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FORM 10-Q

RACKSPACE HOSTING, INC. - RAX

Filed: November 12, 2009 (period: November 12, 2009)

Quarterly report which provides a continuing view of a company's financial position

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[10-Q - FORM 10-Q]

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2009.

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)**

For the transition period from ______ to ______.

Commission file number 001-34143

RACKSPACE HOSTING, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware **(State or Other Jurisdiction of Incorporation or Organization)**	**74-3016523** **(IRS Employer Identification No.)**

5000 Walzem Rd.
San Antonio, Texas 78218
(Address of principal executive offices, including Zip Code)
(210) 312-4000
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer, large accelerated filer and a smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☑ Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☑

On November 6, 2009, 122,508,591 shares of the registrant's Common Stock, $0.001 par value, were outstanding.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

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PART I – FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	December 31, 2008	September 30, 2009 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 238,407	$ 102,950
Accounts receivable, net of allowance for doubtful accounts and customer credits of $3,295 as of December 31, 2008, and $5,184 as of September 30, 2009	30,932	39,902
Income taxes receivable	12,318	4,072
Prepaid expenses and other current assets	10,838	14,056
Total current assets	292,495	160,980
Property and equipment, net	362,042	419,454
Goodwill	6,942	22,329
Intangible assets, net	15,101	12,344
Other non-current assets	8,681	10,223
Total assets	$ 685,261	$ 625,330
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 71,387	$ 77,108
Current portion of deferred revenue	16,284	15,338
Current portion of obligations under capital leases	38,909	46,408
Current portion of debt	5,944	4,850
Total current liabilities	132,524	143,704
Non-current deferred revenue	3,883	2,884
Non-current obligations under capital leases	50,781	63,063
Non-current debt	204,779	53,655
Non-current deferred income taxes	13,398	19,665
Other non-current liabilities	10,212	11,967
Total liabilities	415,577	294,938
COMMITMENTS AND CONTINGENCIES		
Stockholders' equity:		
Common stock, $0.001 par value per share: 300,000,000 shares authorized; 117,154,094 shares issued and outstanding as of December 31, 2008, 122,426,741 shares issued and outstanding as of September 30, 2009	117	122
Additional paid-in capital	207,589	241,355
Accumulated other comprehensive income (loss)	(16,027)	(10,273)
Retained earnings	78,005	99,188
Total stockholders' equity	269,684	330,392
Total liabilities and stockholders' equity	$ 685,261	$ 625,330

See accompanying notes to the unaudited consolidated financial statements.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONSOLIDATED STATEMENTS OF INCOME – (Unaudited)

(In thousands, except per share data)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Net revenue	$ 138,354	$ 162,399	$ 388,796	$ 459,471
Costs and expenses:				
Cost of revenue	45,499	53,093	127,564	147,538
Sales and marketing	21,462	19,860	58,876	59,442
General and administrative	38,729	43,622	110,470	122,728
Depreciation and amortization	23,174	32,696	63,862	90,211
Total costs and expenses	128,864	149,271	360,772	419,919
Income from operations	9,490	13,128	28,024	39,552
Other income (expense):				
Interest expense	(1,912)	(2,147)	(5,076)	(6,854)
Interest and other income (expense)	(144)	523	276	165
Total other income (expense)	(2,056)	(1,624)	(4,800)	(6,689)
Income before income taxes	7,434	11,504	23,224	32,863
Income taxes	2,199	3,900	8,365	11,680
Net income	$ 5,235	$ 7,604	$ 14,859	$ 21,183
Net income per share				
Basic	$ 0.05	$ 0.06	$ 0.14	$ 0.18
Diluted	$ 0.04	$ 0.06	$ 0.13	$ 0.17
Weighted average number of shares outstanding				
Basic	111,231	121,501	105,698	119,788
Diluted	118,724	129,160	112,796	125,849

See accompanying notes to the unaudited consolidated financial statements.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONSOLIDATED STATEMENTS OF CASH FLOWS – (Unaudited)

(In thousands)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Cash Flows From Operating Activities		
Net income	$ 14,859	$ 21,183
Adjustments to reconcile net income to net cash provided by operating activites		
Depreciation and amortization	63,862	90,211
Loss on disposal of equipment, net	2,277	976
Provision for bad debts and customer credits	2,340	8,848
Deferred income taxes	10,486	5,103
Share-based compensation expense	10,873	14,866
Deferred rent	419	2,049
Other non-cash compensation expense	212	599
Excess tax benefits from share-based compensation arrangements	(3,212)	-
Changes in certain assets and liabilities		
Accounts receivable	(5,446)	(16,991)
Income taxes receivable	(10,837)	8,246
Accounts payable and accrued expenses	17,665	2,620
Deferred revenue	2,114	(2,394)
All other operating activities	(3,399)	(4,112)
Net cash provided by operating activities	102,213	131,204
Cash Flows From Investing Activities		
Purchases of property and equipment, net	(132,849)	(82,640)
Earnout payments for acquisitions	-	(6,822)
Net cash used in investing activities	(132,849)	(89,462)
Cash Flows From Financing Activities		
Principal payments of capital leases	(22,881)	(32,513)
Principal payments of notes payable	(5,521)	(5,908)
Borrowings on line of credit	200,000	-
Payments on line of credit	(57,301)	(150,000)
Payments for debt issuance costs	(158)	(367)
Proceeds from sale leaseback transactions	1,543	-
Proceeds from issuance of common stock at IPO net of offering expenses of $13,555	145,195	-
Proceeds from issuance of common stock, net	548	-
Exercise of warrants	278	-
Proceeds from exercise of stock options	1,964	9,743
Excess tax benefits from share-based compensation arrangements	3,212	-
Net cash provided by (used in) financing activities	266,879	(179,045)
Effect of exchange rate changes on cash and cash equivalents	(862)	1,846
Increase (decrease) in cash and cash equivalents	235,381	(135,457)
Cash and cash equivalents, beginning of period	24,937	238,407
Cash and cash equivalents, end of period	$ 260,318	$ 102,950
Supplemental cash flow information:		
Acquisition of property and equipment by capital leases	$ 58,708	$ 52,294
Acquisition of property and equipment by notes payable	11,934	3,690
Vendor financed equipment purchases	$ 70,642	$ 55,984
Shares issued in business combinations	$ -	$ 8,680
Cash payments for interest, net of amount capitalized	$ 5,676	$ 6,266
Cash payments for income taxes	$ 6,075	$ 5,300

See accompanying notes to the unaudited consolidated financial statements.

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—

NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. Overview and Basis of Presentation

Nature of Operations

As used in this report, the terms "Rackspace", "Rackspace Hosting", "we", "our company", "the company", "us," or "our" refer to Rackspace Hosting, Inc. and its subsidiaries. Rackspace Hosting, Inc., through its operating subsidiaries, provides hosting services and cloud computing solutions, including managed hosting, cloud hosting, as well as email and application hosting. We focus on providing a service experience for our customers, which we call Fanatical Support®.

Rackspace Hosting, Inc. was incorporated in Delaware on March 7, 2000. However, our operations began in 1998 as a limited partnership which became our subsidiary through a corporate reorganization completed on August 21, 2001.

We operate consolidated subsidiaries which include, among others, Rackspace US, Inc., our domestic operating entity, and Rackspace Limited, our United Kingdom operating entity.

In October 2008, we completed the acquisition of Jungle Disk, Inc., a company specializing in cloud storage. Also in October 2008, we completed the acquisition of Slicehost LLC, a company specializing in cloud hosting. Accordingly, their operating results have been included in our consolidated financial statements since the date of acquisition.

Basis of Consolidation

The consolidated financial statements include the accounts of our wholly owned subsidiaries located in the United States of America (U.S.), the United Kingdom (U.K.), the Netherlands, and Hong Kong. Intercompany transactions and balances have been eliminated in consolidation.

Basis of Presentation

The accompanying consolidated financial statements as of September 30, 2009, and for the three and nine months ended September 30, 2008 and 2009, are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States ("GAAP") for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all financial information and disclosures required by GAAP for complete financial statements and certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary for a fair statement of our financial position as of September 30, 2009, our results of operations for the three and nine months ended September 30, 2008 and 2009, and our cash flows for the nine months ended September 30, 2008 and 2009.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2008 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 2, 2009, as amended. The results of the three and nine months ended September 30, 2009 are not necessarily indicative of the results to be expected for the year ending December 31, 2009, or for any other interim period, or for any other future year.

Certain reclassifications have been made to prior year balances in order to conform to the current year's presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, we evaluate our estimates, including those related to accounts receivable and customer credits, property and equipment, fair values of intangible assets and goodwill, useful lives of intangible assets, fair value of stock options, contingencies, and income taxes, among others. We base our estimates on historical experience and on other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. We engaged third party valuation consultants to assist management in the purchase price allocation of significant acquisitions. We also engaged third party valuation consultants to assist management in the valuation of our common stock price, which affected transactions recorded in our consolidated financial statements prior to Rackspace becoming a public company.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the application of certain significant accounting policies. There have been no material changes to our significant accounting policies that are disclosed in our audited consolidated financial statements and notes thereof as of December 31, 2008 included in our Annual Report on Form 10-K, as amended.

Recently Adopted Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 168, *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162*. U.S. GAAP will no longer be issued in the form of an "accounting standard," but rather as an update to the applicable "topic" or "subtopic" within the codification. As such, accounting guidance will be classified as either "authoritative" or "nonauthoritative" based on its inclusion or exclusion from the codification. The codification will be the single source of authoritative U.S. accounting and reporting standards, except for rules and interpretive releases of the SEC under authority of federal securities laws, which are sources of authoritative GAAP for SEC registrants. The codification of U.S. GAAP became effective for interim and annual periods ending after September 15, 2009. This statement did not have a material impact on our consolidated financial statements.

Recent Accounting Pronouncements

In June 2009, the FASB issued SFAS 167, *Amendments to FASB Interpretation No. 46(R),* which is to be included in Accounting Standards Codification (ASC) Topic 810, Consolidation. This guidance amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. SFAS 167 also replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity. Additionally, SFAS 167 provides more timely and useful information about an enterprise's involvement with a variable interest entity. SFAS 167 will become effective in the first annual reporting period that begins after November 15, 2009 and for interim periods within that first annual reporting period. It will become effective for Rackspace in the first quarter of 2010. We are currently evaluating the impact of this standard on our consolidated financial statements.

In September 2009, the FASB issued two Accounting Standards Updates (ASU): (i) ASU 2009-13 (EITF 08-1), *Multiple-Deliverable Revenue Arrangements*, and (ii) ASU 2009-14 (EITF 09-3), *Certain Revenue Arrangements that Include Software Elements*, which will be effective prospectively for revenue arrangements, entered into or materially modified in fiscal years beginning on or after June 15, 2010. ASU 2009-13 amends ASC Subtopic 605-25 to eliminate the requirement that all undelivered elements in a multiple-element revenue arrangement have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) before an entity can recognize the portion of an overall arrangement fee that is attributable to items that already have been delivered. In the absence of VOSE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. Application of the "residual method" of allocating an overall arrangement fee between delivered and undelivered elements will no longer be permitted upon adoption. ASU 2009-14 amends ASC Subtopic 985-605 to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. We are currently evaluating the impact of these standards on our consolidated financial statements.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

3. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per share data)	Three Months Ended September 30, 2008	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Basic net income per share:				
Net income	$ 5,235	$ 7,604	$ 14,859	$ 21,183
Weighted average shares outstanding:				
Common stock	110,729	121,501	104,722	119,788
Preferred stock	502	-	976	-
Number of shares used in per share computations	111,231	121,501	105,698	119,788
Earnings per share	$ 0.05	$ 0.06	$ 0.14	$ 0.18
Diluted net income per share:				
Net income	$ 5,235	$ 7,604	$ 14,859	$ 21,183
Weighted average shares outstanding:				
Common stock	110,729	121,501	104,722	119,788
Stock options and awards	7,391	7,659	6,900	6,061
Preferred stock	502	-	976	-
Stock warrants	102	-	198	-
Number of shares used in per share computations	118,724	129,160	112,796	125,849
Earnings per share	$ 0.04	$ 0.06	$ 0.13	$ 0.17

We excluded 4.9 million and 0.5 million potential common shares from the computation of dilutive earnings per share for the three months ended September 30, 2008 and 2009, respectively, and 5.7 million and 5.3 million potential shares for the nine months ended September 30, 2008, and 2009, respectively, because the effect would have been anti-dilutive.

As a result of our initial public offering (IPO) in August 2008, all outstanding stock warrants were exercised, resulting in an issuance of 268,750 shares of common stock, and all shares of our outstanding preferred stock were automatically converted to shares of common stock; thus subsequent to the IPO, the impact of these transactions on the weighted average shares outstanding was reflected in common stock.

4. Cash and Cash Equivalents

Cash and cash equivalents consisted of:

(In thousands)	December 31, 2008	September 30, 2009
Cash deposits	$ 37,787	$ 42,250
Money market funds	200,620	60,700
Cash and cash equivalents	$ 238,407	$ 102,950

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. We actively monitor the third-party depository institutions that hold our deposits. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. In March 2009 and July 2009, we repaid $100.0 million and $50.0 million, respectively, on our revolving credit facility with our money market funds.

Our money market mutual funds invest exclusively in high-quality, short-term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

5. Fair Value Measurements

We adopted the full provisions of ASC Subtopic 820-10 (formerly SFAS 157), *Fair Value Measurements and Disclosures*. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. There is a three-tier fair value of hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – Observable inputs such as quoted prices in active markets for identical assets or liabilities;

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 – Unobservable inputs that are supported by little or no market activity, which require management judgment or estimation.

We measure applicable assets and liabilities at fair value. Our money market funds are classified within Level 1 because they are valued using quoted market prices. Our interest rate swap is classified within Level 2 as the valuation inputs are based on quoted prices and market observable data of similar instruments.

The carrying values of cash deposits, accounts receivable, prepaid expenses and other assets, accounts payable and accrued expenses are reasonable estimates of their fair values due to the short maturity of these financial instruments and are classified within Level II.

Assets and liabilities measured at fair value on a recurring basis are summarized by level below. The table does not include assets and liabilities which are measured at historical costs or any other basis other than fair value.

(In thousands)	December 31, 2008			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 200,620	$ -	$ -	$ 200,620
Total	$ 200,620	$ -	$ -	$ 200,620
Liabilities:				
Interest rate swap agreement (1)	$ -	$ 2,901	$ -	$ 2,901
Deferred compensation (2)	296	-	-	296
Total	$ 296	$ 2,901	$ -	$ 3,197

(In thousands)	September 30, 2009			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 60,700	$ -	$ -	$ 60,700
Rabbi trust (3)	574	-	-	574
Total	$ 61,274	$ -	$ -	$ 61,274
Liabilities:				
Interest rate swap agreement (1)	$ -	$ 2,201	$ -	$ 2,201
Deferred compensation (2)	559	-	-	559
Total	$ 559	$ 2,201	$ -	$ 2,760

(1) Money market funds are classified in cash and cash equivalents and the interest rate swap agreement is classified in other non-current liabilities.
(2) Obligations to pay benefits under a non-qualified deferred compensation plan that are classified in other non-current liabilities.

(3) Investments in marketable securities held in a Rabbi Trust associated with a non-qualified deferred compensation plan located in other non-current assets.

Our Rabbi Trust was established in January 2009 and we elected the fair value option under FASB ASC Subtopic 825-10, *Financial Instruments*, which allows for the recognition of gains and losses to be recorded in the statement of income in the same period as the gains and losses are incurred as part of the non-qualified deferred compensation plan. For the three and nine months ended September 30, 2009, we recognized a net gain of $44 thousand and $92 thousand, respectively, as interest and other income (expense).

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

6. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consisted of:

(In thousands)	December 31, 2008	September 30, 2009
Prepaid expenses	$ 5,481	$ 7,938
Current deferred taxes	3,050	3,265
Other current assets	2,307	2,853
Prepaid expenses and other current assets	$ 10,838	$ 14,056

7. Property and Equipment, net

Property and equipment consisted of:

(In thousands)	Estimated Useful Lives	December 31, 2008	September 30, 2009
Computers, software and equipment	1-5 years	$ 350,697	$ 482,218
Furniture and fixtures	7 years	12,856	19,208
Buildings and leasehold improvements	2-30 years	61,839	110,849
Land	--	13,860	13,860
Property and equipment, at cost		439,252	626,135
Less accumulated depreciation and amortization		(188,300)	(269,561)
Work in process		111,090	62,880
Property and equipment, net		$ 362,042	$ 419,454

Depreciation and leasehold amortization expense, not including amortization expense for intangible assets, was $21.8 million and $31.0 million for the three months ended September 30, 2008 and 2009, respectively, and $61.0 million and $85.4 million for the nine months ended September 30, 2008 and 2009, respectively.

At December 31, 2008, the work in process balance consisted of build outs of $47.0 million for office facilities and $53.5 million for data centers, and $10.6 million for capitalized software and other projects. At September 30, 2009, the work in process balance consisted of build outs of $55.3 million for office facilities and $2.8 million for data centers, and $4.8 million for capitalized software and other projects.

Capitalized interest was $0.5 million and $0.2 million for the three months ended September 30, 2008 and 2009, respectively and $1.7 million and $0.7 million for the nine months ended September 30, 2008 and 2009, respectively.

8. Business Combinations and Goodwill

In October 2008, we acquired two companies with a total purchase price of $28.0 million, which were accounted for as business combinations. The initial purchase price of the combined acquisitions was $11.5 million paid in cash and stock, with up to $16.5 million in additional payouts of cash and stock based on certain earnout provisions. For the nine months ended September 30, 2009, earn-outs totaling $15.5 million were achieved and paid in both cash and stock, of which $8.0 million was achieved in the three months ended September 30, 2009. If the remaining $1.0 million in additional earn-out is achieved, the payment will be accounted for as additional goodwill.

The following table provides a roll forward of our goodwill balance.

Balance at December 31, 2008	$ 6,942
Earn-out payments for acquisitions	15,502
Purchase accounting adjustments	(115)
Balance at September 30, 2009	$ 22,329

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

9. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consisted of:

(In thousands)	December 31, 2008	September 30, 2009
Trade payables	$ 23,459	$ 23,661
Accrued compensation and benefits	19,462	20,049
Foreign income taxes payable	324	6,068
Vendor accruals	19,984	19,257
Other liabilities	8,158	8,073
Accounts payable and accrued expenses	$ 71,387	$ 77,108

10. Debt

Debt outstanding consisted of:

(In thousands)	December 31, 2008	September 30, 2009
Revolving credit facility	$ 200,000	$ 50,000
Notes payable	10,723	8,505
Total debt	210,723	58,505
Less current portion of debt	(5,944)	(4,850)
Total non-current debt	$ 204,779	$ 53,655

Revolving Credit Facility

Our revolving credit facility includes an aggregate commitment of $245.0 million. The facility provides for letters of credit up to $25.0 million. The interest is based on a floating rate, generally the London Interbank Offered Rate (LIBOR) plus a margin spread, which changes ratably from 0.675% to 1.55% dependent on the total funded debt to adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA) ratio. We are required to pay a facility fee of 0.2% per annum on the full amount committed under the facility and a quarterly administrative fee. The facility has a 5-year term and matures in August 2012, and is fully secured by our assets and governed by financial and non-financial covenants. Financial covenants under our facility include a minimum fixed charge coverage ratio and a maximum total funded debt to EBITDA ratio. As of September 30, 2009, we were in compliance with all of the covenants under our facility.

In June 2009, we amended the revolving credit facility agreement to provide us with the ability to borrow under our credit facility in Pounds Sterling and Euros, rather than only allowing our borrowings in U.S. dollars. We have the ability to borrow up to $75 million in alternate currencies. In addition, the amendment provides for changes in regard to certain other items in the credit agreement, including but not limited to (i) the calculation to determine our “Minimum Fixed Charge Coverage Ratio”, (ii) our banking account maintenance, and (iii) requirements for access to collateral located at our various real property locations. These changes were made in order to provide clarifications that reflected compliance expectations that already existed among the parties. We incurred fees of $367 thousand in connection with the amendment which have been capitalized and are being amortized over the remaining term of the revolver. As of September 30, 2009 we did not have any borrowings on our credit facility in alternate currencies.

In July 2009 we repaid $50.0 million, reducing our borrowings on the facility to $50.0 million.

As of September 30, 2009, the amount outstanding under the facility was $50.0 million, with an outstanding letter of credit of $0.7 million, and an additional $194.3 million available for future borrowings.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Interest Rate Swap

We have a cash flow hedge to limit our exposure that may result from the variability of floating interest rates. Effective December 10, 2007, we entered into an interest rate swap agreement with a notional amount of $50.0 million. The interest rate swap hedges the first $50.0 million of our outstanding floating-rate debt. This swap converts floating rate interest based on the LIBOR into fixed-rate interest as part of the arrangement with our primary lender and expires in December 2010.

We are required to pay the counterparty a stream of fixed interest payments at a rate of 4.135%, and in turn, receive variable interest payments based on 1-month LIBOR. The margin spread as of September 30, 2009 was 1.05% resulting in an effective fixed rate of 5.185%. The net receipts or payments from the swap are recorded as interest expense. The swap is designated and qualifies as a cash flow hedge under FASB ASC Topic 815, *Derivatives and Hedging*. As such, the swap is accounted for as an asset or a liability in the accompanying consolidated balance sheets at fair value. We are utilizing the dollar offset method to assess the effectiveness of the swap. Under this methodology, the swap was deemed to be highly effective for the nine month periods ended September 30, 2008 and September 30, 2009. There was no hedge ineffectiveness recognized in earnings for either period. If the hedge becomes ineffective, or if certain terms of the facility change, the facility is extinguished, or if the swap is terminated prior to maturity, the fair value of the swap and subsequent changes in fair value may be recognized in the accompanying consolidated statements of income. The fair value of the swap was estimated based on the yield curve as of December 31, 2008 and September 30, 2009, and represents its carrying value.

The following table presents the impact of the interest rate swap on the consolidated balance sheets:

(In thousands)	December 31, 2008	September 30, 2009
Other non-current liabilities	$ 2,901	$ 2,201
Accumulated other comprehensive income (loss), net of tax	$ (1,886)	$ (1,431)

(In thousands)	Three Months Ending September 30,		Nine Months Ending September 30,	
	2008	2009	2008	2009
Effective gain (loss) recognized in accumulated other comprehensive income, net of tax	$ (77)	$ 130	$ (220)	$ 455

Our counterparty is also the primary lender on our revolving credit facility and we actively monitor the potential credit risk. As of September 30, 2009, we were in a liability position to our primary lender and therefore had limited counterparty credit risk.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

11. Other Non-Current Liabilities

Other non-current liabilities consisted of:

(In thousands)	December 31, 2008	September 30, 2009
Texas Enterprise Fund Grant	$ 5,000	$ 5,000
Other	5,212	6,967
Other non-current liabilities	$ 10,212	$ 11,967

In August 2007, we entered into an agreement with the State of Texas (Texas Enterprise Fund Grant) under which we may receive up to $22.0 million in state enterprise fund grants on the condition that we meet certain employment levels in the State of Texas paying an average compensation of at least $56,000 per year (subject to increases). To the extent we fail to meet these requirements, we may be required to repay all or a portion of the grants plus interest. In September 2007, we received the initial installment of $5.0 million from the State of Texas, which was recorded as a non-current liability.

In July 2009, the Texas Enterprise Fund Grant agreement was amended to modify the job creation requirements. Under the amendment, the grant was divided into four separate tranches. The first tranche, called "Basic Fund" in the amendment, is $8.5 million with a target of 1,225 new jobs created in the state of Texas by December 31, 2012. We already have drawn $5.0 million of this tranche. We can draw an additional $3.5 million when we reach the target. While we expect to meet the job target requirements, if we do not create these jobs by December 31, 2012 and maintain them through December 31, 2021, we will be required to repay portions of the grant (clawback), with the maximum clawback being the amounts we have drawn plus 3.4% interest on such amounts per year. The remaining three tranches are at our option and provide for additional draws up to $13.5 million, which are also subject to clawbacks.

12. Commitments and Contingencies

Legal Proceedings

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. In addition, on October 22, 2008, *Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston*, was filed in the 37th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us. We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

Contingent Liability

We previously recorded a $---2.1 million charge to cost of revenue related to an unresolved contractual issue with a vendor. We recorded a loss contingency liability with respect to this matter in accordance with FASB ASC Topic 450, *Contingencies* (formerly SFAS 5). Due to the uncertainty regarding the interpretation of certain contractual terms, it is possible the ultimate loss may exceed or be less than the amount currently accrued.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

13. Share-Based Compensation

In January 2009, our board of directors approved an additional 5.5 million shares for future grant under the Amended and Restated 2007 Stock Plan. As of September 30, 2009, the total number of shares authorized under all of our plans was 42.8 million shares, of which approximately 6.3 million shares were available for future grants.

Outstanding stock awards were as follows:

	December 31, 2008	September 30, 2009
Restricted stock units	50,000	2,050,000
Stock options	19,255,644	17,944,547
Total outstanding awards	19,305,644	19,994,547

The following table summarizes our restricted stock unit activity for the nine months ended September 30, 2009:

	Number of Units
Outstanding at December 31, 2008	50,000
Units granted	2,000,000
Units vested	-
Units cancelled	-
Outstanding at September 30, 2009	2,050,000

On February 25, 2009, our board approved grants of restricted stock units (RSUs) to our chief executive officer and another member of the executive team. A total of 2,000,000 RSUs were granted. The vesting of the RSUs are dependent on the company's total shareholder return (TSR) on its common stock compared to other companies in the Russell 2000 Index. In addition, the company's TSR must be positive for vesting to occur. Of the total RSUs granted, 1,050,000 have a measurement period at the end of three years, and the remainder at the end of five years. The fair value of these awards was $7.0 million at the date of grant using a Monte Carlo pricing model, and are being amortized over their service periods.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

The following table summarizes the activity under our stock plans:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2008	19,255,644	$ 4.94	7.01	$ 34,050
Granted	3,927,850	$ 5.46		
Exercised	(4,398,980)	$ 2.22		
Cancelled	(839,967)	$ 7.40		
Outstanding at September 30, 2009	17,944,547	$ 5.61	7.64	$ 205,481
Vested and exercisable at September 30, 2009	6,722,666	$ 3.22	6.28	$ 93,030
Vested and exercisable at September 30, 2009 and expected to vest thereafter *	16,517,907	$ 5.45	7.53	$ 191,732

* Includes reduction of shares outstanding due to estimated forfeitures

On February 25, 2009, our board approved the grant of 3.7 million stock options for certain employees with an exercise price of $5.09. The shares vest 25% at the end of each year over a four-year period and expire after ten years. The fair value of these stock options was $2.97 per option using the Black-Scholes option pricing model.

The total pre-tax intrinsic value of the stock options exercised during the three months ended September 30, 2008 and 2009, was $4.2 million and $12.5 million, respectively and $12.4 million and $31.9 million for the nine months ended September 30, 2008 and 2009, respectively.

The weighted average fair value of stock options issued for the three months ended September 30, 2008 and 2009 was $8.52 and $9.03 respectively, and $7.96 and $3.19 for the nine months ended September 30, 2008 and 2009, respectively, using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2009	2008	2009
Expected stock volatility	60% - 61%	59%	60% - 65%	59% - 61%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk-free interest rate	3.30% - 3.45%	3.03%	2.71% - 3.45%	2.24% - 3.03%
Expected life	6.25 - 6.50 years	6.25 years	6.25 - 6.50 years	6.25 years

As of September 30, 2009, there was $44.6 million of total unrecognized compensation cost related to non-vested stock options granted under our various plans, which will be amortized using the straight line method over a weighted average period of 2.2 years.

Share-based compensation expense was recognized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2008	2009	2008	2009
Cost of revenue	$ 819	$ 778	$ 1,788	$ 2,082
Sales and marketing	612	826	1,546	2,245
General and administrative	2,886	4,008	7,539	10,539
Pre-tax share-based compensation	4,317	5,612	10,873	14,866
Less: Income tax benefit	(1,356)	(1,913)	(3,916)	(5,284)
Total share-based compensation expense, net of tax	$ 2,961	$ 3,699	$ 6,957	$ 9,582

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

14. Income Taxes

We are subject to U.S. federal income tax and various state, local, and international income taxes in numerous jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions and the timing of recognizing revenue and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file.

We currently file income tax returns in the U.S., the U.K., the Netherlands and Hong Kong, which are periodically under audit by federal, state, and international tax authorities. These audits can involve complex matters that may require an extended period of time for resolution. The Internal Revenue Service completed an examination of our consolidated U.S. Federal income tax returns through fiscal year 2004 with no changes to the tax return. We remain subject to U.S. federal and state income tax examinations for the tax years 2005 through 2008, and to U.K. income tax examinations for the years 2002 through 2007. There are no income tax examinations currently in process. Although the outcome of open tax audits is uncertain, in management's opinion, adequate provisions for income taxes have been made. If actual outcomes differ materially from these estimates, they could have a material impact on our financial condition and results of operations. Differences between actual results and assumptions, or changes in assumptions in future periods are recorded in the period they become known. To the extent additional information becomes available prior to resolution, such accruals are adjusted to reflect probable outcomes. Our effective tax rate is impacted by earnings being realized in countries where we have lower statutory rates.

During the three and nine months ended September 30, 2009 we received federal income tax refunds totaling $7.5 million and $10.1 million, respectively, related to the 2008 tax period. We experienced a taxable loss in 2008 primarily as a result of the accelerated depreciation allowed under the 2008 Economic Stimulus Act passed in February 2008.

15. Comprehensive Income

Total comprehensive income was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2008	2009	2008	2009
Net income	$ 5,235	$ 7,604	$ 14,859	$ 21,183
Derivative instrument, net of deferred taxes of $64 and $(70) for the three months ended September 30, 2008 and 2009, and $142 and $(245) for the nine months ended September 30, 2008 and 2009.	(77)	130	(220)	455
Foreign currency cumulative translation adjustmment, net of taxes of $986 and $109 for the three months ended September 30, 2008 and 2009, $985 and $(1,588) for the nine months ended September 30, 2008 and 2009.	(4,160)	(2,176)	(4,168)	5,299
Total other comprehensive income (loss)	(4,237)	(2,046)	(4,388)	5,754
Total comprehensive income	$ 998	$ 5,558	$ 10,471	$ 26,937

(In thousands)	Derivative Instrument	Translation Adjustment	Accumulated other comprehensive income (loss)
Balance at December 31, 2008	$ (1,886)	$ (14,141)	$ (16,027)
2009 changes in fair value	455	-	455
2009 translation adjustment	-	5,299	5,299
Balance at September 30, 2009	$ (1,431)	$ (8,842)	$ (10,273)

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

16. Segment Information

FASB ASC Topic 280, *Segment Reporting* (formerly SFAS 131), establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information by business unit and geographic region for purposes of evaluating financial performance and allocating resources. We are organized as, and operate two business units: managed hosting and cloud computing services, which includes cloud hosting, as well as email and application hosting. We have evaluated the criteria for aggregation by products and services, and by geography, and determined we have one reportable segment, which we describe as Hosting. Revenue is attributed by geographic location based on the Rackspace Hosting operating location that enters into the contractual relationship with the customer, either the U.S. or outside U.S., primarily the U.K. Our long-lived assets are primarily located in the U.S. and U.K., and to a lesser extent Hong Kong.

Total net revenue by geographic region was as follows:

(In thousands)	Three Months Ending September 30, 2008	Three Months Ending September 30, 2009	Nine Months Ending September 30, 2008	Nine Months Ending September 30, 2009
United States	$ 99,173	$ 119,896	$ 276,120	$ 343,769
Outside United States	39,181	42,503	112,676	115,702
Total net revenue	$ 138,354	$ 162,399	$ 388,796	$ 459,471

Long-lived assets by geographic region were as follows:

(In thousands)	December 31, 2008	September 30, 2009
United States	$ 322,949	$ 373,261
Outside United States	68,930	89,236
Total long-lived assets	$ 391,879	$ 462,497

17. Related Party Transactions

We lease some facilities from a partnership controlled by our chairman of the board of directors. For these leases, we recognized $166 thousand and $180 thousand of rent expense on our consolidated statements of income for the three months ended September 30, 2008 and 2009, respectively, and $443 thousand and $546 thousand for the nine months ended September 30, 2008 and 2009, respectively.

18. Subsequent Events

In connection with the preparation of the consolidated financial statements and in accordance with FASB ASC Topic 855, *Subsequent Events*, (formerly SFAS 165) we evaluated events after the balance sheet date of September 30, 2009 through November 12, 2009, the day the consolidated financial statements were issued.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to "we," "our," "our company," "us," "the company," "Rackspace Hosting," or "Rackspace" refer to Rackspace Hosting, Inc. and its consolidated subsidiaries. We have made forward-looking statements in this Quarterly Report on Form 10-Q that are subject to risks and uncertainties. Forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section and Section 21E of the Securities Exchange Act of 1934, as amended, are subject to the "safe harbor" created by those sections. The forward-looking statements in this report are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as "anticipates," "aspires," "believes," "can," "continue," "could," "estimates," "expects," "intends," "may," "plans," "projects," "seeks," "should," "will" or "would" or the negative of these terms and similar expressions intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this document in greater detail under the heading "Risk Factors." We believe it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. The risks described in "Risk Factors" included in this report, as well as any other cautionary language in this report, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of the events described in "Risk Factors" and elsewhere in this report could harm our business.

Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this document completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. 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 those anticipated in these forward-looking statements, even if new information becomes available in the future.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes contained elsewhere in this document.

Overview of our Business

Rackspace Hosting, Inc. is the world leader in hosting and cloud computing. Our growth is the result of our commitment to serving our customers, known as Fanatical Support®, and our exclusive focus on hosting and cloud computing. We have been successful in attracting and retaining thousands of customers and in growing our business. We are a pioneer in an emerging category, hybrid hosting, which combines the benefits of both traditional dedicated hosting and cloud computing. We are committed to maintaining our service-centric focus and will follow our vision to be considered one of the world's greatest service companies.

Rackspace offers a full suite of hosting services, including managed hosting, cloud hosting, as well as email and application hosting. The equipment required (servers, routers, switches, firewalls, load balancers, cabinets, software, wiring, etc.) to deliver services is typically purchased and managed by us.

We sell our services to small and medium-sized businesses as well as large enterprises. For the nine months of 2009, 25.2% of our net revenue was generated by our operations outside of the U.S., mainly from the U.K. Late in 2008, we also began operations of a Hong Kong data center and a sales office, which generated minimal revenue in 2008 and the first nine months of 2009. Our growth strategy includes, among other strategies, targeting international customers as we plan to expand our activities in continental Europe and Asia. For the first nine months of 2009, no individual customer accounted for greater than 2% of our net revenue.

Key Metrics

We carefully track several financial and operational metrics to monitor and manage our growth, financial performance, and capacity. Our key metrics are structured around growth, profitability, capital efficiency, infrastructure capacity, and utilization. The following data should be read in conjunction with the consolidated financial statements, the notes to the financial statements and other financial information included in this Quarterly Report on Form 10-Q.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

(Dollar amounts in thousands, except annualized net revenue per average technical square foot)	Three Months Ended (Unaudited) September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009	September 30, 2009
Growth					
Managed hosting customers at period end	18,012	18,480	19,048	19,363	19,328
Cloud customers at period end*	18,173	34,820	43,030	51,440	61,616
Number of customers at period end	36,185	53,300	62,078	70,803	80,944
Managed hosting, net revenue	$ 131,908	$ 134,275	$ 134,204	$ 138,943	$ 147,065
Cloud, net revenue	$ 6,446	$ 8,862	$ 10,873	$ 13,052	$ 15,334
Net revenue	$ 138,354	$ 143,137	$ 145,077	$ 151,995	$ 162,399
Revenue growth (year over year)	44.0%	34.2%	21.3%	16.2%	17.4%
Net upgrades (monthly average)	1.8%	1.4%	0.9%	1.2%	1.2%
Churn (monthly average)	-1.2%	-1.3%	-1.1%	-1.0%	-1.1%
Growth in installed base (monthly average)	0.6%	0.1%	-0.2%	0.2%	0.1%
Number of employees (Rackers) at period end	2,536	2,611	2,661	2,648	2,730
Number of servers deployed at period end	45,231	47,518	50,038	52,269	54,655
Profitability					
Income from operations	$ 9,490	$ 12,125	$ 13,021	$ 13,403	$ 13,128
Depreciation and amortization	$ 23,174	$ 26,310	$ 27,804	$ 29,711	$ 32,696
Share-based compensation expense					
Cost of revenue	$ 819	$ 678	$ 629	$ 675	$ 778
Sales and marketing	$ 612	$ 595	$ 698	$ 721	$ 826
General and administrative	$ 2,886	$ 2,871	$ 2,910	$ 3,621	$ 4,008
Total share-based compensation expense	$ 4,317	$ 4,144	$ 4,237	$ 5,017	$ 5,612
Adjusted EBITDA (1)	$ 36,981	$ 42,579	$ 45,062	$ 48,131	$ 51,436
Adjusted EBITDA margin	26.7%	29.7%	31.1%	31.7%	31.7%
Operating income margin	6.9%	8.5%	9.0%	8.8%	8.1%
Income from operations	$ 9,490	$ 12,125	$ 13,021	$ 13,403	$ 13,128
Effective tax rate	29.6%	27.7%	36.6%	36.2%	33.9%
Net operating profit after tax (NOPAT) (1)	$ 6,681	$ 8,766	$ 8,255	$ 8,551	$ 8,678
NOPAT margin	4.8%	6.1%	5.7%	5.6%	5.3%
Capital efficiency and returns					
Interest bearing debt	$ 297,933	$ 300,413	$ 201,507	$ 210,284	$ 167,976
Stockholders' equity	$ 269,008	$ 269,684	$ 282,880	$ 308,823	$ 330,392
Less: Excess cash	$ (235,421)	$ (200,620)	$ (117,611)	$ (129,638)	$ (83,462)
Capital base	$ 331,520	$ 369,477	$ 366,776	$ 389,469	$ 414,906
Average capital base	$ 316,245	$ 350,499	$ 368,127	$ 378,123	$ 402,188
Capital turnover (annualized)	1.75	1.63	1.58	1.61	1.62
Return on capital (annualized) (1)	8.5%	10.0%	9.0%	9.0%	8.6%
Capital expenditures					
Purchases of property and equipment, net	$ 45,328	$ 32,547	$ 25,589	$ 31,027	$ 26,024
Vendor financed equipment purchases	$ 23,009	$ 14,848	$ 11,683	$ 23,637	$ 20,664
Total capital expenditures	$ 68,337	$ 47,395	$ 37,272	$ 54,664	$ 46,688

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Customer gear	$ 27,627	$ 23,073	$ 19,255	$ 32,448	$ 28,705
Data center build outs	$ 21,679	$ 14,240	$ 11,386	$ 13,914	$ 4,028
Office build outs	$ 11,227	$ 8,340	$ 2,239	$ 1,651	$ 5,432
Capitalized software and other projects	$ 7,804	$ 1,742	$ 4,392	$ 6,651	$ 8,523
Total capital expenditures	$ 68,337	$ 47,395	$ 37,272	$ 54,664	$ 46,688
Infrastructure capacity and utilization					
Technical square feet of data center space at period end **	136,962	134,923	157,523	177,371	167,821
Annualized net revenue per average technical square foot **	$ 4,093	$ 4,212	$ 3,969	$ 3,631	$ 3,764
Utilization rate at period end	63.4%	70.4%	64.6%	59.8%	62.3%

* Beginning December 31, 2008 amounts include customers resulting from the Slicehost acquisition, and beginning March 31, 2009 amounts include SaaS customers for Jungle Disk.

** The technical square feet as of September 30, 2009 includes an additional 2,200 square feet for the Virginia data center less 11,750 square feet for operations at a U.K. data center that was decommissioned and migrated to the Slough data center during the third quarter 2009.

(1) See discussion and reconciliation of our Non-GAAP financial measures to the most comparable GAAP measures.

Non-GAAP Financial Measures

Return on Capital (ROC) (Non-GAAP financial measure)

We define Return on Capital as follows: ROC = Net operating profit after tax (NOPAT) /Average capital base

NOPAT = Income from operations x (1 – Effective tax rate)

Average capital base = Average of (Interest bearing debt + stockholders' equity – excess cash) = Average of (Total assets – excess cash – accounts payables and accrued expenses – deferred revenue– other non-current liabilities and deferred income taxes)

Year-to-date average balances are based on an average calculated using the quarter end balances at the beginning of the period and all other quarter ending balances included in the period.

For the periods ending March 31, 2009 through September 30, 2009 we define excess cash as the amount of cash and cash equivalents that exceeds our operating cash requirements, which for these periods is calculated as three percent of our annualized net revenue for the three months prior to the period end. For prior periods, we defined excess cash as our investments in money market funds. As a result of a decrease in capital requirements due to the completion of the last phase of our DFW data center build out and phase 2 of our Slough, U.K. data center, as well as the signing of leases to occupy data centers that have minimal data center build out costs, our operating cash needs have declined. We will periodically review the calculation and adjust it to reflect our projected cash requirements for the upcoming year.

We believe that ROC is an important metric for investors in evaluating our company's performance. ROC relates to after-tax operating profits with the capital that is placed into service. It is therefore a performance metric that incorporates both the Statement of Income and the Balance Sheet. ROC measures how successfully capital is deployed within a company.

Note that ROC is not a measure of financial performance under GAAP and should not be considered a substitute for return on assets, which we consider to be the most directly comparable GAAP measure. ROC has limitations as an analytical tool, and when assessing our operating performance, you should not consider ROC in isolation, or as a substitute for other financial data prepared in accordance with GAAP. Other companies may calculate ROC differently than we do, limiting its usefulness as a comparative measure.

ROC increased from 8.5% to 8.6% for the three months ended September 30, 2008 compared to the three months ended September 30, 2009, primarily due to a reduction of operating costs as a percentage of revenue due to a focus on scaling our cost structure during 2008 and continuing into 2009, partially offset by a lower tax rate favorably impacting the ROC calculation for the three months ended September 30, 2008. Included in the average capital base for 2008 and 2009 are capital expenditures related to the build out of our new corporate headquarters facility and data centers.

Return on assets increased from 3.8% for the three months ended September 30, 2008 to 4.7% for the three months ended September 30, 2009. This increase was primarily due to higher revenue and net income, partially offset by growth in our asset base due to the purchase of property and equipment to support the growth of our business. In addition we have held additional amounts of cash and cash equivalents since our IPO in August 2008.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

See our reconciliation of the calculation of return on assets to ROC in the following table:

(In thousands, except financial metrics)	Three Months Ended (Unaudited) September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009	September 30, 2009
Income from operations	$ 9,490	$ 12,125	$ 13,021	$ 13,403	$ 13,128
Effective tax rate	29.6%	27.7%	36.6%	36.2%	33.9%
Net operating profit after tax (NOPAT)	$ 6,681	$ 8,766	$ 8,255	$ 8,551	$ 8,678
Net income	$ 5,235	$ 6,844	$ 6,588	$ 6,991	$ 7,604
Total assets at period end	$ 685,211	$ 685,261	$ 601,434	$ 656,793	$ 625,330
Less: Excess cash	$ (235,421)	$ (200,620)	$ (117,611)	$ (129,638)	$ (83,462)
Less: Accounts payable and accrued expenses	$ (81,740)	$ (71,387)	$ (71,211)	$ (87,316)	$ (77,108)
Less: Deferred revenues (current and non-current)	$ (20,055)	$ (20,167)	$ (20,374)	$ (20,011)	$ (18,222)
Less: Other non-current liabilities and deferred taxes	$ (16,475)	$ (23,610)	$ (25,462)	$ (30,359)	$ (31,632)
Capital base	$ 331,520	$ 369,477	$ 366,776	$ 389,469	$ 414,906
Average total assets	$ 546,761	$ 685,236	$ 643,348	$ 629,114	$ 641,062
Average capital base	$ 316,245	$ 350,499	$ 368,127	$ 378,123	$ 402,188
Return on assets (annualized)	3.8%	4.0%	4.1%	4.4%	4.7%
Return on capital (annualized)	8.5%	10.0%	9.0%	9.0%	8.6%

Adjusted EBITDA (Non-GAAP financial measure)

We use Adjusted EBITDA as a supplemental measure to review and assess our performance. We define Adjusted EBITDA as Net income, plus income taxes, total other income (expense), depreciation and amortization, and non-cash charges for share-based compensation.

Adjusted EBITDA is a metric that is used in our industry by the investment community for comparative and valuation purposes. We disclose this metric in order to support and facilitate the dialogue with research analysts and investors.

Note that Adjusted EBITDA is not a measure of financial performance under GAAP and should not be considered a substitute for operating income, which we consider to be the most directly comparable GAAP measure. Adjusted EBITDA has limitations as an analytical tool, and when assessing our operating performance, you should not consider Adjusted EBITDA in isolation, or as a substitute for net income or other consolidated income statement data prepared in accordance with GAAP. Other companies may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Adjusted EBITDA as a percentage of net revenue has increased from 26.7% for the three months ended September 30, 2008 to 31.7% for the three months ended September 30, 2009 due to revenue increasing at a faster rate than our operating costs, partially offset by marginal increases in most cost categories.

Income from operations has been favorably impacted by cost reduction efforts, but was partially offset by higher depreciation and amortization expense resulting from capital investments, and increasing share-based compensation expense from grants of stock options and other stock awards to employees. Our operating income margin increased from 6.9% for the three months ended September 30, 2008 to 8.1% for the three months ended September 30, 2009.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

See our Adjusted EBITDA reconciliation below.

	Three Months Ended (Unaudited)				
(Dollars in thousands)	September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009	September 30, 2009
Net revenue	$ 138,354	$ 143,137	$ 145,077	$ 151,995	$ 162,399
Income from operations	$ 9,490	$ 12,125	$ 13,021	$ 13,403	$ 13,128
Net income	$ 5,235	$ 6,844	$ 6,588	$ 6,991	$ 7,604
Plus: Income taxes	$ 2,199	$ 2,620	$ 3,807	$ 3,973	$ 3,900
Plus: Total other (income) expense	$ 2,056	$ 2,661	$ 2,626	$ 2,439	$ 1,624
Plus: Depreciation and amortization	$ 23,174	$ 26,310	$ 27,804	$ 29,711	$ 32,696
Plus: Share-based compensation expense	$ 4,317	$ 4,144	$ 4,237	$ 5,017	$ 5,612
Adjusted EBITDA	$ 36,981	$ 42,579	$ 45,062	$ 48,131	$ 51,436
Operating income margin	6.9%	8.5%	9.0%	8.8%	8.1%
Adjusted EBITDA margin	26.7%	29.7%	31.1%	31.7%	31.7%

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Results of Operations

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

(In thousands)	September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009	September 30, 2009
Net revenue	$ 138,354	$ 143,137	$ 145,077	$ 151,995	$ 162,399
Costs and expenses:					
Cost of revenue	45,499	45,019	46,210	48,235	53,093
Sales and marketing	21,462	21,447	20,502	19,080	19,860
General and administrative	38,729	38,236	37,540	41,566	43,622
Depreciation and amortization	23,174	26,310	27,804	29,711	32,696
Total costs and expenses	128,864	131,012	132,056	138,592	149,271
Income from operations	9,490	12,125	13,021	13,403	13,128
Other income (expense):					
Interest expense	(1,912)	(3,153)	(2,535)	(2,172)	(2,147)
Interest and other income (expense)	(144)	492	(91)	(267)	523
Total other income (expense)	(2,056)	(2,661)	(2,626)	(2,439)	(1,624)
Income before income taxes	7,434	9,464	10,395	10,964	11,504
Income taxes	2,199	2,620	3,807	3,973	3,900
Net income	$ 5,235	$ 6,844	$ 6,588	$ 6,991	$ 7,604

Consolidated Statements of Income, as a Percentage of Net Revenue (Unaudited):

(Percent of net revenue)	September 30, 2008	December 31, 2008	March 31, 2009	June 30, 2009	September 30, 2009
Net revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses					
Cost of revenue	32.9%	31.5%	31.9%	31.7%	32.7%
Sales and marketing	15.5%	15.0%	14.1%	12.6%	12.2%
General and administrative	28.0%	26.7%	25.9%	27.3%	26.9%
Depreciation and amortization	16.7%	18.4%	19.2%	19.5%	20.1%
Total costs and expenses	93.1%	91.5%	91.0%	91.2%	91.9%
Income from operations	6.9%	8.5%	9.0%	8.8%	8.1%
Other income (expense)					
Interest expense	-1.4%	-2.2%	-1.7%	-1.4%	-1.3%
Interest and other income (expense)	-0.1%	0.3%	-0.1%	-0.2%	0.3%
Total other income (expense)	-1.5%	-1.9%	-1.8%	-1.6%	-1.0%
Income before income taxes	5.4%	6.6%	7.2%	7.2%	7.1%
Income taxes	1.6%	1.8%	2.6%	2.6%	2.4%
Net income	3.8%	4.8%	4.5%	4.6%	4.7%

Due to rounding, totals may not equal the sum of the line items in the table above.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Third Quarter 2009 Overview

To aid in understanding our operating results for the periods covered by this report, we have provided an executive overview and a summary of the significant events that affected the most recent reporting period. These sections should be read in conjunction with the other portions of management's discussion and analysis of our financial condition and results of operations, our "Risk Factors" section, and our consolidated financial statements and notes included in this report.

The highlights and significant events of the three months ended September 30, 2009 and the impact on our operating results compared to the three months ended, June 30, 2009 were as follows:

Net Revenue - Net revenue increased $10.4 million or 6.8% from $152.0 million in the three months ended June 30, 2009 to $162.4 million in the three months ended September 30, 2009. The growth rate continued to be impacted by the broader economic environment. Also, the market for hosting services continues to be highly competitive and we face increasing competition from our existing competitors as well as new market entrants resulting in downward pricing pressure for some of our offerings. Partially offsetting the negative impact was a weakening U.S. dollar relative to the pound sterling, which resulted in an increase to revenue of approximately $2.4 million or 1.5% for the three months ended September 30, 2009 compared to the three months ended June 30, 2009 with a minimal impact to our margins as the majority of these customers are invoiced, and substantially all of our expenses associated with these customers are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. In addition, for the three months ended June 30, 2009, revenue was impacted by approximately $2.4 million in service credits related to service interruptions in a portion of our Grapevine, Texas data center. Customer revenue lost in the third quarter due to downgrades and defection churn has been offset with customer upgrades and the addition of new customers. For the three months ended June 30, 2009 we experienced a monthly average churn rate of 1.0%, which slightly increased to 1.1% for the three months ended September 30, 2009, while net upgrades remained flat at 1.2% for the three months ended June 30, 2009 and September 30, 2009. Overall, our installed base had growth at an average rate of 0.2% per month for the three months ended June 30, 2009 compared to growth at an average rate of 0.1% for the three months ended September 30, 2009.

Income from Operations - Income from operations decreased $0.3 million or 2.2% from $13.4 million for the three months ended June 30, 2009 to $13.1 million for the three months ended September 30, 2009. Operating income margin was 8.8% for the three months ended June 30, 2009 compared to 8.1% for the three months ended September 30, 2009.

Adjusted EBITDA -Adjusted EBITDA increased $3.3 million or 6.9% from $48.1 million for the three months ended June 30, 2009 to $51.4 million in the three months ended September 30, 2009. Adjusted EBITDA as a percentage of revenue was 31.7% for the three months ended June 30, 2009 and September 30, 2009. See the discussion of Adjusted EBITDA, a non-GAAP financial measure for additional information.

Net Income and Net Income per Share - Net income was $7.0 million, or $0.06 per share on a diluted basis for the three months ended June 30, 2009 compared to net income of $7.6 million, or $0.06 per share on a diluted basis for the three months ended September 30, 2009. The increase in net income was mainly due to revenue growth. Lower general and administrative expenses, and sales and marketing expenses as a percentage of revenue, as well as a decrease in other expense for the three months ended September 30, 2009 compared to the three months ended June 30, 2009, were offset by an increase in cost of revenue, and depreciation and amortization expense as a percentage of revenue.

In February 2009 and July 2009, Rackspace entered into agreements with DuPont Fabros Technology to lease approximately 11,000 and 36,700 square feet of technical square feet in a data center facility in the Northern Virginia area and the Chicago area, respectively. Although we have made only minimal payments for the Virginia lease and have not begun making payments for the Chicago lease, the lease accounting rules require the lease costs to be amortized on a straight-line basis beginning in the period that we have physical possession of the property. We have already commenced operations in a portion of the Virginia facility and expect to commence operations in the Chicago facility in early 2010. Non-cash rent expense for these two facilities, which we believe reflects the portion of the facilities that have not commenced operations, was $0.2 million for the three months ended June 30, 2009 and $1.9 million for the three months ended September 30, 2009 and is reflected in our cost of revenue.

We continue to make investments in our cloud computing division. During the three months ended June 30, 2009, we released the specifications for our Cloud Servers and Cloud Files APIs under the Creative Commons 3.0 Attribution open source license. During the three months ended September 30, 2009, we launched Cloud Tools, which is an online service for sharing tools, applications and services built by our strategic partners and independent developers for The Rackspace Cloud, and Rackspace Archiving, which enables our hosted email customers to automatically keep a long-term backup of incoming and outgoing email.

In July 2009, we decommissioned operations at a U.K. data center with 11,750 technical square feet due to the completion of the second phase of our data center build out at our Slough, U.K. data center in June 2009.

Quarterly Results of Operations (September 30, 2008 through September 30, 2009)

Revenue has increased sequentially in each of the quarters primarily due to increased volume of services provided, both due to an increasing number of customers over time and due to incremental services rendered to existing customers. In the three months

ended December 31, 2008 and the three months ended March 31, 2009, the growth rate was negatively impacted by the deteriorating economic conditions and the strengthening U.S. dollar versus the pound sterling. For the three months ended June 30, 2009 and the three months ended September 30, 2009, we continued to be negatively impacted by the economic conditions and decreased IT spend by our customers, but we experienced a favorable impact by a weakening U.S. dollar versus the pound sterling. For the twelve month period ended September 30, 2009, our average monthly growth in installed base was 0.1% per month.

Because of the growth of our revenue, total operating expenses increased sequentially in each of the quarters presented. During the second half of 2008, we focused on scaling our expenditures, which is evidenced in the reduction in sales and marketing, and general and administrative expenses as a percentage of revenue. Sales and marketing continued to scale through 2009 as we identified more efficient use of our sales resources. These reductions were partially offset with increasing depreciation and amortization expense resulting from equipment expenditures and facility additions to support our customer growth. Rackspace completed strategic build outs during this time period including the Slough, U.K. data center, in June 2008, the completion of the third phase of our Grapevine, Texas data center in January 2009, and the second phase of our Slough U.K. data center in June 2009, as well as capital expenditures related to the build out of a corporate facility.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Three Months Ended September 30, 2008 and September 30, 2009

Net Revenue

Our net revenue was $138.4 million for the three months ended September 30, 2008 and $162.4 million for the three months ended September 30, 2009, an increase of $24.0 million, or 17.3%. Our increase in net revenue was primarily due to increased volume of services provided, resulting from an increasing number of customer accounts and incremental services rendered to existing customers. Partially offsetting the revenue increase was the negative impact of a stronger U.S. dollar relative to the pound sterling for the three months ended September 30, 2009 compared to the three months ended September 30, 2008. Net revenue for the three months ended September 30, 2009 would have been approximately $6.5 million higher had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year. Net revenue includes non-recurring revenue of $4.6 million for the three months ended September 30, 2008 compared to $4.5 million for the three months ended September 30, 2009, a decrease of 2.0% as a result of decreased customer overage charges.

Cost of Revenue

Our cost of revenue was $45.5 million for the three months ended September 30, 2008, and $53.1 million for the three months ended September 30, 2009, an increase of $7.6 million, or 16.7%. Of this increase, $2.4 million was attributable to an increase in salaries, benefits, and share-based compensation expense. Total compensation increased as a result of the hiring of data center and support personnel to support our growth. The cost increase was further attributable to an increase in license costs of $2.5 million and an increase in data center costs of $1.6 million related to power and rent.

Sales and Marketing Expenses

Our sales and marketing expenses were $21.5 million for the three months ended September 30, 2008 and $19.9 million for the three months ended September 30, 2009, a decrease of $1.6 million, or 7.4%. Of this decrease, $2.7 million was attributable to advertising and Internet-related marketing expenditures, with a focus on areas that generate more efficient growth opportunities. The overall decrease was partially offset by a $1.1 million increase in salaries, commissions, benefits, and share-based compensation expense. Total compensation increased as a result of the hiring of additional sales and marketing personnel and the impact of commissions associated with increased sales.

General and Administrative Expenses

Our general and administrative expenses were $38.7 million for the three months ended September 30, 2008 and $43.6 million for the three months ended September 30, 2009, an increase of $4.9 million, or 12.7%. Of this increase, $3.7 million was attributable to an increase in salaries and benefits, of which share-based compensation expense increased by $1.0 million as a result of stock option and restricted stock unit grants to employees in 2008 and in the first nine months of 2009. Bad debt expense increased by $1.2 million due to customers generally extending payment terms or not being able to pay as a result of the current economic conditions.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $23.2 million for the three months ended September 30, 2008 and $32.7 million for the three months ended September 30, 2009, an increase of $9.5 million, or 40.9%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs (primarily the expansion of our data center in Grapevine, Texas and the opening, as well as expansion, of the data center in Slough, U.K.) and internally developed and purchased software.

Other Income (Expense)

Our interest expense was $1.9 million for the three months ended September 30, 2008 and $2.1 million for the three months ended September 30, 2009, an increase of $0.2 million or 10.5%. Interest expense was partially offset by capitalized interest of $0.5 million for the three months ended September 30, 2008 and $0.2 million for the three months ended September 30, 2009. Although we had an increased level of indebtedness in 2009, interest expense did not increase significantly due to lower borrowing rates.

Interest and other income (expense) was $(0.1) million for the three months ended September 30, 2008 and $0.5 million for the three months ended September 30, 2009. In the three months ended September 30, 2008, we recognized $0.4 million in interest income and foreign currency losses of $(0.5) million. In the three months ended September 30, 2009, we recognized $0.1 million of interest income and $0.4 million of foreign currency gains.

Income Taxes

Our effective tax rate increased from 29.6% for the three months ended September 30, 2008 to 33.9% for the three months ended September 30, 2009. The differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income, state income taxes, research and development credits, and permanent differences between the book and tax treatment of certain items. Our foreign earnings are generally taxed at lower rates than in the United States.

Nine months ended September 30, 2008 and September 30, 2009

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

(In thousands)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Net revenue	$ 388,796	$ 459,471
Costs and expenses:		
Cost of revenue	127,564	147,538
Sales and marketing	58,876	59,442
General and administrative	110,470	122,728
Depreciation and amortization	63,862	90,211
Total costs and expenses	360,772	419,919
Income from operations	28,024	39,552
Other income (expense):		
Interest expense	(5,076)	(6,854)
Interest and other income (expense)	276	165
Total other income (expense)	(4,800)	(6,689)
Income before income taxes	23,224	32,863
Income taxes	8,365	11,680
Net income	$ 14,859	$ 21,183

Consolidated Statements of Income, as a Percentage of Net Revenue (Unaudited):

(Percent of net revenue)	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2009
Net revenue	100.0%	100.0%
Costs and expenses		
Cost of revenue	32.8%	32.1%
Sales and marketing	15.1%	12.9%
General and administrative	28.4%	26.7%
Depreciation and amortization	16.4%	19.6%
Total costs and expenses	92.8%	91.4%
Income from operations	7.2%	8.6%
Other income (expense)		
Interest expense	-1.3%	-1.5%
Interest and other income (expense)	0.1%	0.0%
Total other income (expense)	-1.2%	-1.5%
Income before income taxes	6.0%	7.2%
Income taxes	2.2%	2.5%
Net income	3.8%	4.6%

Due to rounding, totals may not equal the sum of the line items in the table above.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Net Revenue

Our net revenue was $388.8 million for the nine months ended September 30, 2008 and $459.5 million for the nine months ended September 30, 2009, an increase of $70.7 million, or 18.2%. Our increase in net revenue was primarily due to increased volume of services provided, due to both an increasing number of customers and incremental services rendered to existing customers. Partially offsetting the revenue increase was the negative impact of a stronger U.S. dollar relative to the pound sterling for the nine months ended September 30, 2009 compared to the nine months ended September 30, 2008. Net revenue for the nine months ended September 30, 2009, would have been approximately $30 million higher had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year. Net revenue includes non-recurring revenue of $13.9 million for the nine months ended September 30, 2008 compared to $12.7 million for the nine months ended September 30, 2009, a decrease of 8.7% as a result of decreased customer overage charges.

Cost of Revenue

Our cost of revenue was $127.6 million for the nine months ended September 30, 2008 and $147.5 million for the nine months ended September 30, 2009, an increase of $20.0 million, or 15.6%. Of this increase, $7.0 million was attributable to an increase in salaries, benefits, and share-based compensation expense. Total compensation increased as a result of the hiring of data center and support personnel to support our growth. The cost increase was further attributable to an increase in license costs of $9.1 million and an increase in data center costs of $3.8 million related to power and bandwidth.

Sales and Marketing Expenses

Our sales and marketing expenses were $58.9 million for the nine months ended September 30, 2008 and $59.4 million for the nine months ended September 30, 2009, an increase of $0.5 million, or 0.8%. Of this increase, $5.3 million was attributable to an increase in salaries, commissions, benefits, and share-based compensation expense. Total compensation increased as a result of the hiring of additional sales and marketing personnel and the impact of commissions associated with increased sales. Partially offsetting the increase was a $4.7 million decrease to advertising and Internet-related marketing expenditures as a result of a concentrated effort to decrease marketing spend, with a focus on areas that generate more efficient growth opportunities.

General and Administrative Expenses

Our general and administrative expenses were $110.5 million for the nine months ended September 30, 2008 and $122.7 million for the nine months ended September 30, 2009, an increase of $12.2 million, or 11.0%. Of this increase, $6.9 million was attributable to an increase in salaries and benefits, of which share-based compensation expense increased by $3.0 million as a result of stock option and restricted stock unit grants to employees in 2008 and in the first nine months of 2009. Bad debt expense increased $4.6 million due to customers generally extending payment terms or not being able pay as a result of the current economic conditions. We also experienced increases in internal software support and maintenance of $1.3 million. Partially offsetting these increases were decreases to travel expenditures of $1.1 million.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $63.9 million for the nine months ended September 30, 2008 and $90.2 million for the nine months ended September 30, 2009, an increase of $26.3 million, or 41.2%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets including increases in data center equipment and leasehold improvements due to data center build outs (primarily the expansion of our data center in Grapevine, Texas and the opening, as well as expansion, of the data center in Slough, U.K.) and internally developed and purchased software, as well as intangible assets acquired through acquisitions.

Other Income (Expense)

Our interest expense was $5.1 million for the nine months ended September 30, 2008 and $6.9 million for the nine months ended September 30, 2009, an increase of $1.8 million, or 35.3%. This relative increase was primarily due to the increased level of indebtedness, which was mostly offset by decreased borrowing rates. Interest expense was partially offset by capitalized interest of $1.7 million for the nine months ended September 30, 2008 and $0.7 million for the nine months ended September 30, 2009.

Interest and other income (expense) was $0.3 million for the nine months ended September 30, 2008 and $0.2 million for the nine months ended September 30, 2009. In the nine months ended September 30, 2008, we recognized $0.9 million in interest income partially offset by foreign currency losses of $(0.6) million. In the nine months ended September 30, 2009, we recognized $0.2 million of interest income.

Income Taxes

Our effective tax rate was decreased from 36.0% for the nine months ended September 30, 2008 to 35.5% for the nine months ended September 30, 2009, primarily as a result of a larger portion of our earnings being realized in countries where we have lower statutory rates than compared to the nine months ended September 30, 2008. The differences between our effective tax rate and the

U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income, state income taxes, research and development credits, and permanent differences between the book and tax treatment of certain items. Our foreign earnings are generally taxed at lower rates than in the United States.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Liquidity and Capital Resources

At September 30, 2009, our cash and cash equivalents balance was $103.0 million. We use our cash and cash equivalents, cash flow from operations, capital leases, and existing amounts available under our revolving credit facility as our primary sources of liquidity. We believe that internally generated cash flows, along with cash and cash equivalents currently available to us, are sufficient to support business operations and capital expenditures, in addition to a level of discretionary investments.

In June 2009, we amended our revolving credit facility agreement to provide us the ability to borrow from our credit facility in pounds sterling and euros, rather than restricting borrowings to U.S. dollars. We are limited to borrowings of $75 million in alternate currencies. The option to borrow in other foreign currencies will provide protection against fluctuations in currencies in the countries in which we do business.

We maintain debt levels that we establish through consideration of a number of factors, including cash flow expectations, cash requirements for operations, investment plans (including acquisitions), and our overall cost of capital. Outstanding debt under our line of credit decreased from $200.0 million as of December 31, 2008 to $50.0 million at September 30, 2009. The decrease in amounts outstanding under our line of credit was due to the repayment of $150.0 million in the nine months ended September 30, 2009. As of September 30, 2009, we had an additional $194.3 million available for future borrowings.

We have vendor finance arrangements in the form of leases and notes payable with our major vendors that permit us to finance our purchases of data center equipment. As of December 31, 2008 and September 30, 2009, we had $100.4 million and $118.0 million outstanding with respect to these arrangements. We believe our borrowings from these arrangements will continue to be available and, as long as they are competitive, we will continue to finance purchases through these arrangements.

Capital Expenditure Requirements

For the full year of 2009, we expect to have total capital expenditures of approximately $185 million, including $110 million dollars for customer gear, $35 million for data centers, $15 million for office space, and $25 million for capitalized software and other.

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. Our money market mutual funds invest exclusively in high-quality, short-term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies. We actively monitor the third-party depository institutions that hold our cash and cash equivalents. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances may exceed the Federal Deposit Insurance Corporation or "FDIC" insurance limits or are not insured by the FDIC. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted if the underlying depository institutions fail or could be subject to other adverse conditions in the financial markets. To date, we have experienced no loss or lack of access to our invested cash and cash equivalents; however, we can provide no assurances that access to our funds will not be impacted by adverse conditions in the financial markets.

We currently believe that current cash and cash equivalents, cash generated by operations, as well as available borrowings through vendor financing arrangements and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future. Our long-term future capital requirements will depend on many factors, most importantly our growth of revenue, and our investments in new technologies and services. Our ability to generate cash depends on our financial performance, general economic conditions, technology trends and developments, and other factors. We could be required, or could elect, to seek additional funding in the form of debt or equity.

The following table sets forth a summary of our cash flows for the periods indicated:

	Nine Months Ended (Unaudited)	
(In thousands)	September 30, 2008	September 30, 2009
Cash provided by operating activities	$ 102,213	$ 131,204
Cash used in investing activities	$ (132,849)	$ (89,462)
Cash provided by (used in) financing activities	$ 266,879	$ (179,045)
Acquisition of property and equipment by capital leases and equipment notes payable	$ 70,642	$ 55,984

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Operating Activities

Net cash provided by operating activities is primarily a function of our profitability, the amount of non-cash charges included in our profitability, and our working capital management. Net cash provided by operating activities was $102.2 million in the first nine months of 2008 compared to $131.2 million in the first nine months of 2009, an increase of $29.0 million or 28.4%. Net income increased from $14.9 million in the first nine months of 2008 to $21.2 million in the first nine months of 2009. A summary of the significant changes in non-cash adjustments affecting net income and changes in assets and liabilities impacting operating cash flows is as follows:

- Depreciation and amortization expense was $63.9 million in the first nine months of 2008 compared to $90.2 million in the first nine months of 2009. The increase in depreciation and amortization was due to the purchases of servers, networking gear and computer software (internally developed technology), and leasehold improvements, as well as amortization of intangibles related to acquisitions.

- Our provision for bad debts and customer credits increased from $2.3 million in the first nine months of 2008 to $8.8 million in the first nine months of 2009 due to certain customers' inability to pay as a result of the current economic conditions.

- Share-based compensation expense was $10.9 million in the first nine months of 2008 compared to $14.9 million in the first nine months of 2009. The increase in expense was due to stock options and restricted stock units granted in 2008 and the first nine months of 2009.

- The change in accounts receivable was a cash outflow of $5.4 million in the first nine months of 2008 compared to a cash outflow of $17.0 million in the first nine months of 2009. Our accounts receivable balance has increased during the first nine months of 2009 as a result of increased sales and slower customer payment patterns that are being influenced by the current economic conditions.

- The change in income taxes receivable was a cash outflow of $10.8 million in the first nine months of 2008 compared to a cash inflow of $8.2 million in the first nine months of 2009. As we anticipated a net loss for tax in 2008, the September 30, 2008 balance sheet included an income tax receivable for a carryback claim for our loss. We received federal income tax refunds totaling $10.1 million in 2009, related to the 2008 tax period.

- The change in accounts payable and accrued expenses created a $17.7 million cash inflow in the first nine months of 2008 compared to a $2.6 million cash inflow in the first nine months of 2009. The changes resulted from the timing of payments for trade payables.

Investing Activities

Net cash used in investing activities was primarily capital expenditures to meet the demands of our growing customer base. Historically our main investing activities have consisted of purchases of IT equipment for our data center infrastructure, furniture, equipment and leasehold improvements to support our operations.

Our net cash used in investing activities was $132.8 million for the first nine months of 2008 compared to $89.5 million for the first nine months of 2009, a decrease of $43.3 million, or 32.6%.

We also purchase equipment through capital lease arrangements and other types of vendor financing that do not require an initial outlay of cash. Purchases through these arrangements decreased from $70.6 million for the first nine months of 2008 to $56.0 million for the first nine months of 2009.

The combined total for cash and non-cash capital expenditures for property and equipment decreased from $203.5 million for the first nine months of 2008 to $138.6 million for the first nine months of 2009. Of the 2009 amount, $80.4 million was used to purchase dedicated customer equipment, $29.3 million for data center build outs, $9.3 million related to build out of office space and $19.6 million was invested in capitalized software, including internally developed software that is focused on improving our service offerings, and other purchases. The decrease in combined capital expenditures resulted primarily from a decline of $36.3 million in data center build outs and $23.6 million from office build outs, which mostly resulted from the renovations for our headquarters facility in 2008.

Financing Activities

Net cash provided by (used in) financing activities was $266.9 million for the first nine months of 2008 compared to $(179.0) million for the first nine months of 2009, a change of $445.9 million. This was due primarily to $142.7 million in net advances on our revolving credit facility for the first nine months of 2008 compared to repayments of $150.0 million on our revolving credit facility in the first nine months of 2009. Principal payments on capital leases and notes payable were $28.4 million for the first nine months of 2008 compared to $38.4 million for the first nine months of 2009. In addition, proceeds from exercises of stock options and the related excess tax benefits increased by $4.6 million in the first nine months of 2009.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Contractual Obligations, Commitments and Contingencies

The following table summarizes our contractual obligations as of September 30, 2009 (unaudited):

(In thousands)	Total	2009	2010-2011	2012-2013	2014 and Beyond
Capital leases (1)	$ 117,225	$ 12,082	$ 86,618	$ 18,525	$ -
Operating leases	243,607	4,075	35,697	41,227	162,608
Purchase commitments	5,839	1,086	4,222	531	-
Revolving credit facility (2)	50,000	-	-	50,000	-
Software and equipment notes (2)	8,505	651	6,974	880	-
Total contractual obligations	$ 425,176	$ 17,894	$ 133,511	$ 111,163	$ 162,608

(1) Represents principal and interest.
(2) Represents principal only.

Leases

Capital and finance method leases are primarily related to expenditures for IT equipment. Our operating leases are primarily for data center facilities and, to a lesser extent, office space.

In July 2009, Rackspace entered into an agreement to lease approximately 36,700 raised square feet and approximately 10,000 square feet of office and storage space in a data center facility in the Chicago area. The operating lease has a term of 15 years from the commencement date. Rackspace has a one-time option to terminate the lease after ten years subject to a penalty, as well as upon expiration of the lease, to renew the lease for two successive five year periods.

Purchase commitments

Our purchase commitments are primarily related to bandwidth for our data centers.

Revolving Credit Facility

We have a credit facility with a committed amount of $245.0 million. As of September 30, 2009, we had $50.0 million of revolving loans outstanding and a $0.7 million letter of credit outstanding under the credit facility, and $194.3 million available for future borrowings.

In December 2007, we entered into an interest rate swap agreement converting a portion of our interest rate exposure from a floating rate basis to a fixed rate of 4.135% per annum. The interest rate swap agreement has a notional amount of $50.0 million and matures in December 2010.

Software and Equipment Notes

We finance certain software and equipment from third-party vendors. The terms of these arrangements are generally one to five years.

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities or any other entity defined as such within ASC Topic 810, *Consolidation* (formerly FASB Interpretation No. 46 (Revised 2003), *Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51*). These entities are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

We have entered into various indemnification arrangements with third parties, including vendors, customers, landlords, our officers and directors, stockholders of acquired companies, and third parties to whom and from whom we license technology. Generally, these indemnification agreements require us to reimburse losses suffered by third parties due to various events, such as lawsuits arising from patent or copyright infringement or our negligence. Certain of these agreements require us to indemnify the other party against certain claims relating to property damage, personal injury or the acts or omissions by us, our employees, agents or representatives. To date, there have been no claims against us or our customers pertaining to such indemnification provisions and no amounts have been recorded.

These indemnification obligations are considered off-balance sheet arrangements in accordance with ASC Topic 460, Guarantees (formerly FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*). To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnification obligations in our financial statements.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with GAAP. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, significant judgment is required in making estimates, and selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. These judgments and estimates affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We consider these policies requiring significant management judgment and estimates used in the preparation of our financial statements to be critical accounting policies.

We review our estimates and judgments on an ongoing basis, including those related to revenue recognition, service credits, allowance for doubtful accounts, property and equipment, goodwill and intangibles, contingencies, the fair valuation of stock related to share-based compensation, software development, and income taxes.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances to determine the carrying values of assets and liabilities. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected. We believe the following accounting policies to be critical to the judgments and estimates used in the preparation of our financial statements.

- Revenue recognition;
- Valuation of accounts receivable and service credits;
- Property, equipment, and other long lived assets;
- Goodwill and intangible assets;
- Contingencies;
- Share-based compensation;
- Software development; and
- Income taxes.

A description of our critical accounting policies that involve significant management judgment appears in our Annual Report filed on Form 10-K filed with the SEC on March 2, 2009, as amended under "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies."

Recent Accounting Pronouncements

For a full description of new accounting pronouncements, including the respective dates of adoption and impact on results of operation and financial condition, see Note 2 of the Consolidated Financial Statements.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Power Prices. We are a large consumer of power. During the first nine months of 2009, we expensed approximately $13.2 million that was paid to utility companies to power our data centers, representing 2.9% of our net revenue. Because we anticipate further revenue growth for the foreseeable future, we expect to consume more power in the future. Power costs vary by geography, the source of power generation, seasonal fluctuations, and are subject to certain proposed legislation that may increase our exposure to increased power costs. Our largest exposure to energy prices based on consumption currently exists at our Grapevine, Texas data center in the Dallas-Fort Worth area, a deregulated energy market. In August 2008, we entered into a fixed price contract with a provider of electricity for power for our Grapevine data center. The contract allows the company to periodically convert the price to a floating market price during the arrangement. The contract is for 19 months, and allows the provider an option to extend the contract for an additional 19 months. Also, in June 2009, we entered into a fixed price contract for 12 months for our Slough U.K. data center.

Interest Rates. Our main credit facility is a revolving line of credit with a base rate determined by the London Interbank Offered Rate, or LIBOR. This market rate of interest is fluctuating and exposes our interest expense to risk. Our credit agreement obligates us to hedge part of that interest rate risk with appropriate instruments, such as interest rate swaps or interest rate options. On December 10, 2007, we entered into an at-the-market fixed-payer interest rate swap with a notional amount of $50.0 million at an annual rate of 4.135%. This swap essentially fixes the rate we pay on the first $50.0 million outstanding on our revolving credit facility. As we borrow more, we may enter into additional swaps to continuously control our interest rate risk. Generally, we do not hedge our complete exposure. As a result, we may be exposed to interest rate risk on the un-hedged portion of our borrowings. For example, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of September 30, 2009 we did not have exposure to interest rate risk as we only had $50.0 million outstanding on our revolving credit facility.

Leases. The majority of our purchases of customer gear are vendor financed through capital leases with fixed payment terms generally over three to five years, coinciding with the depreciation period of the equipment. As of September 30, 2009, we have a liability for these leases of $109.5 million on our consolidated balance sheet, of which $46.4 million is classified as current. Although we believe our borrowings from these arrangements will continue to be available, we have exposure that vendor financing may no longer be available or the borrowing rates, which are fixed rates, may increase.

Foreign Currencies. The majority of our customers are invoiced, and substantially all of our expenses are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. A relatively insignificant amount of customers are invoiced in currencies other than the applicable functional currency, such as the euro. Therefore, our results of operations and cash flows are subject to fluctuations in foreign currency exchange rates. We also have exposure to foreign currency transaction gains and losses as the result of certain receivables due from our foreign subsidiaries, which are denominated in both the U.S. dollar and the pound sterling. During the first nine months of 2009, we recognized foreign currency losses of $(0.2) million within other income (expense). We have not entered into any currency hedging contracts, although we may do so in the future. We recently amended our revolving credit facility agreement to provide us the ability to borrow from our credit facility in pounds sterling and euros, rather than restricting borrowings to U.S. dollars. We currently do not have borrowings in any alternative currencies from our credit facility. As we grow our international operations, our exposure to foreign currency risk could become more significant.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

ITEM 4. - CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), as amended, as of the end of the period covered by this quarterly report (the “Evaluation Date”). Based on this evaluation, our chief executive officer and chief financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to the Company, including our consolidated subsidiaries, required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting

There were no changes in our internal controls over financial reporting during our most recent fiscal quarter reporting period identified in connection with management’s evaluation as required and defined by paragraph (d) of Rules 12a-15 and 15d-15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

The SEC, as required by Section 404 of the Sarbanes-Oxley Act, adopted rules requiring every company that files reports with the SEC to include a management report on such company’s internal control over financial reporting in its annual report. In addition, our independent registered public accounting firm must attest to our internal control over financial reporting. Our first annual report on Form 10-K did not include a report of management’s assessment regarding internal control over financial reporting or an attestation report from our independent registered public accounting firm due to a transition period established by SEC rules applicable to newly public companies. Management will be required to provide an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2009.

Inherent Limitations of Internal Controls

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. In addition, on October 22, 2008, *Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston*, was filed in the 37th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us. We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

ITEM IA – RISK FACTORS

Risks Related to Our Business and Industry

Our physical infrastructure is concentrated in a few facilities and any failure in our physical infrastructure or services could lead to significant costs and disruptions and could reduce our revenue, harm our business reputation and have a material adverse effect on our financial results.

Our network, power supplies and data centers are subject to various points of failure, problems with our cooling equipment, generators, uninterruptible power supply, or UPS, routers, switches, or other equipment, whether or not within our control, could result in service interruptions for some or all of our customers as well as equipment damage. Because our hosting services do not require geographic proximity of our data centers to our customers, our hosting infrastructure is consolidated into a few large facilities. While data backup services and disaster recovery services are available as a part of our hosting services offerings, the majority of our customers do not elect to pay the additional fees required to have disaster recovery services store their backup data offsite in a separate facility, which could substantially mitigate the adverse effect to a customer from a single data center failure. Accordingly, any failure or downtime in one of our data center facilities could affect a significant percentage of our customers. The total destruction or severe impairment of any of our data center facilities could result in significant downtime of our services and the loss of customer data. Since our ability to attract and retain customers depends on our ability to provide customers with highly reliable service, even minor interruptions in our service could harm our reputation. The services we provide are subject to failure resulting from numerous factors, including:

- Power loss;
- Equipment failure;
- Human error or accidents;
- Sabotage and vandalism;
- Failure by us or our vendors to provide adequate service or maintenance to our equipment;
- Network connectivity downtime;
- Improper building maintenance by the landlords of the buildings in which our facilities are located;
- Physical or electronic security breaches;
- Fire, earthquake, hurricane, tornado, flood, and other natural disasters;
- Water damage; and
- Terrorism.

Additionally, in connection with the expansion or consolidation of our existing data center facilities from time to time, there is an increased risk that service interruptions may occur as a result of server relocation or other unforeseen construction-related issues.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

We have experienced interruptions in service in the past, due to such things as power outages, power equipment failures, cooling equipment failures, routing problems, hard drive failures, database corruption, system failures, software failures, and other computer failures. For example, during the second quarter of 2009, portions of our data center in Grapevine, Texas experienced certain service interruptions due to power system failures. These system failures resulted in downtime for a portion of the servers located in the facility. As a result of the downtime, we extended approximately $2.4 million in service credits to our customers and our reputation may have suffered. While we have not experienced larger than normal customer attrition following these events, the extent to which our reputation suffered is difficult to assess. We have taken and are continuing to take certain steps to avoid this situation in the future including upgrades to our electrical and mechanical infrastructure. However, service interruptions due to equipment failures, power outages, natural disasters, accidents, or otherwise could still materially impact our business.

Any future interruptions could:

- Cause our customers to seek damages for losses incurred;
- Require us to replace existing equipment or add redundant facilities;
- Affect our reputation as a reliable provider of hosting services;
- Cause existing customers to cancel or elect to not renew their contracts; or
- Make it more difficult for us to attract new customers.

Any of these events could materially increase our expenses or reduce our revenue, which would have a material adverse effect on our operating results.

Customers with mission-critical applications could potentially expose us to lawsuits for their lost profits or damages, which could impair our financial condition.

Because our hosting services are critical to many of our customers' businesses, any significant disruption in our services could result in lost profits or other indirect or consequential damages to our customers. Although we require our customers to sign agreements that contain provisions attempting to limit our liability for service outages, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a service interruption or other Internet site or application problems that they may ascribe to us. The outcome of any such lawsuit would depend on the specific facts of the case and any legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may exceed our liability insurance coverage by unknown but significant amounts, which could materially impair our financial condition.

We provide service level commitments to our customers, which could require us to issue credits for future services if the stated service levels are not met for a given period and could significantly decrease our revenue and harm our reputation.

Our customer agreements provide that we maintain certain service level commitments to our customers relating primarily to network uptime, critical infrastructure availability, and hardware replacement. If we are unable to meet the stated service level commitments, we may be contractually obligated to provide these customers with credits for future services. As a result, a failure to deliver services for a relatively short duration could cause us to issue these credits to a large number of affected customers. In addition, we cannot be assured that our customers will accept these credits in lieu of other legal remedies that may be available to them. Our failure to meet our commitments could also result in substantial customer dissatisfaction or loss. Because of the loss of future revenue through these credits, potential customer loss and other potential liabilities, our revenue could be significantly impacted if we cannot meet our service level commitments to our customers.

If we fail to hire and retain qualified employees and management personnel, our growth strategy and our operating results could be harmed.

Our growth strategy depends on our ability to identify, hire, train, and retain executives, IT professionals, technical engineers, operations employees, and sales and senior management personnel who maintain relationships with our customers and who can provide the technical, strategic, and marketing skills required for our company to grow. There is a shortage of qualified personnel in these fields, specifically in the San Antonio, Texas area, where we are headquartered and a majority of our employees are located. We compete with other companies for this limited pool of potential employees. There is no assurance that we will be able to recruit or retain qualified personnel, and this failure could cause our operations and financial results to be negatively impacted.

Our success and future growth also depends to a significant degree on the skills and continued services of our management team, especially Graham Weston, our Chairman, and A. Lanham Napier, our Chief Executive Officer and President. We do not have long-term employment agreements with any members of our management team, including Messrs. Weston and Napier. Mr. Napier is the only member of our management team on whom we maintain key man insurance.

If we are unable to maintain a high level of customer service, customer satisfaction and demand for our services could suffer.

We believe that our success depends on our ability to provide customers with quality service that not only meets our stated commitments, but meets and then exceeds customer service expectations. If we are unable to provide customers with quality customer support in a variety of areas, we could face customer dissatisfaction, decreased overall demand for our services, and loss of revenue. In addition, our inability to meet customer service expectations may damage our reputation and could consequently limit our ability to retain existing customers and attract new customers, which would adversely affect our ability to generate revenue and negatively impact our operating results.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Our existing customers could elect to reduce or terminate the services they purchase from us because we do not have long-term contracts with our customers, which could adversely affect our operating results.

Customer contracts for our services typically have initial terms of one to two years which, unless terminated, may be renewed or automatically extended on a month-to-month basis. Our customers have no obligation to renew their services after their initial contract periods expire. Moreover, our customers could cancel their service agreements before they expire. Our costs associated with maintaining revenue from existing customers are generally much lower than costs associated with generating revenue from new customers. Therefore, a reduction in revenue from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue to retain our existing customers could have a material adverse effect on our operating results.

Our corporate culture has contributed to our success, and if we cannot maintain this culture, we could lose the innovation, creativity, and teamwork fostered by our culture, and our operating results may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity, and teamwork. If we implement more complex organizational management structures because of growth or other structural changes, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future operating results. In addition, being a publicly traded company may create disparities in personal wealth among our employees, which may adversely impact our corporate culture and employee relations.

If we are unable to manage our growth effectively, our financial results could suffer and our stock price could decline.

The growth of our business and our service offerings has strained our operating and financial resources. Further, we intend to continue expanding our overall business, customer base, headcount, and operations. Creating a global organization and managing a geographically dispersed workforce requires substantial management effort and significant additional investment in our operating and financial system capabilities and controls. If our information systems are unable to support the demands placed on them by our growth, we may be forced to implement new systems which would be disruptive to our business. We may be unable to manage our expenses effectively in the future due to the expenses associated with these expansions, which may negatively impact our gross margins or operating expenses. If we fail to improve our operational systems or to expand our customer service capabilities to keep pace with the growth of our business, we could experience customer dissatisfaction, cost inefficiencies, and lost revenue opportunities, which may materially and adversely affect our operating results.

If we are unable to adapt to evolving technologies and customer demands in a timely and cost-effective manner, our ability to sustain and grow our business may suffer.

Our market is characterized by rapidly changing technology, evolving industry standards, and frequent new product announcements, all of which impact the way hosting services are marketed and delivered. These characteristics are magnified by the continued rapid growth of the Internet and the intense competition in our industry. To be successful, we must adapt to our rapidly changing market by continually improving the performance, features, and reliability of our services and modifying our business strategies accordingly. We could also incur substantial costs if we need to modify our services or infrastructure in order to adapt to these changes. For example, our data center infrastructure could require improvements due to the development of new systems to deliver power to or eliminate heat from the servers we house or as a result of the development of new server technologies that require levels of critical load and heat removal that our facilities are not designed to provide. We may not be able to timely adapt to changing technologies, if at all. Our ability to sustain and grow our business would suffer if we fail to respond to these changes in a timely and cost-effective manner.

New technologies or industry standards have the potential to replace or provide lower cost alternatives to our hosting services. The adoption of such new technologies or industry standards could render some or all of our services obsolete or unmarketable. We cannot guarantee that we will be able to identify the emergence of all of these new service alternatives successfully, modify our services accordingly, or develop and bring new products and services to market in a timely and cost-effective manner to address these changes. If and when we do identify the emergence of new service alternatives and bring new products and services to market, those new products and services may need to be made available at lower price points than our then-current services. For example, a current managed hosting customer may determine that all or part of their service can be delivered through our cloud computing offerings at a much lower price point.

Our failure to provide services to compete with new technologies or the obsolescence of our services could lead us to lose current and potential customers or could cause us to incur substantial costs, which would harm our operating results and financial condition. Our introduction of new service alternative products and services that have lower price points than current offerings may result in our existing customers switching to the lower cost products, which could reduce our revenue and have a material, adverse effect of our operating results.

We may not be able to continue to add new customers and increase sales to our existing customers, which could adversely affect our operating results.

Our growth is dependent on our ability to continue to attract new customers while retaining and expanding our service offerings to existing customers. Growth in the demand for our services may be inhibited and we may be unable to sustain growth in our customer base for a number of reasons, such as:

- A reduction in the demand for our services due to the economic recession;
- Our inability to market our services in a cost-effective manner to new customers;
- The inability of our customers to differentiate our services from those of our competitors or our inability to effectively communicate such distinctions;
- Our inability to successfully communicate the benefits of hosting to businesses;
- The decision of businesses to host their Internet sites and web infrastructure internally or in colocation facilities as an alternative to the use of our hosting services;
- Our inability to penetrate international markets;
- Our inability to expand our sales to existing customers;
- Our inability to strengthen awareness of our brand; and
- Reliability, quality or compatibility problems with our services.

A substantial amount of our past revenue growth was derived from purchases of service upgrades by existing customers. Our costs associated with increasing revenue from existing customers are generally lower than costs associated with generating revenue from new customers. Therefore, a reduction in the rate of revenue increase or a rate of revenue decrease from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue attracting new customers or grow our revenue from existing customers for a prolonged period of time could have a material adverse effect on our operating results.

We may not be able to compete successfully against current and future competitors.

The market for hosting services is highly competitive. We expect to face additional competition from our existing competitors as well as new market entrants in the future.

Our current and potential competitors vary by size, service offerings and geographic region. These competitors may elect to partner with each other or with focused companies like us to grow their businesses. They include:

- Do-it-yourself solutions with a colocation partner such as AT&T, Equinix, SAVVIS, Switch & Data, and other telecommunications companies;
- IT outsourcing providers such as CSC, EDS, and IBM;
- Hosting providers such as AT&T, Pipex, SAVVIS, Terremark, The Planet, and Verio; and
- Large Internet companies such as Microsoft, Google, and Amazon.

The primary competitive factors in our market are: customer service and technical expertise; security reliability and functionality; reputation and brand recognition; financial strength; breadth of services offered; and price.

Many of our current and potential competitors have substantially greater financial, technical and marketing resources, larger customer bases, longer operating histories, greater brand recognition, and more established relationships in the industry than we do. As a result, some of these competitors may be able to:

- Develop superior products or services, gain greater market acceptance, and expand their service offerings more efficiently or more rapidly;
- Adapt to new or emerging technologies and changes in customer requirements more quickly;
- Bundle hosting services with other services they provide at reduced prices;
- Take advantage of acquisition and other opportunities more readily;

- Adopt more aggressive pricing policies and devote greater resources to the promotion, marketing, and sales of their services; and
- Devote greater resources to the research and development of their products and services.

If we do not prevent security breaches, we may be exposed to lawsuits, lose customers, suffer harm to our reputation, and incur additional costs.

Our internal infrastructure has limited security controls in place, which may affect our ability to protect our equipment and hardware against security breaches. The services we offer involve the transmission of large amounts of sensitive and proprietary information over public communications networks, as well as the processing and storage of confidential customer information. Unauthorized access, computer viruses, accidents, employee error or malfeasance, fraudulent service plan orders, intentional misconduct by computer “hackers”, and other disruptions can occur that could compromise the security of our infrastructure, thereby exposing such information to unauthorized access by third parties and leading to interruptions, delays or cessation of service to our customers. Techniques used to obtain unauthorized access to, or to sabotage systems, change frequently and generally are not recognized until launched against a target. We may be unable to implement security measures in a timely manner or, if and when implemented, these measures could be circumvented as a result of accidental or intentional actions by parties within or outside of our organization. Any breaches that occur could expose us to increased risk of lawsuits, loss of existing or potential customers, harm to our reputation and increases in our security costs. Although we typically require our customers to sign agreements that contain provisions attempting to limit our liability for security breaches, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a security breach that they may ascribe to us. The outcome of any such lawsuit would depend on the specific facts of the case and legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may significantly exceed our liability insurance coverage by unknown but significant amounts, which could seriously impair our financial condition.

Our operating results may be further adversely impacted by the current recession, worldwide political and economic uncertainties and specific conditions in the markets we address. As a result, the market price of our common stock could decline.

Recently, general worldwide economic conditions have experienced a deterioration due to among other things, credit conditions resulting from the financial crisis affecting the banking system and financial markets including: slower economic activity, concerns about inflation and deflation, volatility in energy costs, decreased consumer confidence, reduced corporate profits and capital spending, the ongoing effects of the war in Iraq and Afghanistan, recent international conflicts, terrorist and military activity, and the impact of natural disasters and public health emergencies. These conditions make it extremely difficult for both us and our customers to accurately forecast and plan future business activities. Additionally, they could cause U.S. and foreign businesses to slow spending on our services, which could delay and lengthen our new customer sales cycle and cause existing customers to do one or more of the following:

- Cancel or reduce planned expenditures for our services;
- Seek to lower their costs by renegotiating their contracts with us;
- Move their hosting services in-house; or
- Switch to lower-priced solutions provided by us or our competitors.

Customer collections are our primary source of cash. We have historically grown through a combination of an increase in new customers and revenue growth from our existing customers. We have experienced a decrease in our installed base growth and if the economic recession continues or deteriorates further, we may experience additional reductions in our installed base growth, increases in churn and/or longer new customer sales cycles. If these events were to occur, we could experience a decrease in revenue and a reduction in operating margins. Further, during challenging economic times, our customers may have difficulty gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. We have experienced an increase in our allowance for doubtful accounts already, and if our customers’ ability to pay is further eroded, we may be required to increase our allowance for doubtful accounts. We cannot predict the timing, strength or duration of any economic slowdown or subsequent economic recovery. If the economy or markets in which we operate do not improve, we may record additional charges related to the impairment of goodwill and other long-lived assets, and our business, financial condition and results of operations could be materially and adversely affected.

Finally, like many other companies, our stock price decreased during the onset of the economic downturn. Although our stock price has recently increased, if investors have concerns that our business, financial condition and results of operations will be negatively impacted by a continued or worsened worldwide economic downturn, our stock price could decrease again.

If we overestimate or underestimate our data center capacity requirements, our operating margins and profitability could be adversely affected.

The costs of construction, leasing, and maintenance of our data centers constitute a significant portion of our capital and operating expenses. In order to manage growth and ensure adequate capacity for new and existing customers while minimizing unnecessary excess capacity costs, we continuously evaluate our short and long-term data center capacity requirements. Due to the lead time in expanding existing data centers or building new data centers, we are required to estimate demand for our services as far as two years into the future. We currently plan to increase our infrastructure as required through the addition of data centers in the U.S. and internationally. In contrast to our data centers that we have established to date, several of which were acquired relatively

inexpensively as distressed assets of third parties, our current expansion plans may require us to pay full market rates for new data center facilities. If we overestimate the demand for our services and therefore overbuild our data center capacity or commit to long term facility leases, our operating margins could be materially reduced, which would materially impair our profitability.

If we underestimate our data center capacity requirements, we may not be able to service the expanding needs of our existing customers. Additionally, we may be required to limit new customer acquisition while we work to increase data center capacity to satisfy demand, either of which may materially impair our revenue growth.

We rely on a number of third-party providers for data center space, equipment and maintenance, and the loss of, or problems with, one or more of these providers may impede our growth or cause us to lose customers.

We rely on third-party providers to supply data center space, equipment and maintenance. For example, we lease data center space from third party landlords, lease or purchase equipment from equipment providers, and source equipment maintenance through third parties. While we have entered into various agreements for these products and services, any failure to obtain additional capacity or space, equipment, or maintenance, if required, would impede the growth of our business and cause our financial results to suffer. For example, if a data center landlord does not adequately maintain its facilities, or provide services for which it is responsible, we may not be able to deliver services to our customers according to our standards or at all. Further, the equipment that we purchase could be deficient in some way, thereby affecting our products and services. If, for any reason, these providers fail to provide the required services or suffer other failures, we may incur financial losses and our customers may lose confidence in our company, and we may not be able to retain these customers.

We may not be able to renew the leases on our existing facilities on terms acceptable to us, if at all, which could adversely affect our operating results.

We do not own the facilities occupied by our current data centers, but occupy them pursuant to commercial leasing arrangements. The initial terms of our main existing data center leases expire over a period ranging from 2009 to 2027, with each having at least one renewal period of no less than three years, except our older U.K. data center lease, which expires in November 2010. Data centers with leases expiring in 2009 are in the U.K. and operations have been migrated to another data center location in the U.K. Upon the expiration or termination of our data center facility leases, we may not be able to renew these leases on terms acceptable to us, if at all. If we fail to renew any data center lease and are required to move the data center to a new facility, we would face significant challenges due to the technical complexity, risk, and high costs of relocating the equipment. For example, if we are required to migrate customer servers to a new facility, such migration could result in significant downtime for our affected customers. This could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Even if we are able to renew the leases on our existing data centers, we expect that rental rates, which will be determined based on then-prevailing market rates with respect to the renewal option periods and which will be determined by negotiation with the landlord after the renewal option periods, will be higher than rates we currently pay under our existing lease agreements. If we fail to increase revenue in our existing data centers by amounts sufficient to offset any increases in rental rates for these facilities, our operating results may be materially and adversely affected.

We rely on third-party hardware that may be difficult to replace or could cause errors or failures of our service, which could adversely affect our operating results or harm our reputation.

We rely on hardware acquired from third parties in order to offer our services. This hardware may not continue to be available on commercially reasonable terms in quantities sufficient to meet our business needs, which could adversely affect our ability to generate revenue. Any errors or defects in third-party hardware could result in errors or a failure of our service, which could harm our reputation and operating results. Indemnification from hardware providers, if any, would likely be insufficient to cover any damage to our business or our customers resulting from such hardware failure.

We rely on third-party software that may be difficult to replace or which could cause errors or failures of our service that could lead to lost customers or harm to our reputation.

We rely on software licensed from third parties to offer our services. This software may not continue to be available to us on commercially reasonable terms, or at all. Any loss of the right to use any of this software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained, and integrated, which could harm our business. Any errors or defects in third-party software or inadequate or delayed support by the third party could result in errors or a failure of our service which could harm our operating results by adversely affecting our revenue or operating costs.

Increased energy costs, power outages, and limited availability of electrical resources may adversely affect our operating results.

Our data centers are susceptible to increased regional, national or international costs of power and to electrical power outages. Our customer contracts do not allow us to pass on any increased costs of energy to our customers, which could affect our operating margins. Further, power requirements at our data centers are increasing as a result of the increasing power demands of today's servers. Increases in our power costs could impact our operating results and financial condition. Since we rely on third parties to provide our data centers with power sufficient to meet our needs, our data centers could have a limited or inadequate amount of electrical resources necessary to meet our customer requirements. We attempt to limit exposure to system downtime due to power outages by using backup generators and power supplies. However, these protections may not limit our exposure to power shortages or outages entirely. Any system downtime resulting from insufficient power resources or power outages could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Increased Internet bandwidth costs and network failures may adversely affect our operating results.

Our success depends in part upon the capacity, reliability, and performance of our network infrastructure, including the capacity leased from our Internet bandwidth suppliers. We depend on these companies to provide uninterrupted and error-free service through their telecommunications networks. Some of these providers are also our competitors. We exercise little control over these providers, which increases our vulnerability to problems with the services they provide. We have experienced and expect to continue to experience interruptions or delays in network service. Any failure on our part or the part of our third-party suppliers to achieve or maintain high data transmission capacity, reliability or performance could significantly reduce customer demand for our services and damage our business.

As our customer base grows and their usage of telecommunications capacity increases, we will be required to make additional investments in our capacity to maintain adequate data transmission speeds, the availability of which may be limited or the cost of which may be on terms unacceptable to us. If adequate capacity is not available to us as our customers' usage increases, our network may be unable to achieve or maintain sufficiently high data transmission capacity, reliability or performance. In addition, our business would suffer if our network suppliers increased the prices for their services and we were unable to pass along the increased costs to our customers.

Our operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.

Our operating results may fluctuate due to a variety of factors, including many of the risks described in this section, which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our operating results for any prior periods as an indication of our future operating performance. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of long-term future revenue. Given relatively fixed operating costs related to our personnel and facilities, any substantial adjustment to our expenses to account for lower than expected levels of revenue will be difficult and time consuming. Consequently, if our revenue does not meet projected levels, our operating expenses would be high relative to our revenue, which would negatively affect our operating performance.

If our revenue or operating results do not meet or exceed the expectations of investors or securities analysts, the price of our common stock may decline.

We could be required to repay substantial amounts of money to certain state and local governments if we lose tax exemptions or grants previously awarded to us, which could adversely affect our operating results.

In August 2007, we entered into an agreement with the State of Texas (Texas Enterprise Fund Grant) under which we may receive up to $22.0 million in state enterprise fund grants on the condition that we meet certain employment levels in the State of Texas paying an average compensation of at least $56,000 per year (subject to increases). To the extent we fail to meet these requirements, we may be required to repay all or a portion of the grants plus interest. In September 2007, we received the initial installment of $5.0 million from the State of Texas, which was recorded as a non-current liability.

On July 27, 2009, the Texas Enterprise Fund Grant agreement was amended to modify the job creation requirements. Under the amendment, the grant has been divided into four separate tranches. The first tranche, called "Basic Fund" in the amendment, is $8.5 million with a Job Target of 1,225 new jobs by December 2012 (in addition to the 1,436 jobs in place as of August 1, 2007 for a total of 2,661 jobs in Texas). We already have drawn $5.0 million of this grant. We can draw an additional $3.5 million when we reach 1,225 new jobs. If we do not create 1,225 new jobs in Texas by 2012, we will be required to repay the grant at a rate of $1,263 per job missed per year (clawback). The maximum clawback would be the amounts we draw plus 3.4% interest on such amounts per year. The remaining three tranches are at our option. We can draw an additional $13.5 million, based on the following amounts and milestones: $5.5 million if we create a total of 2,100 new jobs in Texas; another $5.25 million if we create a total of 3,000 new jobs in Texas; and $2.75 million more if we create a total of 4,000 new jobs in Texas. We are responsible for maintaining the jobs through January 2022. If we eliminate jobs for which we have drawn funds, the clawback is triggered.

In October 2008, we received a grant in partnership with the State of Texas and Alamo Community College District, which will provide us the opportunity to be reimbursed for up to $4.7 million for certain training expenses conducted through Alamo Community College over the next three years. In order to fulfill our requirements, we must meet the employment requirements defined in the original Texas Enterprise Fund Grant agreement, which is unlikely. Although we have not received any reimbursements, we are in the process of evaluating this grant and the need to renegotiate its terms.

On August 3, 2007, we entered into a lease for approximately 67 acres of land and a 1.2 million square foot facility in Windcrest, Texas, which is in the San Antonio, Texas area, to house our corporate headquarters and potentially a future data center operation. In connection with this lease, we also entered into a Master Economic Incentives Agreement ("MEIA") with the Cities of Windcrest and San Antonio, Texas, Bexar County, and certain other parties, pursuant to which we agreed to locate existing and future employees at the new facility location. The agreement requires that we meet certain employment levels each year, with an ultimate job requirement of 4,500 jobs by December 31, 2012, provided that if the job requirement in any grant agreement with the State of Texas is lower, then the job requirement under the MEIA is automatically adjusted downward. Consequently, because the Texas Enterprise Fund Grant agreement has been amended to reduce the state job requirement, we believe the job requirement under the MEIA has been reduced to 1,774. In addition, the MEIA requires that the median compensation of those employees be no less than $51,000 per

year. In exchange for meeting these employment obligations, the parties agreed to enter into the lease structure, pursuant to which, as a lessee of the Windcrest Economic Development Corporation, we will not be subject to most of the property taxes associated with the property for a 14 year period. If we fail to meet these job creation requirements, we could lose a portion or all of the tax benefit being provided during the 14 year period by having to make payments in lieu of taxes (PILOT) to the City of Windcrest. The amount of the PILOT payment would be calculated based on the amount of taxes that would have been owed for that period if the property were not exempt, and then such amount would be adjusted pursuant to certain factors, such as the percentage of employment achieved compared to the stated requirements.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

We have significant debt obligations that include restrictive covenants limiting our flexibility to manage our business; failure to comply with these covenants could trigger an acceleration of our outstanding indebtedness and adversely affect our financial position and operating results.

As of September 30, 2009, outstanding indebtedness under our credit facility totaled $50.0 million, with an outstanding letter of credit of $0.7 million. Our credit facility requires that we maintain specific financial ratios and comply with covenants, including financial covenants, which contain numerous restrictions on our ability to incur additional debt, pay dividends or make other restricted payments, sell assets, enter into affiliate transactions and take other actions. Our existing credit facility is, and any future financing arrangements may be, secured by all of our assets. If we are unable to meet the terms of the financial covenants or if we breach any of these covenants, a default could result under one or more of these agreements, which may require us to repay all amounts owed under our credit facility.

If we are unable to generate sufficient cash to repay our debt obligations when they become due and payable, either when they mature or in the event of a default, we may not be able to obtain additional debt or equity financing on favorable terms, if at all, which may negatively impact our ability to continue as a going concern.

We also have substantial equipment lease obligations, which totaled approximately $109.5 million as of September 30, 2009. The payment obligations under these equipment leases are secured by a significant portion of the hardware used in our data centers. If we are unable to generate sufficient cash flow from our operations or cash from other sources in order to meet the payment obligations under these equipment leases, we may lose the right to possess and operate the equipment used in our data centers, which would substantially impair our ability to provide our services, which could have a material adverse effect on our liquidity or results of operations.

We may require additional capital and may not be able to secure additional financing on favorable terms to meet our future capital needs, which could adversely affect our financial position and result in stockholder dilution.

In order to fund future growth, we will be dependent on significant capital expenditures. We may need to raise additional funds through equity or debt financings in the future in order to meet our operating and capital needs. We may not be able to secure additional debt or equity financing on favorable terms, or at all, at the time when we need such funding. If we are unable to raise additional funds, we may not be able to pursue our growth strategy and our business could suffer. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new equity securities we issue could have rights, preferences, and privileges senior to those of holders of our common stock. In addition, any debt financing that we may obtain in the future could have restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions.

We are exposed to commodity and market price risks that have the potential to substantially influence our profitability and liquidity.

We are a large consumer of power. During the first nine months of 2009, we expensed approximately $13.2 million to utility companies to power our data centers. We anticipate an increase in our consumption of power in the future as our sales grow. Power costs vary by locality and are subject to substantial seasonal fluctuations and changes in energy prices. Our largest exposure to energy prices currently exists at our Grapevine, Texas facility in the Dallas-Fort Worth area, where the energy market is deregulated. Power costs have historically tracked the general costs of energy, and continued increases in electricity costs may negatively impact our gross margins or operating expenses. We periodically evaluate the advisability of entering into fixed price utilities contracts. If we choose not to enter into a fixed price contract, we expose our cost structure to this commodity price risk.

The majority of our customers are invoiced, and substantially all of our expenses are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. However, some of our customers are currently invoiced in currencies other than the applicable functional currency, such as the Euro. As a result, we may incur foreign currency losses based on changes in exchange rates between the date of the invoice and the date of collection. In addition, large changes in foreign exchange rates relative to our functional currencies could increase the costs of our services to non-U.S. customers relative to local competitors, thereby causing us to lose existing or potential customers to these local competitors. Thus, our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. Further, as we grow our international operations, our exposure to foreign currency risk could become more significant. To date, we have not entered into any foreign currency hedging contracts, although we may do so in the future.

We may be accused of infringing the proprietary rights of others, which could subject us to costly and time-consuming litigation and require us to discontinue services that infringe the rights of others.

There may be intellectual property rights held by others, including issued or pending patents, trademarks, and service marks that cover significant aspects of our technologies, branding or business methods, including technologies and intellectual property we have licensed from third parties. Companies in the technology industry, and other patent and trademark holders seeking to profit from royalties in connection with grants of licenses, own large numbers of patents, copyrights, trademarks, service marks, and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. These or other parties could claim that we have misappropriated or misused intellectual property rights and any such intellectual property claim against us, regardless of merit, could be time consuming and expensive to settle or litigate and could divert the attention of our

technical and management personnel. An adverse determination also could prevent us from offering our services to our customers and may require that we procure or develop substitute services that do not infringe. For any intellectual property rights claim against us or our customers, we may have to pay damages, indemnify our customers against damages or stop using technology or intellectual property found to be in violation of a third party's rights. We may be unable to replace those technologies with technologies that have the same features or functionality and that are of equal quality and performance standards on commercially reasonable terms or at all. Licensing replacement technologies and intellectual property may significantly increase our operating expenses or may require us to restrict our business activities in one or more respects. We may also be required to develop alternative non-infringing technology and intellectual property, which could require significant effort, time, and expense.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Our use of open source software could impose limitations on our ability to provide our services, which could adversely affect our financial condition and operating results.

We utilize open source software, including Linux-based software, in providing a substantial portion of our services. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to offer our services. Additionally, the use and distribution of open source software can lead to greater risks than the use of third-party commercial software, as open source software does not come with warranties or other contractual protections regarding infringement claims or the quality of the code. From time to time parties have asserted claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes their intellectual property rights. We could be subject to suits by parties claiming infringement of intellectual property rights with respect to what we believe to be open source software. In such event, we could be required to seek licenses from third parties in order to continue using such software or offering certain of our services or to discontinue the use of such software or the sale of our affected services in the event we could not obtain such licenses, any of which could adversely affect our business, operating results and financial condition. In addition, if we combine our proprietary software with open source software in a certain manner, we could, under some of the open source licenses, be required to release the source code of our proprietary software.

We may not be successful in protecting and enforcing our intellectual property rights, which could adversely affect our financial condition and operating results.

We rely primarily on copyright, trademark, service mark, and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. We rely on copyright laws to protect software and certain other elements of our proprietary technologies, although to date we have not registered for copyright protection. We cannot assure you that any future copyright, trademark or service mark registrations will be issued for pending or future applications or that any registered or unregistered copyrights, trademarks or service marks will be enforceable or provide adequate protection of our proprietary rights. We currently have one patent in the U.S. Our patent may be contested, circumvented, found unenforceable or invalidated.

We endeavor to enter into agreements with our employees and contractors and agreements with parties with whom we do business to limit access to and disclosure of our proprietary information. The steps we have taken, however, may not prevent unauthorized use or the reverse engineering of our technology. Moreover, others may independently develop technologies that are substantially equivalent, superior to, or otherwise competitive to the technologies we employ in our services or that infringe our intellectual property. We may be unable to prevent competitors from acquiring trademarks or service marks and other proprietary rights that are similar to, infringe upon, or diminish the value of our trademarks and service marks and our other proprietary rights. Enforcement of our intellectual property rights also depends on successful legal actions against infringers and parties who misappropriate our proprietary information and trade secrets, but these actions may not be successful, even when our rights have been infringed.

In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the U.S. Despite the measures taken by us, it may be possible for a third party to copy or otherwise obtain and use our technology and information without authorization. Policing unauthorized use of our proprietary technologies and other intellectual property and our services is difficult, and litigation could become necessary in the future to enforce our intellectual property rights. Any litigation could be time consuming and expensive to prosecute or resolve, result in substantial diversion of management attention and resources, and harm our business, financial condition, and results of operations.

We may be liable for the material that content providers distribute over our network and we may have to terminate customers that provide content that is determined to be illegal, which could adversely affect our operating results.

The law relating to the liability of private network operators for information carried on, stored on, or disseminated through their networks is still unsettled in many jurisdictions. We have been and expect to continue to be subject to legal claims relating to the content disseminated on our network, including claims under the Digital Millennium Copyright Act, other similar legislation and common law. In addition, there are other potential customer activities, such as online gambling and pornography, where we, in our role as a hosting provider, may be held liable as an aider or abettor of our customers. If we need to take costly measures to reduce our exposure to these risks, terminate customer relationships and the associated revenue or defend ourselves against such claims, our financial results could be negatively affected.

Government regulation of data networks is largely unsettled, and depending on its evolution, may adversely affect our operating results.

We are subject to varying degrees of regulation in each of the jurisdictions in which we provide services. Local laws and regulations, and their interpretation and enforcement, differ significantly among those jurisdictions. Future regulatory, judicial, and legislative changes may have a material adverse effect on our ability to deliver services within various jurisdictions. National regulatory frameworks that are consistent with the policies and requirements of the World Trade Organization have only recently been, or are still being, put in place in many countries. Accordingly, many countries are still in the early stages of providing for and adapting to a liberalized telecommunications market. As a result, in these markets we may encounter more protracted and difficult procedures to obtain any necessary licenses or negotiate interconnection agreements, which could negatively impact our ability to expand in these markets or increase our operating costs in these markets.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Our ability to operate and expand our business is susceptible to risks associated with international sales and operations.

We anticipate that, for the foreseeable future, a significant portion of our revenue will continue to be derived from sources outside of the U.S. A key element of our growth strategy is to further expand our customer base internationally and successfully operate data centers in foreign markets. We have limited experience operating in foreign jurisdictions other than the U.K. and expect to rapidly grow our international operations. Managing a global organization is difficult, time consuming, and expensive. Our inexperience in operating our business globally increases the risk that international expansion efforts that we may undertake will not be successful. In addition, conducting international operations subjects us to new risks that we have not generally faced. These risks include:

- Localization of our services, including translation into foreign languages and adaptation for local practices and regulatory requirements;
- Lack of familiarity with and unexpected changes in foreign regulatory requirements;
- Longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- Difficulties in managing and staffing international operations;
- Fluctuations in currency exchange rates;
- Potentially adverse tax consequences, including the complexities of transfer pricing, foreign value added tax systems, and restrictions on the repatriation of earnings;
- Dependence on certain third parties, including channel partners with whom we do not have extensive experience;
- The burdens of complying with a wide variety of foreign laws and legal standards;
- Increased financial accounting and reporting burdens and complexities;
- Political, social, and economic instability abroad, terrorist attacks and security concerns in general; and
- Reduced or varied protection for intellectual property rights in some countries.

Operating in international markets also requires significant management attention and financial resources. The investment and additional resources required to establish operations and manage growth in other countries may not produce desired levels of revenue or profitability.

Our acquisitions may divert our management's attention, result in dilution to our stockholders and consume resources that are necessary to sustain our business.

We have made acquisitions and, if appropriate opportunities present themselves, we may make additional acquisitions or investments or enter into joint ventures or strategic alliances with other companies. Risks commonly encountered in such transactions include:

- The difficulty of assimilating the operations and personnel of the combined companies;
- The risk that we may not be able to integrate the acquired services or technologies with our current services, products, and technologies;
- The potential disruption of our ongoing business;
- The diversion of management attention from our existing business;
- The inability of management to maximize our financial and strategic position through the successful integration of the acquired businesses;
- Difficulty in maintaining controls, procedures, and policies;
- The impairment of relationships with employees, suppliers, and customers as a result of any integration;
- The loss of an acquired base of customers and accompanying revenue; and
- The assumption of leased facilities, other long-term commitments or liabilities that could have a material adverse impact on our profitability and cash flow.

As a result of these potential problems and risks, businesses that we may acquire or invest in may not produce the revenue, earnings, or business synergies that we anticipated. In addition, there can be no assurance that any potential transaction will be successfully identified and completed or that, if completed, the acquired business or investment will generate sufficient revenue to offset the associated costs or other potential harmful effects on our business.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Terrorist activity throughout the world and military action to counter terrorism could adversely impact our operating results.

Terrorist attacks and other acts of violence, as well as governments' responses to such activities, may have an adverse effect on business, financial, and general economic conditions internationally. Terrorist activities may disrupt our ability to provide our services or may increase our costs due to the need to provide enhanced security, which would have a material adverse effect on our business and results of operations. These circumstances may also adversely affect our ability to attract and retain customers, our ability to raise capital, and the operation and maintenance of our facilities. We may not have adequate property and liability insurance to cover catastrophic events or attacks brought on by terrorist attacks and other acts of violence. In addition, we depend heavily on the physical infrastructure, particularly as it relates to power, that exists in the markets in which we operate. Any damage to such infrastructure in these markets where we operate may materially and adversely affect our operating results.

We have and will continue to incur significant increased costs as a result of operating as a public company, and our management will be required to devote substantial time to new compliance initiatives.

As a public company, we have and will continue to incur significant legal, accounting, and other expenses that we did not incur as a private company. In addition, the Sarbanes-Oxley Act of 2002, as well as rules subsequently implemented by the Securities and Exchange Commission, and the New York Stock Exchange have imposed various requirements on public companies, including requiring changes in corporate governance practices. Our management and other personnel have and will need to continue to devote a substantial amount of time to these new compliance initiatives. Moreover, these rules and regulations have and are expected to continue to increase our legal and financial compliance costs, making some activities more time-consuming and costly. For example, these new rules and regulations make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantial costs to maintain the same or similar coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, our board committees or as executive officers.

In order to respond to additional regulations applicable to public companies, such as Section 404 of the Sarbanes-Oxley Act, we have hired a number of finance and accounting personnel. In the future, we may be required to hire additional full-time accounting employees to fill these and other related finance and accounting positions. Some of these positions require candidates with public company experience, and we may be unable to locate and hire such individuals as quickly as needed, if at all. In addition, new employees will require time and training to learn our business and operating processes and procedures. If our finance and accounting organization is unable for any reason to respond adequately to the increased demands resulting from being a public company, the quality and timeliness of our financial reporting may suffer and we could experience internal control weaknesses. Any consequences resulting from inaccuracies or delays in our reported financial statements could have an adverse effect on the trading price of our common stock as well as an adverse effect on our business, operating results, and financial condition.

We are in the process of evaluating our system of internal controls and may not be able to demonstrate that we can accurately report our financial results or prevent fraud. As a result, our stockholders could lose confidence in our financial reporting, which could harm our business and the trading price of our common stock.

Ensuring that we have adequate internal financial and accounting controls and procedures in place so that we can produce accurate financial statements on a timely basis is a costly and time-consuming effort that needs to be re-evaluated frequently. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with U.S. generally accepted accounting principles, or GAAP. We are in the process of documenting, reviewing and improving our internal controls and procedures for compliance with Section 404 of the Sarbanes-Oxley Act, which requires an annual management assessment of the effectiveness of our internal controls over financial reporting and a report by our independent auditors assessing the effectiveness of such internal controls.

Changes to financial accounting standards or practices may affect our reported financial results and cause us to change our business practices.

We prepare our financial statements to conform to GAAP. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the interpretation of our current practices may adversely affect our reported financial results or the way we conduct our business.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

Risks Related to the Ownership of Our Common Stock

The trading price of our common stock may be volatile.

The market price of our common stock has been highly volatile and could be subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, and other factors beyond our control, such as stock market volatility and fluctuations in the valuation of companies perceived by investors to be comparable to us.

Further, the stock markets have experienced price and volume fluctuations that have affected and continue to affect our stock price and the market prices of equity securities of many other companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political, and market conditions, such as recessions, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock. We may experience additional volatility as a result of the limited number of our shares available for trading in the market.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008 and the price of our common stock has fluctuated substantially since then and may fluctuate substantially in the future.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008. The trading price of our common stock has fluctuated significantly since then. For example, between December 31, 2008 and September 30, 2009, the closing trading price of our common stock was very volatile, ranging between $4.38 and $18.33 per share, including single-day increases of up to 12.9% and declines up to 11.7%. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this quarterly report on Form 10-Q.

Contractual lock-up restrictions on the sale of approximately 99 million shares held by certain stockholders expired on February 3, 2009 and to the extent a stockholder is not an affiliate, its shares are now eligible for sale without restriction. Affiliate sales are subject to the volume, manner of sale and other restrictions of Rule 144 of the Securities Exchange Act of 1933 which allow the holder to sell up to the greater of 1% of our outstanding common stock or our average weekly trading volume during any three-month period. Shares beneficially held by Graham Weston, Norwest Venture Partners and its affiliates, and certain other parties will be subject to such requirements to the extent they are deemed to be our "affiliates" as that term is defined in Rule 144. Additionally, Weston, Norwest, and other holders possess registration rights with respect to some of the shares of our common stock that they hold. If they choose to exercise such rights, their sale of the shares that are registered would not be subject to the Rule 144 limitations. If a significant amount of the shares that become eligible for resale enter the public trading markets in a short period of time, the market price of our common stock may decline.

Additionally, certain of our larger stockholders are venture funds that may from time to time distribute the shares of our stock held by them to their limited partners in order to provide them with liquidity with respect to their investment in our stock. The distributed shares may be eligible for immediate resale, in which case all or a significant portion of these shares may be sold by these limited partners in the public markets during a short period of time following their receipt of these shares, which may cause the market price for our stock to decline.

The issuance of additional stock in connection with acquisitions, our stock option plans, or otherwise will dilute all other stockholdings.

We have a large number of shares of common stock authorized but unissued and not reserved for issuance under our stock option plans or otherwise. We may issue all of these shares without any action or approval by our stockholders. We intend to continue to actively pursue strategic acquisitions. We may pay for such acquisitions, partly or in full, through the issuance of additional equity. Any issuance of shares in connection with our acquisitions, the exercise of stock options or otherwise would dilute the percentage ownership held by our then existing stockholders.

Your ability to influence corporate matters may be limited because a small number of stockholders beneficially own a substantial amount of our common stock.

Our directors and executive officers and their affiliates beneficially own a significant portion of our outstanding common stock. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. Although our directors and executive officers are not currently party to any agreements or understandings to act together on matters submitted for stockholder approval, this concentration of ownership could limit your ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

Anti-takeover provisions in our organizational documents and Delaware law may discourage or prevent a change of control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our restated certificate of incorporation and amended and restated bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors deemed undesirable by our board of directors that our stockholders might consider favorable. Some of these provisions:

- Authorize the issuance of blank check preferred stock which can be created and issued by our board of directors without prior stockholder approval, with voting, liquidation, dividend, and other rights senior to those of our common stock;
- Provide for a classified board of directors, with each director serving a staggered three-year term;
- Prohibit our stockholders from filling board vacancies or increasing the size of our board, calling special stockholder meetings or taking action by written consent;
- Provide for the removal of a director only with cause and by the affirmative vote of the holders of a majority of the shares then entitled to vote at an election of our directors; and
- Require advance written notice of stockholder proposals and director nominations.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our restated certificate of incorporation, amended and restated bylaws and Delaware law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by our then current board of directors, including a merger, tender offer or proxy contest involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could cause the market price of our common stock to decline.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Sales of Unregistered Securities

On August 31, 2009, we issued 477,964 shares of our common stock to the two owners of Slicehost, LLC as partial consideration for reaching an earn-out target related to our acquisition of substantially all of the assets of Slicehost, LLC on October 22, 2008. The issuances of these shares of common stock were made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 – SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5 – OTHER INFORMATION

None

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

ITEM 6 – EXHIBITS

Exhibit Number	Description
10.1 *	**First Amendment to Lease Agreement by and between Grizzly Ventures LLC and Rackspace US, Inc. dated October 1, 2009**
31.1 *	**Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**
31.2 *	**Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**
32.1 **	**Certifications of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
32.2 **	**Certifications of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

* Filed herewith
** Furnished herewith

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, on November 12, 2009.

Rackspace Hosting, Inc.

Date: November 12, 2009	By:	/s/ Bruce R. Knooihuizen
		Bruce R. Knooihuizen Chief Financial Officer, Senior Vice President and Treasurer (Principal Financial Officer)

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

FIRST AMENDMENT TO DEED OF LEASE

THIS FIRST AMENDMENT TO DEED OF LEASE ("***First Amendment***") is dated as of October 1, 2009 (the "***Effective Date***"), by and between **GRIZZLY VENTURES LLC** , a Delaware limited liability company ("***Landlord***"), and **RACKSPACE US, INC.**, a Delaware corporation ("***Tenant***").

W I T N E S S E T H:

WHEREAS, Landlord and Tenant entered into that certain Deed of Lease dated February 5, 2009, (the "***Original Lease***"), pursuant to which Landlord leased to Tenant, and Tenant leased from Landlord, (i) a computer room designated as Pod 8b; (ii) storage space designated as Storage Room No. 108A and (iii) office space designated as Office No. 3 and Office No. 4, in the data center facility commonly known as "ACC4," located at 44480 Hastings Drive, in the Ashburn Corporate Center, Ashburn, Virginia (the " ***Building***"); and

WHEREAS, Landlord and Tenant now desire to amend the Original Lease in the manner set forth below, upon and subject to the terms, covenants and conditions hereinafter set forth.

NOW, THEREFORE, in consideration of the mutual covenants and agreements contained herein, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

1. Recitals; Defined Terms. The foregoing recitals are hereby incorporated into this First Amendment by reference, as if fully set forth in this first paragraph. Capitalized terms not otherwise defined herein shall have the same meaning as set forth in the Original Lease, as amended hereby. As of the Effective Date, the term "***Lease***" shall mean the Original Lease, as amended by this First Amendment.

2. Tenant's Additional Metering Apparatus. Tenant has been permitted to install, at its sole cost, a redundant set of current transformers and related circuitry and facilities, including communications connectivity equipment (hereinafter collectively referred to as "***Tenant's Metering Apparatus***"), on the incoming sources of the Critical Load Power for the Premises (the "***D-Boards***"). Tenant's installation of Tenant's Metering Apparatus shall be subject to the terms and provisions of Article IX of the Original Lease. Without limiting the foregoing, Landlord acknowledges that it approved Tenant's installation of Tenant's Metering Apparatus on the D-Boards and the plans and specifications therefor, pursuant to Section 9.2 of the Original Lease. Tenant's installation of Tenant's Metering Apparatus is further subject to the following terms and conditions:

(a) Tenant acknowledges and agrees that Tenant's Metering Apparatus shall be used solely for the acquisition of data to assist Tenant in its power and space management efforts within the Premises. Landlord's metering equipment shall be utilized for all other purposes under the Lease, including, but not limited to, determining Tenant's Critical Load Power and CRAC usage under Section 13.4 thereof and determining Critical Load Power quality and availability under Exhibit F of the Lease, including the occurrence of any Power Deficiencies, HVAC Deficiencies and/or Services Interruption Events.

(b) Without limiting the generality of the terms and provisions in this Section 2 above, Landlord acknowledges that, prior to scheduling the installation of Tenant's Metering Apparatus, Tenant submitted to Landlord, and Landlord approved, "***Specification Documents***," including drawings and plans, specifications of all proposed materials and wiring schematics, for Tenant's Metering Apparatus.

(c) Landlord acknowledges that it: (i) inspected the work methods and materials during and after installation of Tenant's Metering Apparatus; and (ii) deemed the work not to be substandard or inconsistent with the Specification Documents. Landlord shall have a continuing right to inspect the Tenant's Metering Apparatus and, to the extent Landlord reasonably determines that the installation thereof was substandard or inconsistent with the Specification Documents, any corrective action that Landlord may reasonably require in connection therewith shall be performed at Tenant's sole expense.

(d) Tenant shall be solely responsible for the installation, repair and maintenance of Tenant's Metering Apparatus, provided, that, to the extent any repairs or maintenance of Tenant's Metering Apparatus are required due to the negligence or willful acts or omissions of Landlord, its agents, contractors or employees, such repairs and/or maintenance shall be at Landlord's cost and expense. Prior to performing repairs or maintenance to Tenant's Metering Apparatus that would require access to the current transformers, connections or wiring to the D-Boards, Tenant shall coordinate and schedule such repairs or maintenance with Landlord's data center operations personnel. Landlord, on behalf of itself and its data center operations personnel, agrees to reasonably cooperate with Tenant in connection with Tenant's repair and maintenance of Tenant's Metering Apparatus.

(e) Tenant covenants and agrees that the installation and operation of Tenant's Metering Apparatus shall not interfere with Landlord's obligations under the Lease, including, but not limited to Landlord's obligations set forth in Article XIII and Exhibit F thereof, and shall not interfere with Landlord's operations within the Building. For purposes of the foregoing sentence, the term "interfere" shall not be deemed to include any incidental interference that has no adverse impact on Landlord's obligations under the Lease or operations within the Building. In the event that Tenant's (or its agents', contractors' or employees') installation and/or operation of Tenant's Metering Apparatus, or, except to the extent caused by the negligence or willful acts or omissions of Landlord, its agents, contractors or employees, the malfunctioning of Tenant's Metering Apparatus, causes damage to Landlord's electrical distribution systems serving the Premises (subject to the exception set forth herein above, the duration of any such event (ceasing upon successful repair of the damage or when successful repair of such damage would have occurred if Landlord had pursued said repair promptly and diligently), a "***Tenant's Metering Apparatus Damage Event***"), as reasonably determined by Landlord, Tenant shall be responsible for all costs to repair such damage and shall pay such costs as Additional Rent within thirty (30) days after receipt of an invoice of the costs of such repairs from Landlord. During (i) any Tenant's Metering Apparatus Damage Event or (ii) any reasonable period that it is reasonably necessary for Landlord's electrical distribution systems to be de-energized to allow for the repair of Tenant's Metering Apparatus (a "***De-energized Period***"), (A) Landlord's obligations under Article XIII and Exhibit F under the Lease with respect to the provision of Critical Load Power to the Premises shall be suspended, but only to the extent Landlord's inability to satisfy said obligations is caused by such Tenant's Metering Apparatus Damage Event and/or De-energized Period, and (B) notwithstanding any provision of the Lease to the contrary, no Power Deficiency caused by such Tenant's Metering Apparatus Damage Event and/or De-energized Period shall constitute a Power Interruption Event for purposes of Exhibit F of the Lease. Notwithstanding the foregoing, Landlord shall use commercially reasonable efforts to avoid Power Deficiencies and other interruptions to the Premises, and, except as expressly provided above, shall satisfy Landlord's obligations under the Lease, including, without limitation, Landlord's obligations set forth in the penultimate grammatical paragraph of Section 13.2 of the Lease, during a Tenant's Metering Apparatus Damage Event or a De-energized Period.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

(f) In the event that during the Lease Term, in Landlord's sole but reasonable determination, the location of Tenant's Metering Apparatus (or any portion thereof) physically conflicts with Landlord's operations within the Building, including, but not limited to construction of improvements or installation of equipment, upon the receipt of written notice from Landlord, Tenant shall relocate Tenant's Metering Apparatus (or portion thereof, if applicable), at Tenant's sole cost, to a location designated by Landlord.

(g) In the event that during the Lease Term, there is a four percent (4%) or greater discrepancy between the Premises' electrical current and/or Critical Load Power readings from Tenant's Metering Apparatus and Landlord's metering equipment, the parties agree to work cooperatively to conduct a recalibration exercise for Tenant's Metering Apparatus and Landlord's metering equipment and to determine the reason for, and to reasonably resolve, such discrepancy. The costs associated with such recalibration shall be borne equally by the parties.

(h) Upon the expiration or earlier termination of the Lease Term, Tenant shall remove Tenant's Metering Apparatus and shall repair or replace any damage or injury to all or any portion of the Premises resulting from the installation and/or removal of Tenant's Metering Apparatus.

(i) In addition to Tenant's general indemnification of Landlord under Section 14.2(a) of the Lease, Tenant hereby expressly agrees to indemnify and hold Landlord harmless against all losses, costs, damages, claims, liabilities, suits, and causes of action, including reasonable attorneys' fees and costs of litigation, suffered by or claimed against Landlord, directly or indirectly, based on or arising out of the installation, operation, use, maintenance, repair or removal of Tenant's Metering Apparatus, including, without limitation, any accident, injury, or damage whatsoever caused to any person, contractor, tenant or third party, or to the property or operations of Landlord or any person, contractor, tenant or third party, except to the extent caused by the negligence or willful acts or omissions of Landlord, its agents, contractors or employees. In no event, however, shall Tenant, Guarantor or any of Tenant's Representatives (nor any past, present or future board member, partner, trustee, director, member, officer, employee, agent, representative or advisor of any of them), under any circumstances under this Section 2(i) be liable for: (I) any exemplary or punitive damages or (II) any consequential or indirect damages (or for any interruption of or loss to business) to the extent that (A) Tenant is not covered therefor by insurance carried, or required to be carried, under this Lease, and (B) provided that Tenant is carrying such required insurance, Tenant does not receive proceeds therefor.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

3. Modifications to Original Lease.

(a) The following sentence shall be added as the final sentence to the penultimate grammatical paragraph of Section 13.2 of the Original Lease:

"Without limiting the foregoing, Landlord represents, warrants and covenants that, throughout the Lease Term, Landlord shall schedule and perform routine maintenance of the UPSs and Engine Generators of the Building only in a manner which, subject to unplanned interruptions and breakdowns, will maintain, at a minimum, the UPSs in the Building in a N+1 configuration."

(b) The final sentence of Section 14.1 of the Original Lease is hereby amended such that subsection (b)(ii)(B) thereof is hereby deleted in its entirety and the following is inserted in lieu thereof:

"(B) provided that Landlord is carrying such required insurance, Landlord does not receive proceeds therefor, all in connection with or relating to this Lease."

(c) The final sentence of Section 14.2(a) of the Original Lease is hereby amended such that subsection (II)(B) thereof is hereby deleted in its entirety and the following is inserted in lieu thereof:

"(B) provided that Tenant is carrying such required insurance, Tenant does not receive proceeds therefor."

(d) The following paragraph shall be added as Section E, entitled "Reporting," to Exhibit F to the Original Lease:

"**E. REPORTING**

Landlord agrees to provide Tenant, at Landlord's sole cost and expense and without reimbursement from Tenant as part of Operating Expenses, not less than one (1) time each year during the Lease Term, a so-called SAS70 Type II report performed by a nationally recognized public accounting firm engaged by Landlord for such report. Each annual SAS70 Type II report prepared by Landlord shall audit the time period from January 1 to September 30, or such other nine (9) month period as may be mutually agreed upon in writing by the parties during the Lease Term, (the "***Initial Audit Period***"), with an update letter subsequently delivered covering the three (3) month period not included within the Initial Audit Period, and each SAS70 Type II report and/or update letter shall be delivered to Tenant within sixty (60) days after the end of the applicable time period. Furthermore, Landlord will cooperate with, and use commercially reasonable efforts to assist, Tenant with respect to Tenant's compliance obligations and reporting, including, without limitation, (i) Tenant's preparation of independent SAS70 Type II reports, (ii) Tenant's PCI DSS compliance and (iii) Tenant's ISO27001 compliance. Such cooperation shall include, without limitation, allowing Tenant and Tenant's auditors and consultants access to the Building or such other location reasonably agreed to by Landlord and Tenant, in order to review testing logs and information and maintenance logs, schedules and other information regarding the Building's electrical and mechanical systems, as well as evidence of the Building's physical controls and environmental controls. Notwithstanding the foregoing, Tenant's preparation of independent SAS70 Type II reports, Tenant's PCI DSS compliance, Tenant's ISO27001 compliance and any other of Tenant's compliance obligations and reporting, shall be prepared and/or carried out at Tenant's sole cost and expense. "

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

4. Other Terms and Provisions.

(a) Conflicts. If any provision of this First Amendment conflicts with the Original Lease, the provisions of this First Amendment shall control.

(b) Ratification. Except as otherwise expressly modified by the terms of this First Amendment, the Original Lease shall remain unchanged and continue in full force and effect. All terms, covenants and conditions of the Original Lease not expressly modified herein are hereby confirmed and ratified and remain in full force and effect, and, as further amended hereby, constitute valid and binding obligations of the parties hereto enforceable according to the terms thereof.

(c) Binding Effect. All of the covenants contained in this First Amendment, including, but not limited to, all covenants of the Original Lease as modified hereby, shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, legal representatives and permitted successors and assigns.

(d) Effectiveness. The submission of this First Amendment shall not constitute an offer, and this First Amendment shall not be effective and binding unless and until fully executed and delivered by each of the parties hereto.

(e) Counterparts. This First Amendment may be executed in multiple counterparts, each of which shall be an original, but all of which shall constitute one and the same First Amendment. Additionally, the parties hereto hereby covenant and agree that, for purposes of facilitating the execution of this First Amendment, (i) a facsimile signature shall be deemed to be an original signature and (ii) a telecopy delivery or electronic delivery (i.e., the transmission by any part of his, her or its signature on an original or any copy of this First Amendment via telecopy, fax machine or e-mail) shall be deemed to be the delivery by such party of his, her or its original signature hereon.

(f) Entire Agreement. The terms and provisions set forth in this First Amendment constitute the entire agreement and understanding between Landlord and Tenant with respect to the specific subject matter addressed herein, and are hereby deemed to supersede all prior agreements and understandings (including, without limitation, those expressed originally in the Lease, to the extent inconsistent with the terms and provisions of this First Amendment, and any prior oral or written communications between Landlord and Tenant, or their respective agents or representatives) concerning the specific subject matter hereof. No subsequent modification or amendment of the terms and provisions of this First Amendment shall be effective unless in writing and signed by Landlord and Tenant.

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

(g) Authority. By its execution and delivery hereof, Landlord does hereby certify and confirm to Tenant that the undersigned party executing this First Amendment as Landlord is, in fact, presently the “Landlord” under the Lease, that the person(s) or party(ies) executing this First Amendment on behalf of Landlord has/have done so with all requisite due authority, with the effect that this First Amendment, as so executed, constitutes the valid and binding agreement of Landlord, enforceable against Landlord in accordance with the terms and provisions hereof, and that this First Amendment has been duly executed and delivered by Landlord without the necessity of the joinder of any third party. By its execution and delivery hereof, Tenant does hereby certify and confirm to Landlord that the person(s) or party(ies) executing this First Amendment on behalf of Tenant has/have done so with all requisite due authority, with the effect that this First Amendment, as so executed, constitutes the valid and binding agreement of Tenant, enforceable against Tenant in accordance with the terms and provisions hereof, and that this First Amendment has been duly executed and delivered by Tenant without the necessity of the joinder or consent of any third party.

(h) Construction. Descriptive headings used herein are for convenience of reference only and shall not control or affect the meaning or construction of any provision set forth in this First Amendment. Where required for proper interpretation, words used herein in the singular tense shall include the plural, and vice versa; the masculine gender shall include the neuter and the feminine, and vice versa. As used in this First Amendment, the words “hereof,” “herein,” “hereunder” and words of similar import shall mean and refer to this entire First Amendment and not to any particular section or paragraph of this First Amendment, unless the context clearly indicates otherwise. If any provision hereof is for any reason unenforceable or inapplicable, the other provisions hereof will remain in full force and effect in the same manner as if such unenforceable or inapplicable provision had never been contained herein. This First Amendment shall be construed without presumption of any rule requiring construction to be made against the party causing same to be drafted. This First Amendment shall be construed and interpreted pursuant to the laws of the Commonwealth of Virginia.

(Signatures on Next Page)

Source: RACKSPACE HOSTING, INC., 10-Q, November 12, 2009

IN WITNESS WHEREOF, Landlord and Tenant have executed this First Amendment to Deed of Lease under seal on or as of the day and year first above written.

LANDLORD:
GRIZZLY VENTURES LLC,
a Delaware limited liability company

By: Grizzly Equity LLC, a Delaware limited liability company, its Manager Member

By: DuPont Fabros Technology, L.P., a Maryland limited partnership, its Managing Member

By: Dupont Fabros Technology, Inc., a Maryland corporation, its General Partner

By: /s/ Hossein Fateh
Name: Hossein Fateh
Title: President & CEO

TENANT:

RACKSPACE US, INC.,
a Delaware corporation

By: /s/ Alan Schoenbaum
Name: Alan Schoenbaum
Title: Sr. Vice President, General Counsel

Exhibit 31.1

CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a) OF THE SECURITIES EXCHANGE ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, A. Lanham Napier, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rackspace Hosting, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2009

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer, President and Director
(Principal Executive Officer)

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a) OF THE SECURITIES EXCHANGE
ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF
THE SARBANES-OXLEY ACT OF 2002**

I, Bruce R. Knooihuizen, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rackspace Hosting, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 12, 2009

By: /s/ Bruce R. Knooihuizen
Bruce R. Knooihuizen
Chief Financial Officer, Senior Vice President and
Treasurer
(Principal Financial Officer)

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), A. Lanham Napier, as Principal Executive Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: November 12, 2009

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer, President and Director
(Principal Executive Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Bruce R. Knooihuizen , as Principal Financial Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: November 12, 2009

By: /s/ Bruce R. Knooihuizen

Bruce R. Knooihuizen
Chief Financial Officer, Senior Vice President and Treasurer
(Principal Financial Officer)

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