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RAX - Q1 2015 Rackspace Hosting Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting Q1 2015 earnings call.

As a reminder, this call is being recorded May 11, 2015.

At this time, all lines are in a listen-only mode to prevent background noises.

(Operator Instructions)

It is now my pleasure to introduce Mr. Jason Luce, Vice President of Finance for Rackspace. Please go ahead, sir.

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

Hello, everyone. Welcome to Rackspace's first quarter 2015 earnings conference call.

We hope that you have had a chance to read our press release, which we issued earlier today. If you don't have a copy of the press release, please visit our Investor Relations page of our website at 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 CEO, and Karl Pichler, our Chief Financial Officer.

I need to remind you that some of the comments we may make today are forward-looking statements, including statements regarding expected operations and business results, our growth plans and expectations, the impact of new products and services, and our expected level of CapEx. 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 webpage of our site. After our prepared remarks this afternoon, we'll 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 to everyone on the call. Thank you for joining us.

When we spoke three months ago, I reported that Rackspace was taking a series of important steps to build on our leadership position in the managed cloud market. Our Q1 results represent another quarter of delivering on our promises. We've discussed in the past how the cloud market is splitting into two distinct categories, Unmanaged Cloud and Managed Cloud. That trend continues to become more visible, and the buying patterns in the market are following a predictable path.

In the early stages of the cloud market, the main driver of cloud adoption was the easy availability of cloud infrastructure, but a Company had to invest in technically advanced resources on its own payroll to operate its cloud. Now, as the irresistible draw of low cost infrastructure accelerates mainstream adoption, the portion of the market that requires both cloud infrastructure and managed services to make cloud applications valuable for them is beginning to grow more rapidly. This means that the new scarcity is the availability of the skills of the cloud age that can make it all work, or what we call economies of expertise. Every Company must answer the question, who is going to manage my cloud? And choose between the Unmanaged Cloud or the Managed Cloud model.

As we all saw via the first-time disclosure of AWS's financial metrics, the cloud market overall is not only very large, but it is also profitable. Rackspace is the world's number one Managed Cloud provider, and we are well positioned to benefit from the growth and profitability in the Managed Cloud part of the market. In the Managed Cloud landscape, we increasingly find ourselves competing against large Telecom companies and legacy providers of IC hardware and services, none of whom are cloud specialists, and most of whom are struggling to adapt to the demands of the cloud era.

We continue to win large opportunities that once went to those providers, and these deals are very healthy for Rackspace. We've won more such deals over the past three quarter, since we launched our Managed Cloud strategy, than we did in the previous six quarters. So we're landing big deals at twice the pace we did before, and our pipeline of such deals is strong.

Moreover, the execution of our Managed Cloud strategy is driving profitable growth, as you can see from our margins over the past three quarters. This is because Managed Cloud customers find business value in the unique expertise and Fanatical Support that we provide, and are glad to pay more for it than they would for infrastructure alone.

Let's get to the specifics for the first quarter. Our sequential revenue growth rate was 2.8%, on a constant currency basis. Compared to the first quarter of 2014, Q1 revenue grew by 16.6%, again on a constant currency basis. Our adjusted EBITDA margin was 33.6%, and was an improvement from Q1 of 2014.

We held our fourth Rackspace Solve event in San Francisco in March, which featured presentations from customers, including DigitalFilm Tree and Tinder. At these Solve events, our customer and engineers demonstrate to perspective customers, industry analysts and journalists the ways in which smart companies are achieving faster growth on our Managed Cloud.

The Solve series has been successful for us, both on the ground, in terms of sales, and through the air in terms of marketing. It's a winning play that we're going to keep running. We have announced a busy schedule of Solve events in Q2, with two already completed, and others scheduled in London, Sidney and Dallas.

Our event last month in Mexico City sold out in four days. It attracted some of the largest companies in Latin America, who heard presentations by Rackspace customers such as Accenture. Our event last week in New York City was similarly successful. We featured customers who use our eCommerce and data management solution.

Speaking of customer advocates, we're pleased to announce that we've added Activision Publishing, Made-in-China.com, and Treasure Data to the Rackspace family. Each is an innovator in its industry, and uses our Managed Cloud to stay fast and lean as it grows its business. Activation publishes popular video games, such as Call of Duty and Skylanders, and leverages our expertise in web content management.

Made-in-China is a world leader in B2B eCommerce. Its website traffic has increased 20-fold since it began using Rackspace eCommerce solutions. Treasure Data is a rapidly growing provider of managed analytics infrastructure as a service, which helps companies glean valuable insights from their data.

It has signed a mutual partnership agreement with Rackspace, and reports a 50% increase in performance, since it moved to our on-metal single tenant servers. A big part of our managed cost strategy is to wrap Fanatical Support around industry-leading technologies, as we have always done.

Early in our history, we focused on the Linux and Windows Operating Systems. We then extended our expertise and support to the private cloud platforms of OpenStack, VMware and Microsoft. Just this year, we have launched Managed Cloud solutions for Google Apps that work. And today, we announced the launch of Microsoft Office 365's suite of productivity applications.

As we've discussed, we are exploring the viability of delivering Fanatical Support on other leading cloud platforms beyond our own. This is an important priority that we're working on every day. We are having conversations with potential partners, and we are developing internal solutions to help us build a service model on one or more of the largest providers.

Furthermore, we are supporting entrepreneurial activities in this space. One example is our investment in a San Francisco-based startup called Scale FT, meaning Scale For Teams. This startup is building a cloud native administration and security platform that will help operations teams, including ours at Rackspace, to manage modern infrastructure more easily and securely.

I'm proud to add that this startup is lead by a Racker well known to most of you, Jason Luce, who has served for seven years as our VP of Finance. We thank Jason for his service, and wish him well as an entrepreneur.

Jason leaves our IR function in the capable hands of Bryan McGrath, who has served as a valuable member of our IR team since 2010, and will now lead the IR efforts, effective immediately. Bryan will manage all interactions with our investment community from this call forward.

Before I turn the call over to Karl, I want to mention a few factors that will affect our guidance for the second quarter. First, as we continue to pursue and win more large enterprise deals, the timing and longer implementation cycles of these deals will impact our quarterly results from time to time. As an example, in April, we signed a large and innovative contract with a leading financial services company. We are building and operating a production OpenStack private cloud for some of this customer's most critical applications.

We will operate this OpenStack private cloud in the customer's data center, which is a manifestation of our strategy to provide Fanatical Support on environments, regardless of location, which significantly expands our addressable market. While this deal is important for Rackspace and OpenStack, we were not able to steer it into the first quarter, so the revenue growth from it will materialize in Q3. As we continue to pursue our advantage for larger deals like this one, we may experience some variability in our quarterly revenue results.

Next, we have a one-time revenue headwind in the second quarter, resulting from a unique circumstance. For data sovereignty reasons, one of our largest and longest-tenured customers was forced to move their production element of a large environment from our data center in the UK, to a location in Africa, where Rackspace does not have a data center. This results in a one-time revenue reduction at the beginning of the second quarter. We retain all other environments, and a healthy relationship with this customer, and expect to grow this revenue back with them over time.

Despite our slower start to the year, we are not making changes to our full-year guidance range for revenue growth and adjusted EBITDA margin. Our pipeline is building nicely, and we expect that our sales activities will improve during the second quarter, and create higher revenue growth in the second half of the year.

With that, I'll turn the call over to Karl.

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Thank you, Taylor.

Let me now get to the specific results for Q1. Reported revenue on a GAAP basis for the fourth quarter grew 1.6% sequentially, to $480 million. Currency changes affected this result negatively by $5.3 million. On a constant currency basis, sequential revenue growth was 2.8%. Comparing Q1 of 2015 to the first quarter of 2014, we grew 14.1% on the reported basis, and 16.6% on a constant currency basis.

Adjusted EBITDA for the first quarter was at $161 million, for a margin of 33.6%. Net income was $28 million, for a margin of 5.9%. EPS on a fully diluted basis was $0.20, and return on capital was 12.6%. Operating cash flow was $145 million, and capital expenditures came in at $90 million. Our adjusted free cash flow was $67 million, and our cash balance increased by $62 million. We ended the quarter with $276 million in cash.

As you have observed in previous years, our Q1 margin usually declines relative to Q4. This is normal, expected and planned for. The main reason for the decline this year, as in years before, are personnel-related expenses. Also note that in this quarter, we had a negative contribution from one-time items to our margins, whereas in Q4, we had a net positive contribution to our margin from one-timers, both on the pretax and on the after-tax basis.

After our low effective tax rate of 25.1% in Q4 that pulled down our 2014 ETR to 30.7%, we estimate our 2015 effective tax rate to increase to 33%, mainly due to the expiration of federal R&D tax credits. With respect to Q1, the effective tax rate was 32.4%, due to discrete items that just affected Q1 individually. Also, our capital expenditures were fairly low in the first quarter, which, in combination with a strong collections quarter, contributed to the increase in our capital turnover. We expect CapEx to increase, again, to more typical levels in the near future.

For Q2, we expect our sequential constant currency growth rate to be within a range of 1.5% to 2.5%, and adjusted EBITDA margins are expected to be within the range of 32% to 34%. And as Taylor stated previously, we expect to deliver full-year results that are within the previously-stated ranges for revenue growth and profit margins.

This concludes our prepared remarks. Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question is from the line of James Breen with William Blair.

James Breen - *William Blair & Company - Analyst*

Great, thanks. Just a couple questions. One with respect to the sales force, and just overall sales momentum. You'd said, in the third and fourth quarter, you're seeing good momentum, in the 100,000 plus type of customer range. Are you allocating more sales resources to these larger customers? And just wondering how that impacts the business? And then also, with respect to the Solve series, I think they have been good at educating the market around some of the things you're doing for other customers. Do you view these as an outbound sales type of endeavor, where you're gaining customers through these events? Thanks.

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

Yes, Jim, this is Taylor. Thanks for the questions. Yes, you saw in 2014, the results when we are able to bring in the bigger deals and materialize those into revenue. They are a very efficient growth machine for us, meaning that they are profitable. Rather than trying to close 100 $1,000 deals, I'd rather close a $100,000 deal any time. So we are allocating more resource there, because of the success that we had in 2014. That looks like changes in our marketing, to what I would call more solution marketing, toward our practice areas. That's different than our historical marketing, which was more online only, and more product level.

So this is out -- getting the message out there to people, like CMO buyers, around our digital and big data solutions. So a shift in marketing. Solve and other out-bounding marketing activities, to complement our inbound machine, and that's a layer cake on top of our traditional inbound transactional model. So you'll see us continuing with more what I would call enterprise grade out-bounding marketing. And finally, on the sales force, continuing to hire and build enterprise sales management and talent out in the field, to be close to where these customers live, and have expertise in the practice areas, so that we can go sell more of them.

I think the second part of your question, around Solve is a perfect example of how that comes together. For those of you who have attended a Solve event, it is not only a very credible event that helps us get our message across. When you have companies ranging from the world's largest retailer to born on the cloud innovators like Tinder, coming and getting on stage with us, talking about how they use Managed Cloud, how they take advantage of our practice areas. That is the most credible marketing we can do. And it does turn into sales pipeline. And in fact, in our event just this last week in New York, it turns into sales closed, as well, where we've got customers who come, and we actually consummate deals at those events.

So from a sales perspective, they are very good. I think also, from a halo effect, when you bring together that type of a mix of analysts and journalists and prospects and partners, you get a halo from those, as well, that's written on. Partners go back and educate their organizations about Rackspace. So we'll continue to do more of those types of events, because of the outbound sales nature and quality.

James Breen - *William Blair & Company - Analyst*

And then just one follow-up, on -- CapEx was up just a little bit year over year. Obviously, revenue was up more. Are you seeing better efficiency there, on the capital side, than you had previously? Thanks.

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Yes, certainly. We had, both on the working capital site and on the PP&E side, significant improvements quarter over quarter. And also, as we stated in 2013 and 2014, we built up quite some capacity that we are now burning into. Some of it is timing-related, so we expect some of the purchases that were originally timed for Q1 to happen in Q2. But still, overall, it's much better than over the last 18 months.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Thank you. And our next question is from the line of Gray Powell with Wells Fargo.

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

Great, thank you very much. So can you expand on the potential to support workloads on other cloud platforms? What could the timing of something like that be? And then, how should we think about the operating margin and free cash flow profile of that opportunity?

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

Okay, great, thanks, this is Taylor. Thank you for the question. I think that ultimately, the model around supporting on other clouds is -- it makes a lot of sense for us. We've talked, in the past, about why that is a consistent model with our heritage. Where part of the value we add, because we don't come in with a point of view on only one technology type, is that technology agnosticism, being able to offer customers choice of leading technology. And then adding value by making it all work with fanatical support. So it's very consist with that model.

We are working on it, and we have good conversations going on with potential partners. We're developing internal capabilities on it. As an example, today, we launched Fanatical Support for Office 365, which, as you know, is a market-leading technology, set around productivity and collaboration. And being able to find the market that doesn't really want to manage that stuff -- it just wants it to work -- is a big opportunity for us. And so we're excited to launch Office 365 with Microsoft today.

In terms of the financial model on it, we've talked in the past about the fact that obviously, this is a capital light model for us. Whereas in our traditional model, we deploy the capital, as well as the other components of the cost stack, to manage it fully. Deploying Fanatical Support on somebody else's cloud allows us to reduce the amount of capital, which means that it's a higher ROC model for us. And the revenue units may be smaller, depending on the type of deals, because we don't price it in the capital. But ultimately, they are more efficient and profitable revenue units, from a capital utilization perspective. So that's what the profile would look like, from our perspective.

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

Okay, and then maybe just a follow-up question. I'm not sure if you can segment out. But if you had to segment your business into a commodity infrastructure unit, and a services and support organization, how do you think the EBITDA and operating margin profile of your infrastructure segment will compare to the metrics that Amazon disclosed?

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

I'll take a first crack at that, and I'll turn it over to Karl. First of all, note on this was good. It was good, provocative compare between the AWS result and what Rackspace's model might be. We don't break out the differences between the IS only and the service piece. In our perspective, historically, the model has worked because we do both. And we can create higher value outcomes by doing both, clearly. In a third-party cloud model, we would be taking a bit of a bet that we don't need to control both to deliver Fanatical outcomes.

When you think about the AWS results, though I think they show us a couple things. First of all, obviously, they are by far the leader in the -- what we call Unmanaged, or IS-only space. But the good news, for all of us in the industry, is that they are not only large and growing fast, but they are also profitable. We make no claim to know what AWS will do, in terms of pricing. But the fact they are able to compete, and grow at the rate they're growing, and maintain healthy profitability, may speak to how much of an emphasis the price war is, in terms of the currency of competition, going forward.

The second thing is that, if you look at their results, along the line of your questioning, between pure IS and high value managed services, you can get a sense that we compete in different markets with different offers. I think you estimated a 20/80 split between IS-only and services for us. When you look at their model, and their capital intensity, and the type of ROC they're getting on their deals, they are clearly competing in the more capital intensive IS-only segment, whereas we are adding more value on top. And we like that.

And the last thing I would comment, on the results, is that you might even go so far as so say, these are complimentary business models, for that very reason. And so we took a lot of -- just like everybody -- wow, they are growing really fast, they're profitable. But that's a big market, and there's room for multiple players, room for the Unmanaged Cloud, as well as Managed Cloud segment, to do very well.

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

Got it. Thank you very much. That's helpful.

Operator

Thank you. And our next question is from the line of Pat Walravens with JMP.

Pat Walravens - *JMP Securities - Analyst*

Great, thank you. So two questions, and maybe I'll just ask them both up front, and then you guys can address them. So Taylor, when did you first realize that your sales productivity in Q1 wouldn't meet your expectations? That's number one. And number two is, what do you guys need to accomplish first, before you could start managing work loads on Amazon [listservs]?

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

Okay, thanks, Pat. This is Taylor. I'll take the second one first. So we are, again, today, a step forward is launching Office 365. We're excited about that. That is a big market opportunity for us. The rest is work in progress that requires us to be training internal resources, looking in the market for all of the avenues that we might go down on this path, both organic and inorganic.

And working with partners who bring new tools and technologies and capabilities to the table, so that we can actually manage third-party infrastructure well, in a Fanatical way. So all of those are underway. We have people working on it every day, from a dedicated resource perspective, and that's all I have for you today. We'll be back with an update for you soon, on our activities there, and keep on progressing down that path. I think your second question was around, when did we know our sales --

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Pat Walravens - *JMP Securities - Analyst*

Yes, when did you know that your sales productivity in Q1 wouldn't meet your expectations?

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

I think obviously, Pat, we don't -- we're not going to give you a specific answer to that. But I can tell you that we provide guidance that we believe is accurate and fair, at the time we provide it. As I commented, the main driver of this really is that some of these larger deals are forecasted to happen in a certain period, and they slip out 30, 45, 60 days.

And so some of the learning curve, on us, as we move from a mostly inbound transactional model to some of these, has to do with learning curve on how many buyers are in the process. Learning to forecast accurately on when these deals will land. And then of course, you also have the longer materialization cycle on the other side. So all of this goes into what I'd call the shift, on top of our transactional layer cake of revenue, to the bigger deals. And some of that leads in new complexity, and will drive some quarterly lumpiness and revenue for us, going forward.

Pat Walravens - *JMP Securities - Analyst*

So you've been doing this a long time, Taylor, with bigger deals. When investors hear this, they worry this is not going to be a one-time phenomenon. What would you suggest that makes you think it is?

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

I can -- as we've commented, Pat, I think our forecast, in terms of our pipeline visibility, looks healthy and strong, and we know how to look at that pipeline. Again, some of the learning curve, every time you have a learning, you take advantage of it, and you get better the next time. And I think bottom line is, the pipeline looks healthy, and they're qualified deals.

Also, I think that in 2014, we showed execution capability there. Just the best I can tell you right now is that Q1 normally starts out a little bit slow, anyway. You lose some of the January, and even into February, selling time, with some of these customers. And by the time you get everybody around the table in Q1, you realize it's late February, early March. And you're going to not hit when you forecasted, on a couple of these. So I think some of it is also peculiar to Q1 cycles.

Pat Walravens - *JMP Securities - Analyst*

Okay, thank you.

Operator

Thank you. Our next question is from the line of Colby Synesael with Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

Great. I guess similar topic, just the dynamic between the lower than expected second-quarter guide, relative to expectations to maintain guidance for 2015? I was wondering where that confidence is coming from? Is it based on just a broad conversation that you're having, and the number of them? Or is it really deals that have already been signed, it's just a matter of installing them? Just seeing a little bit more conviction on the confidence to actually still hit that guidance?

And also, to the point, I would assume we're now targeting towards the lower end of that. Just wanted to get some [sense]. And then my second question is, I think there had been an expectation that, if you're at the higher end of your revenue guidance, you'd also be at the higher end of your margin guidance, and vice versa. With the churn you're experiencing, is that still likely to be the case? Thanks.

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

Colby, this is Taylor. I'll start off on that, and then Karl, I think, has some comments, as well. The confidence, for us, it comes from pipeline, frankly. And it comes from the fact that yes, we know we have signed a couple of these that will materialize in Q3, and drive revenue. If you remember, in 2014, we were able to tell you about some sizeable deals that we closed in Q2, that drove part of the revenue growth that we saw in the second half of the year. So we've got some pattern recognition on this.

So it's a combination of pipeline visibility and deals that are not yet signed, and some visibility into deals that have signed, and when they will materialize. In terms of the churn, and the profit range relative to the revenue range, as we said, we've got a peculiar one-time revenue headwind event from a large churn in Q2. It hit, unfortunately, April 1, which makes it a full effect in Q2. And that's a contained, unique event there. Karl, you want to talk about it?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Yes, you can just do the sequential growth rate mathematics, to see what you need to get into the guidance range. Both from revenue perspective, and then profit, I'll talk about that in a second. So basically, if you look at the guidance we have, and the actuals we have right now, we need somewhere between 3.5% and 4% sequentially, in the second half of the year. Which is significant -- which is higher than we tracked in Q1 and Q2, from a guidance perspective for Q2.

But which represents our expectations that our performance -- our actual revenue growth performance will accelerate in the second half of the year. From a profit perspective, you're right. In the short-term, we have a positive relationship between sequential revenue growth and margins. And so in the short term, for a given year, I would say that they are more positively correlated. So lower end of guidance rate, on the revenue side, would probably imply lower guidance on the -- lower outcome on the profit range, as well.

Colby Synesael - *Cowen and Company - Analyst*

Is it fair, I guess, to assume that right now, you're targeting towards the lower end of the guidance range?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

No, we are expecting to be within the range.

Colby Synesael - *Cowen and Company - Analyst*

Okay, thank you.

Operator

Thank you. Our next question is from the line of Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks very much. Karl, would it be possible to size the Q2 churn impact, just so we get a sense of how much we're dealing with here? And then Taylor, you made some comments, earlier in your remarks, just about the competitive landscape. And I think you talked about some of the challenges some of your competitors have. Can you just update us on that? Where you stack up versus some of the Telcos, and some of the legacy IT companies? And how you're doing in the RFPs, et cetera, pricing trends?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Yes, we're not going to specifically articulate what that single customer event is, in terms of percentage contribution, but it's not insignificant.

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

Yes, Simon, the reason we decided to mention it -- and we've never done it before -- is it is material, and it is significant. So -- but we have customer agreements in place, things like that. So we're not going to disclose the amount. On -- in terms of your competitive landscape question, look, I think that the good news for us is that we continue to feel, and can measure, an increased number of opportunities, in terms of RFP, or inbound non-RFP-related opportunities, that normally would have gone to what we would call the traditional enterprise players, especially as we start to land more and more of our punches around our particular practice areas.

We're seeing good, healthy opportunities, where it's all about helping the company maximize the effectiveness of eCommerce platform, with content management platform, with big data. Those are the places where you're in, not arguing about pennies per gigabyte per hour. You're talking about making things work that are high value to business unit decision makers. We feel like we are competitively advantaged over the large Telcos, and traditional non-specialist tech players, who actually have a hosting business line.

And so we feel good there. Also, just as a comment, the market continues to gain wisdom around cloud. And so we are seeing more of the commentary around Unmanaged Cloud and Managed Cloud elements show up in these bids. So customers are starting to get smart about knowing what they're asking for, and comparing competitors differently. And that's good news for us.

Simon Flannery - *Morgan Stanley - Analyst*

Okay, thank you.

Operator

Thank you. Our next question is from the line of Frank Louthan with Raymond James.

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

Great, thank you. Looking at -- forward to some of these third-party infrastructure support models, what sort of investment do you think that's going to take, and over what time period? And what kind of margin dilution should we expect along the way?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

As Taylor mentioned before, I think the investments that really need to be made are on the people side, and on the tooling side. And I think, as we also mentioned, we're pursuing multiple avenues. On the people side, it's really a continuation of our business, which is to hire people, Rackers, that have a high degree of technical expertise, combined with a Fanatical attitude to serve. And those two things are crucially important for us, as ingredients. So we will basically start to shift our hiring efforts, and retrain those people towards those technologies, as we've always done in the past, that are seeing the biggest market traction.

So this is the whole notion of, we're being technology agnostic, we're acquiring expertise where it matters, and then we basically deploy resources as we need, and as the revenue momentum is building up. So I would not see us having a huge, extensive margin dip that is due to our building up of expertise. That's -- we've done that, over the last 60 years, as a business. And I think we've done that fairly well, I would say. Then there is the -- there is always the opportunity of inorganic acquisition of capabilities, or maybe doing some internal investment funds, to accelerate certain development efforts.

Obviously, we have a big R&D organization, a product development organization, of which part of their road map is associated with that. Of which the cost base is already embedded in our current cost structure. So absent a large, inorganic acquisition that would be associated with such activities, it will be absorbed along the way, I would say.

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

So you can hire the more expensive folks, and keep them on, as you're building the practice, without seeing much of a margin impact?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Yes, basically, the allocation of resources will be coming with respect to the revenue opportunities that we have. So of course, there will be an initial investment to be made, where we allocate a specific group of people to this effort, without having immediate revenue. But that is going to be a rounding error on our corporate margins.

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

(multiple speakers) And is this expected to be a higher or lower margin business than what your current mix of business is?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

They are going to be -- they have different characteristics on different parts of the margin profile, right? So the -- if you look at a -- on an after-tax or pre-tax margin after D&A, I don't think that the margin profile would be significantly different. But you have very different capital characteristics, and very different free cash flow characteristics, as Taylor alluded before, the margin business -- the service business has operating margins that are much closer to free cash flow. Because you don't require the upfront investment that right now creates a wedge between free cash flow and operating margins.

And then the capital characteristics are better, as well, on the service portion, which you can see from -- when you look at the comparison between the AWS financials and ours, their depreciation is significantly higher, as a percent of revenue. Their turns are low, their operating margins are about similar to our consolidated business. So it really depends on where you want to hang up the comparison to. But --

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

Okay, great, thank you.

Operator

Our next question is from the line of Jonathan Schildkraut with Evercore ISI.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Good afternoon, and -- or good evening. And thanks for taking the questions. Two, if I may. First, just in terms of disclosures, I notice that you guys pulled the IBT disclosure this quarter. And I was wondering if there was some sort of reasoning behind that, that maybe you could share with us? Whether it's something that might come back in the future? And then I have a follow-up question after, if I may. Thanks.

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Okay, yes, Jonathan, this is Karl. On the IBT thing, just to give back context a little bit, we have been talking about reviewing our set of key metrics that we're disclosing, and we've made the two changes about -- that we've talked about in the past. One is the combination of the revenue lines, to better reflect the fact that we have multiple form factors that are coming together. And IBT is a little bit of a related issue. As you know, IBT goes all the way back to our pre-IPO days.

And it's really a metric that has served us really well on all of the subscription-based dedicated hosting type of business lines. And if we think about it in terms of cloud, it has much less informational qualities, for a variety of reasons. One is just because A, the utility world is not subscription-based in the first place, so that's the more fundamental reason. But then it also becomes a little bit murky, because you have -- utility-based billing is always days-related, so you have these anomalies about when customers spin off. If it's in the middle of the month, or at the end of the month. And it's just not as clean.

And so we have left the metric as is. We have talked about, a long time, as to when is the right time, how to evolve it, or how to pull it. And we have now started, and we have confirmed last quarter, that we will continue to give earnings guidance. And you know us, this was a difficult decision for us, philosophically. But into the conclusion that the best way of telling you all of the things that we know is by summarizing it in the revenue ranges that we expect, rather than giving you the piecemeal metrics that are getting harder and harder to interpret, and to really understand what's going on.

So we are sticking firm with providing the quarterly guidance that summarizes all we know about revenue, and we're removing only that one metric that has gained quality and significance over the last couple of years.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Great, thanks, Karl. So my follow-up question has to do with Office 365. Seems a pretty exciting announcement. I guess it's my understanding, then, that this would be applications that lived on Microsoft hardware servers, as opposed to Rackspace servers? And I just wanted to confirm that. And I guess my question is, what challenges, hurdles did Rackspace have to overcome, in order to be able to do that? Are you able to provide an SLA around that? And what kind of integration partnership did you need on the Microsoft side, in order to put an SLA around it, if that's the case?

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

This is Taylor. We were excited about it, as well. Office 365 is taking share. If you think about what Office 365 does, it provides a SaaS-based managed solution for some of the most ubiquitous and mature types of apps in the world: e-mail, collaboration, productivity. These are all applications that CIOs are, in increasing numbers, saying why should I run that? I add no value to it. So the size of the market is big, and it's moving faster out of the corporate data center. And Office 365 has a leading position in it. So we're excited about that. The way that we'll add value in it is that there is a healthy part of the market that would rather not invest in all of the headcount, et cetera, to go and manage Office 365 itself.

They would not like to have to manage migrations. They would like to not have to manage what happens when it breaks, all those sorts of things. And so we have a very identifiable market segment, similar to our traditional support seekers, who would prefer to buy it as a fully managed service, for a few bucks more, versus buy it at a cheaper price, and then have to add that head count and headache into their own cost model. The things that we needed to make it work were one, a good agreement with Microsoft. As with any large tech provider, they have a channel enabled ecosystem, where they want to focus on the product, and not so much the service.

Yes, it is hosted inside of a Microsoft data center. And so they add value from the product level, as well as the infrastructure level. And then we'll take it from there, for the customers who choose Rackspace to let us manage it on top. We do provide SLAs to our customers. And we are focused on adding services from the front end, for people who need an efficient way to help migrate to Office 365, as well as, then, the run and operate task that happened after that. That's a very traditional model for us, where we know it well and can get very efficient on it.

So I hope that answers your questions, and we're excited about it. And again, it's another good example of the opportunity to go leverage someone else's product expertise and capital, and really differentiate on what makes us a specialist in our market.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Thanks for taking the questions.

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

Absolutely.

Operator

Thank you. Our next question is from the line of Siti Panigrahi with Credit Suisse.

Siti Panigrahi - *Credit Suisse - Analyst*

Hi guys, thanks for taking my question. First, Karl, what's your expectation about FX impact in Q2? And Taylor, you talked about the OpenStack deals that you signed in April, and also we heard about how successful Wal-Mart was with OpenStack. Just wondering, what's your view about OpenStack, in terms of reaching an inflection point? Maybe, could you characterize what stage it is, at this point, in terms of adoption?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Sure. I'm going to take the FX quickly first. So our guidance range is expressed on a constant currency basis, just to repeat that, so everybody is clear on that. Also, the [PVP], which is the currency we have the most exposure to, has recently experienced a lot of volatility, and somewhat of a little bit of a turnaround last weekend.

And so right now, the rate is basically, we're very close to where we were in Q1, slightly above. So if you just take the current rate as the best predictor, short-term, for where we are going to be prevailing during the second quarter, we're talking about the very small tail wind of maybe 10 to 20 basis points. But right now, if it stays the same, it's fairly insignificant.

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

This is Taylor. In terms of the OpenStack question -- yes, look, the reason I featured the deal I talked about, that we closed in April, was for a couple reasons. One, you'll remember last year, when we started hitting these large deals, again, they create a nice bow wave of growth for us in the second part of the year. Two, this one is a large production grade OpenStack private cloud, running in the customers' data center. And we've talked before about our vision of being able to put Fanatical support anywhere, on top of our target product. So that's a good validation point for the market. And this is, I think, another validation point, also, that the market is warming up to OpenStack, in terms of its readiness.

There are certainly, clearly, paths still ahead of us, around tools and functionality, to be able to make OpenStack an at-parity stack, compared to a more mature technology stack. But I think the progress is increasing there. We are seeing OpenStack take a very private cloud-oriented path, in terms of the new demand signal. And largely, it's change agents, CTOs, CIOs, et cetera, who are traditionally running VMware or another traditional stack. They are not ready to dump their old stack, by any means.

This is not a rip-and-tear from one old to a new. But it is a statement about intent, in the future, to have more than one option, in terms of the stacks they choose to run production. So we see building signals in our pipeline, certainly, that private cloud is the biggest manifestation, the new manifestation, for OpenStack. And that the pace of readiness of OpenStack is picking up. And more and more enterprise-grade customers are getting serious about doing something big with it.

Siti Panigrahi - *Credit Suisse - Analyst*

Great, thank you.

Operator

Thank you. Our next question is from the line of Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks. So just a little bit more detail on international, if I could. And if you could quantify the actual exposure to the British pound? And maybe just the second most significant currency? And then, as you think about that business, how would you think about the demand trends and margins, versus the US? And then I have a follow-up.

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Okay. So the -- yes, let me talk about the first part first. So the exposure to the [PVP] is really the most significant one, with respect to FX. So we bill customers in US dollars, PVP, Euro, Hong Kong dollars, Australian dollars. Those are the currencies that we allow our customers to be billed in, and to remit their invoices for. The vast majority of FX exposure is with respect to this pound sterling, so that's really predominantly the one that creates the exposure. We have a fairly sizeable operation in the UK, as well. So when we think about top line exposure, that looks fairly pronounced. Bottom line exposure is almost nothing.

So just for illustrative purposes, we had a $5 million impact on the top line this very quarter, so our constant currency revenue would have been [485]. If the currency would not have moved, the impact on net income is less than $1 million. And so you can see that basically, the -- that there is a huge amount of offset. Pretty much the entire profit is really offset, in terms of the cost base that we have in the UK, and relative to the exposure that we have.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And historically, I think you've been a little more enterprise indexed in that market and elsewhere? Is that still the case? Or how would you qualitatively describe some of the business trends there?

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

Yes, this is Taylor. I used to lead that business for a few years. So the UK business is more what I would call enterprise. The proximity to London helps us have more interaction with those types of customers, historically. We are the brand leader in the UK market, and so we tend to get more pull from medium and large size businesses, naturally. And we got there earlier than we have in the US. But overall, the demand in the international market is healthy.

Our business in Asia-Pac is growing, and our business, not only in the UK, but also some expansion that is promising into the continent in particular markets, such as central Europe and the Nordics, is interesting, as well. So we feel pretty good about demand traction from the international market. And frankly, the international markets, particularly in Europe, are usually 18-24 months behind the US, in terms of adoption cycles. So what we're seeing there is now a catch-up, in terms of demand, for as-a-service model. And feeling good about the pipeline creation opportunities there.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then just switching topics, you talked about economies of expertise. And as you think about launching Managed Cloud on major third-party IS platforms, like Amazon or Azure, Google Computing, so forth, what operationally needs to happen? Whether it's technologies that you need to develop or purchase, or expertise you just need to develop in house. Is there automation involved? If you could talk a little bit about the milestones along the way that you need to pass before you're comfortable making that type of shift in your model?

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

Yes, thanks. One is people and training, right? So skills, certifications, learning the technologies themselves. That is right in our wheelhouse. We have Rackspace University. We're very used to training technical people on new things, so -- but that is a piece of work. The second is development of your offer, so where are you going to add value on top of the vast set of options available in the leading IS players? Are you going to go be a horizontally-focused player? Or are you going to be a solution-driven, application-driven value add in particular areas? So you need to have a product strategy.

Second -- or third, pardon me, is there are some technological elements to it, certainly. Being able to either build or partner or buy for tool sets that allow us to operate and add value on top of the third-party cloud platforms. And so we're working on all those things. And I think that, as I mentioned before, assume that the launch of Office 365 today is a good sign, in terms of our intent down these paths. And we will have an update for you all, as soon as we're ready. As anyone developing a good strategy, you don't want to give too much of it away before you're ready to launch it. So we'll be back with an update on that topic when we're ready.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then for Karl, real quick, just wondering, R&D, sales and marketing both flat sequentially. G&A was up. And how do we think about that, as we move through the year?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Yes, nothing really that should constitute the trend here. As I mentioned before, we had -- Q4 had a bunch of very positive one-timers, including taxes, but also on the other lines. Q1 is traditionally low on the sales and marketing side. And we had -- so that's probably going to uptick a little bit, given the expected better performance, especially, that we have for the second half of the year. Cost of revenue was affected by both data center license cost one-timers, that makes Q1 look heavy, and on the R&D side, that's an item that we generally expect to leverage over the longer term in the business. Those are kind of the -- [trying to stay].

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks.

Operator

Thank you. Our next question is from the line of Phil Cusick with JPMorgan.

Phil Cusick - *JPMorgan - Analyst*

Hi guys. Following up a little bit, in 2014, you began going after deals. Can you just give a little bit of an overview on how that strategy has worked out so far? And where are you, in terms of addressing that market, ramping up? And you had talked about hiring enterprise sales reps. What kind of expertise do you need, when you're going into that? And who do you usually run into in those RFPs? Thanks.

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

Okay, thanks, Phil. This is Taylor. I -- look, we're further along than we were in 2014. I think that you saw, I think, the results that impacted in 2014 were a big contribution from the big deals. So that gave us confidence that this was a space we should invest more, and build out. As I mentioned, we've hired more reps. We've hired more managers. We have shifted and allocated marketing dollars, and added marketing dollars toward being more outbound-oriented. So all of those are following the success we had, and we wouldn't be investing there more if we didn't feel good about that opportunity.

In terms of the types of skills and knowledge, clearly, enterprise sellers from other technology and tech services context are helpful. People who come from specific backgrounds that align to our practice area of focuses, who bring that level of product and business expertise around our practice areas, are places that we're targeting. So those are the kind of folks we're looking for. And we feel like our pipeline, again, of these opportunities looks healthy and good, for the rest of the year. So we continue to move down that path, and feel like it's a very good spot for us, because of the dynamics in the market, where a lot of the traditional incumbents are truly going through a lot of disruption.

You can look at some of the three-letter acronym companies who are going through a lot of disruption, the Telcos who are not specialists in this space, who have a hosting line of business. And generally don't score very well, in terms of their service quality. So we feel it is a place that we can be competitively advantaged and profitable at the same time, so we're going to go for it.

Phil Cusick - *JPMorgan - Analyst*

Can you see this accelerate over the next couple of years, as you get some more credibility in deals?

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

Yes, absolutely. I think that it is a credibility game. And so when you come back to talking to events like Solve, a lot of the rationale for doing those events is when you can get those types of customers on stage, or partners on stage. Again, we don't pay them to do this. This is their credibility on the line.

And so when you can get that type of virtuous cycle going on, from credibility, from we have a large customer advocacy program, which is also a new add in the last 12 months. And we're up to over 100 customer case studies that we can now share. So this is all about credibility building. It's all about picking your target markets. Again, don't go out and try to win everything. Be great at five or six things, and really be differentiated there. So as we build our credibility, we feel like this is a fly wheel similar to areas we've experienced in past parts of our business.

Phil Cusick - *JPMorgan - Analyst*

Thanks, Taylor.

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

Absolutely.

Operator

Thank you. Our last question for today is from the line of Amir Rozwadowski with Barclays.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for taking the question. In talking about the potential opportunities with working with large cloud service providers, it seems like you've got a lot of potential opportunities in the pipeline. How should we think about the demand curve, relative to your conversations with customers right now? Is there a demand pull-through for wanting to work with those folks? And this is a positioning that you can fill, in terms of serving as the go-between in providing that type of service? And could that lead to accelerating growth, at some point, as we start to see demand pickup for that type of service? Thanks.

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

Yes, certainly, the way we always plan our businesses here, as you've heard me talk before about horizon one, two and three businesses. And one is your mature business that makes your numbers this year. Two are things that are post-finding product market fit, and now it's about getting them into wider distribution, and they will help you start driving revenue next year. And then horizon three are opportunities where you still have to go understand product market fit, and how you add value over the life cycle of the customer, how you make money doing it, et cetera.

We've characterized these opportunities as a horizon three business right now, meaning we expect no revenue acceleration, in a material way, from them this year. And we've been clear about that from the beginning. We think that the demand signal is large. But again, per all of the questions about business model on this call, it is a model where you have to get into it, and then go figure it out. Experientially, you want to launch in a way that allows you to get pilot customers on board with you, customers who are willing pioneers, who are willing to go help you learn.

And you want to create milestones along the way that are about product release, traction in terms of winning lighthouse customers, traction in terms of stickiness, meaning high NPS and low churn, from those pilot customers. And as you get through those gates, then you widen the distribution model more fully. We certainly think that this one has the chance to move quickly into major demand, but we want to be prudent about going after it.

And making sure that we don't open the window to lots of demand that we either can't service, or we service, but it's chaotic for us, in terms of being able to make money, and not confuse our customers on our overall portfolio, et cetera. So that's how I would characterize our plan on progressing through the stages of turning this from a horizon three into a horizon two in one business.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much. And one follow-up, if I may, in terms of your near-term outlook. I realize that you can't quantify the impact of the churn versus some of the deal push-outs that you guys have impacted. But if we were to look at the two, in terms of materiality, where would you rank the impact of either/or, in terms of your near-term outlook?

Karl Pichler - *Rackspace Hosting Inc. - CFO*

It's just -- what happens, from a revenue perspective, it's just heavily skewed, right? So you basically have the -- if the revenue materializes equally over three months, you have a very different sequential growth rate than if it materializes in a sloped matter. And so when we look at Q2 relative to Q1, we have the worst possible outcome, given the timing, and given the back loads of the larger deals. We have -- the best month is going to be June, and the worst month is going to be April. And that just mathematically leads to the outcome that we're talking about.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the incremental color.

Karl Pichler - *Rackspace Hosting Inc. - CFO*

Sure.

Operator

Thank you. And ladies and gentlemen, that does conclude the conference call for today. We thank you for your participation, and ask that you please disconnect your line.
