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PRESENTATION

Operator

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

(Operator Instructions)

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

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

Good afternoon. Thank you for joining Rackspace's first quarter 2010 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 first quarter of 2010. 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 first quarter 2010 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 or 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 Form 10-K for the ended December 31, 2009, which was filed with the SEC on February 26, 2010, and our first quarter Form 10-Q that will be filed on or before May 10, 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 results 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 questions.

Okay, let's get started. Lanham?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Good afternoon, and thank you for joining us today. Before I turn the floor over to Bruce to review our first quarter results, I want to highlight four key points to take away from this call. One, we are very pleased with our performance in Q1, as we accelerate revenue growth and improve margins. From a growth perspective, total revenue growth accelerate on sequential and year-over-year basis.

Rackspace also set a number of performance high-water marks, one of the most during the first quarter. For example, bookings in the month of March were very strong, setting a new company record. We deployed a company record number of new servers in Q1, and our enterprise group closed the largest new deal in the Company's history in the quarter. Perhaps just as important, we accomplished all these growth milestones, while simultaneously improving margins and return on capital in the quarter.

Two, hosting and cloud computing represent a massive virtually untapped market opportunity for Rackspace. We made good progress in the quarter toward capturing a larger share of its market.

There is a tectonic shift underway that is fundamentally altering the way the world consumes computing resources. We expect the magnitude of this change to eclipse that of past technology era, such as mainframe computers and PCs, simply because there is especially more computing power in the world today.

Our best estimate is that there are 50 million servers presently in service, and we manage only 0.1% of these machines. We believe that both the absolute number of servers, as well as our share of servers manage will grow in the future. We are the leader in the hosting and cloud computing industry, and our mission is to aggressively pursue this emerging multi-year, multi-billion dollar market opportunity.

Three, we are focused on only the non-commodity service intensive segment of the market. Many technical aspects of hosting and cloud computing required a trusted partner, due to the complexity of the system or the mission critical nature of the business processes that they support.

Rackspace is dedicated to providing our customers with the optimal technology outcomes that they demand, and we deliver on this to our culture customer service known throughout IT world as Fanatical Support.

Fanatical Support is a prescriptive complex business process we built over the past decade that differentiates our company in the market. Fanatical Support generates the best customer outcomes in our industry. It involves everything from the way we recruit and interview and test perspective employees, to the way we design the right solutions for customers, to the way we measure customer satisfaction and churn on daily basis down to the team level, to the way we incent our team and managers. Fanatical Support gives Rackspace a sustainable advantage that our competitors simply cannot replicate.

We differentiate not only through superior customer service, but also through our ability to offer our customers the right mix of dedicated, public, private and cloud application technologies that they acquire, a capability that we call hybrid hosting. These advantages had made us the recognized leader in the hosting and cloud computing industry.

Our historical operating and financial performance is a proof point that our competitive advantage is real, and we believe that our future financial and operating performance relative to the overall market and our competitors will strengthen this proof point in the marketplace.

Four, we are committed to taking a financially discipline approach to executing on this strategy. Our historical financial results prove our ability to profitably grow revenues and our Q1 results further validate our strategy.

Our revenue growth will be driven by four main areas; enterprise, cloud adoption, SMBs and installed base growth. For enterprise, we added 14 new enterprise customers in the quarter and as previously mentioned, we closed the largest new deal in company history. Our initiatives to penetrate more enterprise accounts are just over year old, and we are very pleased with the traction that we gained in the enterprise market so far.

One example, of an enterprise customer win (inaudible) is Apache Corporation, an $8.7 billion independent energy company in the crude oil and natural gas liquid sector. Apache selected Rackspace opposed it's electronic invoice presentment and payment application, because of our industry leading reputation of hosting enterprise great software apps. Apache has been extremely happy with our Fanatical Support approach, and our flexibility in executing on their changing IT hosting needs.

Within our Cloud business, momentum continues to build as customers leverage our deep technical expertise that's help them benefit from the cost and flexibility advantages provided by virtualization and other cloud technologies.

We are continuing to expand the breadth of our portfolio by introducing more and more services on our cloud. An example of the product that we have introduced is cloud service for windows. Although this product is still in its beta form, interest has been strong and we anticipate making this product generally available in the future. We are also working on a number of new offerings that will enable us to gain further traction and drive more revenue from our cloud service.

SMBs continue to represent an important growth area for Rackspace. Our portfolio approach enables us to provide SMBs with the optimal mix of dedicated and cloud-base technologies to fit their business needs. By choosing Rackspace, SMBs gain the technology advantages previously limited to corporation with large IT departments.

3

We see many new companies choosing to partner with the Rackspace for their computing needs, rather than building their capabilities in-house. In order to better reach SMB customers, we introduced a new partner program during the first quarter, designed to allow our partners to more efficiently add affiliates and resell cloud hosting services.

Installed based growth is a function of net upgrade minus churn. In some periods prior to the economic downturn, our installed base generate as much as 20% annual revenue growth for Rackspace. While churn has stabilized a very healthy levels, we have not yet experienced a material improvement in net upgrade activity. We are optimistic that upgrade activity will improve barring any negative shocks to the economy, which would help improve revenue growth.

On Thursday, May 6th, we will host the financial Analyst Day in New York City, to further cover Rackspace's market opportunity, growth strategy and financial performance goals.

The event will give members from the investment community the chance to interact directly with Rackspace's customers, to get a better understanding of why they choose Rackspace, why Fanatical Support and our portfolio approach to meet their needs matters, and how they plan to grow their relationship with Rackspace in the future. We hope to see all of you there at this inaugural event for Rackspace.

Finally, our strong first quarter results, as well as our success as a company to-date would not be possible without dedicated employees and loyal customers. I want to thank the Rackers for all their hard work, as well as our customers for entrusting us to run their most critical IT systems.

2010 will be an exciting year for Rackspace. Our advantages as the leader and specialist and hosting computing, and provider of Fanatical Support are validated everyday by customers, who pay us premium rates, stay with us for years and recommend us to their friends.

Our customers are incredibly royal; we aspire to serve them so well, that we will be known as most trusted company in all of IT. We have earned a strong position in the market, and we will create more and more value for our stakeholders. We see the opportunity and we intend to grab it.

With that, I'll turn it over the Bruce to review our detailed financial results. After Bruce finishes, we'll take your questions. Bruce?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Thank you, Lanham. As Lanham indicated, we are very pleased with our first quarter results, as almost all operating metrics improved on a sequential and annual basis. Beginning with revenue and growth, our total net revenue for the first quarter was $179 million, up 5.5% sequentially from the fourth quarter, and 23.2% year-over-year from the first quarter of 2009.

Changes in currency exchange rates quarter-over-quarter had a negative impact on net revenue of $2.1 million, adjusting for this and the $1.3 million one-time or non-recurring service [credits] issued in the fourth quarter of 2009, sequential revenue growth was 5.9%. Changes in currency exchange rates year-over-year had a positive impact on the net revenue of $3.6 million. On a constant currency basis, year-over-year revenue growth was 20.8% in the first quarter of 2010.

Cloud revenue for the first quarter was $19 million, accelerating to 13% sequential growth from the fourth quarter and 77% year-over-year growth from the first quarter of 2009. Managed hosting revenue increased to $160 million, accelerating to 5% sequential growth from the fourth quarter and a 19% year-over-year from the first quarter of 2009.

Once again, our Managed Hosting business was benefiting from our enterprise offering, which has allowed us to close bigger deals with new customers, including the 14 new enterprise accounts that Lanham highlighted in his opening remarks.

Moving on to activity within the installed base. First, our churn from the first quarter was 0.9%. This is slightly above the 0.8% mark we recorded in Q4, but well within a healthy range for the business.

Net upgrades for the first quarter were 1.1%, down slightly from the 1.3% from the fourth quarter. Net upgrades are a key part of our installed base growth, and we remain optimistic that net upgrades will trend higher as the economy continues to improve. The combination of installed base growth and churn, results in installed base growth of 0.2% for the quarter.

Total server count increased by 3,205 servers to 59,876, up from 56,671 servers at the end of the fourth quarter. We ended the quarter just below the 100,000 customer mark, with 99,446 total customers, up from 90,925 at the end of the fourth quarter. Total managed hosting customers grew to 19,366 in the first quarter, from 19,304 in Q4. And cloud customers grew to 80,080 from 71,621 in the prior quarter.

We were pleased to see managed hosting customer additions turn positive for the first time in three quarters, even though we actively migrated 135 single server customers to our cloud offering in the quarter.

Shifting to profitability on the cost side of the business, adjusted EBITDA for the first quarter grew to $59 million, a sequential increase of 6% and year-over-year increase of 32%. Adjusted EBITDA margin, adjusted only for non-cash share based compensation was 33.2%. This represents an improvement of more than 20 basis points sequentially and 216 basis point year-over-year. On a net basis, onetime items did not materially help or hurt margins in this quarter.

Adjusted EBITDA margin was negatively impacted by GAAP accounting rules. As you may recall from prior periods, lease accounting rules under GAAP require us to straight line the full amount of rental expense for data centers, even though we structure the cash payments to match our expected demand.

Because of the GAAP requirement, we recognize $1.8 million of non-cash rent expense in the first quarter. Excluding the non-cash rent expense, adjusted EBITDA margins would have been higher for the first quarter. We continue to expect approximately $6 million to $8 million of non-cash rent expenses for all of 2010.

For the remainder of 2010, we are focused on growing revenue while maintaining our current margin profile. The business continues to scale, and we continue to get more efficient on an operational capital basis. However, you will not see the full benefit of the increase affecting this in the margins, as we are investing the incremental profits in people and systems to automate our operations in data centers that will help us scale the business as we continue to grow.

We are committed to future profitability increases and any investments that we make will be closely scrutinized based on the impact they will have on our overall profitability profile in shareholder returns in the future.

Let's move onto capital expenditures. We spent $55 million in total capital expenditures during the first quarter; of this amount we spent $32 million on customer gear, $17 million on data center build-outs, $1 million on office space, and $5 million on capitalized software and other.

For the full year, we continue to expect total capital expenditures between $185 million and $235 million. Adjusted free cash flow in the quarter was $1 million. We expect that adjusted free cash flow will be positive in 2010, unless revenue growth exceeds 35% year-over-year.

Return on capital for the first quarter was 10.6% annualized, up from 10% in the fourth quarter. However, our return on capital would have been higher excluding the non-cash rent expense required under GAAP accounting rules. Net income for the quarter was $9.8 million, up 49% from last year and 9% from the fourth quarter.

Our balance sheet remains strong. We ended the quarter with $131 million of cash and cash equivalent, and access to an additional $194 million under our revolving credit facility. Our total debt outstanding including capital leases was $170 million, and net debt was $38 million. Net leverage at the end of the quarter was 0.18 times.

In summary, we are very pleased with our performance in the first quarter. We delivered on our commitments to improve revenue growth while maintaining profitability. When we looked at our total adjustment market, we continue to believe that hosting in cloud computing represent a massive, virtually untapped market opportunity for Rackspace. We will aggressively pursue this multi-year, billion dollar opportunity, but we will do so in a financially discipline manner.

We look forward to revisiting all of these points in our Inaugural Financial Analyst Day later this week, and we hope you will be able to make it in person or participate via the webcast.

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

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

We'll take our first question with Winston Len, with Goldman Sachs.

Winston Len - *Goldman Sachs - Analyst*

Hey, thanks for taking the question. Lanham, with Microsoft in the top market for a few months now and (inaudible) is talking up it's emending [launch] today. Can you update us on your strategy for maintaining a lead there? And some people are also concerned about potential pricing driven by big guys, so I would love your thoughts around that. And then I have a follow up question for margins.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Okay. We'll start with competitive set, and what happens as we have new entrants into the marketplace. Our strategy remains the same. Up to this point, we have built a leadership position through Fanatical Support. We possess a differentiated position in the market, around the service outcomes and technology outcomes that we deliver to our customers.

We believe the opportunity in front us is massive, that we have a long runway ahead of us, as IT goes through the shift from doing yourself, to buying IT as a service from a company like Rackspace. So, our strategy is to compete will remain the same.

We believe the market will segment over time -- that there will be different flavors. One will be a commodity flavor, where the people will want to buy things and it's based on the cheapest price; another will be a service flavor, where people will want a partner to run critical IT workload and they will want a world-class service experience around that critical IT workload.

Our strategy is to be the leader in that service intensive segment -- to be the leader in the segment, where people want to find a trusted partner to run a critical IT workload. This is where Fanatical Support really comes into play. So, how are we going to do this?

Number one. We want to be that number one service provider to compete for critical workloads. And then secondly, we are going to bring a portfolio approach. In our prepared remarks, we talked about public and private clouds, dedicated infrastructure, along with our traditional offerings.

This portfolio gives us a leg up on new incumbents, because they don't possess all those pieces. So basically, our target market remains the same and it's about serving businesses who are willing to pay for a world-class service outcome. We have the same four primary growth drivers; we have enterprise, Cloud, SMB and installed base growth.

When we look at pricing, what's happened there if you comb through the metrics, you can see where our revenue for servers actually trending up. So, what we think that this is just further validation that there are segments in the market, that there is a class of customer out there that wants the Fanatical Support and is willing to pay for a Fanatical Support experience.

Winston Len - *Goldman Sachs - Analyst*

Great. And then on margins, it sounds like you're making investments to make the business more operationally and capital efficient. So excluding those investments, how would your margins trend? And with these investments, how should we think about the potential returns on invested capital?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes. No -- that's a great question. Last year, we made significant progress in increasing our returns or our margins, ending the year at about 33% level. Our core business continues to scale and -- whether you're looking at the manage side of business or the growth that we're seeing in the Cloud business. But again, the idea is that we want to take those investment or those incremental dollars -- profit dollars above the 33% threshold and reinvest those for future growth.

Now in terms of the invested capital on our margins, we're going to look at all the things we're investing that to make sure that they both have a positive impact on our shareholders values as we look forward. And we're very cognizant about our return on capital as well. Here again, we've made some progress; we got to our return up to 10% last year and 10.6% this year on margins that are relatively flat quarter-to-quarter -- just slightly improved.

Winston Len - *Goldman Sachs - Analyst*

Great. Thank you.

Operator

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

Chris Larsen - *Piper Jaffray - Analyst*

Hey, thanks. And I'll just follow up on that. So -- as we're thinking about modeling, I know you don't give guidance but we'll start with the first quarter this 33% is, sort of, good baseline to start with for -- throughout the year and obviously you're fluctuating on and off with that. But, that's the way we should think about it as we're modeling out the rest of the year?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes. As we see the business today, absolutely; that's the way we think about the business. And in fact, at our analyst conference, we'll talk a little bit about the targets on returns and what different revenue growth rates -- how the affect them.

Chris Larsen - *Piper Jaffray - Analyst*

Okay. And then, going back to the core business, you talked a little bit about how you expect with GDP coming back, you'll start to see some of your installed based growth accelerate, I guess in the back half. What gives you the confidence in that? Are customers telling you that they are going to begin spending in the back half, or what do you think that they're waiting to see?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Well, Chris, this is Lanham. As we built the business over the last decade, we've been through a couple of cycles and this is how it has worked inside our company whether it was the tech wreck the first time, or the recession we've just experienced. The way the IT behavior works inside our company, specifically within our SMB business base, is it's highly linked to general economic activity.

So as we look at things today -- a year ago we were talking about first quarter GDP that shrank. This year, first quarter GDP was below the fourth quarter, but at least it was still on positive territory. So from a macro point the things are better today than they were a year ago. Our belief and expectation is that as things continue to improve and SMBs, in particular, start to invest in IT infrastructure again, we will see that in our business as we serve them.

Chris Larsen - *Piper Jaffray - Analyst*

Okay. And then, I got a last question on your balance sheet. I know you've been leasing a lot of your servers. And -- my thought is being that, couldn't you finance it cheaper yourselves using their own balance sheet, which is extremely under-levered right now? Or, do you feel that just having an under-levered balance sheet is the right way to run the business?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes. In terms of leasing versus using cash, we're in a position right now from a financing standpoint, where we are fully-funded. And certainly, we have that choice of leasing or buying using our cash. So far at this point, we've decide to maintain our cash balances and continue leasing. The cost will be a little bit cheaper, if we would use our cash, but at this point not significantly. We get pretty good rates with our vendors on a leasing standpoint.

Chris Larsen - *Piper Jaffray - Analyst*

All right. Thanks a lot, and congratulations.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Thank you.

Operator

We'll hear next from Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thanks very much. Good afternoon. Good to -- you mentioned you had record bookings in March, perhaps you would give a little bit more color around what sort of customers those are, and what sort of products they are taking? I know you have touched on Apache earlier.

And then on the expense trends, can you talk through where you're adding the people? Is this sale force additions primarily, is it IT people -- some color on what you did in Q1 and what you see for the rest of the year. Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Okay. This is Lanham, again.

Simon Flannery - *Morgan Stanley - Analyst*

Hi, Lanham.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

To give you little more context around March. For us, March was special outcome. We talked in our prepared remarks little bit about enterprise, how we've been on the path there for about a year. For us, what's happening is our ability to win enterprise customers has improved over the past year. And when we have a record month like we experienced in March, enterprise is a factor that basically makes all the difference. So, to give you little more color around that, here is what's going on.

This enterprise customers were winning, the competitive set tends to IBM, EDS, HP or CSC -- it's the traditional outsourcers. So what happens is, why are these customer considering us and migrating away from those -- one of those traditional outsourcers? It's a few things, first is at Rackspace we are deep when it comes to expertise in critical Web apps.

The traditional outsourcers, those guys are really good at legacy systems, but the Web is a different world. The Web moves at a faster pace than those companies typically operate. So when it comes down to expertise in a Web app that's mission critical, we are a great choice. When it comes down to speed and flexibility and responsiveness, many of the customer we win talk about how we can deliver infrastructure and solutions in days, where literally it takes the traditional outsourcers months.

In a Web world you can't wait for months for something to change. Our customers, in the mission critical loads they ask us to run for them, demand that this loads leave in a dynamic environment. Then lastly, we save them money.

So, the recession has been a great thing for our enterprise business because this traditional enterprise buyers, who have been in outsourcing environments, realize now in the recession they've got to save money and find new ways to do things. For this enterprise wins, we routine check customers a third, sometimes it's high as 40% or 50%. So, we just have a confluence of event here that really give us an advantage in this marketplace.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay. Your second question was around the people that we've added in the quarter.

Simon Flannery - *Morgan Stanley - Analyst*

Yes.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

The vast majority of our people that we added were really associated with our growth initiatives. And those folks are coming in either through our sales organization or within our cloud division, which is the faster growing part of the business. Now, in addition to that if you remember, we have opened up our Chicago data center to handle this growth, and so we also had to add folks to man the data center. So, almost all the people we added are really associated with growth at this point.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

We'll take our next question from Kash Rangan with Merrill Lynch.

Kash Rangan - *Merrill Lynch - Analyst*

Hi. Thank you very much. It's really good to see the managed net customer account -- that trending back up, and also the cloud metrics look pretty impressive. Lanham, just as a clarification, I think there is a descent amount of concern that what -- Microsoft/Azure might do or might not do. I think you did spend upfront some minutes talking about that.

Can you give us little bit more specifics? I know that you have a sizeable portion of your customer base on the dot-net platform, what you're fearing from this customer as to their willingness to continue to work with Rackspace in light of the Microsoft/Azure pitch? Any sensitivity you hear with respect to pricing attrition or loyalty through Rackspace that you can share with us? And I have a follow-up question. Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Okay. Yes. It's specially cash. When we look at our point of difference in the market around Fanatical Support and the services we provide, customers select us because they want a world class experience and a trusted partner. So when we -- one easy model to think about here is how things play out in the cloud will most likely be similar with how it's played out in hosted exchange. So we have a Hosted Exchange business that is a good business for us, it's thriving and it generates high customer royalty scores within our service set today.

And the reason why is that we tailor Fanatical Support around the basic technology itself, and there's some magic combination when it comes to the world class service expertise that a Racker provides with great technology like hosted exchange. We are taking that same model and applying it to the cloud. The cloud -- I think, the loyalty rates actually go a little deeper, because we're able to combine the cloud offering with some of our traditional decade offerings. So --

Kash Rangan - *Merrill Lynch - Analyst*

Lanham, I was actually more talking about the existing manage services customers that run a dot-net stack on your cloud, how do you -- what are these customers saying with respect to taking that same implementation and potentially hosting it on the

Azure cloud? Your thoughts on how you could standup, when Microsoft makes that pitch -- or, if they do make the pitch, is basically what I am trying to get it.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Yes. No -- this is the next point.

Kash Rangan - *Merrill Lynch - Analyst*

Oh,, I'm sorry, go ahead.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

No worries, it's a great question. So, I think that the short answer is customers today they run a workload on the window stack, don't want to move anyplace else to go do it at Azure. Right? Basically, what they want is to have a hybrid environment, where you can get the dedicated stake today Rackspace, along with the technology stake that a cloud provides on a Windows platform.

So we talked in our prepared remarks about our Windows cloud in beta. We are very pleased with the results and traction so far in that offering. We expect that the combination of that offering with our dedicated offering will enhance the loyalty and service capability that we can provide to our customers.

So, we feel like we're in really good spot, and all customer feedback that we received so far has been basically very positive. So, I think that what we will have here is some workloads will remain on dedicated infrastructure, other workloads will tap into the cloud infrastructure and our dot-net customers are anxiously anticipating to be able to do all that.

Kash Rangan - *Merrill Lynch - Analyst*

Great. So it doesn't look like you're overly worried about Azure or anything on the competitive side, at least when Microsoft is concerned.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

No, sir. I think where we hang our hat at Rackspace is around or service focused and we want to build the service leader. We believe we have a great early leadership position in that; we want to deepen that position. Everything we do around here about Fanatical Support and deepening the prescriptive business process that Fanatical Support is which generates customer outcomes. So, we like our spot there; we just want to do more of it.

Kash Rangan - *Merrill Lynch - Analyst*

And as you map out the trajectory of the enterprise -- when certainly 14 events looks pretty impressive, what could that mean to your business model? I mean, are you hitting more economies of scales, or do you have actually to invest more in CapEx to be able to win more and more of this enterprise customers? And that's it for me. Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

The Enterprise business for us represents an enormous opportunity. When we think -- one way to think about it is if we segment IT spend by SMB versus enterprises. Enterprises are a disproportionate share of spend relative to customer count and IT spending in general. We have been historically an SMB company that has used a volume operations model to cheat-up in the enterprise.

Now that are service set and brand perception allows us to compete in enterprise, we see big opportunity here. It's one of those situations where we have a productized model, we can take the same services and deliver those services to an enterprise customer in a way that generates loyalty for the enterprise customer, gives them a great value, and still fits within our financial discipline model.

Operator

Thank you. Kash, did you have any other questions? Hearing no response, we will move to our next question from Alex Kurtz with Merriman and Company.

Alex Kurtz - *Merriman & Company - Analyst*

Yeah. Thanks for taking the question. Lanham, can you just dig a little bit more on the rez team -- the Rackspace enterprises team, and what the strategy is there trying to win when business against the larger customers in the US -- sort of what that team's doing? And, did they drive a big portion of the 14 wins this quarter?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Yes. So, right now all enterprise group is the fastest group within manage hosting. And I give full credit to the Rackers over there doing it. Jim Lewandowski, Taylor Rhodes, Chris Cochran, Jeff Cotten, these folks are incredible Rackers and have done a amazing work getting this going.

So what's happening is the way we go to market here is we have a service set that's productized that we -- that's replicable that we can bring to this enterprise customers. We've had to tailor on messaging to enterprise customers because the classic enterprise buyer thinks about things differently in our traditional SMB buyer does. But what we have discovered is that enterprise customers have needs we can serve, and we can serve those needs really, really well. So our --

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Alex Kurtz - *Merriman & Company - Analyst*

-- Just building on the last question, I mean traditionally to get into enterprise markets you need a lot of bodies, you need a lot of brand and these are long sale cycles. Right? So, how are guys overcoming that or do you have to double down SG&A at some point to get there?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Yes. Look today, if you compare to Rackspace brand relative to the IBM brand and enterprise customer, we are in a disadvantage to IBM. Right? IBM has a 100 year brand history serving enterprise customers, but I tell you where we have a brand advantage is when it comes to running a mission critical Web app. So we have not had hired a ton of hands and feet in the street. Okay?

Instead, what we are doing is we are leveraging our central model. We do have some assets around the country -- some reps around the country, but really the way we think about is how do we leverage the central team we have in our offices in San

Antonio, Texas -- use our field reps to be an extension of the theme out in the marketplace. So we don't feel like we have to -- we aren't taking a traditional enterprise approach; we're going to do this Rackspace way.

We're going to figure out how to compete on our terms with this other incumbent outsourcers. And so what's happened is, while our enterprise cycles are longer than our historic cycles -- man, we are not working on year and a half long enterprise cycle deals. None of that hit us at all. Our sales cycle and our business today on the top-end is four-five months. So when you get to an SMB deal with maybe a month or two, when you get to an enterprise deal, most of it in three or four months. So we --

Alex Kurtz - *Merriman & Company - Analyst*

-- Just to finish up my questions on this topic. When we look at pricing -- question earlier. When we look at pricing in these large manage hosting deals, Lanham, what are the big guys doing versus what you're doing? Are you pricing these deals at a discount, or are you actually waiting at a premium because of the service? How are those deals playing out competitively? Thanks.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Sure. In the enterprise market, most of the time we are at a discount to the incumbent outsourcer -- we are at a discount to them. The way it plays out is as we follow our discipline financial approach, we know with our cost of service, we understand what it takes to generate a good value to the customer, and so we follow that approach, hit the right price point, save the customer money and we're still at a discount to the incumbent there. And this works for us, all the while maintaining the margin profile and returns that we expect to generate in that offering.

Alex Kurtz - *Merriman & Company - Analyst*

Okay. Thank you.

Operator

We'll hear next from Gray Powell with Wells Fargo Securities.

Gray Powell - *Wells Fargo Securities - Analyst*

Hi, guys. Thanks for taking the questions. Just had a few quick ones. What percentage of demand in Q1 came from the corporate enterprise, or sort of the higher end of your target markets? And where do you see enterprise as a percentage of revenue just shaking out longer term?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Okay. Yes -- we don't want to get into the real specific breakdowns on each segment and what's driving it. What we are comfortable sharing is that enterprise is our fastest growing. We picked up 14 new wins. We do believe that the enterprise opportunity ahead of us is every bit is big or bigger than the SMB opportunity.

So that over time, we would expect if we execute on this well that enterprise plays a larger and more important piece of our growth going forward, which is why we're so excited about it. We feel like we have discovered a sweet spot in the marketplace here to where we can take our service sets to a new group of customers, provide them great value and it's a deal for us as well.

So we believe that enterprise over the long term is a really big important opportunity to our company. We want to build the service leader in hosted and cloud computing; building the right enterprise capabilities and serving these customers well is critical to that future.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay. That make a lot of sense. And then just switching topics, can you talk about the margins in return on invested capital on your cloud offering today, versus your Manage Hosting business? And just -- and then, where you expect that trend to go over the next, I don't know -- two to three years.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes. That's a good question. Currently, we don't break those out, but certainly our Manage Hosting business is a more mature business -- still a high growth, but more mature business than our cloud. And so, our cloud returns at this point -- that business has its scale, so they're low at this point.

Now overtime though, when you think about cloud, one of the huge advantages of cloud is that you've got a lot more capital efficiency in that versus our Manage Hosting business. And so our expectations are that we'll get margins very similar between the two businesses, but our return on capital would be much higher because I turns on the cloud will be higher.

Now, whether that takes three or four years to ultimately gets there -- a big part of that depends on how fast this business develops. But certainly we expect from a profitability standpoint return on capital, primarily that we love the Cloud business, it's much more efficient for us as well as for the customer.

Gray Powell - *Wells Fargo Securities - Analyst*

Got it.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay. Thank you very much.

Operator

And our next question will come from Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, good afternoon. The CapEx guidance you kept it the same, I'm wondering -- it's still a pretty range, are you're going to be trending maybe just above the midpoint as your first quarter actual CapEx might imply if we annualize that number? Is that a decent place to think about for CapEx?

And then in terms of management selling activity in the first quarter and early part of the second quarter, can you kind of comment on the pace and whether we might see a churn off that? Thank you.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Well, on the CapEx side, we kept the range because we still we will be within that range. It still early in the year. We'll give you another update at the end of the second quarter, but we believe that there is an opportunity on -- within that whole range at this point.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

As far as the insider selling goes, Graham and I each sold through a 10b5-1 plan, and those plans at this points have concluded.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. And then one more question on enterprise. What's typically the range that we're seeing in terms of MMR for enterprise customers? Is there a range to think about that's meaningful at this point?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Yes, and to use round numbers, I can -- why don't we talk a little bit about enterprise adoption and the growth of those customers once they are here? A good round number to use and the way to think about is a enterprise customers typically selects us and test us with one to two apps. This will be an environment where we charge $300,000 a year. What's critical here is how quickly we deploy the customer and how quickly we earn their trust.

Our experience has been, once we earn their trust, within a matter of a few months, call it three or four months, we will start to see upgrade activity within that customer space. So, they will test us with one to two apps, and that is a great way for us to start to win business because it's easy for the customer to test us that way.

We are not asking for everything. We are just asking to earn the shot at the table and earn their trust. Once we earn their trust, they will migrate additional apps to us. So some of the traction we see in customers, they may start out at call it $300,000 a year and before you know it a year later -- nine months later, they are north of $1 million. So that we'd experienced really good traction with these customers, once we have them inside of our fold.

Jonathan Atkin - *RBC Capital Markets - Analyst*

That's very helpful. Thanks very much.

Operator

We'll hear next from Frank Louthan with Raymond James.

Frank Louthan - *Raymond James - Analyst*

Great. Thanks. Again, staying with the enterprise side, what sort of the biggest pushbacks you get, and the sales process here and -- with the enterprise when you're pitching them? You said they are kind of slowly warming up to you guys. And what percentage of IT spend do you think you guys ultimately end up representing when you get a good solid enterprise customer over the longer term?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay. Yes, sure, some of the questions that come up with an enterprise customer tend to be around their legacy apps. So here at Rackspace, we cannot do everything. We have a discipline approach. We have a productized service set, and so the services we provide are what we want to sell to our customers. We don't want to get into a situation where we're doing a bunch of one-offs. One-offs would break our productized model and put us into a custom shop. Our productized model is what enables us to create Fanatical Support in a replicable fashion.

So as we are talking to enterprise customers, it's how do we take their apps and serve them with our productized model. To the extent they have an app that doesn't rest on one of the technologies they actually provide, that becomes a question during the sale process. How will the customer to take care of this app? Many times that app just stays right where it is today.

In the long run, what's going to happen is apps are all going to be moved into the Web. Things are going to come up from mainframes and get into a Web-centric computing model. So, in the long run as this shift toward buying computing as a service through a hosted provider like us continues apps will migrate our way. Okay? So the short run question is all those apps that are being written for the Web today on the Windows or Linux stack absolutely in our wheelhouse.

This is where we have a deep expertise, an expertise that we would stack up against anybody in the world in those kind of comparative situations. The question becomes that legacy app, and how does it get can handled; most of the time it stays right where it is inside the customer's environment.

Frank Louthan - *Raymond James - Analyst*

Okay. Great. Thank you.

Operator

We'll hear next from Srinivas Anantha with Oppenheimer.

Srinivas Anantha - *Oppenheimer - Analyst*

Yes. Good evening, and thank you. Lanham, I think you mentioned in your prepared remarks the growth from installed base should begin to improve with an uptick in economy. When you go back and look back historically, how long -- does it take before you see a pickup in the installed base spending, once the economy stabilizes?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

The short answer is they varies based on what's going on. Our expectation would be as economic expansion returns, and companies put investment dollars to work in IT systems, you'll see it immediately in a very short lag in our installed base growth numbers.

So what you see today is -- the enterprise examples we've talked about, those are companies that are, number one, trying to save money or number two, putting additional investment dollars to work. You've seen that in that segment already today. The question is, when does that happen more broadly across the economy?

Our belief is when that condition occurs, we will see it in our installed base growth number. We haven't seen it yet, so what we know today is the broad expansion in terms of IT spending hasn't taken root.

Srinivas Anantha - *Oppenheimer - Analyst*

Okay. And just one more question, as more enterprise clouds apps migrate to the cloud, what do you think is ultimately going to differentiate the winners and the losers? Is that having more proprietary applications that you write on your own, or just partnering with existing vendors and then truly build useful platforms a bit and hence the (inaudible) conflicts? Thank you.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Okay. It's really hard to maintain a close proprietary technology advantage. It's just hard to make that durable and sustainable. Our belief is that any technology advantage that gets created is (inaudible). It's just a matter of time before another company makes a different type of investment that generates a better technology advantage. This is why as we believe -- think about our future and how we believe computing ought to be consumed by businesses, we believe that it will be consumed as a service.

So that you buy from who you want, when you want, on the terms you want. You buy it as a service experience that enhances your business and doesn't strain assets. So our belief here at Rackspace is that in the future, the vast majority of computing will migrate from in-house computing to on-process computing to out-process computing.

We want to be -- have been working at it to run that. Our point of difference is going to be around the service that we provide. We're going to write a covenant in our SOAs about what this performance is going to be. So our belief is the way this marketplace works out is there will be segments -- there will be a commodity infrastructure segment where people want to buy for the cheapest price. For people that want that experience, Rackspace is not the right pick.

Our businesses want a entrusted partner to handle and navigate the change in all their technology, they want a world-class service experience; that's where Rackspace is going to be a pick. We want to build the Company that's known as the service leader within this technology revolution.

Srinivas Anantha - *Oppenheimer - Analyst*

Okay. Thank, Lanham.

Operator

Our next question will be from Erik Suppiger with Signal Hill.

Erik Suppiger - *Signal Hill - Analyst*

Hi. Good afternoon. You said you added 14 enterprise customers. Can you give us some kind of relative metric -- how did that compare to prior quarters?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Sure. The short answer is it was larger. It contributes meaningfully to our record bookings month in March, where we had a good pipeline going into the quarter. Our enterprise team executed really well on it and so we've had a good -- we had a good outcome based on that.

THOMSON REUTERS

Erik Suppiger - *Signal Hill - Analyst*

On the upgrades, you suggested that you expect them to recover when -- as the economy recovers that it actually came down a little bit here in the March quarter. Was there anything that happened in the March quarter that has started the upgrades to decline? The economy seems to have been getting better over the last three quarters.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Erik, the most recent macro data I read talked about Q1 GDP, coming in significantly lower than Q4. So, as far as anything specific that happened in the quarter, that would be the only thing I'd be able to point you to.

I think with what we're seeing as we talk to customers throughout the quarter is year-over-year, and I think people's body language is better in the first quarter of 2010 versus the first quarter of 2009 -- that a year ago, people really were in a much different place. So by all the psychological factors I think things are better, which is why we are optimistic about our future in relation to installed base growth and general economic recovery.

Erik Suppiger - *Signal Hill - Analyst*

Okay. Then, in terms of the average revenue for the cloud, for cloud customers, it showed a little bit of increase here in the March quarter, but are there any particular new services whether their net service or anything that's going on that you think might start to take your average revenue per cloud customer up?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

We are certainly working on increasing our service levels in the cloud. So as we do that, we believe there is an opportunity to increase the value that we provide customers, that could also therefore translate into a higher price that customers are willing to pay for that value.

Much of that is still in development stages in Rackspace. I mean the model that we think about is when we started the business in managed hosting, we were able to charge a premium for Fanatical Support relative to the first generation hosting competitors out there. As we add additional value and service to the cloud, we think there is a similar opportunity.

Erik Suppiger - *Signal Hill - Analyst*

Okay. Well, thank you very much.

Operator

Your next question comes from Rajesh Ghai with ThinkEquity.

Rajesh Ghai - *ThinkEquity - Analyst*

Yes. Thanks. I just wanted to go back to the answer that you just gave Lanham. Considering that on the cloud, most of your revenue comes from an automated service levels -- the human involvement is pretty low. I just wanted to understand, as we go forward what value can we add, considering that most customers expect an automated service in the cloud? And, how you really did get any pricing premium and how you really made money in this business going forward?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Sure. In cloud today -- cloud works potentially under the demand world. In an on demand world, much of the work wants to be done through a council, through a quick process, through automated processes, to where the customers doesn't necessarily want to talk with a recording.

The interesting thing is cloud does create technology complexity. This complexity creates service opportunities for Rackspace. So as cloud starts to virtualized physical environments and diversify the software layer from the physical layer, it does create service opportunities. And this is where we are interested in providing new service levels to the customers themselves.

So as cloud continues to develop new service opportunities to present themselves, this is what we are working on right now.

Rajesh Ghai - *ThinkEquity - Analyst*

Okay. And you talked about lifecycle of enterprise contract -- you said that very few customers give you one -- larger enterprise customers give you one app and that could be a $300,000 opportunity. I just wanted to understand that -- putting these specifics in enterprise user, you talk about this quarter. How big are those deals at this point of time, without considering what -- they might be big -- how big they could be in the future? And how much revenue was actually contributed during this Q1? That is the last.

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay. Yes. We have and working now -- Q1 revenue by enterprise customers. So that's a level of detail that we have not shared, historically in these calls. Generally speaking, what the enterprise customers that we've won follow in line with the examples that we've talked about already on this call.

It is an early entry point -- we've won one or two apps. We did mention on the call that we've literally won the biggest initial one we've ever had as a company. And that was larger than the $300,000 that we've talked about, obviously. It was significantly more than that.

So we have a little bit of mix, but our expectation is that these new wins are developed, like the wins we had last year and we will have additional opportunities to earn that customers trust and do work for them. So we see this enterprise wins -- we were in that first piece and we had opportunity to develop that business with the customer, once we earn their trust. So, we expect that process to continue with these customers.

Rajesh Ghai - *ThinkEquity - Analyst*

All right. Thank you.

Operator

We'll hear next from Colby Synesael with Kaufman & Company.

Colby Synesael - *Kaufman & Company - Analyst*

Great. Thanks for taking my question. Just wanted to talk a little bit more about the additional cost that you are referring to, it seems like you have a contribution margin in the worth of 50% -- huge incremental value that you guys are bringing in, but you are talking about maintaining the margins flat in 2010.

THOMSON REUTERS

Just trying to get an understanding of where that cost is going into -- I've actually heard that you guys are talking about investing in the Cassandra Open Source project of that more to compete with Amazon and I guess even Google. I'm just trying to get a better sense of that.

And also these costs that you are investing in, is this to maintain your current growth rate or just to accelerate the growth rate? I guess you did, in a roughly 20% growth right now. What's the implication for the money that you've been investing in 2010, if we are looking at 2011?

Bruce Knooihuizen - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes. I would categorize it as two buckets. One bucket is we want to improve the value that we provide customers in its cost effect, in our traditional offering. So many investments we are making make our current offering more efficient and lay the groundwork for future offering that we believe will add more incremental growth.

So the second bucket is about that incremental growth. The investments here as we are comfortable with them, have to do a scale in, capability and new technology. We are trying to create a technology advantage here at Rackspace like the conversation and point -- the dialogue we had a little bit earlier about, all competitive strategies that we announced are we are the service leader and we are going to have a portfolio approach, so that we are the number one tech for critical workloads.

The investments we are making support that strategy. So it's all stuff that is close in for what we are doing. We think that we are in a leadership position today within the service capability. We want to dig deep in that service capability. So that's why we are making the investments. So it's one part in our traditional offerings, making those offerings more effective, valuable and efficient for our customers, the other part is for new capabilities to build out that portfolio approach.

Colby Synesael - *Kaufman & Company - Analyst*

And this does lead to accelerating revenue growth?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

Well we'll see -- we are certainly not going to slow things down, as we make these investments, we believe there is a huge opportunity in front of us and we want to tap it. Now, how quickly the market adopts that, we don't know yet, we will do everything. We can influence it positively after rapid adoption. We believe the cloud today is going through rapid adoption phase, and we like our position in it.

Colby Synesael - *Kaufman & Company - Analyst*

Okay. Thank you.

Operator

You have follow-up from Alex Kurtz with Merriman & Company.

Alex Kurtz - *Merriman & Company - Analyst*

Yeah. Thanks for taking the second question here. Just back on the legacy ops kind of conversation with, earlier, Lanham, are you guys thinking about deploying some of kind of block base storage capability, maybe later this year, maybe getting in next

year that could compete for more of the private, the larger enterprise customers -- not the low-end cloud hosting we're doing today, but a sophisticated SAN base kind of storage, is that on the -- that something on the docket?

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

You know, we have a -- we still have lots of internal discussion about our roadmap on storage and when we want to wind things up and what we think the biggest opportunity are -- opportunities are.

One thing we're going to do at our session here this week at the Stock Exchange on Analyst Day, is given some of those roadmaps, that's a little deeper than we want to get into on this call. So I'd like to hold up until that session later on in the week to get into that.

Alex Kurtz - *Merriman & Company - Analyst*

Fair enough. Thank you.

Operator

And this does conclude the Q&A portion of today's conference. I'd like to turn the conference back over to today's speakers for any additional or closing remarks.

Lanham Napier - *Rackspace Hosting Inc. - CEO and President*

First of all, thank you for tuning into our call. We are proud of what we've done and we are more excited about the future than we've ever been. I want to thank Rackers who make this stuff actually happen, they make Fanatical Support every day. I want to thank our customers for trusting us to service them with their mission critical workloads, and I want to thank the stockholders for their support. We will continue to keep our head down and get after building one of the world's greatest service companies. Thank you.

Operator

Again, ladies and gentlemen, this does conclude today's conference call. We thank you for participation.