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RAX - Q4 2014 Rackspace Hosting Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and thank you for standing by. Welcome to the Rackspace Hosting's Q4 2014 earnings call. As reminder, this call is being recorded.

(Operator Instructions)

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

Jason Luce - *Rackspace Hosting - VP of Finance*

Hello, everyone. Welcome to Rackspace's fourth-quarter and FY14 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 at our website at www.ir.rackspace.com. This call is also being webcast online and can be accessed through our Investor Relations site.

For Rackspace on the call today will be 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 and 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 results. 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 hand the call over to Taylor. Taylor?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Thank you, Jason. Good afternoon and thank you for joining us. I'm excited to be here today with you. This is my second earnings call with you as the new CEO of Rackspace.

We're coming off a year where we got back to our roots in Fanatical Support and are making progress leading the managed cloud segment of the massive overall cloud market. This is a long-term opportunity and we're at the beginning of a series of important steps to capture more power in the market by improving our current business model and investing for future growth.

Our fourth-quarter results represent another quarter of strong growth and improving margins for Rackspace. We believe that the progress and momentum that we built in the quarter and throughout 2014, demonstrates the success of our strategy and our position as the world's number one managed cloud company. The three trends that we discussed on our last call were even more evident in Q4.

First, the cloud market is bifurcating into two distinct categories, unmanaged cloud and managed cloud. The unmanaged cloud segment is for those who want to rent access to multi-tenant infrastructure and then manage the complexity of making cloud applications work by themselves. The managed cloud segment on the other hand, offers a different value proposition for a different buyer, the choice of best fit hybrid infrastructure, plus valuable services to manage the exploding complexity of rapidly changing cloud applications and tools.

The managed cloud models appeals to companies who view technology as critical, but not differentiating. They leverage our economies of expertise and Fanatical Support to stay focused on what is strategic to their business.

Second, Rackspace has emerged as the Company best positioned to dominate the managed cloud segment of the market. We're now competing primarily against large telecom companies and legacy providers of IT hardware and services, most of whom are struggling to adapt to the demands of the cloud era. More and more of the phone calls and RFPs that once went to those companies now come to Rackspace. As a result, during the last half of 2014, we won more deals worth $100,000 or more per month than we did in the previous five quarters combined.

Third, the execution of our managed cloud strategy is driving profitable growth. Our progress in 2014 proves that there's a large and healthy market in which customers value our economies of expertise, targeted toward critical areas such as e-commerce, content management, big data and security. This execution is delivering improvements in our operating performance and trajectory.

Let's get to the specifics for the fourth quarter. Our sequential revenue growth was 4.1% on a constant currency basis, this was the third consecutive quarter in which our constant currency growth topped 4%, and was in the high end of our range, a winning streak that we haven't experienced since two years ago.

On a constant currency basis we added $19 million of incremental revenue in the quarter, in line with our average of $19 million of constant currency incremental revenue over the past three quarters. On a year-over-year basis, our constant currency revenue growth accelerated for the third consecutive quarter to 16.4%. The last time we saw such growth acceleration for three quarters was back in 2011. We are showing leverage in our business model by improving margins in the quarter.

Our adjusted EBITDA margin rose to 35%, at the high end of our guidance range. We continued our international expansion in Q4, opening a new office in Mexico City, our first in Latin America. We held our third Rackspace Solve event in Chicago in October, which included presentations from customers including Edelman, Kendra Scott, Razorfish, and the University of Notre Dame. At these Solve events, our customers and engineers demonstrate to other businesses, industry analysts and journalists the way in which smart companies are growing on the Rackspace managed cloud.

We also recently announced our global Solve schedule for 2015, it includes events in major cities around the world. The first Solve event will be held in San Francisco on Wednesday, March 4. We hope to see many of you there. You can register for events and learn more about our Solve conference series at www.rackspacesolve.com.

Speaking of new customers, we are very pleased to announce that Tinder the fast-growing mobile matchmaking app, has swiped right for Rackspace. We're also proud to announce our relationship with two other great brands, Weight Watchers International and Oscar de la Renta, have both chosen Rackspace and we're proud to be serving them. Now without ever leaving our managed cloud you can lose weight, buy some elegant evening wear, and find your soul mate online.

Our strong and improving financial results for the fourth quarter, and the momentum that we built during 2014 are the result of our renewed focus as the world's number one managed cloud company, and an enhanced operating discipline that flows from that focus. We plan to stick with that focus throughout 2015 and beyond.

We believe this is the right focus because companies increasingly want to harness the power of cloud technologies. But there is a hitch. The growing availability and affordability of cloud infrastructure has led to an explosion of software and tools that take advantage of it. This proliferation of software and tools presents an era of unprecedented complexity for businesses to navigate and is creating a real scarcity of critical skills around these new and evolving technologies.

So we find that buyers are faced with two choices. They can rent the infrastructure and do the rest themselves, which means placing the right bets on rapidly evolving technologies, and keeping up with the rapid evolution of skill sets on their own payrolls, or they can choose a model that enables them to consume these skills as a service from a managed cloud specialist, a specialist who can combine the power of hybrid infrastructure options with deep economies of expertise and the evolving skills that make cloud applications valuable to businesses.

The latter is the managed cloud segment and quite simply, Rackspace is the best position specialist to lead it. We intend to dominate this part of the cloud market. Going into 2015 we look forward to demonstrating to customers and investors the success of our strategy, and our position as the world's number one managed cloud company.

With that, I'll turn the call over to Karl Pichler our CFO. Karl?

Karl Pichler - *Rackspace Hosting - CFO*

Thank you, Taylor.

Q4 was indeed a great quarter for us. Operationally we have grown in excess of 4% sequentially for the third quarter in a row now, and we have improved our quarterly year-over-year growth rate three times in a row.

Like other firms who operate globally, our reported GAAP results were negatively affected by the strengthening of the dollar, but operationally we demonstrated solid and consistent growth. Our cost structure improved both for the year and during this last quarter. We have made improvements across the board and we feel comfortable that our 2015 margins will show an improvement throughout the 2014 margins while giving ourselves room to invest for growth.

Our fourth-quarter net income and EPS results were also positively impacted by both operating improvements and an unusually low effective tax rate. The lower tax rate was largely due to the extension of R&D tax credits, which were granted during the fourth quarter of 2014. And last, our capital related metrics improved significantly, total CapEx in 2014 represented 24.3% of total 2014 revenue. That's a meaningful improvement compared to 2013, when CapEx represented 30.8% of annual revenue.

Not only did we improve our capital expenditures on a relative basis, we actually spent fewer dollars in 2014 than we did in 2013. This lead to improvements in all capital-related metrics, such as capital turnover, revenue per server, return on capital, and cash flow.

Let me now get to the specific results. Reported revenue for the fourth quarter grew 2.8% sequentially to $472 million. Currency changes negatively affected this result by $6.3 million. When we gave guidance on our last call, the currency headwind was estimated to be $5 million. Since then, the dollar continued to strengthen and the GAAP results were affected by a total of $6.3 million. On a constant currency basis, sequential revenue growth was 4.1%, for the full year of 2014 we grew 16.9% on a recorded basis, and 15.5% on constant currency basis.

Our margins and returns improved in the fourth quarter, and year-over-year as well. For the fourth quarter, adjusted EBITDA was at $165 million for a margin of 35%, up from 34.5% in the third quarter. Net income was $37 million for a margin of 7.8%, up from 5.6% in the third quarter. And return on capital was 15.5%, up from 11.7% in the third quarter.

For the full year of 2014, adjusted EBITDA was at $605 million for a margin of 33.7%, up from 33% in 2013, net income was $111 million for a margin of 6.2%, up from 5.7% in 2013. This represents a 27% increase in earnings year-over-year. Return on capital was 12.2% for the year, up from 11.0% in 2013.

For the fourth quarter, operating cash flow was at a record $151 million, and capital expenditures came in at $105 million, which represents 22.1% of quarterly revenue. This led to strong free cash flow, our adjusted free cash flow was $55 million for the fourth quarter, and on the record. This strong cash flow partially offset the cash reduction we had due to the $200 million accelerated share repurchase. We ended the quarter with $214 million in cash and cash equivalents, and less than $50 million in debt.

With respect to the first quarter and the full year of 2015, we would like to share with you our current view. For the first quarter of 2015, we expect revenue to grow between 2% and 3.5% on a constant currency basis. Based on foreign currency movements to date, we anticipate that 100 basis point headwind to revenue growth in the first quarter, resulting in GAAP revenue in the range of $477 million to $484 million.

We expect adjusted EBITDA margins to be between 32% and 34% for the first quarter. As usual in our Business, Q1 is relatively weak because of seasonal trends that affect growth and margins. It is normal for our business trajectory to improve coming out of the first quarter, and we have every reason to believe that it will do so again in 2015.

For the full year of 2015, we expect revenue to grow between 14 % and 18% on a constant currency basis. Based on foreign currency movements to date, we anticipate a 200 basis point headwind to revenue growth for the full year of 2015, resulting in GAAP revenue in the range of $2 billion to $2.1 billion. We expect adjusted EBITDA margins to be between 33% and 36% for the year. Furthermore, we expect total CapEx to come in around 25% of total revenue, similar to 2014.

In addition to the full-year guidance that we've just provided, we plan to continue our practice of providing quarterly guidance throughout the year. Beginning with our reporting of financial results for the first quarter of 2015, we will show revenue on a consolidated basis only and will discontinue the breaking out of public cloud and dedicated revenue.

This breakout has become less and less relevant to our Business. More of our customers are consuming multi-tenant and single tenant products together in hybrid solutions, where the solution itself will dictate the best infrastructure form factor for that particular application.

At the same time, the line between cloud and dedicated products continues to blur. For example, with such technologies as virtualized private clouds and single tenant API accessible OnMetal services. As always, we will continue to evaluate our key metrics as our Business evolves.

This concludes 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 a couple questions. One, from a strategy perspective, you announced Tinder and Weight Watchers and Oscar de la Renta, can you just talk about what you're doing for them and sort of why you thought that they chose you over some of the competition?

And then secondly, just on the numbers side, Karl, if you can just talk about, when I look at the GAAP guidance for the full year, relative to the impact in the growth rate, it seems like probably a $30 million to $40 million impact year-over-year from currency. Is that sort of in the ballpark and do you expect more of that impact to come in the first half of the year versus the second, given how the currency has fluctuated in 2014? Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Karl, why don't you answer the currency question first.

Karl Pichler - *Rackspace Hosting - CFO*

Okay. All right. Let me clarify a couple of the currency numbers here, also with respect to the fourth quarter maybe.

So when we've given guidance in the fourth quarter, we basically said we're going to have a constant currency growth rate between 3% and 4.5% and our constant currency growth rate actual came in at 4.1%. When we express that in terms of dollar ranges, this was $469 million to $476 million, which back then assumed the $5 million headwind, which really translates into $474 million to $481 million in Q4 revenue. That was the range that we basically guided to. And we came in just above the midpoint of that, $478.7 million, if you add the $6.3 million of constant currency headwind to the reported number of $472.4 million.

So that's kind of the approach that we have chosen to utilize to differentiate to you the difference between what we're actually growing from a traction perspective, from a customer perspective, versus what happens from currency changes. So similarly to that, when we look at full year, and granted we are very early in 2015 and the currency volatility was enormous over the last couple of months specifically, so we don't really know where the currency will go, but so when we're talking about the 200 basis points headwind, that really means if the currency stays where it is today.

And so if we have no movement from now going forward, and all the full impact of the changes are basically flat going into this year and stay flat still going into this year, we will have roughly 200 basis points lower growth rate on a reported basis than we will have on a constant currency basis. So the way that we want to talk about it and the way we want you to think about it, is that we're expressing ourselves in constant currency terms on a sequential growth basis, and then we will have pluses or minuses due to currency.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

And, Jim, this is Taylor. I'll talk about the customer wins and put a little color on those. We're super-excited to be able to announce customers like Tinder and Weight Watchers International today.

These customers are doing what everybody in the market is doing. They're saying I need to harness the power of the cloud, it has irresistible economics, irresistible speed and nimblenes factors, et cetera, so I'm going to evaluate the options in the market space. The market, as you've heard me say, is moving from hype to wisdom, and the recognition is that there are choices that you need to make around what type of infrastructure form factor you use, what you want to manage yourself versus what you should tap into, as a variable cost service from a specialist.

And these customers running these big production workloads care about reliability and trustworthy outcomes. And so with those factors in mind they chose us. With Tinder specifically, we've talked about our big data focus with ObjectRocket, for Tinder we are managing complexity of making big databases work in the cloud for them, which for Tinder actually gets their developers back to writing code and shipping product. We get to offer them a highly managed service in a specialized way for their critical databases and this is the perfect example of managed cloud at work.

For Weight Watchers, it's a dev ops model on top of OpenStack private cloud. This gives them the ability to take advantage of OpenStack, the power and cost advantages of it. Rackspace is the place that has the most expertise by far, and ultimately it gets Weight Watchers back to creating amazing ads that they ran in the Super Bowl and growing the revenue of their own business, so again another great example of managed cloud at work, and really for us this is just the beginning.

I think for those of you who can join us at Solve, in March, in San Francisco, you're going to see big names like Tinder, but also Walmart Labs and Core OS and VMware on stage with us, really talking about the managed cloud model and how they use economies of expertise to get back to running their business. And that's ultimately the name of the game for us, so that's how we won those big customers.

James Breen - *William Blair & Company - Analyst*

Great. Thanks.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Great. Thank you very much. Thanks for the guidance for continuing with that. The guidance is quite wide both on revenues and margins and it was good to see the margin trends and the commitment to increase the margins. Can you just talk a little bit about some of the levers around that? I know that the Racker count was pretty stable quarter to quarter, so are you trying to get a little bit tighter in terms of labor efficiency and other cost items? And then, you had touched on Mexico, perhaps, Taylor, you could just expand on the international opportunity and how that plays out in 2015? Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Sure. Thanks, Simon. So to your first point, you know, look, Simon, you've heard me say that in 2010 when we launched OpenStack we started building out a very large product organization and adding additional, very expensive resources to Rackspace. We went from almost nothing to a product organization of 700-plus people. And today we get to harvest the scale of those super valuable resources. We're still adding, but we don't have to go from 0 to 700 again, and so that's just one example of a big part of our business that we get the scale.

You're seeing that scale come into effect as we improve the margin profile throughout 2014, and we have continuing opportunities to scale and take advantage of resource in 2015, as well. So that's where the margin guidance comes from. And we feel good about that. It also preserves for us the ability to invest for growth, which we think is also very important since we're playing in a long run, big game here.

On the Mexico City expansion, look, you know, I think that Latin America for us is a wonderful adjacent market here in San Antonio, we're very close. We've got data centers that are acceptable in terms of latency and time zone for those customers. We have lots of Spanish and Portuguese speaking rackers who are already here, and so we've been building a LatAm business at over the last, I'd say, 24 months, and now it's time to go bigger there. We feel good tailwinds and pull from our install base customers and so the opening of the Mexico City office with a Mexico country manager and resources on the ground, lets us start to go after that market in a bigger way.

Simon Flannery - *Morgan Stanley - Analyst*

Do you think we'll see more international markets opened in 2015?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes, our focus markets right now, really I would say LatAm is our biggest new push for 2015. You know, as we've talked in the past, recently we have a European business that we continue to penetrate markets like Central Europe, Germany, et cetera. In the Asian Pacific markets we have resources in Hong Kong, selling into the Asian market, as well as in Australia, New Zealand and Sydney, those have been existing but we continue to drive growth out of those spaces as well. So I would say LatAm is the notable new office location for 2015.

Simon Flannery - *Morgan Stanley - Analyst*

Great. Thank you.

Operator

Jonathan Schildkraut, Evercore ISI.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Great. Thanks. I'd like to ask two questions, if I may. The first just is sort of strategic pathway. Over the course of 2015, you guys did a lot of progress, I think, with partners, Google, VMware, Microsoft, and I was wondering if you might kind of update us from where we are in your managing those types of infrastructures? And then give us a little bit of a peek into what you hope to accomplish strategically in 2015.

The second question just has to do with some accounting. When we were down there visiting you guys in November, there were some questions around the big London lease that was going live this year and the potential impacts to accounting that that could have. I was wondering how you ultimately decided to account for that lease and how that's rolling through the P&L cash flow statement balance sheet? Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Okay, Jonathan. Thanks. This is Taylor. I'll talk to the strategy question with partners and then turn it over to Karl for the accounting question. In terms of partnerships, we talked in 2014 about the fact that as the managed cloud service leader, we have opportunities to take leading standard and open technologies like Microsoft technologies, like VMware and like OpenStack, and put those into Fanatical Support service models for our customers. And the reason that's important is that the market is full of companies who have a broad portfolio of applications, not all of them are created equal and some companies prefer, if they're already on a VMWare stack or a Microsoft stack, to stay on that, and then use us to develop new greenfield applications for the multi-tenant public cloud.

We also see a big opportunity to differentiate in the market with our model by being the leader in private clouds, managed private clouds. And so our focus with a VMware managed private cloud and a Microsoft managed private cloud, as well as our OpenStack managed private cloud, really gives our customers that choice. It lets us partner up with the big software vendors who are really needing to monetize their products through a cloud services model, and really leverages our strength in that. So it really brings us into a cooperation model with them, so we expect to see the private cloud portfolio on those technologies be an important part of our growth in 2015.

We also, as you know, launched the pilot with support on Google apps for work. And that is sort of the model that we call third-party cloud. We have rackers working on alternative and other cloud models there where we can take Fanatical Support and manage other cloud infrastructure for our customers. As I said openly, I call that a horizon-three opportunity, meaning it's in R& D and I don't expect it to necessarily be a big revenue driver for us this year. But we do have focused effort on it and we think that's a big market opportunity for us. Karl, do you want to talk about the accounting question?

Karl Pichler - *Rackspace Hosting - CFO*

Yes. Absolutely. Hi, Jonathan. You asked a question, so let's talk accounting a little bit.

So maybe not everybody on the call -- well, certainly not everybody on the call has the background on this story, so we are opening a facility in partnership with Digital Realty in London, this first quarter. We will take over that facility in March of this year for an initial two megawatts of capacity. And then Digital, who was tightly involved, obviously, in designing, building and also raising the capital for this facility, will then provision additional two megawatts of capacity in 2016. Another two megawatts in 2017 and then scheduled for additional two and two in the two following years, so 2018 and 2019, although we have delay options on those last two chunks.

So that's kind of the new model that we're entering into where we basically work with specialized providers on the data center side, to really have an operating lease agreement, really, in terms of how we consume data center space. Really with the kind of wholesale co-location approach in mind. And those leases are constructed as operating leases with the key parameters that there is no ownership transfer of these assets, there is no bargaining purchase option included in these assets and also that the assets' life is significantly longer than the lease terms. So in this specific situation of the data center, with continuous maintenance and renewals around along the way, those facilities will last way longer than the lease is scheduled for.

However, due to the close collaboration we have with our partners on design, not so much on funding but mainly on design, the accounting rules deem this to be an owned asset. And what happens, as a result, is that while the asset is being built, we have to start accruing the construction cost as an asset under the construction progress sub category, if you want, or sub account. We have to accrue the construction costs as an asset on our balance sheet. And we have done that.

We have accrued those costs. They are on our balance sheet. They're part of total assets. And there is no cash outflow from our side. There is no real cash impact on any of that. It's just a recording of those accruing costs.

And when the lease commences in March, what happens is then we will start paying rent to Digital Realty, based on our contract, and that rent then is basically used to offset or pay down the liability over time. So what happens is that the [state] that comes into production will be moved from construction progress into in-service, which is just a different asset category, so total assets will remain unchanged, it will just move from one asset category to another, corresponding liability is being recorded over time.

And that is shown as a financing lease liability; again, no real cash flow impact there. And then as we pay rent, the rent will be split into an interest component. The interest component will flow through the income statement. And the remainder, so rental payment minus interest component, will reduce the financial liability over time. And that reduction over time is based on the term of the lease.

On the asset side, we now have an asset that is deemed ours, that we will depreciate based on the useful life of the asset, which is different, i.e., longer than the lease term, so you will have an asset that is depreciating through the P&L and you have a liability that's being unwound through the cash flow from financing section. So that's how the accounting treatments will most likely look like. We will probably end up there, although we haven't filed for Q1 yet, so there's always the final determination that has to come, just before we file, but that is the most likely outcome of the situation.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Great. Thank you for taking the questions.

Operator

Gray Powell, Wells Fargo.

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

Great. Thanks for taking the questions. I just have a couple, if I may. Maybe starting off with something bigger picture. Roughly speaking, this is kind of rough math, but I think I'm pretty close. I think about 40% of the net growth of infrastructure spending industry-wide, whether that be traditional data center management hosting public cloud, I think 40% of that went public cloud in 2014 and based on different industry analyst assessments, it looks like it's probably closer to 50% in 2015. So just kind of curious, do you see a point a few years out where the majority of new applications are deployed in some kind of public cloud? And then if so, what does Rackspace's growth profile look like in that type of environment and how does that -- does that make you change the way you think about your business?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes, Gray, thanks. This is Taylor. I think over the long run, more and more applications will go into the public cloud. I think that those figures you just give us, I read your recent paper, I think that there's a couple things there.

One, the overall pie of the industry is probably getting bigger over time. Because cloud models bring more applications, again, remember my commentary about lower cost infrastructure, ubiquity of lower cost infrastructure, will drive more development of software and tools which need to be hosted somewhere into the market, so we believe fundamentally the pie is getting bigger over time.

I think also that the managed cloud segment gets bigger over time as well, because a lot of customers will step across private cloud into public cloud, or they will sort of separate their app portfolios into things that will stay on single tenancy forever, either because they won't be re-platformed or because performance and security and other things are better on single tenancy. And they will use the public cloud as a tool and a component. So essentially, we feel that in 10 years, the balance of the market, assuming that public cloud technologies continue to mature and hit compliancy goals and solve for all of the general concerns in the market around them, that I would say the majority of new applications will be developed with a public cloud in mind.

I think that's kind of a 10-year view. In between now and then, if you look at the amount of computing still running in the corporate data center, the skills shortages that are required to re-platform a lot of those apps for the multi-tenant public cloud, and basically preference for a lot of the market to have a private cloud or a hybrid cloud model, we feel like the pie gets bigger for the managed cloud segment, right alongside the multi-tenant kind of only segment.

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

Got it. That's really helpful. Thank you very much. And then just one more, if I may, this is a quicker one. Your return on invested capital profile improved substantially in Q4, even if I normalize out the lower tax rate. What was the main driver there? And then just how should we think about the trend in 2015? Specifically can ROIC get back to -- approach 20% again?

Karl Pichler - *Rackspace Hosting - CFO*

Yes. Okay. So basically, the math is fairly simple. It's margin times capital turns equals return, and so every improvement of one point in our margin, in our after-tax margin, translates into two points of ROC. So we've already talked a little bit about guidance in terms of where margins are going to go and where this leverage is coming from. And the other piece that we've also guided to is that our capital utilization or capital efficiency, if you want, is going to be reflective of what we've seen in 2014.

And as a result of that, we don't have any expectation that our capital turns should change significantly, if anything they will slightly move up. It's a big capital base, so it's moving -- it's not a metric that fluctuates quickly and wildly. But we have continuous positive trends there over the past couple of quarters and we will continue to see that if our capital efficiency stays where it is today. And so, that's kind of what it is. So if we're at 15% now and we can drive margins by a point or two, that gets you back to the 20% ROC land that we've previously mentioned.

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

Okay. That makes a lot of sense. Thank you very much.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Thanks, Gray.

Operator

Pat Walravens, JMP Securities.

Pat Walravens - *JMP Securities - Analyst*

Great. Thank you. So first of all, congratulations on hitting your adjusted EBITDA margin of 35%. It's hard to remember that there was a lot of doubt about whether you could do that recently. Did you guys exercise some extra cost discipline in Q4 to get there?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Hey, Pat. It's Taylor. No. Nothing extraordinary. We told you a couple times throughout the year that we had some scale opportunities and that we had excess capacity laid on in 2013 that we were driving utilization over. But you've talked to me enough to know that also that as the president of the Company, when I took over in January, I was looking for areas where we could go get tighter in terms of our operational discipline and preserving investment funds for future growth.

So there's been some just kind of what I would call operational tightening of the way we run the ship. But you've been here recently, I wouldn't call it austerity. I think it's just being smarter with how we spend and what we spent and then taking advantage of our scale opportunities.

Pat Walravens - *JMP Securities - Analyst*

Great. And then, just to help get investors' expectations in line on this, what are some of the challenges to getting the third-party cloud support model to work?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. Hey, I think that it's a very doable model and I think we, as the Fanatical Support leaders in the market, have a very strong opportunity to become the dominant players in that space.

I think the work to be done -- there are, frankly, that we need to be able to make sure that the offer is fanatical. And that means, as I've talked about before, that we have the ability to have visibility into the cloud platforms that we're operating on top of, have the ability to have engineering connections in that we can specialize and particular application types, rather than just sort of saying, hey, we'll just support all the bits and bytes.

So we're choosing those areas that we already focus in, like e-commerce and big data, et cetera, and figuring out how do we leverage the portions of the cloud platforms to run those most effectively.

So I would just call it an R&D project right now that is very serious. And we've got rackers learning all the time. And then I think there are also, that we need to stay the number one in managed cloud, so it will take our time to get it right. We don't want to go rush into that market and have an offer that we're embarrassed of, or that gets a lot of customer feedback that says, hey, it's no good when it breaks, and you just tell us, sorry, it's broken and we can't help you.

So that's what we're going for, Pat. We would expect to have an update for you on the next call with progress on that offer, but it's important to us.

Pat Walravens - *JMP Securities - Analyst*

Great. And then last one, can you tell us roughly how many customer accounts you have and is that something you would be comfortable giving us on a quarterly basis?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. I think, Pat, we're over 300,000 customers now. But there's so much variability in that base, because if you remember, we have, for instance, email customers in our email and apps business, our cloud office business, who are buying 100 email boxes. And then we have Weight Watchers who is buying something much more material and substantial, so it's very difficult to use that number in a useful way.

We used to disclose it for you when the cloud was early and it was a traction metric. Now it's probably a non-helpful number without a lot more disclosure behind it. And that's just a lot of overhead and something that I don't know that we could add a lot of value to.

Pat Walravens - *JMP Securities - Analyst*

Okay. Well, good job, and thank you.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Thanks, Pat.

Operator

Colby Synesael, Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

Hi. Great. Two questions, if I may. The first one on CapEx, I'm just wondering in your guidance for 2015, if there's any expected meaningful changes in either the data center or office buildout number? And then, or numbers -- and then the second question is, in your press release you talked about how you want to expand your specialized expertise, particularly around e-commerce, big data, and security. And I guess, just one of the things some investors struggle with conceptually is that IT service companies, the legacy ones, historically have had lower margins.

And I'm trying to get a sense of how much can you really do, how far can you really scale this level of expertise before you start running into issues that push up against your margins. Meaning that effectively that you can't continue to scale this and see margins continue to go up, because it

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seems like there would be a limit at some point to what you could ultimately do without this starting to see some potential margin degradation. Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. So, thanks, Colby. This is Taylor. I'll answer the second question first and then I'll give it to Karl for the CapEx question. Look, bottom line is, I don't want anyone on the call to mistake our ambition to become a system integrator sort of PS model, where we pull up the bus of 40 people and park over you for six months and do the low margin app migration stuff, not the model. What we have always done is we have found scarcity of expertise gaps in the market.

For instance, in 2005 for us what really sparked that decade of [gross] was linux was a scarce resource. We were able to build the deepest pools of economies of expertise of linux in the market, and we said if you want to run a linux operating system in a web app, come to Rackspace because we've got more people in that you can buy it as a fractional cost service from us and we're going to be the best at it.

When we talked today about expertise in MongoDB and Retis, or Oracle commerce or Sitecore content management, we are not talking about going and getting into the messy PS front end. We're talking about having people here who understand how to architect those applications for a multi-tenant single center in a hybrid cloud and then deliver amazing Fanatical Support running and managing that operation for customers so their e-commerce site works well, for instance.

And so it's very productized, it's very focused, it follows the model that we've always made money off of and we feel like we can do that, especially now. Again, one of the biggest drivers that is driving our optimism is, as infrastructure becomes more available, we are just seeing an explosion of software and tools and they're moving and changing fast and it's very hard for the mainstream companies to keep up with this rapidly moving sort of set of skills.

So we are grabbing market where, for instance with Tinder on ObjectRocket, where we have more Mongo and Retis people who know how to make that work super well than anybody else in the market. So I hope that helps to answer the question in how we'll approach these. We're also seeing the effects of scale in the model as we execute the strategy. When we do this well, we get out of the debate of pennies per bits and bytes and we get into value of making critical applications work well. So that's our model and that's how we do it.

Karl Pichler - *Rackspace Hosting - CFO*

On the capital side, the short answer is no. We have DC buildout continuing just in time as we've always had our models, which is really kind of the buildout within the data center to make it operational in [hours]. So we've spent roughly $50 million this year, probably going to spend a little bit more, maybe slightly more in 2015.

We spent about $20 million, $25 million on office, we're going to spend about the same amount next year, going to have about $100 million in software and other. And then customer gear is all success based, right? So that's really the piece where we time it as closely as we can. And so we've had this long-standing relationship of 10% prior-year revenue, plus 50% of incremental revenue, that is a fairly good proxy for customer gear CapEx for 2014, that marginal rate was $0.47 on an incremental dollar of revenue.

So we were better than historical averages. We continue to monitor and manage that, so the number may get bigger from a dollar perspective, but the relationship and the efficiency, the marginal CapEx productivity should be roughly the same.

Colby Synesael - *Cowen and Company - Analyst*

Great. Thank you very much.

Karl Pichler - *Rackspace Hosting - CFO*

Sure.

Operator

Frank Louthan, Raymond James.

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

Great. Thank you. How should we be thinking about uses of cash going forward? Thinking about more buybacks, possibly M&A in that as well. And then, looking forward, I think some investors may be a little concerned looking at your guidance range, even on a constant currency basis, more at that lower end of the range, obviously there's a reason you put it there. How realistic is that and should we see a corresponding upper end of the margin range if you actually come in that Zip code? Can you walk us through your assumptions on the range of the guidance?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Sure. Frank, this is Taylor. First, we have a growing stockpile of cash and I'm happy to have that because I think, again, we're in a big market and we want to dominate the managed cloud segment. We will continue to, as we invest in our strategy and build out those focused practice areas and build out new areas potentially like third-party cloud, we will put that cash to work.

We have said publicly that that can be organic stuff and it also will potentially include some M&A activity, and so we are at a big long-term market and we will go put that cash to work for growth. In terms of the guidance range, I'll start first and Karl might add some commentary, but it's early in the year. I am a CEO who's on my second call with you guys.

I inherited a large product set, sales and marketing engine, a Fanatical Support engine that there's lots of moving pieces. And I want to continue to explore the opportunities and places where we need to make change and improvement happen. So for us, we are continuing to kind of look at the market in a long sense. I believe our job this year is to take the next step forward on consistent growth and stable and improving margins.

And we're in the bottom of the first inning of this strategy move for us, so at this point in the year we're giving you the guidance range that we think is most helpful in this point in the conversation. And we think it gives us room to do what we said we would do, which is steady improvement on the revenue growth track, as well as stable to improving margins.

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

Great. Thank you very much.

Operator

Sitikantha Panigrahi, Credit Suisse.

Sitikantha Panigrahi - *Credit Suisse - Analyst*

Thanks for taking my question. It's good to see more larger deals like [$100,000] deals in the last couple of quarters. Just wondering if you could talk about some of the strategy changes you have done in terms of sales execution or product solutions, that benefited from enterprise segments and how should we think about that strategy going forward?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. Well, the strategy for us has been evolving with you guys over, I think the last 18 months, really. We hired Todd Cione to be our sales leader first, now he's our Chief Revenue Officer. Todd joined us from Microsoft. Very experienced in building scaled sales models that include both general sellers as well as specialty sellers. And we have really shifted our focus over the last 18 months from being what I would call more of a horizontal value proposition, i.e., would you like to buy some cloud or some hosting, to being much more solution oriented, would you like us to help you run your e-commerce platform better than anyone else? Would you like us to help you with security in the cloud, et cetera?

So this move towards solution-oriented sales, first of all, gets us into speaking the language of CMOs and CIOs and CTOs with very relevant offers. We have built and invested in expertise around those technologies and products that really matter in those solutions, so we can come and be highly opinionated as experts on how to leverage a hybrid cloud infrastructure around those things. And then, essentially, we've also been getting back to doing effective marketing and getting our customers to tell our story.

So our Solve events as one example, are the best money we can spend because you can get Tinder or Walmart Labs on stage saying things like, we work with Rackspace in these contexts for these things, because they're better than anyone else, then that gives us the credibility with the next Fortune 1000 logo that will consider talking to us, so it really is a combination of factors.

I think also importantly in the competitive landscape, we are seeing a tremendous opening of the market because the traditional players who cover the Fortune 1000 are really struggling. And you guys have seen some of the reorg announcements recently, the struggle of the cloud era is really catching up to large companies who have to completely re-factor their product set, their sales engine, their go to market, their economics. And so this is opening up this opportunity for us to be seen as what I call the relevant safe innovator for that part of the market, and so it really is kind of a combination of those factors.

Sitikantha Panigrahi - *Credit Suisse - Analyst*

That's great color. Thanks, Taylor.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

You're welcome.

Operator

Lou Miscioscia, CLSA.

Louis Miscioscia - *CLSA Limited - Analyst*

Okay. Thank you. A couple of line items seemed to come in a little better than we expected, depreciation, sales and marketing, maybe with R&D you spent a tiny bit more than we expected. Maybe if you could just give us a little bit more color on those line items through the quarter and going forward. And I have one follow-up.

Karl Pichler - *Rackspace Hosting - CFO*

Yes. I mean, if you want to look at quarter to quarter, variability on the margins, I mean, you have this -- we talked about in the third quarter that we had a significant tax good [guide] that positively influenced our gross margin. So if you look at the quarter-to-quarter comparison, it looks like it's coming down, but that's really just an artifact of the tax situation that we had. It was a sales tax rebate that hit quarter and not the tax rate.

So if you take that as the first set, what we really see is that all the different parts of the business are improving slightly or have been improving slightly quarter over quarter. And then, as Taylor mentioned, we have utilized the opportunity, or made use of the opportunity to run a little tighter on the areas that are really around general corporate costs. So the biggest leverage we really have in G&A. And then sales and marketing is the second largest lever, which is always an optimization effort and timing to spend and making, aligning it with a relatively slower activity that is around the year end.

And then lastly, as you mentioned, D&A. D&A is just a function of the lower CapEx as a percent of revenue that we've highlighted in the prepared remarks that now flows through D&A as a lower percent of revenue over time.

Louis Miscioscia - *CLSA Limited - Analyst*

Great. My follow-up was, at the New York City Solve event you had a couple industry experts that talked about almost an inflection point as the early majority starts moving to the cloud. Obviously, the guidance and Taylor's comment a second ago, I didn't obviously anticipate that. I guess maybe, Taylor, could you talk about whether you foresee that sometime happening in 2015, possibly in the second half? Or is it more like something that you would see coming in later, more or less an inflection-path opportunity for accelerating growth.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Sure. Thanks. Look, I don't think you're going to see an inflection point that is a dramatic sort of light switch flip on. I think it's happening at pace every month, every quarter, every year.

And so what we're seeing is that, whereas maybe three years ago cloud was in the hype phase, but it was very early adopter, and most of the cloud public cloud adoption was being driven by technically advanced customers with lots of doves, who could really own it and operate it themselves. Now you're seeing mainstream customers who either have the skills, but would rather them go work on the core business, or have a limited ability to access the relevant skills in the cloud era because they might be a manufacturer or retailer, or what have you, really starting to get comfortable with the cloud model.

But again, I think that the important thing to note is that that doesn't mean all, everything is going into a multi-tenant public cloud. This means hybrid, the majority of the market believes at least for the 5- to 10-year view, that cloud is hybrid. And what you're seeing is more and more applications that are running in corporate data centers, are being moved out if they're mature, ubiquitous type apps, like email or like a virtualized abstract.

They're being moved out into a managed services model to make space in that CIO's data center for more innovation work. Sometimes that is greenfield apps development that goes into a cloud. Sometimes those CIOs are building private clouds for themselves within their own data centers to, again, bring down their cost structure and gain more nimbleness, et cetera. So I wouldn't look for a light switch. I would just continue to see more and more steady adoption of cloud models. You won't see all of that going into a multi-tenant public cloud. Some of it will be taking place right in the corporate data center, but you're building out OpenStack private clouds and other cloud architectures within the corporate DC.

Louis Miscioscia - *CLSA Limited - Analyst*

Okay. Thank you.

Operator

Jonathan Atkin, RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks. So my questions are technology related. First, I wondered what portion of your work loads are on your legacy platform, and have you been actively converting any of those over to OpenStack over the last couple of years or keeping it on legacy? And then, from more of a forward-looking standpoint, I just wondered if there's anything you feel like it would be appropriate to share around containers and around NFV as tools that you might start to use in your own business? Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. Thank you. I think I'm going to try to answer your first question. I'm not sure if you're asking it the way I'm going to answer it, but I'll give it a shot. When you talk about our legacy platform, I'm assuming you mean our cloud-based that was --

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Jonathan Atkin - *RBC Capital Markets - Analyst*

Legacy public cloud. Yes.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Yes. Prior to OpenStack. Okay. So the OpenStack portion of our cloud now is well over 50% of the cloud, and we're accelerating that move. We are doing product lifecycle management and so there is retirement of our kind of first-gen and next-gen platforms onto our performance cloud platforms which are all built on OpenStack. And that's just a natural evolution over time. Customers will move and adopt as we EOL old platforms and make the OpenStack platform better, so well north of 50% now on the OpenStack.

And then in terms of your question around new technologies like containers, containers are a really important part of everyone's future. I think the world is betting that Docker is the winner, but you have companies like CoreOS out there who are presenting an alternative view, but I think that the concept of containerization will be a very important innovation. It's sort of the next wave after virtualization that you get in terms of making applications more efficient to manage from a service provider perspective. There's a lot of upside here, because if we can manage our fleets of servers with containers with way less overhead than you use using traditional VMs, there are huge economic advantages to that. So we've got work underway on that.

I would call that a very early stage technology in the market, but getting lots of traction. And, again, this is another opportunity for us to innovate because new technologies mean more complexity for our customers, and this is a chance for Rackspace to really productize those things for them while driving a more efficient business model for ourselves, so we're all about them.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then NFV, network function virtualization, is that even earlier stage at this point or anything that's on your radar?

Taylor Rhodes - *Rackspace Hosting - President & CEO*

I would say we were early in software defined networking, I think this is another iteration of that and it is very early stage. And so I would say that I don't have a whole lot to comment on that, I would just call it early.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then, just last question, just the UK business, it is a significant portion and perhaps a little bit more enterprise focused. I'm just wondering how that compares with sort of the core US business in terms of size of contract, churn characteristics, verticals, anything qualitatively that makes that different versus similar to the US? Thanks.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Sure. Yes. Our UK business is a great business. It has very low churn rates, a little bit better than Rackspace overall, but not significantly better. Because of the proximity to London, we do tend to have more interaction with what we would call enterprise customers there in terms of the overall mix.

Since launching the public cloud into the UK market, we actually have found a great diversification of our business out into Continental Europe, because cloud customers do business in English and they can access the cloud in the self-service model, so that's been a good market opener for us out of the UK. So, ultimately it's a great business. It's growing well and we feel like we do very, very well as the market leader there in terms of brand.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks very much.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Thank you. Okay, operator. I think that's the last question. I should conclude the call, right?

Operator

Yes, sir. In that case, everybody, ladies and gentlemen, we do thank you for participating and ask that you please disconnect your lines. That does conclude the call.

Taylor Rhodes - *Rackspace Hosting - President & CEO*

Thank you for joining us.
