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PRESENTATION

Operator

Ladies and gentlemen, good day, and welcome to Rackspace Hosting's Fourth Quarter Earnings Conference Call. As a reminder, today's call is being recorded. At this time all ends are in a listen-only mode to prevent back ground noise. After the prepared remarks, there will be a Q&A session.

(Operator Instructions)

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

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

Good afternoon. Thank you for joining Rackspace's fourth quarter and full year 2009 earnings conference call. I'm here today with Lanham Napier, our CEO, and Bruce Knooihuizen, our CFO. We issued a press release after the close of the market today with our unaudited financial results for the fourth quarter and full year of 2009. If you do not have a copy, please visit the investor section of our website at rackspace.com where this call is also being webcast.

The primary purpose of today's call is to discuss the fourth quarter and full year 2009 results. However, some of our comments today are forward-looking statements that involve risks, uncertainties, and assumptions. If the risks or uncertainties materialize or assumptions prove incorrect, our results could differ materially from those expressed or implied by the forward-looking statements and assumptions.

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

These risks, uncertainties, and assumptions include infrastructure failures, the potential deterioration of economic conditions, and other risks that are described in our third quarter Form 10-Q, filed with the SEC on November 12, 2009, and our Form 10-K for the year that will be filed on or before March 1, 2010. These forward-looking statements speak as of today, except, as required by law, we assume no obligation to update these forward-looking statements publicly or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

During today's discussion, we will be using GAAP as well as non-GAAP financial measures, such as adjusted EBITDA. Our GAAP result in GAAP to non-GAAP reconciliations can be found in the earnings release we issued earlier today, which is posted on our website, as mentioned previously. Following our prepared remarks today, we'll open the call for your questions. Okay, let's get started.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Thank you for joining us today. In a moment, Bruce will share our strong fourth quarter and full year results, but before he does, I want to briefly touch on the business, the market opportunity for us, and our aggressive pursuit to build upon our market leadership in 2010.

Today we are the leader in the hosting and cloud computing industry; a massive and emerging sector that is virtually untapped. During our 11 year history, Rackspace has made significant progress and created real value for customers, Rackers, and stockholders. We have built our company in sustainable fashion, and at this point, we have won the first phase of our industry's development.

As we look out to our future, we are well positioned to seize an even larger opportunity. The ongoing trend for businesses to purchase IT as a service from a company like ours has accelerated, because business leaders continue to scrutinize IT budgets, and they recognize that an in-house computing infrastructure does not provide them with a competitive advantage.

Today, more than 90% of corporate computing takes place inside a company's offices. In the future, the vast majority of corporate computing will occur through a service provider like Rackspace. Why will this happen? It's pretty simple. We're cheaper, faster, and more reliable, and we're purpose built to deliver technology outcomes. More and more, corporate IQ organizations are looking for a partner to help them run their computing infrastructure, and the Fanatical Support that Rackspace provides to its customers continue to prove to be a compelling proposition.

The size of the opportunity is hard to precisely calculate, but we know it is massive. We estimate there are 50 million servers in the world today, and we manage about 0.1% of these in our facilities. As the demand for computing grows, we have the opportunity to compete and serve this market. The shift in the computing landscape will be bigger and faster than the shift from mainframes to client server computing or LAN or any other recent trend, simply because there is much more computing in the world today.

The market opportunity for us is billions of dollars and global in nature. Traditional technology markets are blurring as companies enter new segments. For example, Cisco has entered the data center provisioning business as part of its strategy to become one of the major systems companies in the world. Google, Microsoft, and Amazon all see the potential in the market and are therefore positioning for growth while we move quickly to strengthen our market position.

We have spent the past year preparing for the next cycle of growth. We have a strong position in the market today because of our specialized focus on hosted computing, our unique culture of customer service known as Fanatical Support, and our unique highbred portfolio approach that combines dedicated hosting and cloud hosting.

During 2010, we will aggressively pursue market leadership in the next larger phase of hosting and cloud computing. We will make disciplined investments to reach even greater levels of scale. We are expanding our operational capabilities, and giving our Rackers better tools to deliver Fanatical Support to our customers.

Rackspace will only be great if our customers say we are, and this means our Fanatical Support model must continue to serve them well. That's why we intend to invest in our technical depth with specific technologies and software development. We are investing heavily in our leadership, because we need leaders that have experience in executing to capture large opportunities, and leaders that can drive even greater performance for our customer facing service teams.

So, what does all this mean? In 2009, given the extreme uncertainty in the economy, we were focused on cash and margins, and we proved that we could flex our model, which helped us separate ourselves from the pack and emerge as a stronger competitor.

In 2010, we will shift our primary focus to growth. Although we remain committed to enhancing our profitability, we believe that it's best to focus more on growth this year to increase market share at this stage of the technology adoption life cycle. Our ultimate rate of growth in 2010 is highly correlated to the general state of the economy, but regardless of economic conditions, we think we'll experience market leading growth, beating -- boosting our revenue faster than the industry and our competitors.

We are currently seeing certain precursors to faster growth. Our experience has been that customers stop churning and stop cutting their IT expenditures before they finally begin to spend more. In the fourth quarter, we saw evidence in our business that churns slowed and that lead flow ticked upward. As we think about our aggressive pursuit of market leadership, we believe our financial results will be the proof point to our growth strategy. Our financial results will be the proof point that there are millions of companies in the world that value Fanatical Support and the world-class customer outcome that Rackspace uniquely delivers.

We are focused on four key components to our growth strategies. First, enterprises. Our Fanatical Support message resonates with them, but equally important is the potential cost savings for customers when they select us over companies like IBM and HP. We don't have all the brand strength we would like, but we have a business model advantage over these competitors that can deliver enduring value for customers. We launched our enterprise sales initiative in April of 2009, and we are seeing some very encouraging results.

Second, cloud traction. As cloud adoption accelerates, we can deepen our leadership position. In February, we launched the beta version of cloud servers for Windows. This launched more than double the size of our addressable market for cloud servers. We approach our cloud just as we do our core business. We will serve businesses willing to pay a premium for a world-class service experience, because they are running important IT apps in the cloud.

The combination of our traditional managed hosting offerings on dedicated infrastructure and our evolving cloud offerings creates a powerful portfolio approach we call hybrid hosting. This approach is about providing the right fit for our customers. We are able to tailor the right productized IT services to run our customers IT workloads and back all of it with Fanatical Support.

Third, SMBs. These customers will remain a big part of our company's future. Even if IT spending remains flat for many SMB customers, we plan to improve our core offering and, in turn, improve our penetration in this segment. Over the next year, we plan to further separate ourselves from the traditional competitive set in this space.

Fourth, our installed base. In the past, our existing customer base represented revenue growth of almost 20%, net of churn. We stood by our customers in tough times, offering voluntary downgrades while maintaining our pricing discipline. Now we are beginning to see our customers' needs grow, so the investments we made in our customers during the recession are starting to pay us back. This year we'll mine our installed base, serve our customers better, and help reignite their growth.

To successfully execute on our aggressive pursuit of market leadership, we are making investments to make us more efficient. To succeed in the second phase of this industry's development, we need to add more automation to the routine parts of our business to help our Rackers deliver even better customer service in the situations where it matters most. These investments will be critical to our success, and we are committed to making these investments in a profitable way.

As always, we will maintain our transparency and provide you with periodic updates of our most current thinking. In early May, we will host an analyst day in New York where we will share our latest views on the business. 2010 will be an exciting year for us. Our advantage as the world's leader in the hosting and cloud computing industry and as the only provider of Fanatical Support are real and have been embraced by our customers. We have a great position in the market, and we should be able to create lots of value for our stockholders. We can see the opportunity, and now we must do the heavy lifting to further strengthen our position.

The past few quarters we have shared some key customer wins with you, so we'd like to do it again. Now to the customer wins. Gucci, a recognized name in design, distribution, and manufacturing of luxury apparel and accessories, hosts the technical operation of its order management system and its website with Rackspace. Gucci has entrusted these integral parts of their business with Rackspace and has come to know firsthand the value of our world-class Fanatical Support.

[Kongsberg], a leading international provider of high technology systems and solutions, recently selected Rackspace as its infrastructure partner for the first hosted deployment of its oil drilling exploration software. The end user is a major oil company with global operations, which was actively involved in approving the selection of Rackspace for this crucial deployment. Kongsberg chose Rackspace to host its new SaaS offering because of our speed to market as we deployed the full IT hosting solution in eight business days and our commitment to Fanatical Support.

NBCOlympics.com is NBC's marquee website, featuring all the exciting news, photos, and video of the 2010 Winter Olympics Games. Over the 18 days of the Olympic Games this February, this site will be visited by millions of viewers. NBC chose Rackspace as the managed hosting partner to host a secondary infrastructure in the event of a disaster recovery scenario with their primary site. NBC selected Rackspace based on our flexibility, ease of doing business, and our ability to deliver the infrastructure within a very short timeframe.

Serving around the clock breakfasts across America, Denny's operates more than 1,500 restaurants in the US and abroad. With a heavy advertising presence during major sporting events, such as the Super Bowl and Final Four, Denny's realized they needed a very capable hosting partner. They chose Rackspace for our reliability and the commitment we exhibit to our customers. For

Super Bowl XLIV, Dennys.com sailed smoothly, even during sudden traffic spikes following the airing of each of their three commercials, announcing a free Grand Slam breakfast to America. I'd also like to highlight the fact that we hosted websites for three other companies that ran Super Bowl ads this year.

Before I hand the call over to Bruce, I would like to close by saying that I'm proud of our accomplishments in 2009, and I'm excited for 2010. I would like to thank Rackers around the world for their hard work and dedication. With that, I'll turn it over to Bruce to discuss our financial results. After Bruce finishes up, we'll take your questions.

Bruce?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Thank you, Lanham. Last February we outlined three objectives for 2009. First, we wanted to grow our business, albeit, we expected to grow at a slower rate than in the past, due to economic pressures. Second, we wanted to scale the business and enhance returns. And third, we promised minimal, if any, cash burn. A year later, as we sit here today, I am pleased to report that we delivered on each of these objectives.

For the full year of 2009, total revenue was $629 million, representing an annual growth rate of 18%, which is slower than our historic rates, but a rate we are proud of, considering the difficult economic conditions we faced. Adjusted for the full year FX headwind of approximately $28 million, our growth rate would have been 23%.

As we exercise financial and operational discipline, I'm also proud to report a full year adjusted EBITDA margin of 31.9%, an improvement of more than 450 basis points, year-over-year. Lastly, we generated $14 million of adjusted free cash flow, further demonstrating the resiliency of our business model.

Overall, 2009 was a great year, and in a bit, I will discuss our plans for 2010. But before I do, let's get into some detail around the fourth quarter. Beginning with revenue and growth, our total net revenue for the fourth quarter was $170 million, up 4% from the third quarter and 18% from the fourth quarter of 2008. Cloud revenue for the fourth quarter was $17 million, up 12% from the third quarter and almost 100% from the fourth quarter of 2008.

Managed hosting revenue increased to $152 million, up 4% from the third quarter and 14% from the fourth quarter of 2008. Our managed hosting business is benefiting from our new enterprise offering, which has allowed us to move up market and compete and win bigger deals. Lanham highlighted some of these big wins.

Turning to the macro environment and demand, we were certainly excited to see significantly higher levels of economic output in the fourth quarter. We continue to believe our business is highly levered to economic rebound, and these improved economic levels positively impacted our business in the fourth quarter. First, our churn for the fourth quarter was 0.8%. This is the lowest level of churn we have seen since the fourth quarter 2007 and matches our best levels during 2006 and 2007. During the depths of the recession, we stood by our customers, providing them with world-class customer service that we call Fanatical Support. In the down market, our Fanatical Support kept churn rates in check, and in the fourth quarter, we improved on those rates.

Second, towards the end of the year, collection efforts improved, as fewer customers had trouble paying their bills. Both DSOs and bad debt came down from their highs in 2009. In the fourth quarter, our DSOs stood slightly north of 20 days, and bad debt was 0.3% of revenue, both very healthy levels. If the economy remains stable, we feel bad debt levels should stabilize in the 1% area.

Net upgrades for the fourth quarter were 1.3%, up from 1.2% in the third quarter. Net upgrades are a key part of our installed base growth, and we continue to be optimistic that as the economy continues to improve, net upgrades will also improve. As a result of our improved churn and slightly better net upgrades, our installed base growth for the fourth quarter was 0.4%, the highest level we have seen since the third quarter of 2008.

Total server count increased by 2,016 servers to 56,671, up from 54,655 servers at the end of the third quarter. We're getting close to 100,000 customer level as total customers increased by 9,981 to 90,925, up from 80,944 at the end of the third quarter.

Shifting to profitability in the cost side of the business, adjusted EBITDA for the fourth quarter grew to $56 million, a sequential increase of 9% and a year-over-year increase of 31%. Adjusted EBITDA margin, adjusted only for non-cash share-based compensation was 33%. This represents an improvement of more than 130 basis points, sequentially, and 320 basis points year-over-year.

To quickly update you on our progress in our Virginia and Chicago leased data centers, we are now making cash payments for five of ten phases in Virginia and expect to open Chicago operations in the first quarter of this year. As you may recall, lease accounting rules under GAAP require us to straight-line the full amount of rental expense, even though we structured the cash payments to match our expected demand.

Because of the GAAP requirement, we recognized $2.5 million of non-cash data center rent expense in the fourth quarter and $4.6 million for the full year for the two facilities. Excluding the non-cash data center rent expense, adjusted EBITDA margins would have been higher for the fourth quarter and the full year. In the first quarter of 2010, we expect to incur $2 million of non-cash data center rent expense for these two data centers and $6 million to $8 million for all of 2010.

We remain highly focused on controlling our costs, and in the fourth quarter, we were able to improve our cost to revenue, sales and marketing, and G&A line items as a percent of revenue. In our support organization, we focused on improving our efficiency and productivity levels as we continued to reduce air rates and improve the customer service experience, allowing us to serve more customers with the same number of Rackers.

In December of 2009, our frontline support Rackers supported 18% more servers than they did two years ago. We also continued to better align sales and marketing spend with demand, improving our acquisition multiple from the third quarter to the fourth quarter.

Let's move on to capital expenditures. For the year, we spent $186 million. Of this amount, we spent $109 million on customer gear, $37 million on data center build-outs, $15 million on office space, and $25 million on capitalized software and other. Our annualized return on capital for the fourth quarter was 10%, up from 8.6% in the third quarter. However, that number would have been higher excluding the fourth quarter non-cash rent expense.

As we think about returns going forward, every new server added to a customer's dedicated environment adds more profit than the one before, because of economies of scale at the account management level, and lower sales and marketing expense.

An even greater economic return exists in the cloud, because, in the long run, we believe we will get higher revenue per server on a less expensive box, and those assets will have a longer service life. As the mix of Rackspace's total servers shifts more meaningfully toward cloud servers, we expect our return in capital levels to grow.

Net income for the quarter was $9 million, up 32% from last year and 19% from the third quarter. For 2010, as we position our company for the next cycle of growth, we expect to spend between $185 million and $235 million in capital expenditures. Approximately 75% of the total projected capital expenditures are for customer gear, which is virtually all success based. Specifically, we intend to spend between $140 million and $160 million on customer gear.

To round out our capital expenditures, we expect to spend $10 million to $20 million for data center build-outs, $10 million to $20 million for our office build-out, and $25 million to $35 million on capitalized software and other, as we continue to develop proprietary software and manage tools for our Managed Hosting and Cloud businesses.

We also recently hired what we think are the most capable and smartest minds in the data center space to enhance our existing footprint. This is an investment for us as we continue to grow our operations and bring on additional capacity.

Our balance sheet remains strong. We ended the full year with $125 million of cash and cash equivalents and access to an additional $194 million under our revolving credit facility. Our total debt outstanding, including capital leases, was $167 million, and net debt was $42 million. Net leverage at the end of the year was 0.21 times.

We are pleased with the business performance in 2009. Amid the toughest economy in 70 years, we delivered on the promises that we outlined last February. As we think about 2010, we're excited about the opportunities from both our Managed Hosting and Cloud businesses. We have made significant investments over the past year. We bolstered our management team, developed an enterprise offering, and transformed the cloud. These investments, and others, have earned us the number one spot in the managed hosting and cloud computing market, best positioning us for the next cycle of growth.

To close, the message I hope you walk away with is this. One, we believe we grew faster than the market in 2009. Secondly, normalizing for service credits and FX, we grew fourth quarter revenue sequentially at a rate faster than any other quarter in 2009. We expect for installed base growth to come back with the economy, which should provide a boost to sales this year.

We continue to show that there is leverage in this model. We posted fourth quarter adjusted EBITDA margins to 33%, and that percentage includes the non-cash rent expense associated with our Virginia and Chicago lease facilities. We are positioned well to accelerate growth if the economy cooperates, and finally, we remain committed to profit, but have shifted our priority to growth.

With that, we are now ready to take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Let's first go to Winston Len with Goldman Sachs.

Winston Len - *Goldman Sachs - Analyst*

(inaudible) for taking the question. Lanham, maybe just start at the strategic question around the cloud. We've seen Amazon, Microsoft, and other players route -- tout offerings with less focus on customer support than you. So what makes you so confident that your customer support centric approach is the right one? And maybe you can share some data points around what your cloud customers are seeing in terms of customer support. And then I have a follow-up question.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. First of all, that's a good question. Thank you. The cloud represents a huge opportunity. We are taking part in the service revolution within technology. The cloud and the adoption of that technology set accelerates this revolution. As we won the first phase of our industry, we differentiated around being the service leader. It's about Fanatical Support. It's about providing a world-class service experience to our customers. And so, this service revolution that's taking place is going to fundamentally change how businesses consume IT.

The new entrance of Amazon and Microsoft into the marketplace validate the size of this opportunity. All of these companies are going to have to find their point of difference in the marketplace. So, as we think of our point of difference and what we're trying to build, we're trying to build one of the world's greatest service companies. We're trying to build the greatest service company in tech. Fanatical Support is a key part of our strategy to do it.

So we believe the point of difference we've achieved in our traditional managed hosting offering, around Fanatical Support and being the service leader, is entirely consistent with the path we're on now as we extend into the cloud market itself. The new entrants that come in -- for example, Amazon has cut its price. Their price move has not had any impact on our take rate in our cloud. So what this proves is that we're serving a different customer.

When we talked on earlier calls, we discussed the situations into which we are very competitive and the right fit for a customer. These situations are when we're serving a business, and that business wants a service experience, that business is willing to pay a premium for that service experience. Another key attribute of the situations where we're a good fit is when we can bring our portfolio approach to it. So it's the combination of our traditional managed hosting offerings, along with our new cloud offerings, as a hybrid solution to customers, this is when we're a good fit.

So right now we have a portfolio advantage on those pure cloud only players. As the cloud market continues to development -- continues to develop, we believe that that market will segment, and there will be a segment of businesses that want a world-class service experience that are willing to pay a premium. There will be a segment of that market that just wants a commodity experience, and we are not a fit for that segment. If people want a commodity experience, they ought not to call Rackspace. We are about providing a world-class service experience that we call Fanatical Support, so that will remain our point of difference.

Winston Len - *Goldman Sachs - Analyst*

Great. And then, maybe just one on installed base growth. We have churn at a two year low end net upgrades are trending up. So how should we think about growth into 2010, given the positive trends here?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Well, let's talk a little bit about what is causing this change in the churn rates and the installed base growth rates. Last year we made a conscious decision, which we communicated on these calls, that we were going to stand by our customers through the tough times. So we helped customers right size their solutions with us, so that they could really get a high utilization rate on the services we were providing them. What has happened here the back half of the year, we have seen our customer scores, in terms of the quality of service we provide customers, climb. We have also seen the economy start to firm up.

So, in looking at the metrics, we can see where the churn rate has declined. This is a function of we're serving them better, and their businesses are doing better. You see the economy firming up, which, in Bruce's part of the call, we referenced the DSOs and how that -- and how bad debt had fallen. So, you have a macro factor here of things getting better for our customers. You have a specific factor to Rackspace, in that we are serving our customers better.

So what we see here are some of the precursors of demand. In our experience now, building the Company for 11 years, it's that coming out of a tough time. First, people will stop reducing their budgets, meaning their IT budgets will stabilize. Then they'll start thinking about how to get more out of what they have. Then they'll start thinking about how to spend more with us. So we see some of those demand signs -- some of those precursors already assembled. We also have some data from the fourth quarter that indicated our lead flow started to trend up as well. So we don't have everything lined up yet, but we're starting to have some major pieces fall in place.

Winston Len - *Goldman Sachs - Analyst*

Great. Thank you.

Operator

Let's next go to Piper Jaffray -- Chris Larsen.

Chris Larsen - *Piper Jaffray - Analyst*

Thanks for taking the question. Questions on some margins. First, to Bruce. I want to clarify the margins on the non-cash. If I added those back, your margins were about 34.5%. And then as your revenues grow, the margin impact should become less and less meaningful, and I wanted to just make sure I'm thinking about that right. You were at a full run rate now for the non-cash?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Yes. In terms of that non-cash cost element, you're absolutely right. As we go forward, less and less of that will be non-cash. But keep in mind that as we move forward, as well, the way we structured these deals was to have a cash increase over time, as our demand increases. And so, there's a matching between the revenue and the cost as we go forward.

Chris Larsen - *Piper Jaffray - Analyst*

Perfect. And then, Lanham, as you shift now more towards growth, can you talk a little bit about the tradeoff between what that might mean to revenues and -- rather, to margins, and what sort of revenue acceleration? Do we start to see margins either come down or however you want to think -- however you want to phrase that?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Sure. A year ago, when we set forth our plan for 2009, we prioritized profitability and cash a higher level than growth. A year ago things were crazy and uncertain, and so, we really wanted to convey to our investors that we were focused on our -- the margin potential of our business model.

As we sit here today, we see some precursors of demand that we believe are harbingers of higher growth ahead of us. They're not all here yet. It's not all lined up, but we can see this opportunity forming. So as we look at that opportunity, and we think about separating ourselves from our competition, we want to make sure we have market leading, industry leading growth within our service sets. So we prioritized growth ahead of profitability this year. We are able to do that, because, man, last year we made great progress on profitability. We are proud of the work that Rackers did and the improvements we made in profitability.

So we certainly believe that we have additional upside in our margin structure. We believe, as we serve customers better, there's a sweet spot where we can actually serve them better, create a more valuable experience for our customer, and create a larger margin for our investors. It's just right now, that is a secondary concern, relative to the growth opportunity in front of us.

Chris Larsen - *Piper Jaffray - Analyst*

Okay. Thank you. And then, just one more, if you don't mind. Bruce, is there any change in the cost of the customer gear per server or any -- however you want to think about it? As you add more capability, should we think that the dollars spent per number of servers added is going to go up or down or any dramatic changes there?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

In terms of the cost per server, we're not seeing significant changes in the cost per server, but as we talked about, there are a little different economics in terms of the cloud compute versus our managed hosting business, where we can be more efficient with the cloud, much like our customers. And so, over time, we'll see more and more of that impacting our financials, certainly as we start getting to scale in that environment.

Chris Larsen - *Piper Jaffray - Analyst*

Perfect. Thank you very much.

Operator

Jonathan Schildkraut with Jefferies. Go ahead, sir.

Jonathan Schildkraut - *Jefferies - Analyst*

Thanks. Couple of questions. First, let me kind of circle back onto some of the cloud items that were asked earlier and just make sure I get this right and understand the Company's strategy. Lanham, as we look at the cloud market, and cloud has become, probably, too big a definition for what it is, but its shared infrastructure -- we see a bifurcation. Part of that is -- call it on-demand access to infrastructure, which is more of that Amazon model that you noted before. The other part of the bifurcation is, essentially, managed hosting in a cloud, and I define that as different from dedicated, which is the equipment piece there.

I understand that, going forward, it would be Rackspace's position to try to dominate the managed hosting in a cloud environment, but to date, has the business been scaling -- it seems like the business has been scaling more on the kind of on-demand access to infrastructure. So it's a little bit deeper there.

Additionally, it does seem like the growth slowed a little bit in the fourth quarter, and I'm wondering if you've gotten the business to scale from a perspective of enough customers to kind of test your infrastructure and also, maybe where you are in the profitability, in order to kind of allow you to go back and implement the systems around the cloud in order to be profitable longer term. Thanks.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. Thank you, Jonathan. Those are good questions. We agree with your market segmentation and the bifurcation between on-demand access to base level infrastructure versus a managed hosting experience in a cloud. When we talk about our strategy of wanting to differentiate on service in the cloud, we are squarely, in the long term, thinking about that managed hosting type experience within a cloud technology paradigm. Just to clarify the first part of your question.

Some of our early offerings in the cloud have been more on target with the on-demand access piece. So, for example, if you go to our cloud service set today, our cloud servers offering is more akin to the on-demand access piece than it is our traditional managed hosting experience in a cloud. We do run, within our enterprise group specifically, a number of private clouds for customers, and so there it is much more of a traditional managed hosting type service experience on a cloud infrastructure.

Going forward, and the investments we are making today in our cloud are all about increasing the service levels in our cloud offering. So if you migrate from cloud servers into cloud sites, you will see there we have a pretty well managed stack. It's not all the way back to the service levels experienced in managed hosting, but it is certainly a step above some of our initial work that we did in our cloud service offering.

With respect to scale, as we think about our infrastructure, we are making the investments in that infrastructure to run our business at what we consider to be a web scale type level. Recently, we announced the hiring of a new Chief Operations Officer, Mark Roenigk. Mark joined us from eBay, and before eBay, was at Intuit and has had a lot of experience in running infrastructure at those companies, as well as managing their operations and supply chains.

So we see ourselves as a company at a magic inflection point here, where, if we continue to grow, we have a chance to really differentiate ourselves as a service leader within the service revolution in tech and build our infrastructure out at a web scale. So, with the growth we're experiencing in our cloud services, specifically, we have a lot more scaling to do there. I mean, we are still in the early innings of that development and gain.

Jonathan Schildkraut - *Jefferies - Analyst*

All right. Great. Thank you. And just one more housekeeping item, if I may. Last quarter you gave us a sense as to customers, which were at the low end, that transitioned from the dedicated platform to the cloud hosting platform. I was wondering if we might get a similar number this quarter, please.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Yes, the number still remains very small, and it's really immaterial, in terms of our total number. But while that number is small -- I know some people are concerned about the consumption of cloud into the managed hosting. What that's allowed us to do is to gain about 10,000 other customers we otherwise wouldn't have access to, and so, our overall customer base is significantly larger, even though a immaterial amount have migrated over to the -- from managed to cloud.

Jonathan Schildkraut - *Jefferies - Analyst*

Bruce, I fully understand that, particularly from a revenue perspective, having walked through the economics, but (inaudible) I was just trying to get a sense that if I netted out the transition customers to get a sense as to how many customers were actually added on the dedicated side, that's all.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Oh, it's less than 200 that migrated from one to the other.

Jonathan Schildkraut - *Jefferies - Analyst*

Thank you so much.

Operator

Let's move on to Bryan McGrath with Credit Suisse.

Bryan McGrath - *Credit Suisse - Analyst*

Hey, guys, great quarter. Just, Lanham, a question about some of the precursors to growth you kind of mentioned. With more and more interest and demand from larger enterprises -- larger businesses, do you get longer sales cycles and, therefore, have more visibility into what future new deals might be coming online?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Good question. So first, let's touch on the -- some precursors. The precursors specifically are the lower churn, the uptick in lead flow, the economy stabilizing in our enterprise opportunity, which you've identified. The sales cycle that we've experienced in our enterprise initiative, which we launched last April, is a longer cycle than our SMB business. So think of our SMB business as the higher transaction, higher volume economics.

That SMB business gives us a wonderful operational base upon which to add and tailor our services for enterprise customers. So, the sales cycle is longer. That gives us a better visibility into that particular customer set, okay, to understand what is happening there. And when we think about our enterprise market opportunity, we really see it as we have a business advantage -- business model advantage over HP and IBM.

And what happens here is we are purpose built to deliver these services, to run this web infrastructure. We're productized, whereas, HP and EDS and IBM -- their entry into this is really -- it's legacy stuff that started in the original out sourcing movement, where they're a job shop. They'll run your IT from A to Z. We don't do that. So for the services that we can provide as productized, it's a better quality experience and will save you 50%, relative to what those people offer.

So the weird, lucky fact here for Rackspace is that we can get a compelling price, deliver Fanatical Support in a way that is responsive and expertly delivered and also create a high margin for our company. So that what we have here is the confluence of some market factors that just make us a great pick for those customers. And so, as you mentioned, it's a longer sales cycle; we're chipping away at it. We bring our lunch box with us every day and get to work on this stuff.

As we go to work on winning these customers, our approach is going to be very different than how the out sourcers originally approached this market. There are going to be tradeoffs we make in terms of hands and feet in the street, versus our centralized volume model, to make sure we protect our customer acquisition cost.

We cannot allow ourselves to get upside down in the acquisition of these new customers, or else we forfeit that margin opportunity I just talked about. So our desire here is how do we bring our productized approach in a way that resonates with these customers, so that on our service set, we knock their socks off, and they're giving us ten out of ten, at the same time, acquire them in an economically advantaged way for us?

Bryan McGrath - *Credit Suisse - Analyst*

Got it. Thank you very much.

Operator

And now, Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you very much. Good afternoon. Could you -- you talked about some of the precursors to demand. Can you talk about what you're seeing on international markets versus the US? And then, if I look at the customer gear CapEx guidance, you're guiding up about 38% at the midpoint. Is that a pretty fair sort of proxy for what you're expecting in terms of incremental demand? How tight is the relationship between the -- that customer gear and the sort of the revenue we should be seeing next year? Thanks.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Sure. This is Lanham. I'll take the first part of the question about the international feeling today, and then I'll let Bruce handle the CapEx. From an international point of view, I would say -- first, let me cover where we operate. We're the US, Western Europe, and Hong Kong. When you go across those markets, the story between them is really pretty similar. Now Hong Kong is significantly smaller. Okay?

So when you look at percentage growth rates and that stuff, the small numbers tend to inflate those percentages. So it's smaller part of our business, so from a percentage point of view, that's going to give that analysis an advantage toward Hong Kong. Generally speaking, we are seeing very similar attributes across the different geographies in which we operate.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

In terms of the customer gear CapEx, you're right. There is a correlation between customer gear and our growth rates. Now, as we said before, we don't give guidance, but certainly, customer gear is very success based. There are a lot of factors that can influence the growth rates -- how quickly we deploy the equipment when customers come on board, the recycle rate we have for old equipment, the upgrades that some of our customers have.

And so, you have to look at all those factors, but generally, the growth rate will drive the amount of customer gear CapEx that we have. Now, in terms of your growth rates, I'm not going to comment on those, but certainly, you know historically how our CapEx has gone based on our growth rates.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. And is there any sort of first half, second half weight into the CapEx, or is it fairly smooth through the year?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

That customer gear is the biggest item in our CapEx, and it just depends on the growth rates and how they progress throughout the year. If they're relatively flat through the year, I'd say that our CapEx will be relatively flat.

Simon Flannery - *Morgan Stanley - Analyst*

Okay.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

If they accelerate or decelerate, that will impact them.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

Let's go to Chad Bartley with Pacific Crest now.

Chad Bartley - *Pacific Crest - Analyst*

Hi. Thanks a lot. Wanted to follow up on a margin question that was asked earlier. I know you want to stay away from specific guidance, but given the focus on growth this year, directionally, can you talk about EBITDA margin? Is it at all realistic for that to stay flat, or should we definitely expect to see that decline in 2010?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Well, again, on -- just mirroring on some of the things that Lanham had mentioned that we certainly believe we still have room for improvement on the margins where they are today. Likewise, a lot of the improvements we've made historically have not come because sales have declined necessarily, but we've instituted a lot of programs and processes improvements that will help us when demand scales going forward. Ultimately, we are very focused on profits and margins. A big part of that will be influenced on just how robust the economy is, though.

Chad Bartley - *Pacific Crest - Analyst*

Well, it sounds like you guys think the economy is improving or will at least be stronger in 2010. So, again, just hoping to get some color directionally on what you might think margins can do, just to avoid any confusion.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Well, yes, I think what we're trying to convey to everybody is that a year ago, we wanted to clearly state that it was about margins and cash, and then we were going to grow despite the work shrinking. This year, what we want to convey to people is that we want to pursue market leadership. We feel like we're at a point in the development of our industry where leaders are going to separate from the pack. We want to be one of those leaders. We think there is still upside in our margin structure, but we are not going to focus on increasing our margin this year like we did last year.

Our number one priority is going to be to increase our separation from competitors to build a differentiated position. And so, ultimately, our strategy here on how we build the business is we're going to differentiate on Fanatical Support, we're going to bring a portfolio approach to the marketplace, and if we're right, all this stuff is going to show up in our financials and prove out that we picked the right strategy.

Chad Bartley - *Pacific Crest - Analyst*

Okay. Thanks very much, guys.

Operator

And at Wells Fargo, let's go to Gray Powell.

Gray Powell - *Wells Fargo - Analyst*

Hi. Good afternoon, everyone. Thanks for taking the questions. I just have a few here. What kind of impact could Windows in the cloud have on new business wins in 2010, and at what point do you think it becomes -- do you think it actually becomes relevant to driving new business?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. Do you have more questions, or is that it? I kind of felt like you were going to give me four or five or something.

Gray Powell - *Wells Fargo - Analyst*

No, I guess my other question is more a follow-up. How should I just think about the timing of customer demand in 2010? Do you expect it to be more evenly loaded throughout the year or back end loaded?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. So, why don't I take the first question here around the cloud, with respect to our Windows launch? Launching Windows in the cloud basically doubles our addressable market. Up to this point, our cloud -- our public cloud has been driven by the Linux platform. Our private cloud, which we offer enterprise customers, is a VMware based offering.

So what the Windows cloud does is literally double our addressable market. So this is something that certainly -- within that product set, if we get it moving the way we want it to move, it will have a direct and meaningful impact on our traction in the cloud this year.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Looking at the overall demand, when you think about our business -- Lanham just talked a little bit about the impacts that Windows could have on the demand. On the managed hosting side, we really have two components; we have the new customer segment, as well as our installed based.

And if you think back into last year, our installed base, for the most part, until the fourth quarter, was relatively flat. So we didn't get a lot of the growth that you saw last year from our installed base. We believe that that's going to be very closely tied to the economy. That's our expectations. And so, as we're looking out into next year, you need to think about what you believe the economy will do. If the economy grows stronger throughout the year, then our expectation would be that our installed base would grow throughout the year.

If you think the economy is just going to come out blazing from the beginning, then it would probably be a little bit more even throughout the year. And so, that's how we look at growth and how we think about growth and how it relates to the economy.

Gray Powell - *Wells Fargo - Analyst*

Okay, great. That's all I had. Thank you very much.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Thank you.

Operator

Let's now go to Steve Salberta with Boenning & Scattergood.

Steve Salberta - *Boenning & Scattergood - Analyst*

Hi, guys. You mentioned that churn is back to the 2007 level, but when we go back to that time, you were doing much better than 2% monthly net upgrades. Would you expect, assuming a positive economic environment, that you can get back to that sort of number in 2010?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. Yes, so short answer is we sure hope so. If our experience serving customers is that what happens first is things stabilize, okay, meaning IT budgets firm up, churn declines, and then spending starts. Now the take rate of that spending is driven one part by what we can offer our customers. The other part is what is going on in their business?

So if you read some of the analyst reports and stuff out there, they talk about IT budgets starting to expand this year in 2010. If that comes true, then, yes, you'll see the net upgrades lines start to increase. How far it will increase, I think, really depends on the strength of that recovery and the expansion of IT budgets.

So the way we see things today is the middle of last year -- the middle of 2009, we were at the bottom. Okay? We had churn at a higher level than we have it today. We're starting to see the churn improve. We've seen DSOs and bad debt come back to a lower level. This has resulted in the first tick upward in our installed base growth in a meaningful manner in quite a while.

So if this rebound continues to strengthen and firm, the next step that we believe would happen is we would start to have additional spending out of our base, so you'd see the net upgrades line increase.

Steve Salberta - *Boenning & Scattergood - Analyst*

Yes. And it sounds like, so far, in the year, you've kind of seen that things build from the fourth quarter level. Is that fair?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

You're talking about the fourth quarter of 2009?

Steve Salberta - *Boenning & Scattergood - Analyst*

Yes.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Or 2008 --

Steve Salberta - *Boenning & Scattergood - Analyst*

Yes, fourth quarter of 2009. So what you've seen so far is you're seeing the strength in net upgrades and the momentum in churn continue?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

We don't really want to comment on Q1 2010. What we're trying to convey right now is that through the back half of '09, in the calls we told investors that things felt better. And sure enough, they not only felt better, they got better.

Steve Salberta - *Boenning & Scattergood - Analyst*

Yes.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

And so that's what -- that's how we ended last year. Because of our success last year, we think we can reorient our priorities around growth versus margin. We think this is a really important development, because our industry is a place where we believe there is going to be competitive separation that some of our traditional competitors will not make the leap to this service revolution technology.

We want to be a leader who seizes the service leader point of positioning the prospect's mind in the market, so that what we're trying to do here is reorient our thinking, and at the same time, convey to people that we are business model focused.

Steve Salberta - *Boenning & Scattergood - Analyst*

Okay. With respect to the managed hosting customer base, what should we think about, going forward? Should -- is this the right level, but you bring in more larger, more enterprise type customers than smaller customers that leave, so you kind of just hover right around here? Or, as with the economy improving, should we see the total managed hosting customers begin to grow?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes, great question. Okay, so in our portfolio approach that we set forth in 2009, within our traditional managed business, we were moving up the stack to solve more complexity. So this bore itself out. As we look at the average revenue per customer in managed, it grew during the year. We also took more simple IT workloads and wanted to migrate that to the cloud, because we could serve those customers better in the cloud, and we believe, in the long run, we will have a better economic outcome for our company serving them in the cloud.

Now if you look at our customer count today, and you see our managed hosting customer is 19,304. Relative to the total number of SMBs out there, 19,304 is a pretty small number. Right? And so, as we look at what we're going to do, we are going to aggressively pursue our enterprise growth opportunity. We also talked in our prepared remarks about reinvesting in our traditional SMB offer to try to reignite that growth as well.

So, we think there is more progress to be made in the SMB marketplace. We think the portfolio approach, combining cloud with managed there, will really help us further penetrate that market. All right? So what will happen here in our customer accounts is that, over time, we're going to have customers subscribing to what are traditional managed services, as well as, today, what are classified as cloud services.

So we're going to have a blurring of the lines here, so that crisply break out a pure managed customer versus a pure cloud customer. Our ability to provide that data to you will start to decline over time as our portfolio really catches on. So to give you a good picture of it, in managed, we're going to keep moving up market. We're going to win customers. We think there are actually more SMBs to win as well, as SMB IT spending comes out. We think the combination of our cloud service offering and our managed offering is going to be very compelling for SMBs.

Steve Salberta - *Boenning & Scattergood - Analyst*

Okay. My final question, guys, is with respect to employee headcount additions in 2010. When I look at -- when I think about investments, you have software. That kind of rolls into the P&L over time. Capacity -- you added a bunch of it at the end of '09, and utility expenses are kind of things that are success based, so they come pretty coincident with revenue growth. So, really, the remainder there is employees. Can you add employees fast enough, and what is your goals there, in terms of additions throughout '10?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes. Okay. When we think about Rackers, we think about this on a couple levels. As we screen folks, the first thing we screen around is values and an aptitude -- an attitude to serve. Then we want to train the technology skills that they need. And so, sometimes we can find hard core, technical folks that share our values and have an attitude to serve already; other times we have to train more on the technology piece of it.

Our ability to attract the Rackers we need to build the business has never been better. So an example there would be Mark Roenigk, our new COO, who is reloing from the West Coast to lovely San Antonio, Texas. This demonstrates our ability as a company to recruit highly talented folks from very successful companies to volunteer their best for our cause.

So we feel like our ability to attract talent has never been better, that we are a preferred employer in the markets in which we operate, and so we have a high degree of confidence that we will be able to continue to hire people.

In terms of our business model, Bruce had a reference in his language about Rackers being able to support 18% more devices on the front lines relative to a year ago. So the other thing we're being thoughtful about is we improve our operational effectiveness, we get efficiency gains out of the work we do for customers. So, this is where quality makes all the difference in our processes.

The better we serve customers, in some ways, it prevents further rework. It prevents additional work that we have to go do, so we think when we have the ability to hire the right people, we think we still have upside and efficiency effectiveness gains in terms of how we run the business, so that we can continue to get additional leverage in our model. So between those two, we feel really good about our position regarding bringing on new Rackers to build the business.

Steve Salberta - *Boenning & Scattergood - Analyst*

Great. Thank you.

Operator

And now, let's go to Patrick Walravens with JMP Securities.

Patrick Walravens - *JMP Securities - Analyst*

Congratulations, guys. So I just want to -- you've been over some of this, but I just want to see if I'm thinking about right. So your average revenue per cloud customer dropped a little bit, from around $250 a quarter to $240. And then, on the managed hosting side, it actually took a nice step up from -- if I'm doing my math right -- something like $7,200 to $7,900.

So do those trends continue? Does your revenue from managed hosting customer -- does it keep moving up market? Does that keep getting bigger? And on the revenue for cloud customer -- I mean, that's a competitive space. Does it keep going down? How should we think about that?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Pat, this is Bruce. What we really think about is -- in our business we have servers and capital. And so, what we try to do is figure out the most efficient way and effective way we can deploy our capital and provide a service that customers really love via Fanatical Support. And so, when we start looking at some of these statistics, we really focus more on revenue per server than customers.

Certainly, when you think about -- thinking about our revenue, if you try to correlate our revenue to the number of customers, it's going to be all over the board. If you were to correlate it to servers, there's probably a 97% correlation between the two. And so, for us, from a capital utilization, from a capital deployment, and from a ability to see where our business is going, the revenue per server is probably a better measure.

Patrick Walravens - *JMP Securities - Analyst*

Okay. And does that work on the cloud side, too, though?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Oh, absolutely. Absolutely. Because when you look at cloud, for instance, the cloud customers today, on average, bring us less revenue per customer basis. Right?

Patrick Walravens - *JMP Securities - Analyst*

Yes.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

We can put a lot of cloud customers on a piece of hardware, and so that piece of hardware can hold multiple cloud customers, where that same piece of equipment may only be able to hold one managed customer. So if you translate to -- that to what is the actual revenue per server, when you think about the unit economics in our business, that's a much more compelling and probably, more important statistic to think through.

Patrick Walravens - *JMP Securities - Analyst*

I got it.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

The other thing to add to that, Pat, is that we talked earlier about the segmentation of the cloud and how some of our early success there has been more in what -- we talked about the on-demand access to infrastructure versus the managed hosting service experience on the cloud. As we roll out additional services into the cloud, we will be able to increase our price point on those services to customers.

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Patrick Walravens - *JMP Securities - Analyst*

Okay, thank you.

Operator

Excuse me, Alex Kurtz with Merriman and Company. Go ahead, please.

Alex Kurtz - *Merriman and Company - Analyst*

Yes. Thanks for taking the question. So just back to this -- the thoughts around margin for 2010 and sort of where you guys are investing. So as you move upstream, and some enterprise customers, Lanham, do you think that you're going to be getting aggressive with some of the pricing, because those are typically, from a hardware system perspective, pretty aggressive sometimes with larger accounts? Or, do you think the investment is really going to come in the form of sales and marketing and expanding footprint in sales force capabilities there?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes, in terms of expanding our Enterprise business, pricing -- because we're already at a discount to some of the competitors there -- HP/EDS and IBM -- I don't think pricing is a big lever. If anything, I believe that as our brand strengthens, we'll be able to raise our price in that market. So in terms of acquiring new customers, I think it's more about managing our customer acquisition cost, maintaining the discipline with respect to how we price stuff, and building out those capabilities to win more enterprise customers.

Alex Kurtz - *Merriman and Company - Analyst*

Just on that point, you talk about moving into the enterprise aggressively. I'm just trying to figure out a way to quantify what you mean by that. Is that more sales force, more technical training? Sort of, what does that mean, and sort of, how that flows back to the EBITDA margins?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Oh, okay. So, I'll draw some comparisons for you. The traditional approach is to have a lot of hands and feet in the street, okay, that create a lot of account coverage and golf games, et cetera. Our approach has been more of a volume operations model to where we have a centralized sales force, and then we will go visit customers in geographies, as necessary, as part of helping the customer discover if we are the right partner for them.

We are going to be much more -- much closer to our traditional roots on this. That -- will we invest in some hands and feet in the street resources? Yes. But we are talking about minimal investment there and trying to leverage the central investment that we already have. We are not going to go to a high cost direct model. There's a lot of war stories and data out there about the effectiveness of those models.

The leverage that we bring to it is our service experience and our (inaudible) productized shop. And so, we can simply cover more ground centrally than if we can if we're actually out with hands and feet in the street. So from a margin point of view, these customers -- a question earlier we had was we experienced an uptick in our average revenue per managed hosting customer. What's doing it is enterprise customers. We are absolutely selling them more services than we do a traditional SMB customer, and with those services, it is a positive impact on our margin serving those customers.

So as a customer expands their footprint with us, we have economies of scale around the account management and technical services we provide to them. To do it for incrementally, a few more servers, for example, we have a nice incremental margin on that additional service to the customer.

Alex Kurtz - *Merriman and Company - Analyst*

Okay. Got it. Thank you very much.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes. Thank you.

Operator

Let's now go to Frank Louthan with Raymond James.

Frank Louthan - *Raymond James - Analyst*

All right. Great. So you say you may need to make some minimal investment in some feet on the street. What other operational changes do you think that you're going to need to make -- to get to that next phase in the cloud computing, and how do you think that's going to affect the organization? Are these more gradual changes, or are you looking to make some other sort of broader operational changes to serve these larger customers?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay. So -- are you still there?

Frank Louthan - *Raymond James - Analyst*

Yes, I'm here.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Okay, sorry. I heard a phone hang up or something on the line. Okay, so when we talk about enterprise, there's this investment set around customer acquisition, which we've talked about. The key here is we have to remain a productized service delivery model. If we deviate from that and become a job shop, we will wreck the advantage that we have.

The reason we can serve these customers so well at high quality levels, at high customer outcomes and still make a great margin for us is because we're productized. That for us the services we provide, then we just knock out, as if it's a factory and we think of ourselves as a lean services factory. So, this gives us a tremendous advantage relative to the incumbents there of IBM and EDS.

So I think with the investments there, it's about extending this model, not deviating from it. It's making it more powerful and figuring out better tactics and approaches to customer acquisition that still fall within our pricing discipline. When you get into the cloud and the investments we're making there, most of these investments on the people side tend to be development activities.

This is where we start to create additional intellectual property within our business, because as we look at building out our infrastructure to truly web scale and running a larger and larger percentage of apps out there, there's intellectual property opportunity for us.

Most of the traditional technology solutions out there were not conceived or architected with an idea about the cloud in mind. All right? So part of this service revolution that is taking place in technology is companies like Rackspace. It's us providing customers access to this on a web scale basis, even though they may only consume what is perceived to be a small portion of the cloud available.

So the investments here will be in the form of people with IP that we create. There may come a time where are investing in certain infrastructure systems as well to better manage this, because we want to make sure that we maintain our productized approach here in the cloud. So that we have this infrastructure in the cloud today, we're going to add to it additional service sets.

We're going to bring our portfolio to bear, so depending on which workload the customer is running, one of it may be in the cloud; another may be on a traditional dedicated environment. We wrap Fanatical Support around all of this to provide them a world-class experience.

Frank Louthan - *Raymond James - Analyst*

Great. That's helpful. And I -- you're talking about the -- some of the precursors to demand here. Where do you think you are relative to the competition in seeing some of these shifts? Are you ahead of them? Are you seeing some others move in -- move up market in this way that you're trying to keep up with, or how should we think about that from a competitive standpoint?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Well, I will confess that I do not extensively study our competition. I'm much more concerned about what we do and how we serve our customers than what our competitors are doing. I think that we control our destiny in our own hands. Okay? So my first obsession is how are we serving customers? What's our growth rate? We absolutely check how are we performing, relative to others, in terms of our traction. Okay?

So whatever the benchmark is for our industry, our expectation and desire is that we will be higher than that benchmark for growth. We fancy ourselves and believe that we are the market leader, that we are seizing a service point of difference in the marketplace, and therefore, within those segments, we expect to grow faster than our competition.

Frank Louthan - *Raymond James - Analyst*

Okay, great. Thank you.

Operator

Let's go now to Erik Suppiger with Signal Hill.

Erik Suppiger - *Signal Hill - Analyst*

Good afternoon.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Hello.

Erik Suppiger - *Signal Hill - Analyst*

Hey. So, on the CapEx on the customer gear, can you remind us -- is it 10% of your revenues that we can assume goes to maintaining customer gear, and then, everything above that would be the incremental growth?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Yes. We have sort of this crazy little formula that's not a precise formula, but it seemed to hold true in the past that about 10% of our prior year's revenue was for maintenance type capital, and then, roughly 50% of the incremental revenue would be used for customer gear. And there are a lot of factors that influence that. If you look over time and try to follow that rule, you'll see that our incremental spend went from the high 30s to the low 50% level, and so, there are a lot of factors.

When I mentioned earlier about things like our ability to recycle the equipment, how quickly we can get that deployed, in our data centers, the prices we pay for equipment, those are all influenced, ultimately, how much customer gear that we end up spending -- or buying.

Erik Suppiger - *Signal Hill - Analyst*

So just to be clear, did you say that -- the simple math is 150 over [109's] high 30s, and then you're saying that the incremental -- when you factor in the incremental piece, it's more in the kind of the -- the incremental growth is more in the 50% range? Is that right?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

No, no, no. When you -- well, I'm not sure what that question was, but let me sort of go back through the quick and dirty formula. If you're trying to figure out how much CapEx our company may require in terms of customer gear, the quick and dirty formula is 10% of the prior year's revenue would equate to the customer gear that I would call or consider maintenance CapEx. Okay?

Erik Suppiger - *Signal Hill - Analyst*

Yes.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

And in addition to that, we've got new revenue, incremental revenue, whether it's coming from the existing customers or new customers, and that, roughly, you could look at the revenue expectations -- incremental revenue expectations you have and hit it by a factor of from $0.40 to $0.50.

Erik Suppiger - *Signal Hill - Analyst*

Okay. All right. Second question -- on the sequential growth, did you give us what the sequential growth would have been for Q4 on and adjusted basis for FX? Or, put simply, what was the incremental benefit from foreign exchange?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Oh, okay. It's -- the adjusted for FX, sequentially, the fourth quarter would have grown about 5% over the third quarter.

Erik Suppiger - *Signal Hill - Analyst*

Okay. And then, lastly, on the margin front. It sounds to me like there are some areas of investment that you're going to be making going forward, but I don't hear you suggesting that we're going to go back to historical levels, in terms of sales and marketing as a percentage of revenue. And it doesn't sound like we're going to see notable degradation in terms of gross margin.

So I acknowledge that you're going to be focused on growth, but it doesn't sound like we're looking at EBITDA margins eroding so much as probably maintaining these levels. Is that the way to think about it?

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Well, a couple different contextual points here for you. With respect to growth, anything we do, we are going to maintain our discipline. We will make investments, so long as we believe we're going to get a good return out of them. So that what we're thinking about, as we look out in the marketplace, is when we look at the playbook from last year, we executed real well increasing our margins, and it was a priority for us.

I mean, a year ago, things were highly uncertain. There were dark clouds over the economy, so we were very focused on flexing our business model to increase margin. As we -- and with growth, a secondary concern. This year we've just inverted that. All right?

So when we think about our plan this year, growth is more important to us, because we're trying to achieve competitive separation. Margin and margin expansion, specifically, is less important to us. We believe there's upside in our margins from here. It's just not nearly as important to us to achieve that today relative to creating separation from others in our service sets.

So in terms of the timing of investments, a lot of this stuff will track as IT spending starts to grow and how aggressive we want to get. If we make changes to our playbook, we will certainly talk to everybody about it.

Erik Suppiger - *Signal Hill - Analyst*

Okay. But it sounds like it's a question of rate of improving margins from here, rather than rate of declining margins from here.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Well, look, we'll see. I mean, if there was a scenario to grow the business -- let's just say a crazy scenario -- 150% this year. All right? If we want to grow 150%, that would be tough to grow that fast and increase margins. Now I would -- maybe one day we'll figure that out, but I don't know how to do that today. So that when we look at our plan, we put more emphasis on growth today. We think there's upside in margin, but we're not focused on increasing our margins like we were last year.

Will investments come as IT spending rebounds? Absolutely they will. And so, those will be pretty tightly correlated. So as we go through the year, we'll execute on this playbook and be able to update you going forward.

Erik Suppiger - *Signal Hill - Analyst*

Okay, very good. And then, actually, last question, just on the average revenue per cloud customer. I know you've kind of pointed more towards server revenue, but can you just comment -- how much influence does the email service have on your average revenue per cloud customer? Because I think that's included in there. Is that correct?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Yes, that's all part of our cloud offerings. And when you look at our cloud customers -- we talk about managed hosting, there's a wide variation. There's a wide variation even in the cloud. We might have some folks in the cloud that come in and spend $20 with us a month, and then there are going to be folks that come in, whether they're a email customer or not, spending significantly more. So it -- there's a wide variation within even cloud.

Erik Suppiger - *Signal Hill - Analyst*

So the email piece is on a per customer, not a per [seat] basis, so that would actually be benefiting the cloud's revenue per customer. Is that right?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - CFO*

Yes.

Erik Suppiger - *Signal Hill - Analyst*

Okay. Very good. Thank you very much.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes. Thank you.

Operator

And, gentlemen, we have time for one more question. We'll go to Colby Synesael with Kaufman Brothers.

Colby Synesael - *Kaufman Brothers - Analyst*

I'll make it easy. All my questions have been answered. Thanks.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Thanks.

Operator

Thank you very much. At this time we'll conclude the question and answer session, and I'll turn the conference back to our presenters for any closing remarks.

Lanham Napier - *Rackspace Hosting, Inc. - CEO*

Yes, thank you. First off, thanks to all the folks on the call today and their interest in Rackspace. We want to thank our customers that we serve and that are part of this revolution we're trying to build here. Every day we are working to deepen our capability and serve you better. We want to thank all the Rackers on a global basis that volunteer their best to make Fanatical Support real. We are on a special journey to build something truly great -- something that lasts, and that's what we're going to do. So, we will get back to work here. Thank you.

Operator

Again, we now conclude our conference call for Rackspace Limited. Thank you for joining us today.