FINAL TRANSCRIPT

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RAX - Q1 2009 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting's First Quarter 2009 Earnings Call. As a reminder, this call is being recorded. At this time, all lines are in listen-only mode to prevent background noise. After the prepared remarks, there will be a question and answer session.

(Operator Instructions)

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

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

Good afternoon. Thank you for joining Rackspace's First Quarter Conference Call. I'm here with Lanham Napier, Rackspace's CEO and Bruce Knooihuizen, Rackspace's CFO to discuss our financial results for the quarter ended March 31st, 2009.

We issued a press release earlier today with our unaudited financial results for the first quarter of 2009 along with our key metrics page. We hope that you've had a chance to read the release. If you do not have a copy, please visit the investors section of our website at www.rackspace.com.

Let me also point out that this call is being webcast online and can be accessed through our website. Some of the comments we will make today are forward-looking statements that involve risks, uncertainties and assumptions. If the risks or uncertainties materialize or assumptions prove incorrect, our results could differ materially from those expressed or implied by the forward-looking statements and assumptions.

All statements, other than statements of historical fact, are statements that could be deemed forward-looking statements, including any statements concerning expected operational financial results, long-term investment strategies, growth plans, including international expansion plans, the performance or market share relating to products and services and any statements of expectation or belief and any statements of assumptions underlying any of the foregoing.

These risks and uncertainties and assumptions include the potential continuation or further deterioration of the current difficult economic conditions, infrastructure failures and other risks that are described in our Form 10-K for the year ended December 31st, 2008, which was filed with the SEC on March 2nd, 2009 and by our Form 10-Q for the 2009 quarter ended March 31st, that will be filed with the SEC later this week and will supplement such information.

These forward-looking statements speak as of today. Except as required by law, we assume no obligation to update these forward-looking statements publicly or to update the reasons actual results could differ materially from these anticipated in these forward-looking statements. Even if new information becomes available in the future.

During this afternoon's discussion, we will be using GAAP and non-GAAP financial measures, such as adjusted EBITDA, our GAAP results and GAAP to GAAP -- non-GAAP to non-GAAP reconciliations can be found in the earnings release that we issued earlier today. After Lanham and Bruce get through their prepared remarks, we will take some time to field your questions. With that, I will turn the call over to Lanham. Lanham?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Great. Thank you and thank you all for joining us. Welcome to the conference call for Rackspace Hosting's 2009 First Quarter Results. Recessions reveal the strength and character of a company and its business model. During the technology bust in the 2001 recession, we tuned our business model so it can flex with market conditions. In expansionary times, we were able to grow rapidly and during slower growth times, we can respond by increasing our profits and cash flow.

Today, we are running the business to scale the profits and returns of our management hosting offering, while simultaneously investing in the long-term game changing offerings in our Cloud business. We are doing the right thing by our customers and believe that we are strategically positioned for rapid growth, once again, as the economy improves.

Our Cloud business is experiencing rapid traction and as the economy improves, we anticipate the installed base growth of our managed hosting business to provide a meaningful accelerator to our company's growth.

We had a strong first quarter and we are eager to share our financial results and latest thinking with you. We are tracking well against the 2009 operational plan that we shared with you on our last earnings call. We continue to grow.

First quarter 2009 was the 41st consecutive quarter that we've grown our business. Total revenue grew more than 21% year-over-year and our Cloud revenue grew 145% year-over-year. In addition, we believe the continued momentum in our Cloud computing business and a surge of enterprise growth opportunities provides significant growth drivers for us.

We also continue to scale the cost side of our business, adjusted EBITDA margins reached 31.1%. Adjusted EBITDA grew 41.1% year-over-year and I'm pleased to report that we still have opportunity for further improvement.

From a cash flow standpoint, we showed that our business model adjusts rapidly from high growth to cash flow generation in the slower growth scenario. Backing out some working capital timing issues, Rackspace generated free cash flow on a fully taxed and levered basis in the first quarter.

Before we dive in, let me start by thanking the Rackers for all their hard work delivering fanatical support. These times have required a tremendous tremendous level of focus. We are a stronger company because of the effort of our Rackers and we are closer to our goal of building one of the world's greatest service companies. We would also like to thank our customers, who continue to place their trust in us by asking us to run their mission critical IT systems and applications.

On the call today, we will provide the financial results for the first quarter and we'll put those results into context. We will also talk about what those results mean in terms of the operational road map we set forth for 2009.

On our fourth quarter 2008 earnings call this past February, we shared our 2009 operational road map and financial objectives with you. For each of our quarterly calls this year, we will provide you with an update on how we are tracking against those objectives and specifically the changes we are seeing in the marketplace and how we are adjusting our strategy to our customers' needs in this rapidly changing economic environment.

Before we get into the details of our first quarter results, let's start with a recap of what we outlined as our 2009 operational objectives. There are three parts. First, we expect to continue to grow our managed hosting business, albeit slower than we grew in 2008. We also expect to continue investing in our high-growth Cloud business.

Second, we are operating with an increased focus on scaling our business. We have an opportunity to enhance profits and returns during 2009 and have shifted our focus to expanding margins in our managed hosting business.

And third, we noted that CapEx in 2009 will be significantly lower than in 2008 and told the market that we are fully funded and that we expect any cash burn this year to be minimal.

Executing on these objectives during this year will best position us to meet our goal of maximizing long-term economic profits and creating value for our shareholders.

Although there's more work to do, we are pleased to say that we made significant strides during the first quarter and are already emerging as a stronger, leaner and more formidable competitor in the large and growing hosting and Cloud computing marketplace.

Now I'd like to hand the call over to Bruce, so that he can dive into the numbers. I will pick back up after Bruce to discuss our operational plan that's tracking against our strategy and talk about several changes we are seeing in the marketplace. Bruce?

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Thank you, Lanham. Good afternoon everyone and thanks for joining our call. We are very pleased with our first quarter results. Let me get started with some of the detail around how we are tracking.

In terms of growth, our net revenues for the first quarter of 2009 were $145.1 million. This is a 21.3% increase relative to the first quarter of 2008 and a 1.4% increase relative to the fourth quarter of 2008. Once again, our net revenue growth was impacted by fluctuations in foreign currency exchange rates. Mainly the weakening of the pound versus the US dollar.

Approximately 24% of our net revenues are generated in pound sterling. The foreign exchange rate had a negative impact on Q1 net revenue of approximately $3.2 million. This translates to a 3.6% sequential revenue growth rate under a constant exchange rate.

Keep in mind, as we have said in previous calls, because of our operations in the UK, this provides for a natural hedge and most of the declines in revenue due to currency rate fluctuations are offset by declines in expenses, thereby having little impact on our profitability.

We added a net 568 managed hosting customers from the end of Q4 2008 to the end of Q1 2009, representing a 3.1% sequential increase. This increase compares to the 468 customers that we added from Q3 to Q4 in 2008 and it is the first quarter-over-quarter sequential increase in the number of net managed hosting customer adds since Q1 of 2008.

We're also very pleased with the results of our Cloud business. In Q1 alone, we grew our Cloud business by adding over 8,000 new customers from Q4 and by growing revenue approximately 145% year-over-year and greater than 20% sequentially. As of March 31st, we had more than 19,000 managed hosting customers and more than 43,000 Cloud customers for a total of more than 62,000 customers.

We are very enthusiastic to report that we continue to keep churn rates in check. For the first quarter, churn actually improved to 1.1% from 1.3% in the prior quarter. Our overall installed base growth dipped slightly to negative 0.2% from 0.1% growth in Q4.

Our installed base grew our top line at almost 20% annually from 2006 to 2007, before we added any new customers. This growth engine is highly levered to the economy, since it is made up of thousands of customers that span all industries.

Recently, our installed base has been directly impacted by the macroeconomic and financial environment. Businesses and IT departments are susceptible to budget cuts and as customers scale back their services and projects are put on hold or canceled.

We are partnering with our customers to help to right size their needs in order to keep their business. We have made great strides in proactively reaching out to our existing customers to make sure they have the right products and solutions in place to meet their needs.

We should place emphasis on the fact that we've been able to work with our customers to find the right fit without compromising our prudent pricing and return on investment discipline. From a revenue perspective, we have already worked through a significant portion of our customer base.

As we said, we are extremely pleased to see that we are able to improve on our important churn metrics during Q1. This was the first time over the last three quarters that churn declined, so we are optimistic that our strategy is working. If we are able to keep churn at reasonable levels without compromising on price on our return threshold, then we feel strong that we are also highly levered to benefit from a rebound. Our ability to keep churn rates in check is one of the best indicators of how Rackspace will benefit as the economy begins to stabilize.

With greater operational discipline, we successfully continued on our path to improve the cost side of our business for enhanced profitability during Q1. Our margins scaled quickly and we are pleased to announce that adjusted EBITDA margins, adjusted for non-cash share-based compensation increased for the third consecutive quarter, 31.1% in Q1. This is an increase from 29.7% in Q4 2008 and from 26.7% in Q1 2008.

Adjusted EBITDA margins for our managed hosting business, excluding the impact of our investments in our Cloud computing initiatives, were slightly higher. Despite slower top-line growth, the increase in margins drove adjusted EBITDA growth of 41.1% year-over-year and 5.8% sequentially. The continued improvement in our flexible cost structure shows that we have the ability to cut costs quickly to scale the business.

During the most recent quarter, we experienced a slight up tick in cost of revenue as a percent of revenue, mainly due to higher licensing and power costs. Gross margins for the first quarter were 68.1% compared to 68.5% for the fourth quarter 2008. The slight increase in cost of revenue was more than offset by continued improvements in the sales and marketing and G&A line items. We believe that there continues to be opportunities for further margin improvement, even at slower growth rates.

For example, in sales and marketing, the model self-corrects on the variable or commission costs when market demand slows. On the fixed cost side, we constantly look at our customer acquisition multiples and balancing allocating resources to meet demand. In terms of marketing, we have been experimenting with reallocation dollars and resources to reduce our customer acquisition multiples. Most of the improvements we have made will make us that much more efficient through the next growth cycle.

Let's move on to net income and returns. Net income for the first quarter was $6.6 million. This is an increase of 21.1% from the first quarter of 2008 and a slight decline of 3.7% sequentially.

As we stated in our fourth quarter earnings call, net income in Q4 2008 benefited from a couple of adjustments, primarily $750,000 of additional net income due to a tax adjustment. Return on capital for the quarter was 9%, down from 10% return in Q4 2008. Again, the tax benefit in Q4 favorably impacted the Q4 return in this comparison.

Moving to the cash flow statement and balance sheet, excluding certain working capital adjustments, we were free cash flow positive for the quarter on a fully taxed and levered-basis. We would like to point out that we grew our business nearly 50% in 2008, so it didn't take us very long to go from high growth to free cash flow positive. That's the economic advantage we have with the monthly recurring revenue business and the significant number of cost levers that we can adjust rapidly.

Total CapEx for the quarter was $37.3 million. We want to reiterate that most components of our capital expenditures are success based and tightly under our control, highly flexible and quickly adaptable to meet demand.

At the beginning of the year, we stated that our full year CapEx spend was in the range of $105 million to $160 million. We now expect full year CapEx range to be closer to$120 million to $160 million, because we have decided to build out Phase II of our UK data center facility. Other than the adjustment on the data center CapEx, we are not making any adjustments to the ranges for the different categories that we provided at the beginning of the year.

In addition to the data center spend, we also paid out approximately $6 million in the second quarter as earn-out payments related to our acquisitions of Slicehost and JungleDisk. We also expect to pay the second and final earn-out of up to $9 million of these acquisitions in either the third or the fourth quarter of this year.

Finally, we want to make it clear that we do not see a need to go back to the capital markets to raise additional primary capital. After paying back $100 million of our revolving line of credit in Q1, we have $135 million of cash and cash equivalents on our balance sheet as of March 31st and an additional $144 million committed under our revolving credit facility.

Our net leverage, based on our adjusted EBITDA for the trailing 12 months, is less than half of turn. Our strong generation of operating cash, together with our existing cash balance, the additional amount available under our revolving credit line and vendor financing arrangements, provides with a strong liquidity position to pursue growth opportunities. Furthermore, our strong balance sheet and low leverage gives us the flexibility to seize opportunities in the marketplace and provides the financial stability that customers expect from a long-term business partner.

To wrap up, we had a great quarter, considering the adverse economic conditions worldwide. We feel good about our prudent discipline of allocating capital and proven ability to scale our business. We believe that we will exit this economic cycle stronger and positioned to ramp quickly when the economy shows signs of improved strength. With that, I'd like to hand the call back over to Lanham before we turn to the Q&A session. Lanham?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Thank you, Bruce. As you can see, we continue to maintain our recognized leadership position in the hosting industry. Fanatical support creates a competitive advantage by providing a differentiated service experience for our customers at a compelling value. Our managed hosting business and our rapidly growing Cloud business provides customers with a suite of IT services, enabling them to run a broad set of their IT workloads.

Our Cloud business provides a set of computing services that are consumed as needed and that seamlessly scale up and down based on the customers' needs. We've seen our Cloud site service scale to become the largest cross-platform solution in the platform as a service market, hosting well over 100,000 applications, many of them high profile websites, and pushing billions of page views each month. Recent customer wins for us include SaaS provider, Zapproved, and TweetPhoto, the free photo sharing service for Twitter.

In Q1, we announced the formal availability of a complete Cloud suite, Cloud sites, plus Cloud files, plus Cloud servers. We are now proudly the only Cloud provider with a comprehensive offering, combining a server and storage on-demand service as well as a dot-net and LAMP platform as a service offer.

And we're still pushing the envelope on progress in working every day to make the users of Cloud better understood by businesses. We have continued to rapidly evolve our Cloud suite platform to offer even more features and make the technology more usable, alongside our traditional managed hosting offering and are capitalizing on our reputation for customer service to build a hybrid hosting leadership position.

We would like to talk about our operational strategy during this economic cycle. What we mean is, what are we doing to help our customers during these tough times? This is very important to the success of Rackspace and we believe that the choices and decisions we make right now around how we help our customers are critical to how our business will fare as the economic climate improves.

Fanatical support is our point of difference in the marketplace. It's what allows us to price at a premium to the market and the reason why we have been able to grow with a 57% CAGR over the past five years. It significantly increases the customer value proposition of the solution that we deliver and drives industry leading profits and returns for our business. It's part of our economic advantage and it positions us to be the long-term market winner.

The returns to us on the dollars we spend on fanatical support are measurable and are high. Fanatical support drives loyalty, which we measure using B&A Company's net promoter score. In our parlance, we refer to loyal customers as promoters.

Promoters are more profitable for Rackspace because, one, they stay with us longer, which results in lower churn and because our cost to serve a customer goes down over time, allowing us to scale our cost structure. Two, promoters have a history of buying more from us. And three, promoters tell their friends about us, so they become part of our sales force. This helps drive sales and marketing cost efficiencies through lower customer acquisition costs.

This economic cycle provides an opportune time for Rackspace to further differentiate itself by embracing our customers, to drive increased loyalty. We are building loyalty by helping our customers do more with less. Right sizing their needs as budgets remain flat to down, while IT managers are being asked to do this much, if not more.

We believe that this approach best positions our business to maximize growth opportunities as the economy improves and we fully expect to emerge with our leadership position further enhanced.

Today we are experiencing some new pockets of demand, especially on the enterprise side. Over the past few months, we have become part of a new consideration set. The recession has become a tipping point, allowing us to compete for some of the larger enterprise deals. Larger enterprises are coming to Rackspace at an increased rate.

These are deals that typically would have gone to a fully outsourced provider in the past. With our standardized solution, we are able to meet a significant portion of the customers' needs as the low-cost providers, oftentimes at a 50% discount compared to the more customer shops, without compromising on our return thresholds.

A good example of this is Sony Music Entertainment. Recently, Sony Music chose Rackspace to manage the hosting needs for its consumer-facing web properties. We have taken steps to reorganize our sales force to meet this increase in enterprise demand. We still have some work to do, but we are mobilizing quickly and are already seeing meaningful results. We will update you on how this demand shift impacts our business throughout the year.

To wrap up, things feel better today. We are on track for expanding our leadership position in the industry. We grew our business in the first quarter and we see some real opportunities on the enterprise side that should help us continue to grow during this tough environment.

Our Cloud business continues to gain significant momentum, our managed hosting customer additions trended up for the first time in several quarters. We were able to decrease churn in the quarter and we continue to show how much control we have over scaling our cost structure and improving margins.

Before we take your questions, we would like to close by saying that we are proud of what we achieved in the first quarter of 2009 and thank the Rackers around the world for their dedication and hard work. With that, we are now ready to take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Our first question will come from Jonathan Schildkraut from Jefferies.

Jonathan Schildkraut - *Jefferies - Analyst*

Thank you for taking the questions.

A couple here. Mostly kind of strategy-wise. I was wondering if you could dive a little bit more into the competitive environment. Who you're seeing there today. Is it the same folks that you were competing with, maybe, a year or 18 months ago? Or has it changed?

And we're looking at your growth for this year, I guess, or for this quarter. It was 21% year-over-year. Do you think that that represents taking market share? And if so, from whom?

And then finally, one of the things that you noted in your prepared remarks, Lanham, was enterprise as an opportunity. During our research, what we've kind of come up with is that we're seeing a disaggregation of some large-scale projects coming out of enterprises. And we're wondering if you're seeing that as well? And maybe what would be a driver of that trend? Thank you.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Well, let's start with the competitive environment. When we look at the competitive landscape, to a year ago, Jonathan, I would say it's pretty similar. The difference and the shift has been on the enterprise side and there the competitive set tends to be the larger outsource providers, which we would see on occasion. But with the recession creating a tipping point for that opportunity set for us, we're seeing them more regularly.

This goes directly into the second part of your question, with respect to projects coming out of outsourcers and such. We would echo that. Basically, what's happening is our service set doesn't do everything that those companies do. Okay? But for those needs that fit right on with our service set, we can do it at very compelling value. I mean, literally, some of the wins we've had, we've saved people 50%. And that's 5 0, not 1 5. So that is a significant savings for people.

So with a savings of that magnitude, customers are willing to consider changes in how they would do things and how they would provision the infrastructure versus what they would consider a year ago.

Jonathan Schildkraut - *Jefferies - Analyst*

Great. Do you think that will elicit a competitive response from those who you're taking the business from?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well right now I would say it's early in the game. We believe that our ability to deliver fanatical support is a sustainable advantage. So we have a very efficient customer service delivery model. The efficiencies in that model allow us to generate a high-quality service at a significant price advantage. We believe that advantage is durable.

Jonathan Schildkraut - *Jefferies - Analyst*

Great. And let me ask that question a different way. What percent of the spend from those customers do you think that you're taking away from maybe those large scale outsourcers? Are you taking away the entire customer? Are you taking away 5% of the spend? Are you taking away 50% of the spend?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Oh, it's a small piece today.

Jonathan Schildkraut - *Jefferies - Analyst*

So it's still a small piece of the business, but -- from the customer, but it's a big win for you?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

That's correct. It's a significant opportunity for us.

Jonathan Schildkraut - *Jefferies - Analyst*

All right. Thank you very much.

Operator

We'll take our next question from Winston Len with Goldman Sachs.

Winston Len - *Goldman Sachs - Analyst*

Thanks for taking the question, guys. Could you just talk a little bit about the monthly trends in 1Q '09 for bookings and churn, how that's changed from January to March? And then on the CapEx, what are you seeing in the UK that's driving the position to build up Phase II of the UK data center? Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Thanks, Winston. I'll start with the last part, and that's in terms of the build-out of the second phase of our data center. And at the beginning of year, when we gave a range for CapEx, we said it would be somewhere between 10 and 25 million. Obviously we are heading towards the higher end of that and what we're seeing, it's really what we're not seeing.

We're not seeing signs that the economy is continuing to fall. In fact, there have been some indications that both -- on the macro basis, that the economy seems to be stabilizing and so we've decided to go ahead with that build program. So that was always within our range. It's more of a situation where the economy is stabilizing. Or seems to be stabilizing.

Now the second part talked about trends and in terms of churn, we really don't go into a lot of trends unless there is some absolutely big changes. Because on a monthly basis, it tends to fluctuate a little bit and that's what we've seen. But certainly, from our standpoint, with our strategy and -- around the customers, it's very important for us to try and capture and keep as many of our customers as possible so that when the economy does turn around, we have that big base that we can grow from and lever. And that's a strategy we think is starting to work for us.

Winston Len - *Goldman Sachs - Analyst*

Okay. And maybe I can just add one more on the margin side. Last quarter, you talked about a 100 basis of Cloud computing and investment pressures on margins. What's the impact this question -- this quarter and where are we in the product investment cycle at this point in time?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well, in terms of sort of the margin differences with and without, it's still around that range. I would say that our Cloud continues to improve from a margin standpoint every quarter. But I'll also add that we're going to continue to look at Cloud initiatives and if it makes sense to make some investments in that, we will do that. But obviously we'll tell you guys about that if we do. But we've seen good growth in revenue and we've seen that business improving.

Winston Len - *Goldman Sachs - Analyst*

Great. Thank you.

Operator

We'll take our next question from Chris Larsen with Piper Jaffray.

Chris Larsen - *Piper Jaffray - Analyst*

Hi. And thanks for taking the question. Lanham, you talked a little bit about getting churn down and working with your customers. Can you give us a sense -- are you having to price cuts? Are the customers looking for price cuts? I noticed that revenue per customer was down a little bit. So if you could just talk a little bit about that? And then, Bruce, you expanded the margins sequentially. Can you give us a sense for how much is left in terms of margin expansion in the business?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Let's start with the churn and the customer actions. Our strategy with respect to customers right now, the reason churn is so important is that we want to hold onto these customers. We believe that our installed base and the opportunity there is an early indicator of what's happening with the economy.

In years past, our installed base provided half the growth of our company. So that our approach today with the customers is we're going to do everything we can, without violating our discipline. So this gets to your pricing question. We're going to do everything we can, without violating our discipline, to maintain those relationships and keep those customers.

So what we're doing is we are right-sizing configurations for customers. So that we're figuring out how to make their configuration and app work on six servers versus nine. We're figuring out how to squeeze more utilization out of the footprint today so that they don't have to go along additional infrastructure with us. Plus this is about positioning our company for rapid growth once the economic conditions change. Do you want to talk about the second part, Bruce?

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Yes. In terms of margins, in terms of how much room is available from our margins, I would suggest that probably one of the biggest influencers on that will be our rate of growth. Obviously as we grow faster, we get lower margins. As growth slows down, we get higher margins.

Now, absent that, we are continuing to work on the number of initiatives that we talked a little bit about in the last quarter and improving our managed hosting margins. And while we won't get into specific numbers, we expect that and can see opportunities for us to continue to expand those margins.

Now it won't be linear. I mean, some quarters that -- some margins may drop and other margins will increase. But certainly over the long-term trend, we expect margins to continue to increase.

Chris Larsen - *Piper Jaffray - Analyst*

If I could pick up on that, you mentioned something about power costs were up in the quarter. Was that a step-up in rates or was there weather that caused power costs to go up? And is that something we should model for? Or --

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

No, I would not expect those to continue staying at the same level we saw in the first quarter. And so I wouldn't build that into your model.

When you think about things like, particularly on the gross margin, bigger things that will influence gross margin will be things like we had mentioned our data center in Virginia, that we're leasing. That'll come online in the third quarter, and so we're going to see some additional expense in the gross margin level of our income statement, where in the past, when you billed it, it shows up in depreciation and amortization. And those are the kinds of things that would really have a big impact going forward.

And again, as I've said before, as those items come up or as we see some of those things, we'll keep you informed on those kinds of things that can change our margin profile.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Hey, Chris, this is Lanham. Just to add one more thought on the margin. Our strategy right now is basically during a time of slower growth, we're going to work on getting this -- getting our company more efficient and effective, so that during this time period, we've made progress on our customer acquisition efficiencies as well as our G&A. You can see that trend in numbers. We're going to continue to get more effective and capable there. We have more work to do on the components.

We are focusing on our cost of service model, delivery model, so we're going to make that more effective as well. And the reason why we do this is that we want to position ourselves for growth for better times, but we also want to capture incrementally more value with that next wave of growth.

And so the work that we've done today is started, we're not done. We're proud of the fact that we've been able to do this without having the mass layoffs that other companies have had. Our headcount is actually up quarter-over-quarter, yet we've improved our margins. So we're making our business more effective. We're positioning for growth. And we're pretty proud of our progress so far, we're just not done yet.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

And, Chris, the one last question you asked about the ARPUs. When you look at the ARPUs, on the surface, it looks as though they've gone down a little bit. Probably about 2%. Keep in mind, one of the things that's affecting those margins is foreign exchange.

And so if you back out foreign exchange, you'll see the margins -- or the ARPU, excuse me, ARPU is relatively flat from quarter-to-quarter. And that really goes towards the comments that Lanham had made about us following our pricing discipline.

Chris Larsen - *Piper Jaffray - Analyst*

That's great. If you'll grant me one more, and I apologize, I don't mean to monopolize here. It was good to see the increase in net hosting customers. And you talked a little bit about helping your customers work with -- do more with less. Should we expect the working -- doing more with less to have further impact on 2Q? And can you give us sense for the pipeline in 2Q of net new customers?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Yes. Just talking generally, because we don't want to get into specific guidance about Q2.

Chris Larsen - *Piper Jaffray - Analyst*

Sure.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

I would say that the conversations we have with customers feel better. I'd just say it's still early in the game. So our performance in the first quarter grew throughout the quarter. Things got better as the quarter progressed. But it's still early. Our pricing is stable. The increase in managed hosting customer adds, which you referenced, I believe, are an indicator that things are getting better. But it's too early.

With respect to customers and right sizing, etcetera, we will look you straight in the eye and tell you we are not going to violate our discipline. Our discipline has gotten us, in terms of generating industry-leading margins and returns. We're going to stick with that.

At the same time, we will continue to make investments. Because we have a Cloud business that is growing rapidly. I mean, it is exciting, in today's world, to have a business growing 145% year-over-year. We have an opportunity to construct a model there that is a game changer. So we'll continue with all that.

We talk about the pipeline for Q2. I would say sales cycle is relatively steady for us. The enterprise opportunities we are working on. That's a bit of a different animal for us. So I don't -- we don't have good data to share with you on that yet, but we think we will in future calls. The rest of the business, things seem to be a little bit better, but it's early.

Chris Larsen - *Piper Jaffray - Analyst*

Thanks a lot. Appreciate it.

Operator

Turning next, we'll take Kash Rangan with Merrill Lynch.

Kash Rangan - *Merrill Lynch - Analyst*

Hi. Thank you very much. Lanham, I had a question for you on the enterprise initiative that you've got going on. It sound pretty promising. I guess that from the discipline that you guys are showing, you're not trying to really take on the outsources, but really go for the pockets of business that you can profitably exploit. I was just curious, how does that cycle play out? Do you have a specialized sales force? What does the customer acquisition cost here look like?

And what kind of trade-offs do you have to make in your business model, operating expenses, vis-a-vis incremental return on capital over what kind of time horizon? So I was just curious to get your broad thoughts on that, if you really think that this could be a promising business for you? That's it for me. Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Yes. Kash, we do believe that it is a significant opportunity for our company. Basically what we're doing is we -- from a service point of view, we provide the services these customers are asking for. There is some tailoring that we are doing around the edges regarding how we deliver the service to them, but the guts of it really is similar stuff to what we already do.

We are a productized volume operations model. We want to generate a high degree of reliability and quality through our service streams. So what we're doing is we're taking that to these enterprise customers.

The way this started is those customers started to call us. These were people that were seeking us out. Once we -- one enterprise win begets another. And so now what has happened is we're starting to build some momentum with it. So we formed a new division, we have created a new customer acquisition team.

The customer acquisition team is literally cross-functional, we want to handle everything it needs. Because the sales process here is different than our traditional business that we've provided. So what we're doing, really, from an operating point of view is leveraging what we already have. We are just tailoring a new distribution strategy to acquire these customers.

Kash Rangan - *Merrill Lynch - Analyst*

And, Lanham, the trade-off that you may or may not have to make between ramping up your operating expenses versus incremental return on capital, new revenue opportunity? How should we think about that?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

I don't think there's going to be much of a trade-off, Kash. So far the attributes of the enterprise deals that we have won, from an economic point of view, are very attractive. And it feels like a pretty good fit for both parties.

Kash Rangan - *Merrill Lynch - Analyst*

Sounds very good to me. Thanks a lot.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Sure.

Operator

Our next question comes from Patrick Walravens with JMP Securities.

Greg McDowell - *JMP Securities - Analyst*

Hi, guys. This is actually Greg McDowell for Pat.

Just one quick question, I wanted to ask you about your positive adjusted free cash flow number. Can you just talk about how you think about this number and maybe how we should think about it moving forward? I mean, is it, let's say, positive, moving forward? That's all I've got. Thanks.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Yes, that's a good question. Just basically, from a formula standpoint, what we're looking at is our adjusted EBITDA backing out total CapEx and then backing our our cash interest and cash taxes to get to a positive free cash flow position. And our expectations at the beginning of the year were that our cash burn would be minimal at worst. And we still feel strongly about that.

Now there maybe a quarter or two where we may not have positive cash flow for things like the payments on the acquisitions or in the second quarter, for instance, we know we're going to spend a little bit more on our data center in the UK. But certainly for the year we still feel very comfortable with the guidance that we gave you and the fact is that we were able to change the dynamics of our free cash flow very quickly based on the growth rates.

As I mentioned before, we grew at 50% last year and in very short order we brought our cash burn down to actually cash flow positive in the first quarter.

Greg McDowell - *JMP Securities - Analyst*

Great. Thank you, guys.

Operator

Turning next, we'll take Steve Salberta with Boenning and Scattergood.

Steve Salberta - *Boenning and Scattergood - Analyst*

Hi, guys. Can you talk about the churn trends that you would expect as the economy improves? You're at a low number here. But with the addition of enterprise business, you're increasing in enterprise business. Would it -- would you expect it to go down or kind of the other way? Because you'll start adding more new customers at that point?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. As the economy improves, we anticipate churn will improve. Meaning that churn will decline further.

During 2006 and 2007, for example, churn was six points lower than it is today.

Steve Salberta - *Boenning and Scattergood - Analyst*

Yes.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

So that we believe that as the economy improves, churn will decline.

The other thing that will happen as the economy improves, upgrades will increase as well. What's happening right now during this recession is that customer IT budgets are flat to down. So when you think about the net upgrades metric, there aren't a whole lot of IT projects going on inside of companies today.

People are looking for ways to save money, which is why we're making the investment in our customers to help them do more with less. So we still have some upgrades taking place, which we've shared in the metrics. What will happen when the economy rebounds is our installed base growth will pick up again.

So what we're doing is positioning ourselves for that next wave of growth by fighting churn, investing in customers, then as their IT budgets start to expand, you'll see that upgrades and installed base growth rate accelerate again.

Steve Salberta - *Boenning and Scattergood - Analyst*

Now when upgrades in the installed base grows again, what would you expect with sales and marketing? I mean, do you need to add a lot more people? Or are you just doing -- permanently going to do more with less? Holding back on hiring? Or can you kind of see this leverage continue?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well, the leverage will continue, but certainly what happens is it's really a step function, okay? So we can leverage, with existing customers, we can leverage our sales and marketing efforts much further than with new customers. Existing customers understand how we operate. It's a great fit with them already. So it's easy to work through that process.

The place where we will have to make incremental investments will be on the new customer side. That will require additional spending, headcount, etcetera, to take another step function up.

What we've seen already in our progress is we're already getting the productivity level of sales and marketing Rackers up from where it was a year ago, based on the work we've done so far this year. So we think about that in terms of opportunities, close rates, etcetera when we think about the production that we get out of our sales and marketing teams.

Steve Salberta - *Boenning and Scattergood - Analyst*

My next question is with respect to Cloud EBITDA margins. If I calculate -- my calculations are correct, you're right around break even in the Cloud. I mean, can you confirm that?

And then I thought I heard that you said that you would, I guess, outside of some strategic initiative, you're going to continue to see those margins in the Cloud improve this year.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. There are a couple of points here with respect to the Cloud. I think you're rounding up a little bit when you say that Cloud is breaking even. Cloud, what we've done in our metrics here is aggregate all of our Cloud offerings for you. So when we talked about the suite that we launched between Cloud files, Cloud servers and Cloud sites, we've also got our mail -- Email business, our Cloud application business, in there.

So there are different components that have different margin features at the moment. What we are focused on in the long run with Cloud is creating an economic model that has an attractive return on capital.

Features of the Cloud lend itself to higher asset turns. So now we have to go, and we've already got pretty good progress on that and elements of our Cloud business. The next step that we will work on over time is figuring out what the cost of service looks like to get to the margin question that you're asking.

In the long run, what we want to build is an economic model with an attractive return on capital. Between here and there, we want to make progress on it, but the number one priority for Cloud today is growth. We believe --

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Steve Salberta - *Boenning and Scattergood - Analyst*

Well, what --

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Sorry, go ahead.

Steve Salberta - *Boenning and Scattergood - Analyst*

What would cause the margins in the Cloud to kind of head down quite a bit from here, aside from making an acquisition?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Oh, there are different investments that drive down margin. So when we -- when you think about the developer teams that we have, we are on an aggressive investment phase in Cloud. We -- the way we're trying to run the company today is we are scaling our managed business. The incremental profits there, we are investing into our Cloud business. Because we believe Cloud is a game changer. We're going to continue to do that, so long as we feel like the rapid traction we're experiencing in the Cloud is sustainable.

Steve Salberta - *Boenning and Scattergood - Analyst*

Okay. Great. Thank you.

Operator

Turning to our next question, we'll take that from Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes. Thanks for taking the question. Maybe a couple of questions focusing on the expense side. Can you give the number of sales related employees at quarter-end compared to year-end? And then sales and marketing and G&A were both down slightly on a sequential basis in dollars. Are these sorts of levels -- are we going to see this kind of range going forward?

And then finally on network costs, have you pretty much optimized around that, given the declining, again, with expenses? Or is there still some opportunity here to see some benefits from declining prices per megabit?

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Okay. Let me try to get all those questions answered for you. First of all, in terms of the sales and marketing team, it's relatively flat in the first quarter from the fourth quarter of last year. And so there's not been some big changes in that through the first quarter.

On the G&A costs, there are a lot of different components. It did go down. I would suggest that I would not expect it to continue to go down. Particularly if the economy stays where it is or improves over time. Though I do think there are scaling opportunities, I just don't think the absolute amount will continue to drop.

On the cost of revenue, there are more opportunities in that function for us to scale in the managed hosting business. When we look at and Lanham mentioned we had an increase in Rackers in the first quarter, a slightly increase, where we're putting a lot of the investing is in our Cloud initiatives.

And so to the extent that some of those grow faster, there could be some additional costs in cost of service or cost of revenue, excuse me, in the Cloud initiatives. But the managed hosting, we still believe there's opportunities to do some additional scaling.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then if you could maybe just talk about UK versus US and how the demand for your various product suites is maybe at a different stage of customer acceptance? Is there any notable difference to kind of highlight there?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Yes, there's not. We've been in the UK market for years and years at this point. So we have in excess of 500 Rackers over there. So it's pretty consistently looking at managed hosting. Our Cloud, we are in the process of rolling out to the UK. But it's not fully functional there yet. So that would be the difference for you.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. Thanks very much.

Operator

We'll hear our next from Erik Suppiger from Signal Hill.

Erik Suppiger - *Signal Hill - Analyst*

Good afternoon.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Hey, Erik.

Erik Suppiger - *Signal Hill - Analyst*

In terms of your decline in upgrades, how much of that is driven by you versus how much of that is just a natural function of the economy at this point? Is there any way of qualitatively giving us a sense there?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Oh, I don't think we're the big driver there. I would say the big driver is the fact that we are helping customers right-size their config so that they don't need the upgrade later. When customers come to us with upgrade opportunities, we're talking through that with them and helping them understand it.

We're trying to see what we can do on their existing footprint first and then filling out the upgrade. So I think if anything, what's going on is it's really more a function of their IT budget and whether that budget's growing or climbing or when they get a new project they've got to do, how we can try to utilize the current infrastructure.

Our purpose here, with the way we treat customers, is we want to be easier to do business with. We talked in our remarks earlier about creating promoters to drive loyalty in our customer base. We really do believe that these are the types of times where you see the character of a company. We are going to stand by our customers and invest in them. We aren't going to give them heartache over cancellation fees and that type of stuff. So that we will continue to make the investments in the customers. Because we want to be their long-term partner.

Erik Suppiger - *Signal Hill - Analyst*

So this is, presumably, the reduced upgrade growth that we're seeing is something that's going to be here for quite -- indefinitely. Is that the way we should be looking at it?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well I don't think it's indefinite unless you're down on the economic progress of our country. I think that in the long run, as we experience economic expansion again, those net upgrades should trend up.

As IT budgets increase, we're the chosen partner for these companies and customers, so that those up -- those increasing IT budgets should translate into installed base growth here at Rackspace.

Erik Suppiger - *Signal Hill - Analyst*

Okay. And on churn, you saw a modest improvement there. Can you just comment, are you seeing fewer, maybe relative to a year ago or so, are you seeing fewer new addition -- additional customers? Or is it more a function of existing customers terminating?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well, what do you mean, exactly?

Erik Suppiger - *Signal Hill - Analyst*

Well your churn is -- your -- I mean, are you seeing -- your churn is a function of the additional customers that you bring on during the quarter, as well as the customers that terminate. Is that right? It's the net?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well, yes. The churn metric we are providing is lost revenue from customers that depart our services. So it's -- whether you've been on a customer of us for ten years or ten days, it's all churn.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Yes, we don't net new customers against that number. And so we're seeing growth in our revenue because once you get the churn out, we still have new customers coming on board.

Erik Suppiger - *Signal Hill - Analyst*

Okay. All right. That's fine.

On the enterprise deals, how large are some of those deals? Can you give us a sense?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well we don't want to get into specifics there. All I'd tell you is it's a significant win for us. It's many multiples of our average customer size.

Erik Suppiger - *Signal Hill - Analyst*

Can you give us a sense for how many of these large enterprises you've had so far? These wins?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well we'd like to avoid that today and instead, as we make more progress, come back and share it with you later.

Erik Suppiger - *Signal Hill - Analyst*

Okay. Then lastly, you've suggested that you're feeling, I guess, a little bit more comfortable with the tone of the business. You talked about that more on the enterprise side. Are you seeing improvements or during the course of the quarter, did you see improvements in the traditional business as well?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Yes. During the first quarter, the tone of customers improved throughout the quarter. The results from customers improved throughout the quarter. So you've got a little bit of increase in momentum.

In the last call, we talked about how we felt like sales inquiry was picking up a little bit. I would say that that was absolutely the case. I'd also say it's still early in the game. So if the economy takes a step backwards, I imagine that activity will decrease. If the economy continues to strengthen, I think it will increase.

So what we've seen out of customers is their level of decisiveness has increased. When current customers that are buying from us, everything tends to be an expedite. Meaning they delay the decision for as long as possible and now they need it yesterday. So people are starting to become more decisive in their actions. I'd just say it's early.

So for the purpose of this call, we want to give you a balanced message. We want to show you the things that are improving. We also want to tell you that it's still early in the game and we'll see how it all plays out. We have great confidence that we are positioning the company to be the long-term winner. Because we're able to scale our margins in our traditional business and we are making significant investments in our high growth Cloud businesses.

Erik Suppiger - *Signal Hill - Analyst*

Very good. Thank you.

Operator

(Operator Instructions). We'll take our next question from Srinivas Anantha with Oppenheimer:

Srinivas Anantha - *Oppenheimer - Analyst*

Yes. Thank you. Lanham, just following up on the Cloud opportunity. Could you just maybe give us a little bit more color on what kind of services are you offering? And what is the typical sales cycle for these enterprise customers as opposed to your managed -- your regular managed hosting customer?

Secondarily, just on the expense front, I know you guys don't want to talk about long-term margins, but maybe if you could just talk about what is the original margin opportunity? I know you guys recently took space out from DuPont fibrose as opposed to building data center on your own. Would then -- would that in itself provide you some management margin opportunity longer term? Thank you.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Okay. Well, let's -- why don't I start with Cloud and enterprise sales cycle and then Bruce can do extension, data center. So with respect to Cloud, the suite that we just announced, Cloud, it is a comprehensive suite. And basically think of it as a platform as a service, that's our Cloud sites offering. You can load your app based on a dot-net or LAMP platform. We have Cloud files, which is an on-demand Cloud storage business. And then we have Cloud servers, which is basically a Cloud compute business.

Some of these offerings are based on the technologies we acquired last year. Other technologies here we have developed ourselves. So this is really our public Cloud business that we've recently announced that is growing at a high rate. What I'd say about adoption of the Cloud is that the Cloud is on everybody's mind today. Not everyone is buying it today. But the Cloud is ready made and is in position to serve certain IT workloads wonderfully.

We are still making investments in the Cloud because we actually think that Cloud is a game changer. We think the traction we are experiencing there will continue. We think it's a chance for us to change the competitive landscape in our industry, which is why it is our number one investment opportunity at the moment.

When you get to enterprise sales cycle, it's early for us when we talk about this, in terms of our progress and what we're learning. Some of the wins we've already had have been just like our regular sales cycle. Others are still unfolding and we haven't won them yet. So we'll see how that works.

Traditionally, when people say enterprise, the sales cycle is longer than what we have experienced here historically. Yes, we'll see how it all plays out. We've had some that come right on our regular schedule already. So I suspect with our service set, we will end up somewhere in between.

Srinivas Anantha - *Oppenheimer - Analyst*

Okay.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Okay. In terms of margins and data centers, first of all, when we chose to lease space versus building out our own data center, that really came from a decision that looked at the total cost of buying versus leasing. And in this particular case, it was much more economical for us to lease space and added more value to our shareholder by leasing the space versus building our own data center.

Obviously because of that, from an overall standpoint, we believe we'll get greater returns from leasing this space rather than building it our own. Now if you're looking at individual margins, because we're leasing the space vis-a-vis building it, that will have a negative impact on gross margins because we show the lease expense up in our cost of revenue. Where if we built our own data center, you'd see a lot of the costs down in depreciation and amortization.

But certainly because when we went through our analysis and we just think it's a better return for us for leasing it, that should improve our overall margins when you get down to net income.

Srinivas Anantha - *Oppenheimer - Analyst*

Got it. Thank you. And then just one quick clarification, either Lanham or Bruce. Either of you guys talked about working with your customers for the upgrades, trying to do more with less dollars. As these customers, let's say they're promotionally taking ten servers or because of whatever reason now they say, hey, now we need only eight servers, maybe could you guys talk about correspondingly how much does your revenue opportunity come down with these customers? Thank you.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Well I guess the framework we'd use is that in the past, the installed base growth provided half the growth of the company. So to put numbers to it, if we grew 40% in a year, the installed base growth probably provide 15% to 20% of that.

So what's happening today is that customers aren't upgrading at the same rate. So the installed base growth has dipped. In the long run, as things improve, we think we'll get that installed base growth back. So right now, our growth drivers are ability to win new customers in the marketplace.

Last quarter, we picked up 500-something customers relative to the 468 we had in the prior quarter, so that we are improving on that. But that's our primary growth vehicle today, is winning new customers.

The Cloud is the other big growth vehicle, and that one's growing at a very high rate, albeit it's a smaller percentage of our company today when compared to managed hosting.

Srinivas Anantha - *Oppenheimer - Analyst*

Got it. And Lanham, just on this, when I'm looking at your incremental revenue growth this quarter, and looking at the incremental customers, the ARPU seems to be lower than your existing customers. Am I doing that correctly? Or maybe one of you can help me on the cap ratio. Thank you.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

Yes. When you're looking at that, you're looking at incremental customers based on the total change in our revenue. Keep in mind that foreign exchange, when there's a change in our foreign exchange rate, it affects not just new customers, but the whole base.

So when you back out the FX impact, you'll see that new customers are, again, pretty much in line with what we've been doing from a total-basis.

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Yes. The only other point I'd add there is the timing at which customers came on. We've mentioned that the quarter -- our momentum grew as the quarter progressed. So we had more new customer wins coming into March than we did January. So that nets us with the average.

Srinivas Anantha - *Oppenheimer - Analyst*

Yes. And what was the sequential impact from currency impact? Like from 4Q to 1Q?

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

It was $3.2 million between the fourth quarter of last year and the first quarter of this year.

Srinivas Anantha - *Oppenheimer - Analyst*

Thanks so much. I appreciate that, guys. Thank you.

Bruce Knooihuizen - *Rackspace Hosting Inc. - CFO*

You're welcome.

Operator

We'll take our last question from Jonathan Schildkraut with Jefferies.

Jonathan Schildkraut - *Jefferies - Analyst*

Great. Sorry to circle back on you guys.

Lanham, I had a question about the culture. In the business that we've had down there as well as the time we spend, culture seems to be a very important element of the Rackspace story and your ability to succeed. It seems like you've definitely slowed down on the hiring in the near term. And I'm wondering if you are taking a special sensitivity to your approach to your employee growth in this environment?

Because one of the concerns, I guess, that we have is that if the economy does get worse, what the impact of a headcount reduction would look like on a culture like Rackspace, where the business is so tightly tied to what goes on within the four walls of the building, so to speak?

Lanham Napier - *Rackspace Hosting Inc. - CEO*

Yes. Great question. Our culture absolutely matters. In order to have fanatical support, we have to have a culture where people want to volunteer their best every day. This creates our service advantage.

So we are doing some things with the culture right now to invest in it and deepen it and make it more capable. So I'd draw an analogy, just like on the margin side, we are making investments there so we can run the business more effectively. Just like we're making investments in Cloud, so we can grow that business, we're making investments in the culture today.

So I'll put out one big one that we're doing. We are significantly increasing the level of training and investment we make at the manager level at Rackspace. Just like we feel like during an operational slowdown, we can improve our processes and service capability, we think we can do the same thing with people.

So that while we aren't asking people to go out and hire 200 a month, like we used to in the old days, instead of asking people to go on all those recruiting missions, we're asking them to go to training.

So that we feel like during this lull in the activity we can sharpen the saw, so to speak, with respect to the human capital in the business. So Rackspace University and our engagement teams are focused on increasing the talent and capability of our managers across the company.

Of the human capital investments we're making right now, the biggest one is in training. We feel like training, it's one of those things that's hard to measure and quantify the impact all the time, but it pays off exponentially when we do it right.

This is how we deepen the culture and increase our service capability. So we are very sensitive to it. It's something that we monitor. It's something that we measure. We are doing engagement surveys right now. We're running the Q12 Gallup Organization and so we'll get the results here in a few weeks. That's part of a regular program. We will continue to do all that.

Jonathan Schildkraut - *Jefferies - Analyst*

All right. Thank you.

Operator

This does conclude the Q&A portion of the call. Thank you and good evening.
