out? Thanks.

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Hi. This is Taylor. I'll answer those question. The first question was where does the growth come from? Who are we competing with? As always you know the majority of IT in the world still resides within the corporate data center. That is always the largest source of new growth.

We feel very much that as a service model continues to mature I hear all the time from prospects that say look a few years ago I would have just brought a do it yourself case when we were talking about expanding our data center or buying more capital. And if I do that now without an as a service case side by side I am going to get laughed out of the room. So the maturation of as a service models just make this a very normal way. We

see lots of trends where CIOs who spent the last decade virtualizing their servers and their own data centers run out of productivity there, trying to get work loads out of the data centers and into a managed service model so they have space in their budget for innovation work.

That gives us a very nice way to catch new companies coming out and put them into a hybrid model and then go work on them whether it be on an OpenStack private cloud that helps them start to bring innovation value to their company or in other ways. So we usually see that the biggest new demand comes from people moving out of corporate DC into as a service model. In terms of competitors we make IBM Softlayer as a competitor of ours. We feel very good about our ability to do well.

You know they will remain a big player within the fortune 500 install base, but in terms of taking new market share, we feel we are more nimble and more born on the cloud than they are. And we have a much better competitive solution across our portfolio and then clearly with our Fanatical Support than they do. And then you see that the [toko] driven players who have bought hosting providers over time, and I think we feel very good when we go up against them as well.

On the demand generation we are world class in terms of digital marketing. We generate a lot of our demand through inbound digital driven marketing to feed our sales teams. We also more and more do things like Solve where we're out in the market with our customers generating opportunity through them. Another growing part of our demand generation is through our channel partner business where we partner with digital agencies, system integrators and others who go to market with us.

And then finally our own install base of customers, we invest in Fanatical Support partly to make them promoters. And we get a good referral rate off of our install base customer set as well. So those are our primary demand generation engines. Does that answer your question?

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Yes, I'd love to follow up with one go a little bit deeper here which is to say how often does Fanatical Support or the ability to deliver sort of a top down view of somebody's infrastructure play into the before they're a customer sales process versus they are after the customer management process? I guess what I am trying to understand is is the sale process becoming increasingly complex where you can leverage your Fanatical Support in order to help people design a solution, or is it sort of after they're in the door that's when the Fanatical Support begins.

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

I think by definition people who are shopping and find us are looking for a service partner by definition, because that's what we do. Fanatical Support in the sales process looks like this. We have more people here who understand how to solution and run leading e-commerce platforms, web content management platforms, big data solutions, the MWare platforms than anybody else out there. Fanatical Support during the sales process means we're going to bring the best to the table.

They're going to be extremely responsive, nimble and knowledgeable during the sales process, and we're going to put together a solution with great people that they're going to have high confidence in. And that's what wins the deal with us. Fanatical Support shows up very purposefully during our sales process by how we execute the sales motion. We also expose our prospects early on to the Fanatical Support teams who will take care of them so that Fanatical Support moves from a concept to a name and a face and a reality for them. It's very much a part of how we sell and how we attract prospects in the first place.

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

Let me just add to that. I'll just add to that. I think the opportunity for Rackspace is to become IBM of the cloud. 30 years ago IBM was without a doubt the most trusted computing company in the world. With the acquisition of Softlayer they're really going more the commodity route. If you look at the most recent measure quadrant from Gartner IBM didn't show up very well in the managed cloud segment.



We really think that our high service model is really the new model for the cloud, and really the IBM of the cloud is our opportunity, and we don't think IBM is going to be the company. That is we don't think they're going to be the ones that are going to be taking up space, and we think it's ours to have.

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Thank you for taking the questions.

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

Thanks.

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**Operator**

Our next question comes from the line of Siti Panigrahi with Credit Suisse. Please proceed. Your line is now open.

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**Siti Panigrahi** - *Credit Suisse - Analyst*

Good to see some of this improvement in sales [education], and also you guys made some changes in terms of support and products as well. So just wondering like how -- and also you said it's going back to the 2012 levels some of the improvement in the sales education, so just could you discuss some of the pipeline that's in the business and how comfortable you feel are confident that can get back this managed cloud business back to the 20% growth rate that you used to have back in 2012?

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**Taylor Rhodes** - *Rackspace Hosting Inc - President*

Well, look, this is Taylor. Again I think about the second quarter and the results we just reported. We reported these results in the midst of historic price cuts by the big unmanaged cloud providers, in the midst of speculation about our strategic options, and in the midst of lots of change going on in the industry. I feel as though if we can put these type of proof points on the board then it ought to start to help you all understand that there is a different segment of the market out there.

We couldn't have executed on those numbers in Q2 without a strong healthy pipeline, and we feel good about our pipeline and our demand generation going forward. As another reference point, in the month of June we had our highest ever month of cloud units added. A cloud unit is a slice of a server, it's the base unit of how most companies measure cloud. So we had a record month in the month of June which bodes well for our cloud growth going into Q3.

We also had our strongest bookings in over two years. We feel that again just this notion of telling our story, getting the differentiation in the market space out there between managed cloud and unmanaged cloud is filling our pipe giving us plenty of people to talk to, and we feel good about the traction.

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**Siti Panigrahi** - *Credit Suisse - Analyst*

All right. Thank you.

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**Operator**

Our final question comes from the line of Jonathan Atkin with RBC Capital Markets. Please proceed. Your line is now open.

**Jonathan Atkin** - RBC Capital Markets - Analyst

I had a question about the portion of your revenues that are non-dollar denominated as well as what those assumptions might be for third quarter. And then my second question was around the kind of the competitive set, and there is a lot of more particularly larger competitors are opening up lots of new cloud locations and managed sourcing locations in more and more international markets, partly I suppose for data sovereignty reasons. And I wondered how that might inform your -- either your marketing strategy or your own plans to expand geographically? Thanks.

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**Taylor Rhodes** - Rackspace Hosting Inc - President

Sure. So thank you for the question. I will let Karl answer the non-US dollar denominated effect. Look we feel good pull in our international business. Our international business has been a growing share of our overall revenue. We feel exceptional pull into Latin America which is really an adjacency for us here from San Antonio. We have lots of Spanish speakers.

And so it's an adjacent market that is very easy for us to penetrate. We are seeing good growth there. Last year we expanded in Asia Pacific both in Hong Kong and Sidney to serve that important region. We're feeling good pull from those markets as well as developing markets for us like India. We have established a region within central Europe within Germany and Switzerland and have begun selling there as well.

So we feel a good pull from our install base customers in those regions who want us to be able to serve them globally, and so we will continue to expand and grow our share of revenue from outside of the US as we go forward. Karl, did you want to comment on the non-US D revenue segment.

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**Karl Pichler** - Rackspace Hosting Inc - CFO

Yes, exactly. As Taylor mentioned the largest non-US D revenue stream is in British pounds. That's just a reflection of our great success that we've had in that market for many, many years. We pick up some additional exposure to the Euro and to the Australian dollar and to a very small extent the Hong Kong dollar which is tied to the US dollar, so there is very limited exposure there.

The exposure mainly rests on the top line, because most of the dollar pound revenue exposure is kind of naturally hedged through the P&L, because we incur most of the cost there, so the profit exposure is very low. From an assumption standpoint, we -- in the short term we usually assume current rate stay throughout the quarter, and that is our base assumption that we apply for modeling purposes for the current quarter.

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**Jonathan Atkin** - RBC Capital Markets - Analyst

Great. And then I had a question about churn and feel free to chime in if there is any percentage exposure to the pound on the top line number used to be kind of in the 20%, 25% range maybe it's gone a little bit higher as you look at the pound and the Euro collectively maybe. But I'd love to get a little bit more detail on that. But as it relates to churn, Karl, you had commented about the trade off you were going to make with do it yourselfers accepting them leaving the platform in exchange for greater momentum among people that want the high touch support.

I just wondered if that DIY churn effect is already in the run rate since all you've really changed is the pricing model rather than the product? Or do you in fact expect a little bit of a bump up in churn from do it yourselfers and did that inform some of your caution around the guidance range for 3Q in revenue?

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**Taylor Rhodes** - Rackspace Hosting Inc - President

This is Taylor. I will take that question. Look, the portion of customer who are really small buying service from us is too small to matter to the market. We don't expect material churn from that. We simply want do a better job of defining who our target customers are in the future and educating them on the front end that if they buy Rackspace it's not the lowest price for raw infrastructure. We want customer who have multiple applications to run who value what we do with Fanatical Support and expertise and who have more to spend with us. So we don't anticipate any material head



wind from small customers churning out. We are doing a better job of defining who we are and our different offering than the unmanaged clouds going forward, so that is our goal on that change.

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

Okay. Thank you for those questions. With that, we'll conclude the call. Thanks, everybody for joining. We look forward to getting back to you out on the road. Thank you.

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