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RAX - Q3 2014 Rackspace Hosting Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting's Q3 2014 earnings call. As a reminder, this call is being recorded. At this time all lines are in listen-only mode to prevent background noise. After the prepared remarks, there will be a question-and-answer session.

(Operator Instructions)

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

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

Hello, everyone. Welcome to Rackspace's third quarter 2014 earnings conference call. We hope that you've had a chance to read our press release which we issued earlier today. If you don't have a copy of the press release, please visit our investor relations page of our website at ir.rackspace.com. This call is also being webcast online and can be accessed through our investor relation site.

For Rackspace on the call today will be Taylor Rhodes, our President and Chief Executive Officer and Karl Pichler, our Chief Financial Officer. I need to remind you that some of the comments we make today are forward-looking statements, including statements regarding expected operations and business results, our growth plans and expectations, the impact of new products or services, and our expected level of capital expenditures. These statements involve a number of risks and uncertainties that could cause actual results to differ materially. 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 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 will be happy to take your questions. I will now turn the call over to Taylor. Taylor?

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

Thanks, Jason. Good afternoon, and thank you for joining us. We're excited to share our third quarter results with you today. We believe that our progress and momentum in the third quarter and really throughout 2014 demonstrates the success of our strategy and validate our position as the number one managed cloud Company.

Our Company has been working in a pretty noisy environment for much of this year, and we've been glad to put that behind us. Through it all, a clear storyline has been developing, and that's what we want to talk about today. We see three trends that are shaping the future of our industry and of our Company. First, the cloud market is clearly separating into segments, a managed cloud segment and an unmanaged cloud segment. Over the past several years, the cloud market has gone through massive disruption, different business models have emerged along with new technologies that have changed the customers experiences and their expectations.

There is an emerging market category for cloud providers that offer value-added services in conjunction with computing infrastructure. The winners in this managed cloud segment will win by giving their customers the economies of expertise and enabling them to stay fast and lean so that they can focus their engineering resources on work that differentiates their business. The winners of the unmanaged cloud segment will appeal to companies that want to manage all of their IT themselves, either because it's strategic to their business or because they are led by developers who simply enjoy learning new technologies.

The leading IT industry research firm Gartner recently acknowledged this market segmentation by separating its annual evaluation of cloud providers into two reports. The managed quadrant -- or pardon me, the Magic Quadrant for cloud infrastructure-as-a-service which covers unmanaged cloud vendors and the Magic Quadrant for cloud-enabled managed hosting for managed cloud providers like Rackspace. Second, Rackspace has emerged as the Company best positioned to dominate the managed cloud segment. Fanatical Support and specialized expertise are what differentiate us from the unmanaged cloud providers. We are playing a different game than they are, and this strategy is working.

The analysts at Gartner recently validated our approach by positioning us as the leader among 17 top providers in its Magic Quadrant for cloud-enabled managed hosting in both North America and Europe. The managed services market where Rackspace competes was once dominated by the large telco companies and sellers of IT equipment and services like HP and IBM. They appeal to the business customers who are doing their computing in-house and were seeking efficiencies through IT managed services. But we've seen repeatedly in recent periods that those legacy providers are struggling to adapt their business models into the cloud era.

All the IT spending that once flowed into those providers is now in play. Many of the phone calls and RFPs that once went to those companies now come to Rackspace. We see evidence of this trend and the opportunity it presents to Rackspace in the record number of deals worth more than $100,000 a month that we closed in Q3 and in the even larger number of these type of deals that we've got in the pipeline for Q4. In addition to this flow of business from traditional IT models, we are also seeing more business from cloud native companies who are unsatisfied with the do-it-yourself, one-size-fits-all model provided by the unmanaged cloud players. Looking ahead, we are more focused than ever on expanding our leadership of the profitable managed cloud market.

Third, we see improvement in our operating performance and trajectory that validates our strategy. This trend demonstrates that we are executing well and that our positioning as the number one managed cloud Company has taken root. We added $19 million of new revenue in the third quarter. GAAP revenue grew 4.2% sequentially close to the high end of our guidance range. More importantly, our sequential growth rate on a constant currency basis rose to 4.4%. Ex-currency, that is our fastest sequential growth rate since the fourth quarter of 2012. Our year-over-year growth rate of 18.3% in the third quarter marks the third consecutive quarter of improvement following the previous nine quarters where our year-over-year growth decelerated. Our sequential growth rate for cloud revenue remained essentially unchanged at 7.4% and accelerated slightly on a constant currency basis.

We were able to demonstrate leverage in our model by improving margins and returns in the quarter. I'll let Karl go through the details, but to highlight a few, our gross margin, adjusted EBITDA margin, net income margin, return on capital, and revenue per server all improved in the third quarter. We announced the new partnership of Google to provide managed services and Fanatical Support for the full Google Apps for Work technology suite including Gmail, Drive, and Hangouts. This is an expression of our focus on our core differentiator which is adding value through specialized expertise and Fanatical Support.

In further pursuit of that goal, we announced earlier today that we are expanding our Managed Private Cloud product portfolio to include Fanatical Support for the Microsoft cloud OS which includes System Center and Hyper-V server. The offering is now in general availability at all of our US data centers providing customers with SLA-backed management across the underlying infrastructure, guest operating systems and select applications including Microsoft Exchange, SharePoint, and Lync. Our expanded portfolio will to customers additional choice. They can now host of locations across VMware, Microsoft and OpenStack based private clouds and on other Rackspace managed platform options such as dedicated servers and public cloud.

We held the second of our Rackspace Solve events in Q3, this time in New York City where hundreds of prospective customers, journalists and industry analysts heard a half dozen of our customers including Under Armour and Digitas talk about how they are leveraging the Rackspace managed cloud and our specialized expertise. We've since held a similarly successful Rackspace Solve event in Chicago in October and are planning others in the US and abroad for 2015.

We recently reached an major milestone of 300,000 customers worldwide, in part because of the great progress we made in adding new accounts in Q3. We're proud to be working with such respected names as Aldo fashion shoes and handbags, Kendra Scott jewelry, Luxottica, the world's largest premium eyewear company, PetMed Express, America's largest pet pharmacy and Feeding America, a national food bank that just jumped to number five among privately funded US charities. Finally, last week we sent many of our top engineers and other Rackers to Paris for the semiannual OpenStack Summit meeting. Over the five-day conference, our Rackers delivered technical thought leadership at 30 presentations and panel discussions, all aimed at simplifying OpenStack and making it more scalable.

So, that's where we stand. The opportunity we face in the managed cloud market is massive with increasing demand for our managed services and expertise. We've made good progress this year; our managed cloud positioning has gained traction with customers and industry experts. We have strong alignment around our strategy, and the distractions that we have to overcome earlier this year are now behind us.

After a review every our growth strategy, CapEx requirements, capital structure, and cash flow profile, our Board has authorized the repurchase of up to $500 million of the Company stock. We intend to immediately execute the $200 million accelerated share repurchase agreement. The remaining $300 million will be available for purchases at the Company's discretion over the course of the next two years, subject to all applicable conditions including the macroeconomic environment, general market conditions, our growth capital needs, and access to capital. With that, I'll hand the call over to Karl. Karl?

Karl Pichler - *Rackspace Hosting Inc - SVP, CFO and Treasurer*

Thank you, Taylor. Let me start by summarizing the key takeaways for the third quarter 2014. First, strong growth results. Our constant currency growth rate of 4.4% was the highest in almost 2 years. We saw good growth across our product, had traction with new customers as well as our installed base, and we are winning deals of considerable size consistently. Our managed cloud strategy is clearly resonating with customers and industry analysts, and we are well positioned to build on our success.

Second, we are driving improvements in our business model and we already see results. During the third quarter, we started the more deliberate effort to improve our cost structure, and margins have already improved as a result. Furthermore, as we mentioned previously, we are driving capital efficiency higher this year, and the financial results and operating metrics for the third quarter demonstrate the results of our efforts. Third, our Board authorized the share repurchase program for up to $500 million through November 6, 2016. We remain focused on organic growth and we will continue to aggressively invest towards this goal. At the same time, our financial position and cash flow profile affords us the opportunity to make investments in the business while also repurchasing our shares. We intend to start the program immediately with a $200 million accelerated share repurchase agreement that will be funded with available cash and the small and temporary draw on our revolving line of credit.

Let me now good to the specific results. Revenue for the third quarter grew 4.2% sequentially to $460 million. On a constant currency basis, sequential revenue growth was 4.4%, representing the fastest rate of growth since the fourth quarter of 2012.

Moving onto profitability, adjusted EBITDA in the third quarter was $159 million, reflecting a margin of 34.5%, net income was $26 million, reflecting a margin of 5.6%. The profitability in the quarter was affected by a couple of items that we do not expect to recur in the near future. On the net basis, these items added approximately $4.1 million to adjusted EBITDA and lowered net income by $1.5 million, or $0.01 per diluted share. Excluding the impact of these items, adjusted EBITDA margin in the third quarter would have been 33.6% and net income margin would have been 5.9%.

One of our stated goals for 2014 is to improve capital efficiency by driving capital expenditures around towards 25% of revenue. With three quarters of the year complete, we are on track to deliver on this call. In the third quarter, total capital expenditures came to $117 million, representing 25.5% of revenue. For the first three quarters of the year, capital expenditures have averaged exactly 25% of revenue. As a result of this improvement, our capital turns have increased to 1.95 times and average monthly revenue per server has increased to more than $1,400. Adjusted free cash flow in the third quarter came to $41 million, our cash balance increased by $9 million, and we reduced our total at debt outstanding down to $31 million.

For the fourth quarter, we are forecasting total revenue to range between $469 million and $476 million which includes a negative foreign currency impact of approximately $5 million in the quarter, or 110 basis points of sequential growth. Our expected range of revenue assumes constant currency growth of 3.0 % to 4.5%. We expect adjusted EBITDA margins to range between 33% and 35%. This is the end of our prepared remarks. Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Just focusing around the combination between growth and margins, obviously a couple years ago you focused on both, and then it seems like you gave up some margin to get back, the growth back on track. Taylor, I was wondering how now under leadership you think about the trade-off between growth and margins going forward. Thanks.

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

Hey. Thanks James. Good question. Look, I think as our new CEO, our my job is to find profitable revenue growth opportunities for us. Our target strategy, targeting customers who want the managed cloud model, our customers who value support. They value infrastructure options, but even more so, they value what we do on top of infrastructure to make cloud applications work for them. So our job is to keep finding places like our digital practice, our big data practice that Microsoft offers, et cetera, where we can find customers that we call support seekers who value the managed cloud model, and those are higher margin opportunities for us that get us out of the dog fight around pure infrastructure. So, for us, we view very much it's a balance between growth and margin, and the good news for us is that the market is full of demand for us to add higher value things to our customers and they're willing to pay for it. So, it's both growth and margin for us.

James Breen - *William Blair & Company - Analyst*

And obviously, margins took a big step up this quarter from last quarter and you gave similar guidance for the fourth quarter in terms of the levels. Do you feel like you are at a point now in terms of revenue growth scale where margins could continue to improve from here?

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

Well, we'll work on our guidance for you for 2015, James. I think for now what we wanted to do was show that we have mastery of our business model and be able to drive capacity over a lot of the investment we made last year. As we've told you very consistently, we added the data center capacity, the new product capacity and that this year, we would have the chance to grow the revenue over that capacity and get our utilization up. We feel good about our progress so far, and we'll update you on how we think 2015 looks. But again, we're committed to both revenue growth and end margin.

James Breen - *William Blair & Company - Analyst*

Great. Thanks.

Operator

Gray Powell, Wells Fargo.

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

Okay. Great. Congratulations on the quarter, and thanks for taking the questions. Maybe just to follow up on Jim's question. One of the biggest issues that we talk about on Rackspace is how they EBITDA margin and the CapEx profile will look longer term or more like in a steady-state environment. Maybe to give us a better sense as to how to model CapEx as a mature state, what percentage of customer to your CapEx is spent on replacing old servers, and then how should capitalized software look longer term? And then similarly, what do you see as a reasonable long-term target for EBITDA margins? Thanks.

Karl Pichler - *Rackspace Hosting Inc - SVP, CFO and Treasurer*

Yes. This is Karl. I'll take that. Thank you very much. We have republished our target model, again, we just posted the latest version of the investor deck on our IR website. It's on page 18 where we have very specifically laid out how we are thinking about this. Now, let me say that obviously, the steady state of a zero growth environment is one that we want to delay as much as possible, so we don't actually ever want to get there. But really, the purpose of this illustration is really to make a distinction between our corporate economics as we grow versus the embedded cash flow that that business generates. And so when we really think about the two main ingredients to that, which is the OpEx kind of parameters around our business model around the embedded cash flow, we are talking about high 40%s, close to 50% in adjusted EBITDA margin on a steady-state basis, which is very close to our contribution margins that are fully loaded. So, we have a lot of confidence that that is approaching those levels in a steady-state environment.

And then we have done some additional work and basically substantiated the previous findings, our replacement CapEx is pretty much exactly 10% of our previous year's revenue. Depending on how you express it, whether you do it as a percent of this year's revenue or last year's revenue. And depending on some sort of normal business cycles where we build up capacity and burn down capacity, it slightly differs. We've shown on our steady-state slide a range of about 8% to 12%, which should really cover all the variations across time. And the simplifying math that we shared in the past with you on the 10 and 50, as we called it, which is a good proxy for customer gear CapEx is 10% of previous year's revenue, plus $0.50 on incremental dollars of revenue, also still applies. Pretty much what we've done here, we've refined the model. We've introduced a new line item on the P&L, the research and development line, that required us to republish our target model. That's now done, but all the general parameters that we shared with you the past have been substantiated. All of that leads to basically an after-tax free cash flow margin of 27%, assuming a 30% cash tax rate, which is probably a very good proxy for our long-term taxation rate.

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

Got it. Thank you. That's really helpful. And then just one more question, if I may. I think you guys just started doing the Rackspace Solve events in July, how has that helped generate new leads, and how should we expect these events to impact future bookings? Thanks.

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

Thanks, Gray. This is Taylor. I'll take that one. Our Solve events, so far three under our belt, one in San Francisco, one in New York, one in Chicago, all been sold out in terms of attendance. And the attendance is a mixed audience. It is customers, it's prospects. It is analysts who cover us for my financial and/or industry perspective, and then it is general reporters who write about Rackspace. And so this not only has a direct benefit of creating leads from customers who have more applications to talk to us about as well as prospects who haven't done business with us, but it has a halo effect because those analysts and reporters who come, write things about our model, the partners who are there takeaway the learnings that they had on stage and remember, partners are key to our channel execution. For us so far, we are very satisfied with the brand enhancement we're getting from this from a halo or perspective, as well as the number and quality of the leads that we have directly coming out of these events. Look, we wanted to do these this year to get back on the road.

I think I shared very openly with you all that one of the things I was most frustrated about in 2013 is we essentially stopped doing effective marketing. And in 2014 we needed to get back out, hit our stride, have our customers tell our story, and we wanted to see how we did. We have deemed these to be very successful, and that's why we're going to keep doing them in 2015. We will take them on a road show in London in places like Sydney and then back into other cities in the US like LA in the coming year.

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

Got it. All right. Thank you very much.

Operator

Patrick Walravens, JMP.

Patrick Walravens - *JMP Securities - Analyst*

Great. Thank you. Congratulations. Let me ask the question that I get the most often which is, just how is it that you guys are accelerating your revenue and expanding your margins at the same time that Amazon and Google are cutting prices? What key points would you make?

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

Hey, Pat. It's Taylor. Thank you. I think that the answer to that is simple and it is what we've been saying all along, with is we are targeting a different offer with a different value proposition to a different buyer. And the way I look at this is that somebody who wants an infrastructure platform and then cares to go learn the owners manual for 96 APIs and wants to master all of that and thinks it's core and strategic to their business is going to choose an unmanaged cloud model. But the mainstream market or even very, very technically savvy buyers who are finding out that they have more -- they're running -- in the beginning when they're startups, they have more time than money. When they start to get to scale, they realize that they need to focus on writing code and shipping product and doing things that differentiate.

It really is a mainstream buyer motion as well as a technical buyer motion that's starting to hit scale and needing to decide very deliberately what they're going to do. What skills they're going to add on their payroll versus buying as a variable cost service. I think the simple answer, Pat, is different offer, different market, different buyer. And there will be plenty of room in this market for both the managed cloud and unmanaged cloud model to exist. People will just make the decision based on different criteria.

Patrick Walravens - *JMP Securities - Analyst*

If I can follow up on that just a little bit, is there an opportunity for Racks to provide support for Google's cloud platform or for Microsoft's, and how would that work?

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

Yes. Pat, you guys saw in our press releases just a couple of weeks ago and we reiterated it today that we are now in the business of providing Fanatical Support on top of Google Apps. And you can view that as an extension, a close adjacency to our current business model, but really if you think about it, our core DNA is Fanatical Support. It is building economies of expertise on top of infrastructure. And if that's the case, we ought to be able to go out and find effective ways to extend that core competency onto other people's products running in their data centers on their capital. So, view the Google Apps for work as step one. It's a business model we want to figure out and if we can make it successful, then you can anticipate in the future that we would mimic that success in other directions. That is the thesis, and I think it holds with knowing who we are as a service Company and that it opens our addressable market.

Patrick Walravens - *JMP Securities - Analyst*

Thank you.

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

Thanks, Pat.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you very much. Taylor, can you just talk about the decision to do the buyback? I think some folks had hoped it might come if you were -- when you announce your strategic -- the end of the strategic process. What got you over the line at this point? And how does that feed into your potential flexibility to do M&A fill-in type transactions going forward? And then I was wondering if, Karl, if you could just drill into some of the cost priorities, efficiencies that you're focused on right now. Thanks.

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

Simon, Taylor first. On the buybacks, I think last call there was I think an expectation that we were going to announce a buyback, and what we said on the last call was that I'm a brand-new CEO. We have the need to really get in and understand our capital structure and what are our best uses of our growth capital, and how much access to capital do we have? On the last call, we didn't say we weren't going to do it. We just said that as the new CEO, I wanted to go and make sure it was the right thing to do. We've spent the last six weeks working with outside advisers and with our Board to understand all those things. And the good news for us is that we're early in the huge market shift.

We believe fundamentally that we are the leaders in our unmanaged -- in our managed cloud part of that market, the profitable segment of the market. I think our results are proving this, so we are bullish about our future, and we want to make that statement. Our business also, Simon, as you know, has a good, healthy and embedded cash flow element to it. We have access to additional capital, and we continue to invest for growth. The buyback is a demonstration of our confidence in our future. We think it's good for our shareholders and the value that we need to create for them and also, it doesn't constrain our ability to invest in our long-term growth. If you put all those factors together, that's what we accessed and analyzed as a Board, and that's why the Board approved a buyback at this time.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Karl Pichler - *Rackspace Hosting Inc - SVP, CFO and Treasurer*

Hi, Simon. Yes. Look, from a priority standpoint, I think the first answer is we're constantly, as we call it, running up and down the P&L to find opportunities to run the business tighter. I think the highest focal point is always going to be people and making sure that we allocate our Racker talent to the highest leverage point in terms of business that really are focused on supporting the customers and on driving immediate and long-term growth opportunities.

The second-biggest item is certainly infrastructure capital. We have a fairly large fixed base. We have under -- we have excess capacity in our data center and we have certain capacity pools. Both from and OpEx and a CapEx perspective, we have leverage there> And we are pushing that higher as we can, but of course, we also have the launch of new facilities. For example, next year we are going to launch a UK facility. This is a little bit of an improvement, and then we're going to add some capacity and grow into it over the longer term, so that is an ongoing focus. And another one is also, we are experimenting with new forms of marketing, like Taylor said. We started with the Solve events, they've turned out to be really effective. We are constantly reevaluating our more traditional marketing spend dollars as we've had in the past, and we are optimizing our way there as well. It's really, I would say from a big picture perspective, people, infrastructure and marketing effectiveness are probably the three highest priorities.

Simon Flannery - *Morgan Stanley - Analyst*

Great, and can you just clarify on that -- the one-timer, where was that and what was that?

Karl Pichler - *Rackspace Hosting Inc - SVP, CFO and Treasurer*

Yes. We had largely three items. We had a sales tax refund that hit positively our cost of revenue, and that was in the amount of $7.4 million. We had professional fees related to the strategic evaluation process that concluded during the third quarter. It was a mixed bag of expenses adding up to about $3.5 million. And then we had a write-off on our office here in San Antonio with respect to one part of the mall that we originally designed for a data center, but we're not going to do that right now -- we're not going to do that at all. And there was a write-off associated with that, and that was $5 million below the line that hits D&A. The net effect on EBITDA is a positive 4.1, the net effect on that income is a negative 1.5.

Simon Flannery - *Morgan Stanley - Analyst*

That's helpful. Thank you.

Karl Pichler - *Rackspace Hosting Inc - SVP, CFO and Treasurer*

Sure.

Operator

Colby Synesael, Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

Great. Two, if I may. First off, regarding the comments around how you're seeing bigger deals and how you expect to see more in fourth quarter versus third quarter, I was wondering if you could just talk about what's driving that. And then second, as it relates to the Microsoft partnership, I'm just curious how you talk about -- how the Company's thinking around partnerships has evolved over time. How you think about companies like Microsoft, Google and Amazon as potential partners going forward. And maybe a little bit more specificity on how something like this could expand your total addressable market such as perhaps through referrals of someone like Microsoft. Thanks.

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

Okay, Colby, thanks. This is Taylor. First of all, on the big deals, look, I think what's driving it is that when you look at our Magic Quadrant, we're competing with legacy telco service providers, we are competing with IBM, we are competing with HP. We are clearly the leaders high and to the right on that Magic Quadrant. That's the Consumer Reports that a lot of people use to understand who they're going to invite in. I think that you can judge for yourself how those larger companies are doing in executing the conversion of their large legacy business models into cloud models. I think that I've been in a big company trying to make a swing, and it's hard, and I think it's going to take a while if they can't do it.

We are inheriting and I think we've earned a spot to be the leader in the space where this mainstream market that used to call those players is looking for their trusted partner who is cloud relevant, nimble, capable, trustworthy in terms of the quality of service and support, and that's us. And so we are seeing that show up in spades in our pipeline and in our close rate on larger deals. We're very excited about that, we think it's a long-term, very positive trend for our business.

These deals provide us with a lot of scale on our cost of revenue, so they're profitable for us. And these, again, are customers who are on their journey out of the corporate data center into hybrid cloud. And they're looking not just for the infrastructure solution, they're looking for the advice on the front end. They're looking for professional services to help them decide which applications are right for dedicated single tenant environments, multi tenant environments. And ultimately, then they're looking for someone who can deliver really strong operations for them and finally looking for the right portfolio to match their future journey.

With the hybrid options, we get to win them today. We meet them with a standard technology option potentially like VMware or Microsoft or if they're ready to move, we meet them with an OpenStack cloud option. And we get to then help advise and move them down the path in the future and move more and more of their apps into our model. We think that that is a great way for us to grow, so we'll do more and more of that.

I think your question on the Microsoft partnership -- look, we are services Company, and we believe that we have always, and whether you pick supporting Red Hat technologies or supporting Microsoft technologies, supporting Linux operating systems, Windows operating systems, whatever it has been historically, we have always taken other people's technologies, integrated them into a Fanatical Support service model and then delivered them as a service. So, we ought to be able to expand our addressable market with companies like Microsoft who, remember, Microsoft is a product company. And they are primarily a channel-driven company that does the vast majority of their revenue through channel partners. We've always been a very large one for them. This is a chance for us to modernize our Microsoft offer and go to market with them and deliver a choice of technology options that our customers really want alongside our VMware options and our OpenStack options.

We think that partnerships like back can get us further into large tech ecosystems from a go-to-market perspective, and so does increase our addressable market. As you know from past calls, Colby, we've hired Todd Cione as our sales leader, we've hired Will Knight as our partner leader. Both of those folks came from Microsoft and are really masters of the channel world, so we see this being a good place for us to continue to invest as well.

Colby Synesael - *Cowen and Company - Analyst*

Okay. Thank you and congratulations.

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

Thanks, Colby.

Operator

Frank Louthan, Raymond James.

Frank Louthan - *Raymond James & Associates, Inc. - Analyst*

Great. Thank you. I apologize if you covered this in the prepared remarks, but any update on any logos for significantly large customers that you may have been able to sign? How is the traction going with the larger sized deals? And then can you point to maybe one or two things with your improve sales and marketing efforts that have really impacted the quarter that gives you confidence we will see this kind of continued momentum going forward?

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

Yes, Frank. Thanks. In the prepared remarks to the transcript, you'll see that we did talk about the big deals. That, per Colby's question just a second ago, we think that's one of the very positive parts of our business right now is that we're seeing the bigger deals. We closed more of them in Q3 then we've closed in our history. We feel strong about our Q4 pipeline and we again continue to see this market opening up for us to step into these deals that used to go to other legacy providers.

We feel good about that. From a sales and marketing perspective, look, you can just get the results, right? We're closing record revenue in the quarters. We're doing it while increasing our profit margins. Our revenue per server continues to climb. All of these are indicators that we're attracting the right the customers who value Fanatical Support, who value our expertise and running applications on the right form of infrastructure for them. And so those things aren't possible without effective sales and marketing execution, and I think those are the best proof points I can show you.

Frank Louthan - *Raymond James & Associates, Inc. - Analyst*

What's different from, say, a year ago? That's the question we get from investors, that clearly something's changed. Is there anything that you can -- more specifics you can point to within that sales and marketing effort that maybe you weren't doing a year ago?

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

Clarity, clarity, clarity, right? You have to differentiate or die, Frank. And so I think what I've talked about historically is in the past we got muddled on our value proposition in the market and who we were. This year we have put a ton of effort into clarifying the managed cloud strategy, positioning it with not just words but also with pricing model changes, with new offers up the stack with go-to-market partners. And so these are the things. Right? 2013 was a year when we were trying to understand what were we communicating to the market? Were we the open cloud company, were we Fanatical Support, what where we? And clearly that confused the market, it confused our sales force.

As we've talked about multiple times, this clarification of an unmanaged category and a managed category and our bona fide leadership in the managed. And then clearly, you don't sell something on vaporware, you also have to have offers to back it up. We've talked about our practice area, execution in digital and big data and VMware and cloud office. These are the plays that our sales team, that our marketing teams are generating demand around. These are the plays that our sales teams are focusing on. And when you get a focused effort with referenceable customers, your sales teams feel powerful. They increase their win rate, and that shows up in the results. Those are the main things I would highlight.

Frank Louthan - *Raymond James & Associates, Inc. - Analyst*

Thank you. That's very helpful.

Operator

(Operator Instructions)

Siti Panigrahi, Credit Suisse

Siti Panigrahi - *Credit Suisse - Analyst*

Hi, guys. Just wondering, as you get into more into this enterprise cloud and then the managed hosting business, we see that IBM and Microsoft also are getting aggressive in trying to get into the business. I was wondering how you position yourself against those kind of competitors which is different than Google and Amazon. And also, I just follow up, your public cloud business, how should it think about the growth profile going forward?

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

Well, let me start with our public cloud business. Again, just to reframe, right? Managed cloud is our positioning in the market. It includes everything we do because customers want choices of a multi tenant public cloud options and single tenant options which can include dedicated or private cloud. And those infrastructure options are really just part of the offer. CIOs and CTOs have big application portfolios. And some of them are going to be great fits for a multi tenant public cloud solution, some of those are not going to work well in a multi tenant public cloud. So, you really need to have both to be competitive in the space.

I think to your question around, how do we compete with IBM and Microsoft, let me start with Microsoft, First of all, Microsoft is an interesting situation of co-op attition for us, right? We are one of their largest channels, always have been. We sell an awful lot of their product. Microsoft, although they offer Azure, which and they run in their own data centers, they also monetize the vast majority of their revenues through service provider models in the channel. And so as you think about the conversion happening for traditional companies that used to produce software or hardware, they are now all being forced into a model where they monetize their products through a cloud or a services-based model. And we think with Microsoft there's plenty of room for them to work with us and for them to actually provide a Rackspace hosted Microsoft private cloud offer for customers aren't ready for Azure or do not prefer the Azure model. There's a way for us to work in co-op attition with Microsoft. IBM, look, they're a big company with lots of capability.

Again, I think that the challenge for IBM is that they have got to convert a very large model that is really geared toward the last generation of IT toward the cloud. And we get this opportunity now while they're going through that internal journey through the wilderness to be the IBM of the cloud. We get the chance to be the most trusted, most capable, with the best positioned product portfolio to help these companies who would normally call IBM. Because again, they are interested in not just infrastructure, they're interested in a stack of service and support and software and infrastructure altogether. And we get the chance to step in and take advantage of that territory while IBM is going through an internal struggle to convert their business model. We operate at web speed, we like to say. We were born on the cloud and IBM doesn't. Right? They have to go get lots of parts of the business lined up to go execute. So, we're going to take advantage of that while we are able and take leadership.

Siti Panigrahi - *Credit Suisse - Analyst*

That's great color. Thank you.

Operator

Jonathan Atkin, RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes. I was interested in the record number of large deals basically closing this week, and can you give us an idea of the type of ramp that you're seeing from these large customers? Over how many quarters do they grow into the full contract value? And then secondly, Net Promoter Scores is something that, at least in the past, I think you've focused on a lot internally as you assess the quality of customer satisfaction and so forth. And I wondered if there's anything that you'd like to share on the call around Net Promoter. Thanks.

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

Sure. Okay, thank you. On the big deals, our ramp on a traditional big deal is that they will take longer than our -- what I will call our core deals that oftentimes have a 30 to 45 day time from sale to online. These deals will vary, but they're not going to take longer than 60 to 120 days to get online, and we've talked about that in the past. These are deals where we are doing a certainly larger breadth of scale in terms of what we're doing for these customers. They will take us a bit longer to convert to revenue, but still a pretty healthy model in terms of what you would expect to see at IBM or an HP where they take months and months and months to get online. So, we're good at that.

In terms of NPS, look, our whole business still revolves around what we call loyalty economics. The whole reason for being for Fanatical Support is so that we can get these customer outcomes that they can't get anywhere else, and this leads them to trust us. It leads them to take the first application that they give us and turn it into the next opportunity. It keeps them here longer. They buy more product lines from us and ultimately, they tell other people about us. Some of our good wins this quarter actually came on the backs of Promoter references from big existing customers. And that's one of our most effective, both cost effective as well as close rate effective, way for us to grow. NPS for us remains core to our business, and we remain an industry leader, I think by a good long shot, in terms of the overall customer loyalty metrics here at Rackspace.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you.

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

Thank you.

Operator

That was the last question. I will now turn it back over to the presenters.

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

Okay. Thank you, operator. This is Taylor. Thank you all for joining us today. This ends our Q3 call. We'll look forward to speaking with you again when report our Q4 results, and I'm sure we'll see many of you in the roadshows to come. Thank you for joining today. Bye-bye.

Operator

Ladies and gentlemen --