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FORM 10-Q

RACKSPACE HOSTING, INC. - RAX

Filed: May 06, 2010 (period: March 31, 2010)

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

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

FORM 10-Q

(Mark one)
☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2010.

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

For the transition period from ______ to ______.

Commission file number 001-34143

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

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

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

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

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

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

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

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

On April 23, 2009, 124,463,625 shares of the registrant's Common Stock, $0.001 par value, were outstanding.

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RACKSPACE HOSTING, INC.

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PART I – FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

RACKSPACE HOSTING, INC. AND SUBSIDIARIES— CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	December 31, 2009	March 31, 2010 (Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 125,425	$ 131,297
Accounts receivable, net of allowance for doubtful accounts and customer credits of $4,298 as of December 31, 2009, and $3,402 as of March 31, 2010	38,732	39,149
Income taxes receivable	7,509	10,754
Deferred income taxes	9,764	7,745
Prepaid expenses and other current assets	10,239	11,023
Total current assets	191,669	199,968
Property and equipment, net	432,971	448,583
Goodwill	22,329	23,329
Intangible assets, net	10,790	9,243
Other non-current assets	10,886	10,606
Total assets	$ 668,645	$ 691,729
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 89,773	$ 92,828
Current portion of deferred revenue	17,113	16,276
Current portion of obligations under capital leases	46,415	49,129
Current portion of debt	4,893	4,661
Total current liabilities	158,194	162,894
Non-current deferred revenue	2,331	1,768
Non-current obligations under capital leases	63,287	63,544
Non-current debt	52,791	52,183
Non-current deferred income taxes	30,850	26,945
Other non-current liabilities	11,765	13,970
Total liabilities	319,218	321,304
COMMITMENTS AND CONTINGENCIES		
Stockholders' equity:		
Common stock, $0.001 par value per share: 300,000,000 shares authorized; 123,773,977 shares issued and outstanding as of December 31, 2009, 124,361,064 shares issued and outstanding as of March 31, 2010	124	124
Additional paid-in capital	251,337	266,696
Accumulated other comprehensive loss	(10,257)	(14,430)
Retained earnings	108,223	118,035
Total stockholders’ equity	349,427	370,425
Total liabilities and stockholders’ equity	$ 668,645	$ 691,729

See accompanying notes to the unaudited consolidated financial statements.

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

(In thousands, except per share data)	Three Months Ended March 31, 2009	Three Months Ended March 31, 2010
Net revenue	$ 145,077	$ 178,805
Costs and expenses:		
Cost of revenue	46,210	57,007
Sales and marketing	20,502	21,977
General and administrative	37,540	46,395
Depreciation and amortization	27,804	36,698
Total costs and expenses	132,056	162,077
Income from operations	13,021	16,728
Other income (expense):		
Interest expense	(2,535)	(2,144)
Interest and other income	(91)	185
Total other income (expense)	(2,626)	(1,959)
Income before income taxes	10,395	14,769
Income taxes	3,807	4,957
Net income	$ 6,588	$ 9,812
Net income per share		
Basic	$ 0.06	$ 0.08
Diluted	$ 0.05	$ 0.07
Weighted average number of shares outstanding		
Basic	117,608	123,981
Diluted	121,889	132,439

See accompanying notes to the unaudited consolidated financial statements.

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

(In thousands)	Three Months Ended March 31,	
	2009	**2010**
Cash Flows From Operating Activities		
Net income	$ 6,588	$ 9,812
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	27,804	36,698
Loss on disposal of equipment, net	176	148
Provision for bad debts and customer credits	2,309	536
Deferred income taxes	2,507	(1,721)
Deferred rent	(107)	1,804
Share-based compensation expense	4,237	5,978
Other non-cash compensation expense	85	104
Excess tax benefits from share-based compensation arrangements	-	(7,015)
Changes in certain assets and liabilities		
Accounts receivable	(6,336)	(1,366)
Income taxes receivable	(257)	3,770
Accounts payable and accrued expenses	(6,551)	3,407
Deferred revenue	304	(1,074)
All other operating activities	40	(188)
Net cash provided by operating activities	30,799	50,893
Cash Flows From Investing Activities		
Purchases of property and equipment, net	(25,589)	(39,622)
Net cash used in investing activities	(25,589)	(39,622)
Cash Flows From Financing Activities		
Principal payments of capital leases	(9,838)	(12,796)
Principal payments of notes payable	(751)	(840)
Payments on line of credit	(100,000)	-
Proceeds from employee stock plans	2,235	2,262
Excess tax benefits from share-based compensation arrangements	-	7,015
Net cash provided by (used in) financing activities	(108,354)	(4,359)
Effect of exchange rate changes on cash and cash equivalents	(243)	(1,040)
Increase (decrease) in cash and cash equivalents	(103,387)	5,872
Cash and cash equivalents, beginning of period	238,407	125,425
Cash and cash equivalents, end of period	$ 135,020	$ 131,297
Supplemental cash flow information:		
Acquisition of property and equipment by capital leases	$ 11,683	$ 15,766
Shares issued in business combinations	$ 765	$ -
Cash payments for interest, net of amount capitalized	$ 2,543	$ 2,144
Cash payments for income taxes	$ 759	$ 3,414

See accompanying notes to the unaudited consolidated financial statements.

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1. Overview and Basis of Presentation

Nature of Operations

As used in this report, the terms “Rackspace”, “Rackspace Hosting”, “we”, “our company”, “the company”, “us,” or “our” refer to Rackspace Hosting, Inc. and its subsidiaries. Rackspace Hosting, Inc., through its operating subsidiaries, is a provider of hosting solutions. We provide IT as a service, managing web-based IT systems for small and medium-sized businesses as well as large enterprises. We focus on providing a service experience for our customers, which we call Fanatical Support®.

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

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

Basis of Consolidation

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

Basis of Presentation

The accompanying consolidated financial statements as of March 31, 2010, and for the three months ended March 31, 2009 and 2010, are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all financial information and disclosures required by GAAP for complete financial statements and certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary for a fair statement of our financial position as of March 31, 2010, our results of operations for the three months ended March 31, 2009 and 2010, and our cash flows for the three months ended March 31, 2009 and 2010.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2009 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2010. The results of the three months ended March 31, 2010 are not necessarily indicative of the results to be expected for the year ending December 31, 2010, or for any other interim period, or for any other future year.

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

Use of Estimates

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

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2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the application of certain significant accounting policies. There have been no material changes to our significant accounting policies that are disclosed in our audited consolidated financial statements and notes thereto as of December 31, 2009 included in our Annual Report on Form 10-K.

Recently Adopted Accounting Pronouncements

In December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2009-17, which codified Statement of Financial Accounting Standard (SFAS) 167, *Amendments to FASB Interpretation No. 46(R),* issued in June 2009. This guidance amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. ASU 2009-17 also replaces the quantitative-based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity. Additionally, ASU 2009-17 provides more timely and useful information about an enterprise's involvement with a variable interest entity. ASU 2009-17 became effective for us this quarter. This ASU did not have a material impact on our consolidated financial statements.

In January 2010, the FASB issued ASU 2010-06, "Fair Value Measurements and Disclosures," which amends the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). ASU 2010-06 became effective for us this quarter, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us in the first annual reporting period that begins after December 15, 2010 and for interim periods within that annual reporting period. Other than requiring additional disclosures, adoption of this new guidance will not have a material impact on our financial statements.

Recent Accounting Pronouncements

In September 2009, the FASB issued two Accounting Standards Updates (ASU): (i) ASU 2009-13 (EITF 08-1), *Multiple-Deliverable Revenue Arrangements*, and (ii) ASU 2009-14 (EITF 09-3), *Certain Revenue Arrangements that Include Software Elements*, which will be effective prospectively for revenue arrangements, entered into or materially modified in fiscal years beginning on or after June 15, 2010. ASU 2009-13 amends ASC Subtopic 605-25 to eliminate the requirement that all undelivered elements in a multiple-element revenue arrangement have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) before an entity can recognize the portion of an overall arrangement fee that is attributable to items that already have been delivered. In the absence of VOSE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple-element arrangement, entities will be required to estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. Application of the "residual method" of allocating an overall arrangement fee between delivered and undelivered elements will no longer be permitted upon adoption. ASU 2009-14 amends ASC Subtopic 985-605 to exclude from its scope tangible products that contain both software and non-software components that function together to deliver a product's essential functionality. We do not expect the adoption of ASU 2009-13 or 2009-14 to have a material impact on our consolidated financial statements.

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3. Earnings Per Share

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

(In thousands, except per share data)	Three Months Ended March 31, 2009	Three Months Ended March 31, 2010
Basic net income per share:		
Net income	$ 6,588	$ 9,812
Weighted average shares outstanding:		
Common stock	117,608	123,981
Number of shares used in per share computations	117,608	123,981
Earnings per share	$ 0.06	$ 0.08
Diluted net income per share:		
Net income	$ 6,588	$ 9,812
Weighted average shares outstanding:		
Common stock	117,608	123,981
Stock options and awards	4,281	8,458
Number of shares used in per share computations	121,889	132,439
Earnings per share	$ 0.05	$ 0.07

We excluded 12.9 million and 1.2 million potential common shares from the computation of dilutive earnings per share for the three months ended March 31, 2009 and 2010, respectively, because the effect would have been anti-dilutive.

4. Cash and Cash Equivalents

Cash and cash equivalents consisted of:

(In thousands)	December 31, 2009	March 31, 2010
Cash deposits	$ 64,716	$ 70,585
Money market funds	60,709	60,712
Cash and cash equivalents	$ 125,425	$ 131,297

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. We actively monitor the third-party depository institutions that hold our deposits. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds.

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

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5. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. There is a three-tier fair value of hierarchy, which prioritizes the inputs used in measuring fair value as follows:

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

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

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

There have been no material changes to the valuation techniques utilized in the fair value measurement of assets and liabilities presented on our balance sheet as disclosed in our Form 10-K for the year ended December 31, 2009.

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

(In thousands)	December 31, 2009			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 60,709	$ -	$ -	$ 60,709
Rabbi trust (3)	576	-	-	576
Total	$ 61,285	$ -	$ -	$ 61,285
Liabilities:				
Interest rate swap agreement (1)	$ -	$ 1,818	$ -	$ 1,818
Deferred compensation (2)	586	-	-	586
Total	$ 586	$ 1,818	$ -	$ 2,404

(In thousands)	March 31, 2010			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 60,712	$ -	$ -	$ 60,712
Rabbi trust (3)	709	-	-	709
Total	$ 61,421	$ -	$ -	$ 61,421
Liabilities:				
Interest rate swap agreement (1)	$ -	$ 1,445	$ -	$ 1,445
Deferred compensation (2)	693	-	-	693
Total	$ 693	$ 1,445	$ -	$ 2,138

(1) Money market funds are classified in cash and cash equivalents and the interest rate swap agreement is classified in accounts payable and accrued expenses.
(2) Obligations to pay benefits under a non-qualified deferred compensation plan are classified in other non-current liabilities.
(3) Investments in marketable securities held in a Rabbi Trust associated with a non-qualified deferred compensation plan located in other non-current assets.

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6. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consisted of:

(In thousands)	December 31, 2009	March 31, 2010
Prepaid expenses	$ 7,505	$ 8,020
Other current assets	2,734	3,003
Prepaid expenses and other current assets	$ 10,239	$ 11,023

7. Property and Equipment, net

Property and equipment consisted of:

(In thousands)	Estimated Useful Lives	December 31, 2009	March 31, 2010
Computers, software and equipment	1-5 years	$ 511,279	$ 544,439
Furniture and fixtures	7 years	22,311	23,342
Buildings and leasehold improvements	2-30 years	134,045	134,056
Land	--	13,860	13,860
Property and equipment, at cost		681,495	715,697
Less accumulated depreciation and amortization		(298,369)	(322,443)
Work in process		49,845	55,329
Property and equipment, net		$ 432,971	$ 448,583

Depreciation and leasehold amortization expense, not including amortization expense for intangible assets, was $26.3 million and $35.1 million for the three months ended March 31, 2009 and 2010, respectively.

At December 31, 2009, the work in process balance consisted of build outs of $35.7 million for office facilities, $8.0 million for data centers, and $6.1 million for capitalized software and other projects. At March 31, 2010, the work in process balance consisted of build outs of $34.6 million for office facilities, $13.5 million for data centers, and $7.2 million for capitalized software and other projects.

Capitalized interest was $0.3 million and $0.1 million for the three months ended March 31, 2009 and 2010, respectively.

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8. Business Combinations and Goodwill

In October 2008, we acquired two companies for a total purchase price of $28.0 million, which were accounted for as business combinations. The initial purchase price of the combined acquisitions was $11.5 million paid in cash and stock, with up to $16.5 million in additional payouts of cash and stock based on certain earn-out provisions. As of December 31, 2009 earn-outs totaling $15.5 million had been achieved and paid in a combination of cash and stock. The final $1.0 million earn-out was achieved in March 2010 and was paid in April 2010 in a combination of cash and stock. The earn-out was accounted for as additional goodwill.

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

(In thousands)		
Balance at December 31, 2009	$	22,329
Earn-out payment for acquisition		1,000
Balance at March 31, 2010	$	23,329

9. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consisted of:

(In thousands)		December 31, 2009		March 31, 2010
Trade payables	$	24,597	$	31,936
Accrued compensation and benefits		28,469		23,509
Foreign income taxes payable		6,340		6,665
Vendor accruals		17,806		17,714
Other liabilities		12,561		13,004
Accounts payable and accrued expenses	$	89,773	$	92,828

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10. Debt

Debt outstanding consisted of:

(In thousands)	December 31, 2009	March 31, 2010
Revolving credit facility	$ 50,000	$ 50,000
Notes payable	7,684	6,844
Total debt	57,684	56,844
Less current portion of debt	(4,893)	(4,661)
Total non-current debt	$ 52,791	$ 52,183

Revolving Credit Facility

Our revolving credit facility includes an aggregate commitment of $245.0 million. The facility provides for letters of credit up to $25.0 million. The interest is based on a floating rate, generally the London Interbank Offered Rate (LIBOR) plus a margin spread, which changes ratably from 0.675% to 1.55% dependent on the total funded debt to adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA) ratio. We are required to pay a facility fee of 0.2% per annum on the full amount committed under the facility and a quarterly administrative fee. The facility has a 5-year term and matures in August 2012, and is fully secured by our domestic assets and a portion of our foreign subsidiary equity holdings and governed by financial and non-financial covenants. Financial covenants under our facility include a minimum fixed charge coverage ratio of at least 1.50 to 1.00 and a maximum total funded debt to EBITDA ratio of not greater than 3.00 to 1.00. Also, our foreign cash balance is limited to a balance of $25 million. As of March 31, 2010, we were in compliance with all of the covenants under our facility.

The revolving credit facility agreement provides us with the ability to borrow under our credit facility in pounds sterling and euros in addition to U.S. dollars. We have the ability to borrow up to $75 million in alternate currencies. As of March 31, 2010 we did not have any borrowings on our credit facility in alternate currencies.

As of March 31, 2010, the amount outstanding under the facility was $50.0 million, with an outstanding letter of credit of $0.6 million, resulting in an additional $194.4 million available for future borrowings.

Interest Rate Swap

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

We are required to pay the counterparty a stream of fixed interest payments at a rate of 4.135%, and in turn, receive variable interest payments based on 1-month LIBOR. The margin spread as of March 31, 2010 was 1.05% resulting in an effective fixed rate of 5.185%. The net receipts or payments from the swap are recorded as interest expense. The swap is designated and qualifies as a cash flow hedge. As such, the swap is accounted for as an asset or a liability in the accompanying consolidated balance sheets at fair value. We are utilizing the dollar offset method to assess the effectiveness of the swap. Under this methodology, the swap was deemed to be highly effective for the three months ended March 31, 2009 and 2010. There was no hedge ineffectiveness recognized in earnings for either period. If the hedge becomes ineffective, or if certain terms of the facility change, the facility is extinguished, or if the swap is terminated prior to maturity, the fair value of the swap and subsequent changes in fair value may be recognized in the accompanying consolidated statements of income. The fair value of the swap was estimated based on the yield curve as of December 31, 2009 and March 31, 2010, and represents its carrying value. See Note 5 for further disclosure on the fair value of the interest rate swap and Note 15 for further information on comprehensive income.

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

(In thousands)	December 31, 2009	March 31, 2010
Accounts payable and accrued expenses	$ 1,818	$ 1,445
Accumulated other comprehensive income (loss), net of tax	$ (1,182)	$ (940)

(In thousands)	Three Months Ended March 31, 2009	2010
Effective gain (loss) recognized in accumulated other comprehensive income, net of tax	$ 66	$ 242

As the interest rate swap expires in December 2010, the full amount of other comprehensive income related to the interest rate swap as of March 31, 2010 is expected to be reclassified to expense within the next 12 months.

As of March 31, 2010, we were in a liability position to the counterparty of the swap and therefore had limited counterparty credit risk.

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11. Other Non-Current Liabilities

Other non-current liabilities consisted of:

(In thousands)	December 31, 2009	March 31, 2010
Texas Enterprise Fund Grant	$ 5,000	$ 5,000
Deferred rent	5,391	7,526
Other	1,374	1,444
Other non-current liabilities	$ 11,765	$ 13,970

12. Commitments and Contingencies

Legal Proceedings

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

13. Share-Based Compensation

In January 2010, an additional 5.7 million shares became available for future grant pursuant to the automatic share reserve increase or "evergreen" provision under our Amended and Restated 2007 Long-Term Incentive Plan. As of March 31, 2010, the total number of shares authorized under all of our plans was 48.5 million shares, of which approximately 10.6 million shares were available for future grants.

Outstanding stock awards were as follows:

	December 31, 2009	March 31, 2010
Restricted stock units	2,087,500	2,473,818
Stock options	16,841,232	16,931,312
Total outstanding awards	18,928,732	19,405,130

The following table summarizes our restricted stock unit activity for the three months ended March 31, 2010:

	Number of Units	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2009	2,087,500	$ 5.47
Granted	386,958	$ 19.43
Released	-	$ -
Cancelled	(640)	$ 19.51
Outstanding at March 31, 2010	2,473,818	$ 7.65
Expected to vest after March 31, 2010 *	2,382,967	$ 7.23

* Includes reduction of shares outstanding due to estimated forfeitures

In the three months ended March 31, 2010, our board approved grants of approximately 387 thousand restricted stock units (RSUs) to certain employees that vest so long as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date. Stock-based compensation expense for these service vesting RSUs is measured based on the closing fair market value of the company's common stock on the date of grant and is recognized ratably over the service period.

As of March 31, 2010, there were 2.0 million RSUs outstanding that were granted in 2009 to our chief executive officer and another member of the executive team. The vesting of these RSUs is dependent on the company's total shareholder return (TSR) on its common stock compared to other companies in the Russell 2000 Index. In addition, the company's TSR must be positive for

vesting to occur.

As of March 31, 2010, there was $13.4 million of total unrecognized compensation cost related to non-vested RSUs that we have granted, which will be amortized using the straight line method over a remaining weighted average period of 3.04 years.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

The following table summarizes the stock option activity for the three months ended March 31, 2010:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2009	16,841,232	$ 6.02	7.56	$ 249,801
Granted	817,494	$ 19.44		
Exercised	(582,076)	$ 3.89		
Cancelled	(145,338)	$ 7.20		
Outstanding at March 31, 2010	16,931,312	$ 6.73	7.46	$ 203,948
Vested and exercisable at March 31, 2010	7,040,044	$ 3.63	6.29	$ 106,305
Vested and exercisable at March 31, 2010 and expected to vest thereafter *	15,940,079	$ 6.51	7.38	$ 195,372

* Includes reduction of shares outstanding due to estimated forfeitures

In the three months ended March 31, 2010, our board approved the grant of approximately 817 thousand stock options for certain employees with exercise prices of $18.75 and $19.51, depending on the date of the grant. The shares vest so long as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date and have a term of 10 years.

The total pre-tax intrinsic value of the stock options exercised during the three months ended March 31, 2009 and 2010, was $7.7 million and $8.7 million, respectively.

The weighted average fair value of stock options issued during the three months ended March 31, 2009 and 2010 was $2.97 and $10.79 respectively, using the Black-Scholes option pricing model with the following assumptions:

	Three Months Ended March 31,	
	2009	2010
Expected stock volatility	61%	56%
Expected dividend yield	0.0%	0.0%
Risk-free interest rate	2.24%	2.77% - 2.79%
Expected life	6.25 years	6.25 years

As of March 31, 2010, there was $39.3 million of total unrecognized compensation cost related to non-vested stock options that we have granted, which will be amortized using the straight line method over a weighted average period of 1.99 years.

Share-based compensation expense was recognized as follows:

(in thousands)	Three Months Ended March 31,	
	2009	2010
Cost of revenue	$ 629	$ 969
Sales and marketing	698	880
General and administrative	2,910	4,129
Pre-tax share-based compensation	4,237	5,978
Less: Income tax benefit	(1,552)	(2,006)
Total share-based compensation expense, net of tax	$ 2,685	$ 3,972

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

14. Income Taxes

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

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

During the three months ended March 31, 2010 we received federal income tax refunds totaling $1.0 million related to the 2008 tax period. In 2008 and 2009 we experienced taxable losses primarily as a result of the accelerated depreciation allowed under the 2008 Economic Stimulus Act passed in February 2008 and the 2009 American Recovery and Reinvestment Act passed in February 2009. In 2008 Rackspace incurred $28.7 million tax net operating losses which were fully utilized as part of a tax carryback claim. In 2009 Rackspace incurred $41.9 million tax net operating losses, of which $18.3 million will be utilized as part of a tax carryback claim. As of March 31, 2010, our income tax receivable is $10.8 million and the remaining $23.6 million of tax net operating losses will be carried forward to future taxable years and will expire at various dates through 2030.

Rackspace takes certain non-income tax positions in the jurisdictions in which it operates and may be subject to audit from these jurisdictions. Rackspace is also involved in related non-income tax litigation matters. We believe our positions are supportable and we have accrued for known exposure; however, significant judgment is required in determining the ultimate outcome of such matters. In the normal course of business, our position and conclusion related to these non-income taxes may be challenged and assessments may be made. To the extent new information is obtained and changes our views on our positions, probable outcome of assessments, or litigation, changes in estimates to accrued liabilities would be recorded in the period the determination is made.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

15. Comprehensive Income

Total comprehensive income was as follows:

(In thousands)	Three Months Ended March 31, 2009	Three Months Ended March 31, 2010
Net income	$ 6,588	$ 9,812
Derivative instrument, net of deferred taxes of $(36), and $(130) for the three months ended March 31, 2009 and 2010.	66	242
Foreign currency cumulative translation adjustment, net of taxes of $211 and $47 for the three months ended March 31, 2009 and 2010	(780)	(4,415)
Total other comprehensive income (loss)	(714)	(4,173)
Total comprehensive income	$ 5,874	$ 5,639

(In thousands)	Derivative Instrument	Translation Adjustment	Accumulated other comprehensive income (loss)
Balance at December 31, 2009	$ (1,182)	$ (9,075)	$ (10,257)
2010 changes in fair value	242	-	242
2010 translation adjustment	-	(4,415)	(4,415)
Balance at March 31, 2010	$ (940)	$ (13,490)	$ (14,430)

16. Segment Information

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or decision-making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision-maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information by reporting unit and geographic region for purposes of evaluating financial performance and allocating resources. We are organized as, and operate three operating segments based on our product and service offerings, which we refer to as our lines of business. The company's service offerings all (i) provide computing power to similar types of customers, (ii) have similar production processes, (iii) deliver their services in a similar manner, and (iv) use the same data centers and similar technologies. As a result of our evaluation of the criteria for aggregation by products and services, we determined we have one reportable segment, which we describe as Hosting.

Revenue is attributed to geographic location based on the location of the operating entity that enters into the contractual relationship with the customer. We break down the locations into either the U.S. or outside the U.S., which primarily consists of our business operations in the U.K. Total net revenue by geographic region was as follows:

(In thousands)	Three Months Ended March 31, 2009	Three Months Ended March 31, 2010
United States	$ 110,563	$ 132,186
Outside United States	34,514	46,619
Total net revenue	$ 145,077	$ 178,805

Our long-lived assets are primarily located in the U.S. and U.K., and to a lesser extent Hong Kong. Property and equipment, net by geographic region was as follows:

(In thousands)	December 31, 2009	March 31, 2010
United States	$ 344,353	$ 365,682
Outside United States	88,618	82,901
Total property and equipment, net	$ 432,971	$ 448,583

17. Related Party Transactions

We lease some facilities from a partnership controlled by our chairman of the board of directors. For these leases, we recognized $177 thousand and $94 thousand of rent expense on our consolidated statements of income for the three months ended March 31, 2009 and 2010, respectively.

18. Subsequent Events

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On May 4, 2010, we entered into an agreement with Tarantula Ventures LLC, a subsidiary of DuPont Fabros Technology, Inc. to lease approximately 28,200 square feet of raised floor space and storage space in a data center facility located in the Chicago, Illinois area. The leased space will be provided with a maximum critical load power of 4.333 megawatts. The lease provides for a commencement date at the earlier of February 1, 2011 and the date on which Rackspace begins to conduct business at the site. The lease has a term of 15 years from the commencement date and a total estimated financial obligation of approximately $100 million to $110 million over the 15 year term, inclusive of base lease payments and Rackspace's pro-rata share of operating expenses. Upon the expiration of the 15 year term, Rackspace has the option to renew the lease for two successive five year periods. Upon renewal of the lease, the rent can be reviewed and adjusted to market level, as set out in the lease.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

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

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

Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this document completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

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

Overview of our Business

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

We offer a portfolio of hosting services, including managed hosting, cloud hosting and cloud application hosting. The equipment required (servers, routers, switches, firewalls, load balancers, cabinets, software, wiring, etc.) to deliver services is typically purchased and managed by us.

We sell our services to small and medium-sized businesses as well as large enterprises. For the first three months of 2010, 26.1% of our net revenue was generated by our operations outside of the U.S., mainly from the U.K. Additionally, we operate a data center in Hong Kong and sales offices in Hong Kong and the Netherlands, which generate minimal revenue. Our growth strategy includes, among other strategies, targeting international customers as we plan to expand our activities in continental Europe and Asia. For the first three months of 2010, no individual customer accounted for greater than 2% of our net revenue.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Key Metrics

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

(Dollar amounts in thousands, except annualized net revenue per average technical square foot)	Three Months Ended (Unaudited) March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010
Growth					
Managed hosting customers at period end	19,048	19,363	19,328	19,304	19,366
Cloud customers at period end**	43,030	51,440	61,616	71,621	80,080
Number of customers at period end	62,078	70,803	80,944	90,925	99,446
Managed hosting, net revenue	$ 134,204	$ 138,943	$ 147,065	$ 152,394	$ 159,536
Cloud, net revenue	$ 10,873	$ 13,052	$ 15,334	$ 17,122	$ 19,269
Net revenue	$ 145,077	$ 151,995	$ 162,399	$ 169,516	$ 178,805
Revenue growth (year over year)	21.3%	16.2%	17.4%	18.4%	23.2%
Net upgrades (monthly average)	0.9%	1.2%	1.2%	1.3%	1.1%
Churn (monthly average)	-1.1%	-1.0%	-1.1%	-0.8%	-0.9%
Growth in installed base (monthly average) *	-0.2%	0.2%	0.1%	0.4%	0.2%
Number of employees (Rackers) at period end	2,661	2,648	2,730	2,774	2,905
Number of servers deployed at period end	50,038	52,269	54,655	56,671	59,876
Profitability					
Income from operations	$ 13,021	$ 13,403	$ 13,128	$ 15,689	$ 16,728
Depreciation and amortization	$ 27,804	$ 29,711	$ 32,696	$ 35,018	$ 36,698
Share-based compensation expense					
Cost of revenue	$ 629	$ 675	$ 778	$ 768	$ 969
Sales and marketing	$ 698	$ 721	$ 826	$ 639	$ 880
General and administrative	$ 2,910	$ 3,621	$ 4,008	$ 3,851	$ 4,129
Total share-based compensation expense	$ 4,237	$ 5,017	$ 5,612	$ 5,258	$ 5,978
Adjusted EBITDA (1)	$ 45,062	$ 48,131	$ 51,436	$ 55,965	$ 59,404
Adjusted EBITDA margin	31.1%	31.7%	31.7%	33.0%	33.2%
Operating income margin	9.0%	8.8%	8.1%	9.3%	9.4%
Income from operations	$ 13,021	$ 13,403	$ 13,128	$ 15,689	$ 16,728
Effective tax rate	36.6%	36.2%	33.9%	34.0%	33.6%
Net operating profit after tax (NOPAT) (1)	$ 8,255	$ 8,551	$ 8,678	$ 10,355	$ 11,107
NOPAT margin	5.7%	5.6%	5.3%	6.1%	6.2%
Capital efficiency and returns					
Interest bearing debt	$ 201,507	$ 210,284	$ 167,976	$ 167,386	$ 169,517
Stockholders' equity	$ 282,880	$ 308,823	$ 330,392	$ 349,427	$ 370,425
Less: Excess cash	$ (117,611)	$ (129,638)	$ (83,462)	$ (105,083)	$ (109,840)
Capital base	$ 366,776	$ 389,469	$ 414,906	$ 411,730	$ 430,102
Average capital base	$ 368,127	$ 378,123	$ 402,188	$ 413,318	$ 420,916
Capital turnover (annualized)	1.58	1.61	1.62	1.64	1.70
Return on capital (annualized) (1)	9.0%	9.0%	8.6%	10.0%	10.6%
Capital expenditures					

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Purchases of property and equipment, net	$	25,589	$	31,027	$	26,024	$	34,652	$	39,622
Vendor financed equipment purchases	$	11,683	$	23,637	$	20,664	$	12,398	$	15,766
Total capital expenditures	$	37,272	$	54,664	$	46,688	$	47,050	$	55,388
Customer gear	$	19,255	$	32,448	$	28,705	$	28,421	$	32,488
Data center build outs	$	11,386	$	13,914	$	4,028	$	7,880	$	16,644
Office build outs	$	2,239	$	1,651	$	5,432	$	5,350	$	1,220
Capitalized software and other projects	$	4,392	$	6,651	$	8,523	$	5,399	$	5,036
Total capital expenditures	$	37,272	$	54,664	$	46,688	$	47,050	$	55,388
Infrastructure capacity and utilization										
Technical square feet of data center space at period end ***		157,523		177,371		167,821		162,848		169,998
Annualized net revenue per average technical square foot	$	3,969	$	3,631	$	3,764	$	4,101	$	4,298
Utilization rate at period end		64.6%		59.8%		62.3%		65.3%		66.5%

* Due to rounding, totals may not equal the sum of the line items in the table above.
** Amounts include SaaS customers for Jungle Disk using a Rackspace storage solution. Jungle Disk customers using a third party storage solution are excluded.
*** Technical square footage excludes 30,250 square feet and 4,400 square feet for unused portions of the Chicago and Northern Virginia facilities, respectively.
(1) See discussion and reconciliation of our Non-GAAP financial measures to the most comparable GAAP measures.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Non-GAAP Financial Measures

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

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

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

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

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

We define excess cash as the amount of cash and cash equivalents that exceeds our operating cash requirements, which is calculated as three percent of our annualized net revenue for the three months prior to the period end. We will periodically review the calculation and adjust it to reflect our projected cash requirements for the upcoming year.

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

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

ROC increased from 9.0% to 10.6% for the three months ended March 31, 2009 compared to the three months ended March 31, 2010, primarily due to a lower tax rate favorably impacting the ROC calculation for the three months ended March 31, 2010 as well as a reduction of operating costs as a percentage of revenue. Included in the average capital base are capital expenditures of $15.9 million and $53.9 million related to the build out of our new corporate headquarters facility and data centers, respectively, since the beginning of 2009.

Return on assets increased from 4.1% for the three months ended March 31, 2009 to 5.8% for the three months ended March 31, 2010. This increase was primarily due to higher revenue and net income as well as a lower tax rate, partially offset by growth in our asset base due to the purchase of property and equipment to support the growth of our business.

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

	Three Months Ended (Unaudited)				
(In thousands, except financial metrics)	March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010
Income from operations	$ 13,021	$ 13,403	$ 13,128	$ 15,689	$ 16,728
Effective tax rate	36.6%	36.2%	33.9%	34.0%	33.6%
Net operating profit after tax (NOPAT)	$ 8,255	$ 8,551	$ 8,678	$ 10,355	$ 11,107
Net income	$ 6,588	$ 6,991	$ 7,604	$ 9,035	$ 9,812
Total assets at period end	$ 601,434	$ 656,793	$ 625,330	$ 668,645	$ 691,729
Less: Excess cash	$ (117,611)	$ (129,638)	$ (83,462)	$ (105,083)	$ (109,840)
Less: Accounts payable and accrued expenses	$ (71,211)	$ (87,316)	$ (77,108)	$ (89,773)	$ (92,828)
Less: Deferred revenues (current and non-current)	$ (20,374)	$ (20,011)	$ (18,222)	$ (19,444)	$ (18,044)
Less: Other non-current liabilities and deferred taxes	$ (25,462)	$ (30,359)	$ (31,632)	$ (42,615)	$ (40,915)
Capital base	$ 366,776	$ 389,469	$ 414,906	$ 411,730	$ 430,102
Average total assets	$ 643,348	$ 629,114	$ 641,062	$ 646,988	$ 680,187
Average capital base	$ 368,127	$ 378,123	$ 402,188	$ 413,318	$ 420,916

Return on assets (annualized)	4.1%	4.4%	4.7%	5.6%	5.8%
Return on capital (annualized)	9.0%	9.0%	8.6%	10.0%	10.6%

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Adjusted EBITDA (Non-GAAP financial measure)

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

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

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

Adjusted EBITDA as a percentage of net revenue has increased from 31.1% for the three months ended March 31, 2009 to 33.2% for the three months ended March 31, 2010 due to revenue increasing at a faster rate than our operating costs.

Income from operations has been favorably impacted by cost containment initiatives, but was partially offset by higher depreciation and amortization expense resulting from capital investments, and increasing share-based compensation expense from grants of stock options and other stock awards to employees. Our operating income margin increased from 9.0% for the three months ended March 31, 2009 to 9.4% for the three months ended March 31, 2010.

See our Adjusted EBITDA reconciliation below.

	Three Months Ended (Unaudited)				
(Dollars in thousands)	March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010
Net revenue	$ 145,077	$ 151,995	$ 162,399	$ 169,516	$ 178,805
Income from operations	$ 13,021	$ 13,403	$ 13,128	$ 15,689	$ 16,728
Net income	$ 6,588	$ 6,991	$ 7,604	$ 9,035	$ 9,812
Plus: Income taxes	$ 3,807	$ 3,973	$ 3,900	$ 4,648	$ 4,957
Plus: Total other (income) expense	$ 2,626	$ 2,439	$ 1,624	$ 2,006	$ 1,959
Plus: Depreciation and amortization	$ 27,804	$ 29,711	$ 32,696	$ 35,018	$ 36,698
Plus: Share-based compensation expense	$ 4,237	$ 5,017	$ 5,612	$ 5,258	$ 5,978
Adjusted EBITDA	$ 45,062	$ 48,131	$ 51,436	$ 55,965	$ 59,404
Operating income margin	9.0%	8.8%	8.1%	9.3%	9.4%
Adjusted EBITDA margin	31.1%	31.7%	31.7%	33.0%	33.2%

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Adjusted Free Cash Flow (Non-GAAP financial measure)

We define Adjusted Free Cash Flow as Adjusted EBITDA plus non-cash deferred rent, less total capital expenditures (including vendor financed equipment purchases), cash payments for interest, net, and cash payments for income taxes, net.

We believe that Adjusted Free Cash Flow is an important metric for investors in evaluating how a company is currently using cash generated, and may indicate its ability to generate cash that can potentially be used by the business for capital investments, acquisitions, reduction of debt, payment of dividends, etc. Note that Adjusted Free Cash Flow is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies.

See our Adjusted Free Cash Flow reconciliation to Adjusted EBITDA below, as well as our reconciliation of Net income to Adjusted EBITDA provided above.

(In thousands)		**Three Months Ended March 31, 2010**
		(Unaudited)
Adjusted EBITDA	$	59,404
Non-cash deferred rent		1,804
Total capital expenditures		(55,388)
Cash payments for interest, net		(2,098)
Cash refunds (payments) for income taxes, net		(2,284)
Adjusted free cash flow	$	1,438

Net Leverage (Non-GAAP financial measure)

We define Net Leverage as Net Debt divided by Adjusted EBITDA (trailing twelve months). We believe that Net Leverage is an important metric for investors in evaluating a company's liquidity. Note that Net Leverage is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies.

See our Net Leverage calculation below.

(Dollars in thousands)		**As of March 31, 2010**
		(Unaudited)
Obligations under capital leases	$	112,673
Debt		56,844
Total debt	$	169,517
Less: Cash and cash equivalents		(131,297)
Net debt	$	38,220
Adjusted EBITDA (trailing twelve months)	$	214,936
Net leverage		0.18x

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Results of Operations

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

Consolidated Statements of Income (Unaudited):

(In thousands)	March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010
	Three Months Ended				
Net revenue	$ 145,077	$ 151,995	$ 162,399	$ 169,516	$ 178,805
Costs and expenses:					
Cost of revenue	46,210	48,235	53,093	53,405	57,007
Sales and marketing	20,502	19,080	19,860	20,016	21,977
General and administrative	37,540	41,566	43,622	45,388	46,395
Depreciation and amortization	27,804	29,711	32,696	35,018	36,698
Total costs and expenses	132,056	138,592	149,271	153,827	162,077
Income from operations	13,021	13,403	13,128	15,689	16,728
Other income (expense):					
Interest expense	(2,535)	(2,172)	(2,147)	(2,096)	(2,144)
Interest and other income (expense)	(91)	(267)	523	90	185
Total other income (expense)	(2,626)	(2,439)	(1,624)	(2,006)	(1,959)
Income before income taxes	10,395	10,964	11,504	13,683	14,769
Income taxes	3,807	3,973	3,900	4,648	4,957
Net income	$ 6,588	$ 6,991	$ 7,604	$ 9,035	$ 9,812

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

(Percent of net revenue)	March 31, 2009	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010
	Three Months Ended				
Net revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses					
Cost of revenue	31.9%	31.7%	32.7%	31.5%	31.9%
Sales and marketing	14.1%	12.6%	12.2%	11.8%	12.3%
General and administrative	25.9%	27.3%	26.9%	26.8%	25.9%
Depreciation and amortization	19.2%	19.5%	20.1%	20.7%	20.5%
Total costs and expenses	91.0%	91.2%	91.9%	90.7%	90.6%
Income from operations	9.0%	8.8%	8.1%	9.3%	9.4%
Other income (expense)					
Interest expense	-1.7%	-1.4%	-1.3%	-1.2%	-1.2%
Interest and other income (expense)	-0.1%	-0.2%	0.3%	0.1%	0.1%
Total other income (expense)	-1.8%	-1.6%	-1.0%	-1.2%	-1.1%
Income before income taxes	7.2%	7.2%	7.1%	8.1%	8.3%
Income taxes	2.6%	2.6%	2.4%	2.7%	2.8%
Net income	4.5%	4.6%	4.7%	5.3%	5.5%

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

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

First Quarter 2010 Overview

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

The highlights and significant events of the three months ended March 31, 2010 and the impact on our operating results compared to the three months ended, December 31, 2009 were as follows:

Net Revenue - Net revenue increased $9.3 million, or 5.5%, from $169.5 million in the three months ended December 31, 2009 to $178.8 million in the three months ended March 31, 2010. The market for hosting services continues to be highly competitive and we face competition from existing competitors as well as new market entrants. However, we continue to grow our Managed Hosting and Cloud service offerings and believe that this full portfolio of hosting services positions us to benefit from increased IT spending in the future. During the first quarter, we experienced a negative revenue impact due to a strengthening U.S. dollar relative to the pound sterling, which resulted in a decrease to revenue of approximately $2.1 million, or 1.2%, for the three months ended March 31, 2010 compared to the three months ended December 31, 2009 with a minimal impact to our margins as the majority of customers are invoiced, and substantially all of our expenses associated with these customers are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. For the three months ended December 31, 2009 we experienced a monthly average churn rate of 0.8%, which slightly increased to 0.9% for the three months ended March 31, 2010, while net upgrades decreased from 1.3% for the three months ended December 31, 2009 to 1.1% for the three months ended March 31, 2010. Overall, our installed base had growth at an average rate of 0.4% per month for the three months ended December 31, 2009 compared to growth at an average rate of 0.2% for the three months ended March 31, 2010.

Income from Operations - Income from operations increased $1.0 million, or 6.6%, from $15.7 million for the three months ended December 31, 2009 to $16.7 million for the three months ended March 31, 2010. Operating income margin was 9.3% for the three months ended December 31, 2009 compared to 9.4% for the three months ended March 31, 2010.

Adjusted EBITDA - Adjusted EBITDA increased $3.4 million, or 6.1%, from $56.0 million for the three months ended December 31, 2009 to $59.4 million in the three months ended March 31, 2010. Adjusted EBITDA as a percentage of revenue was 33.0% for the three months ended December 31, 2009 compared to 33.2% for the three months ended March 31, 2010. See the discussion of Adjusted EBITDA, a non-GAAP financial measure for additional information.

Net Income and Net Income per Share - Net income was $9.0 million, or $0.07 per share on a diluted basis for the three months ended December 31, 2009 compared to net income of $9.8 million, or $0.07 per share on a diluted basis for the three months ended March 31, 2010. The increase in net income was mainly due to revenue growth. Lower general and administrative expenses, and depreciation and amortization expenses as a percentage of revenue, as well as a decrease in other expense for the three months ended March 31, 2010 compared to the three months ended December 31, 2009, were offset by an increase in cost of revenue, and sales and marketing expense as a percentage of revenue.

Quarterly Results of Operations (March 31, 2009 through March 31, 2010)

Net Revenue

Our net revenue has increased sequentially in each quarter primarily due to an increased volume of services provided, both due to an increasing number of new customers and incremental services rendered to existing customers. During this time period, the growth rate was negatively impacted by the economic conditions and decreased IT spend by our customers. Furthermore, in the first and fourth quarters of 2009 and the first quarter of 2010, the growth rate was also negatively impacted by the strengthening U.S. dollar versus the pound sterling. In the second and third quarters of 2009 we experienced a favorable impact from a weakening U.S. dollar versus the pound sterling. In addition to the impact of the economic conditions and foreign exchange rates, net revenue in the second and fourth quarters of 2009 was negatively impacted by service credits issued to certain customers who experienced downtime as a result of service interruptions in a portion of our data center operations in Grapevine, Texas. In the second and fourth quarters of 2009, we extended approximately $2.4 million and $1.3 million, respectively, for these service credits.

Cost of Revenue

Because of the growth of our revenue, our cost of revenue has increased sequentially in each quarter. Beginning in the second and third quarters of 2009, we began incurring rent expense related to our Northern Virginia and Chicago area data centers, even though we did not begin operations in the Chicago area data center until the first quarter of 2010. We recorded non-cash rent expense related to these data centers of $0.2 million, $1.9 million, $2.5 million and $2.2 million in the second quarter of 2009, third quarter of 2009, fourth quarter of 2009 and the first quarter of 2010, respectively. Additionally, in the three months ended December 31, 2009, there was a $2.1 million reduction to cost of revenue related to the reversal of a previously recorded obligation relating to an unresolved contractual issue with a vendor. This reversal was partially offset by an increase in variable compensation and other employee related expenses of $1.8 million, which occurred in part from the impact the reversal had on fourth quarter of 2009 results

based on targets defined within our non-equity incentive plan. Also, in the first quarter of 2010 consulting costs increased $1.7 million. As a percentage of revenue, cost of revenue remained consistent over the periods presented.

Sales and Marketing Expenses

During 2009, we continued to focus on scaling our expenditures, which is evidenced in the reduction in sales and marketing, expenses as a percentage of revenue. Sales and marketing continued to scale through 2009 and the first quarter of 2010 as we identified more efficient use of our sales resources. Sales and marketing expense had a larger increase in the first quarter of 2010 due to an increase in commissions associated with higher sales. As a percentage of revenue, sales and marketing decreased throughout 2009 from 14.1% to 11.8% with a small increase to 12.3% in the first quarter of 2010.

General and Administrative Expenses

Our general and administrative expenses have increased sequentially throughout 2009 and the first quarter of 2010. Increases have primarily been due to additional headcount in order to support the growth in the business. In the fourth quarter of 2009 an increase in variable compensation was mostly offset by a decrease in bad debt expense. As a percentage of revenue, general and administrative expenses have remained consistent at 25.9% of revenue for the first quarter of 2009 and 2010.

Depreciation and Amortization

Our depreciation and amortization has increased sequentially throughout 2009 and the first quarter of 2010 as a result of capital expenditures to support the growth of our business. As a percentage of revenue, depreciation and amortization has increased from 19.2% in the first quarter of 2009 to 20.7% in the fourth quarter of 2009 with a decrease to 20.5% in the first quarter of 2010.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010
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Three Months Ended March 31, 2009 and March 31, 2010

Net Revenue

Our net revenue was $145.1 million for the three months ended March 31, 2009 and $178.8 million for the three months ended March 31, 2010, an increase of $33.7 million, or 23.2%. The increase in net revenue was primarily due to an increased volume of services provided, resulting from an increasing number of new customers and incremental services rendered to existing customers. Partially contributing to the revenue increase was the positive impact of a weaker U.S. dollar relative to the pound sterling for the three months ended March 31, 2010 compared to the three months ended March 31, 2009. Net revenue for the three months ended March 31, 2010 would have been approximately $3.6 million lower had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year.

Cost of Revenue

Our cost of revenue was $46.2 million for the three months ended March 31, 2009, and $57.0 million for the three months ended March 31, 2010, an increase of $10.8 million, or 23.4%. Of this increase, $5.9 million was attributable to an increase in salaries, benefits, and share-based compensation expense. Total compensation increased as a result of salary increases and the hiring of data center and support personnel to support our growth. The cost increase was further attributable to an increase in license costs of $1.3 million, an increase in data center costs of $1.5 million related to power and rent and an increase in consulting fees related to data center assessments and improvements of $1.7 million. The remaining increase was due to small increases in other cost of revenue expenses.

Sales and Marketing Expenses

Our sales and marketing expenses were $20.5 million for the three months ended March 31, 2009 and $22.0 million for the three months ended March 31, 2010, an increase of $1.5 million, or 7.3%. Of this increase, $1.7 million was attributable to an increase in salaries, commissions, benefits, and share-based compensation expense. Total compensation increased as a result salary increases and the hiring of additional sales and marketing personnel and the impact of commissions associated with increased sales. Travel and other employee related expenses increased $0.3 million. The overall increase was partially offset by a decrease of $0.6 million in advertising and Internet-related marketing expenditures, due to a focus on areas that generate more efficient growth opportunities.

General and Administrative Expenses

Our general and administrative expenses were $37.5 million for the three months ended March 31, 2009 and $46.4 million for the three months ended March 31, 2010, an increase of $8.9 million, or 23.7%. Of this increase, $6.7 million was attributable to an increase in salaries and benefits, of which share-based compensation expense increased by $1.2 million as a result of stock option and restricted stock unit grants to employees in 2009 and in the first three months of 2010. Professional fees increased $1.1 million primarily as a result of increased consulting expenses related to corporate strategy and internal system maintenance and improvements. Property tax increased $0.7 million due to the addition of data center facilities. In addition, travel and other employee related expenses such as recruiting fees and relocation increased $1.5 million primarily due to the addition of several executive level positions and a general increase in hiring during the three months ended March 31, 2010. The overall increase was partially offset by a decrease in bad debt expense of $1.1 million due to a positive change in customer payment patterns and increased cash collections.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $27.8 million for the three months ended March 31, 2009 and $36.7 million for the three months ended March 31, 2010, an increase of $8.9 million, or 32.0%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software.

Other Income (Expense)

Our interest expense was $2.5 million for the three months ended March 31, 2009 and $2.1 million for the three months ended March 31, 2010, a decrease of $0.4 million, or 16.0%. The decrease was primarily due to the decreased level of indebtedness (including capital leases), as well as decreased borrowing rates. Interest expense was partially offset by capitalized interest of $0.3 million for the three months ended March 31, 2009 and less than $0.1 million for the three months ended March 31, 2010.

Interest and other income (expense) was $(0.1) million for the three months ended March 31, 2009 and $0.2 million for the three months ended March 31, 2010. In the three months ended March 31, 2009, we recognized $0.1 million in interest and other income and foreign currency losses of $(0.2) million. In the three months ended March 31, 2010, we recognized $0.1 million of interest and other income and minimal foreign currency gains.

Income Taxes

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Our effective tax rate decreased from 36.6% for the three months ended March 31, 2009 to 33.6% for the three months ended March 31, 2010, primarily as a result of increased earnings in 2010 being realized in countries where we have lower statutory rates than in the previous year. Our foreign earnings are generally taxed at lower rates than in the United States. The differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income, research and development credits, and permanent differences between the book and tax treatment of certain items.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Liquidity and Capital Resources

At March 31, 2010, our cash and cash equivalents balance was $131.3 million. We use our cash and cash equivalents, cash flow from operations, capital leases, and existing amounts available under our revolving credit facility as our primary sources of liquidity. We currently believe that cash generated by operations, current cash and cash equivalents, and available borrowings through vendor financing arrangements and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future.

Our revolving credit facility agreement allows us to borrow in pounds sterling and euros in addition to U.S. dollars. We are limited to borrowings of $75 million in alternate currencies. The option to borrow in other foreign currencies provides some protection against fluctuations in currencies in the countries in which we do business. The credit facility also has financial covenants that include a minimum fixed charge coverage ratio of at least 1.50 to 1.00 each quarter and a maximum funded debt to EBITDA of not greater than 3.00 to 1.00. Also, our foreign cash balance is limited to a balance of $25 million. As of March 31, 2010, we were in compliance with all of the covenants under our facility.

We maintain debt levels that we establish through consideration of a number of factors, including cash flow expectations, cash requirements for operations, investment plans (including acquisitions), and our overall cost of capital. Outstanding debt under our line of credit remained at $50.0 million as of March 31, 2010, with an outstanding letter of credit of $0.6 million. As of March 31, 2010, we had an additional $194.4 million available for future borrowings. Our credit facility expires in August 2012.

We have vendor finance arrangements in the form of leases and notes payable with our major vendors that permit us to finance our purchases of data center equipment. As of December 31, 2009 and March 31, 2010, we had $117.4 million and $119.5 million outstanding with respect to these arrangements. We believe our borrowings from these arrangements will continue to be available, and as long as they are competitive, we expect to continue to finance at least some of our equipment purchases through these arrangements.

Capital Expenditure Requirements

For the full year 2010, we expect to have total capital expenditures between $185 million and $235 million.

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

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

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

	Three Months Ended March 31, (Unaudited)	
(In thousands)	**2009**	**2010**
Cash provided by operating activities	$ 30,799	$ 50,893
Cash used in investing activities	$ (25,589)	$ (39,622)
Cash provided by (used in) financing activities	$ (108,354)	$ (4,359)
Acquisition of property and equipment by capital leases and equipment notes payable	$ 11,683	$ 15,766

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Operating Activities

Net cash provided by operating activities is primarily a function of our profitability, the amount of non-cash charges included in our profitability, and our working capital management. Net cash provided by operating activities was $30.8 million in the first three months of 2009 compared to $50.9 million in the first three months of 2010, an increase of $20.1 million, or 65.2%. Net income increased from $6.6 million in the first three months of 2009 to $9.8 million in the first three months of 2010. A summary of the significant changes in non-cash adjustments affecting net income and changes in assets and liabilities impacting operating cash flows is as follows:

• Depreciation and amortization expense was $27.8 million in the first three months of 2009 compared to $36.7 million in the first three months of 2010. The increase in depreciation and amortization was due to the purchases of servers, networking gear and computer software (internally developed technology), and leasehold improvements, as well as amortization of intangibles related to acquisitions.

• Our provision for bad debts and customer credits decreased from $2.3 million in the first three months of 2009 to $0.5 million in the first three months of 2010 due to positive changes in customer payment patterns and increased cash collections, as well as lower service level agreement credits.

• Share-based compensation expense was $4.2 million in the first three months of 2009 compared to $6.0 million in the first three months of 2010. The increase in expense was due to stock options and restricted stock units granted in 2009 and the first three months of 2010.

• Excess tax benefits from share-based compensation arrangements had no cash impact in the first three months of 2009 and created a cash outflow of $7.0 million in the first three months of 2010. Rackspace did not recognize the excess tax benefit from the exercise of options in 2009 because it did not result in a reduction of its current tax payable. However, for the 2010 period, the company does expect to have taxable income for a full year and, as such, has recognized the cumulative excess tax benefit in accordance with the accounting guidance.

• The change in accounts receivable was a cash outflow of $6.3 million in the first three months of 2009 compared to a cash outflow of $1.4 million in the first three months of 2010.

• The change in income taxes receivable was a cash outflow of $0.3 million in the first three months of 2009 compared to a cash inflow of $3.8 million in the first three months of 2010. We received federal income tax refunds totaling $1.0 million in the three months ended March 31, 2010, related to the 2008 tax period. The remainder of the change in income taxes receivable is due to the recognition of excess tax benefits from share-based compensation arrangements.

• The change in accounts payable and accrued expenses created a $6.6 million cash outflow in the first three months of 2009 compared to a $3.4 million cash inflow in the first three months of 2010. The changes resulted from the timing of payments for trade payables.

• The change in deferred rent created a $0.1 million cash outflow in the first three months of 2009 compared to a $1.8 million cash inflow in the first three months of 2010. The change resulted from data center lease arrangements that were entered into in 2009 with terms that included escalating rental payments. As total rent expense for each of these lease arrangements is recorded on a straight-line basis for the term of the lease, there is a difference between rent expense and cash paid for rent during the quarter.

Investing Activities

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

Our net cash used in investing activities was $25.6 million for the first three months of 2009 compared to $39.6 million for the first three months of 2010, an increase of $14.0 million, or 54.7%. The increase was primarily due to an increase in data center build outs and an increase in purchases of customer gear.

We purchase equipment through capital lease arrangements and other types of vendor financing that do not require an initial outlay of cash. Purchases through these arrangements increased from $11.7 million for the first three months of 2009 to $15.8 million for the first three months of 2010.

Financing Activities

Net cash used in financing activities was $108.4 million for the first three months of 2009 compared to $4.4 million for the first three months of 2010, a change of $104.0 million. This was due primarily to $100.0 million in net payments to our revolving credit facility during the first three months of 2009 compared to no repayments or advances in the first three months of 2010. Principal payments on capital leases and notes payable were $10.6 million for the first three months of 2009 compared to $13.6 million during

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the first three months of 2010. In addition, proceeds from exercises of stock options and the related excess tax benefits increased by $7.0 million in the first three months of 2010. Our net leverage as of March 31, 2010 was 0.18 times. See above for our discussion of Non-GAAP Financial Measures.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Contractual Obligations, Commitments and Contingencies

The following table summarizes our contractual obligations as of March 31, 2010:

(In thousands)	Total	2010	2011-2012	2013-2014	2015 and Beyond
Capital leases (1)	$ 119,624	$ 41,914	$ 72,744	$ 4,966	$ -
Operating leases	227,593	12,987	36,751	33,463	144,392
Purchase commitments	3,807	2,530	1,277	-	-
Revolving credit facility (2)	50,000	-	50,000	-	-
Software and equipment notes (2)	6,844	4,053	2,791	-	-
Total contractual obligations	$ 407,868	$ 61,484	$ 163,563	$ 38,429	$ 144,392

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

Leases

Capital leases are primarily related to expenditures for IT equipment. Our operating leases are primarily for office space and data center facilities.

Purchase commitments

Our purchase commitments are primarily related to costs associated with our data centers including bandwidth and consulting services.

Revolving Credit Facility

We have a credit facility with a committed amount of $245.0 million. As of March 31, 2010, we had $50.0 million of revolving loans outstanding and a $0.6 million letter of credit outstanding under the credit facility, resulting in $194.4 million available for future borrowings. The credit facility has a variable interest rate, which is generally the London Interbank Offered Rate (LIBOR) margin plus a margin spread. The rate was equal to 1.28% at March 31, 2010.

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

Software and Equipment Notes

We finance certain software and equipment from third-party vendors. The terms of these arrangements are generally one to five years. The interest rates on the arrangements range from 0.0% to 6.0%.

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities.

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

These indemnification obligations are considered off-balance sheet arrangements. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnification obligations in our financial statements.

Critical Accounting Policies and Estimates

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

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

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

A description of our critical accounting policies that involve significant management judgment appears in our Annual Report filed on Form 10-K filed with the SEC on February 26, 2010 under "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies."

Recent Accounting Pronouncements

For a full description of new accounting pronouncements, including the respective dates of adoption and impact on results of operation and financial condition, see "Notes to the Unaudited Consolidated Financial Statements – Note 2. Summary of Significant Accounting Policies."

Source: RACKSPACE HOSTING, INC., 10-Q, May 06, 2010 Powered by Morningstar® Document Research℠

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Power Prices. We are a large consumer of power. During the first three months of 2010, we expensed approximately $3.9 million that was paid to utility companies to power our data centers, representing 2.2% of our net revenue. Because we anticipate further revenue growth for the foreseeable future, we expect to consume more power in the future. Power costs vary by geography, the source of power generation, seasonal fluctuations, and are subject to certain proposed legislation that may increase our exposure to increased power costs. Our largest exposure to energy prices based on consumption currently exists at our Grapevine, Texas data center in the Dallas-Fort Worth area, a deregulated energy market. In August 2008, we entered into a fixed price contract with a provider of electricity for power for our Grapevine data center. The contract allows the company to periodically convert the price to a floating market price during the arrangement. The original term of the contract was 19 months and allowed the provider an option to extend the contract for an additional 19 months. The provider opted to extend the option in January 2010 for an additional 19 months. Also, in June 2009, we entered into a similar fixed price contract for 12 months for our Slough U.K. data center that has since been extended for an additional 12 months to expire in May 2011.

Interest Rates. Our main credit facility is a revolving line of credit with a base rate determined by the London Interbank Offered Rate, or LIBOR. This market rate of interest is fluctuating and exposes our interest expense to risk. Our credit agreement obligates us to hedge part of that interest rate risk with appropriate instruments, such as interest rate swaps or interest rate options. On December 10, 2007, we entered into an at-the-market fixed-payer interest rate swap with a notional amount of $50.0 million at an annual rate of 4.135%. This swap essentially fixes the rate we pay on the first $50.0 million outstanding on our revolving credit facility. As we borrow more, we may enter into additional swaps to continuously control our interest rate risk. Generally, we do not hedge our complete exposure. As a result, we may be exposed to interest rate risk on the un-hedged portion of our borrowings. For example, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of March 31, 2010 we did not have exposure to interest rate risk as we only had $50.0 million outstanding on our revolving credit facility.

Leases. The majority of our purchases of customer gear are vendor financed through capital leases with fixed payment terms generally over three to five years, coinciding with the depreciation period of the equipment. As of March 31, 2010, we have a principal liability for these leases of $112.7 million on our consolidated balance sheet, of which $49.1 million is classified as current. Although we believe our borrowings from these arrangements will continue to be available, we have exposure that vendor financing may no longer be available or the borrowing rates, which are fixed rates, may increase.

Foreign Currencies. The majority of our customers are invoiced, and substantially all of our expenses are paid, in the functional currency of our associated operating entity. A relatively insignificant amount of customers are invoiced in currencies other than the applicable functional currency, such as the euro. Therefore, our results of operations and cash flows are subject to fluctuations in foreign currency exchange rates. We also have exposure to foreign currency transaction gains and losses as the result of certain receivables due from our foreign subsidiaries, which are denominated in both the U.S. dollar and the pound sterling. During the first three months of 2010, we recognized minimal foreign currency gains within other income (expense). We have not entered into any currency hedging contracts, although we may do so in the future. Our revolving credit facility agreement provides us with the ability to borrow from our credit facility in pounds sterling and euros, rather than restricting borrowings to U.S. dollars. We currently do not have borrowings in any alternative currencies from our credit facility. As we grow our international operations, our exposure to foreign currency risk could become more significant.

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ITEM 4. - CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

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

Changes in internal control over financial reporting

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

Inherent Limitations of Internal Controls

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

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PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

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

ITEM IA – RISK FACTORS

Risks Related to Our Business and Industry

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

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

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

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

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We have experienced interruptions in service in the past, due to such things as power outages, power equipment failures, cooling equipment failures, routing problems, hard drive failures, database corruption, system failures, software failures, and other computer failures. While we have not experienced a material increase in customer attrition following these events, the extent to which our reputation suffers is difficult to assess. We have taken and continue to take steps to improve our infrastructure to prevent service interruptions, including upgrading our electrical and mechanical infrastructure. However, service interruptions continue to be a significant risk for us and could materially impact our business.

Any future service interruptions could:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Customer contracts for our managed hosting services typically have initial terms of one to two years which, unless terminated, may be renewed or automatically extended on a month-to-month basis. Our customers have no obligation to renew their services after their initial contract periods expire. Moreover, our customers could cancel their managed hosting service agreements before they expire. In addition, most of our other services, such as our cloud computing services, are generally provided on a month-to-month basis and do not have an extended initial term at all. Our costs associated with maintaining revenue from existing customers are generally much lower than costs associated with generating revenue from new customers. Therefore, a reduction in revenue from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue to retain our existing customers could have a material adverse effect on our operating results.

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

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

If we are unable to manage our growth effectively, our financial results could suffer.

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

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

Our market is characterized by rapidly changing technology, evolving industry standards, and frequent new product announcements, all of which impact the way hosting services are marketed and delivered. The adoption of new technologies, a change in industry standards or introduction of more attractive products or services could make some or all of our offerings less desirable or even obsolete. These potential changes are magnified by the continued rapid growth of the Internet and the intense competition in our industry. To be successful, we must adapt to our rapidly changing market by continually improving the performance, features, and reliability of our services and modifying our business strategies accordingly. We cannot guarantee that we will be able to identify the emergence of all of these new service alternatives successfully, modify our services accordingly, or develop and bring new products and services to market in a timely and cost-effective manner to address these changes. Our failure to provide products and services to compete with new technologies or the obsolescence of our services would likely lead us to lose current and potential customers or cause us to incur substantial costs by attempting to catch our offerings up to the changed environment.

We could also incur substantial costs if we need to modify our services or infrastructure in order to adapt to these changes. For example, our data center infrastructure could require improvements due to (i) the development of new systems to deliver power to or eliminate heat from the servers we house, (ii) the development of new server technologies that require levels of critical load and heat removal that our facilities are not designed to provide, or (iii) a fundamental change in the way in which we deliver services. We may not be able to timely adapt to changing technologies, if at all. Our ability to sustain and grow our business would suffer if we fail to respond to these changes in a timely and cost-effective manner.

The acceptance and growth of cloud computing is an example of a rapidly changing technology that has impacted our business and our market. Because of the technological advances and the market adoption and utilization of cloud computing, we have adapted to the changing market and implemented the new technology in our hosting service delivery. This change has already required us to make a substantial financial investment to develop and implement cloud computing into our hosting solution model and has required significant attention from management to refine our business strategies to include the delivery of cloud computing and hybrid solutions. As the market continues to adopt this new technology, we expect to continue to make substantial investments in our service solutions and system integrations.

Even if we have developed an attractive solution to the changing technology or standards, our introduction of the new solution could have lower price points than other offerings and may result in our existing customers switching to the lower cost products and services, which could reduce our revenue and have a material, adverse effect of our operating results. For example, the introduction of our cloud computing solutions provides a reasonable alternative to some of our dedicated hosting solutions at a lower price point and some of our dedicated hosting customers have switched to cloud computing solutions. We expect that other customers in this situation will switch to cloud computing in the future.

Finally, even if we succeed in adapting to a new technology or the changing industry standard by developing attractive products and services and successfully bringing them to market, there is no assurance that the new product or service would have a positive impact on our financial performance and could even result in lower revenue, lower margins and/or higher costs and therefore could negatively impact our financial performance.

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

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

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

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

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

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

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

- Do-it-yourself solutions with a colocation partner such as AT&T, Equinix, SAVVIS, and other telecommunications companies;
- IT outsourcing providers such as CSC, HP, and IBM;
- Hosting providers such as AT&T, British Telecom, SAVVIS, Terremark, The Planet, and Verio; and
- Large technology companies such as Amazon, Microsoft, Google, IBM and Salesforce.com, who are making investments in cloud computing.

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

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

- Develop superior products or services, gain greater market acceptance, and expand their service offerings more efficiently or more rapidly;
- Adapt to new or emerging technologies and changes in customer requirements more quickly;
- Bundle hosting services with other services they provide at reduced prices;
- Take advantage of acquisition and other opportunities more readily;
- Adopt more aggressive pricing policies and devote greater resources to the promotion, marketing, and sales of their services; and
- Devote greater resources to the research and development of their products and services.

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Our operating results may be further adversely impacted by unfavorable economic conditions, worldwide political and economic uncertainties and specific conditions in the markets we address.

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

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

Customer collections are our primary source of cash. We have historically grown through a combination of an increase in new customers and revenue growth from our existing customers. Over some recent quarters, we have experienced a decrease in our installed base growth. If the economic conditions were to deteriorate, we may experience additional reductions in our installed base growth, increases in churn and/or longer new customer sales cycles. We could also experience a decrease in revenue and a reduction in operating margins. Further, during challenging economic times, our customers may have difficulty gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. We cannot predict the timing, strength or duration of any economic slowdown or subsequent economic recovery. If the economy or markets in which we operate were to deteriorate, we may have to record additional charges related to the impairment of goodwill and other long-lived assets, and our business, financial condition and results of operations could be materially and adversely affected.

Finally, like many other companies, our stock price decreased during the onset of the recent economic downturn. Although our stock price has since recovered, if investors have concerns that our business, financial condition and results of operations will be negatively impacted by an economic downturn, our stock price could decrease again.

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

The costs of construction, leasing, and maintenance of our data centers constitute a significant portion of our capital and operating expenses. In order to manage growth and ensure adequate capacity for new and existing customers while minimizing unnecessary excess capacity costs, we continuously evaluate our short and long-term data center capacity requirements. Due to the lead time in expanding existing data centers or building new data centers, we are required to estimate demand for our services as far as two years into the future. We currently plan to increase our infrastructure as required through the addition and expansion of data centers in the U.S. and internationally. In contrast to most of our data centers that we have established to date, several of which were acquired relatively inexpensively as distressed assets of third parties, our current expansion plans may require us to pay full market rates for new data center facilities. If we overestimate the demand for our services and therefore overbuild our data center capacity or commit to long term facility leases, our operating margins could be materially reduced, which would materially impair our profitability.

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

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

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

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

We do not own the facilities occupied by our current data centers, but occupy them pursuant to commercial leasing arrangements. The initial terms of our main existing data center leases expire over a period ranging from 2012 to 2027, with each having at least one renewal period of no less than three years. Upon the expiration or termination of our data center facility leases, we may not be able to renew these leases on terms acceptable to us, if at all. If we fail to renew any data center lease and are required to move the data center to a new facility, we would face significant challenges due to the technical complexity, risk, and high costs of relocating the equipment. For example, if we are required to migrate customer servers to a new facility, such migration could result in significant downtime for our affected customers. This could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

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

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

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

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

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

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We engage and rely on third-party consultants who may fail to provide effective guidance or solutions which could result in increased costs and loss of business opportunity.

We engage third-party consultants who provide us with guidance and solutions relating to everything from overall corporate strategy to data center design to employee engagement. We engage these parties based on our perception of their expertise and ability to provide valuable insight or solutions in the areas that we believe need to be addressed in our business. However, these consultants may provide us with ineffective or even harmful guidance or solutions, which, if followed or implemented, could result in a loss of resources, operational failures or a loss of critical business opportunities.

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

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

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

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

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

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

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

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

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

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

On July 27, 2009, the Texas Enterprise Fund Grant agreement was amended to modify the job creation requirements. Under the amendment, the grant has been divided into four separate tranches. The first tranche, called "Basic Fund" in the amendment, is $8.5 million with a Job Target of 1,225 new jobs by December 2012 (in addition to the 1,436 jobs in place as of August 1, 2007 for a total of 2,661 jobs in Texas). We already have drawn $5.0 million of this grant. We can draw an additional $3.5 million when we reach 1,225 new jobs. If we do not create 1,225 new jobs in Texas by 2012, we will be required to repay the grant at a rate of $1,263 per job missed per year (clawback). As of December 31, 2009, we had created 617 new jobs. The maximum clawback would be the amounts we draw plus 3.4% interest on such amounts per year. The remaining three tranches are at our option. We can draw an additional $13.5 million, based on the following amounts and milestones: $5.5 million if we create a total of 2,100 new jobs in Texas; another $5.25 million if we create a total of 3,000 new jobs in Texas; and $2.75 million more if we create a total of 4,000 new jobs in Texas. We are responsible for maintaining the jobs through January 2022. If we eliminate jobs for which we have drawn funds, the clawback is triggered.

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

On August 3, 2007, we entered into a lease for approximately 67 acres of land and a 1.2 million square foot facility in Windcrest, Texas, which is in the San Antonio, Texas area, to house our corporate headquarters and potentially a future data center operation. In connection with this lease, we also entered into a Master Economic Incentives Agreement ("MEIA") with the Cities of Windcrest and San Antonio, Texas, Bexar County, and certain other parties, pursuant to which we agreed to locate existing and future employees at the new facility location. The agreement requires that we meet certain employment levels each year, with an ultimate job requirement of 4,500 jobs by December 31, 2012, provided that if the job requirement in any grant agreement with the State of Texas is lower, then the job requirement under the MEIA is automatically adjusted downward. Consequently, because the Texas Enterprise Fund Grant agreement has been amended to reduce the state job requirement, we believe the job requirement under the MEIA has been reduced to 1,774. In addition, the MEIA requires that the median compensation of those employees be no less than $51,000 per year. In exchange for meeting these employment obligations, the parties agreed to enter into the lease structure, pursuant to which, as a lessee of the Windcrest Economic Development Corporation, we will not be subject to most of the property taxes associated with the property for a 14 year period. If we fail to meet these job creation requirements, we could lose a portion or all of the tax benefit being provided during the 14 year period by having to make payments in lieu of taxes (PILOT) to the City of Windcrest. The amount of the PILOT payment would be calculated based on the amount of taxes that would have been owed for that period if the property were not exempt, and then such amount would be adjusted pursuant to certain factors, such as the percentage of employment achieved compared to the stated requirements.

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

As of March 31, 2010, outstanding indebtedness under our credit facility totaled $50.0 million, with an outstanding letter of credit of $0.6 million. Our credit facility requires that we maintain specific financial ratios and comply with covenants, including financial covenants, which contain numerous restrictions on our ability to incur additional debt, pay dividends or make other restricted payments, sell assets, enter into affiliate transactions and take other actions. Our existing credit facility is, and any future financing arrangements may be, secured by all of our assets. If we are unable to meet the terms of the financial covenants or if we breach any of these covenants, a default could result under one or more of these agreements, which may require us to repay all amounts owed under our credit facility.

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

We also have substantial equipment lease obligations, the principal balance of which totaled approximately $112.8 million as of March 31, 2010. The payment obligations under these equipment leases are secured by a significant portion of the hardware used in our data centers. If we are unable to generate sufficient cash flow from our operations or cash from other sources in order to meet the payment obligations under these equipment leases, we may lose the right to possess and operate the equipment used in our data centers, which would substantially impair our ability to provide our services, which could have a material adverse effect on our liquidity or results of operations.

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

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

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

We are a large consumer of power. During the first three months of 2010, we expensed approximately $3.9 million to utility companies to power our data centers. We anticipate an increase in our consumption of power in the future as our sales grow. Power costs vary by locality and are subject to substantial seasonal fluctuations and changes in energy prices. Our largest exposure to energy prices currently exists at our Grapevine, Texas facility in the Dallas-Fort Worth area, where the energy market is deregulated. Power costs have historically tracked the general costs of energy, and continued increases in electricity costs may negatively impact our gross margins or operating expenses. We periodically evaluate the advisability of entering into fixed price utilities contracts. If we choose not to enter into a fixed price contract, we expose our cost structure to this commodity price risk.

Our main credit facility is a revolving line of credit with a base rate determined by the London Interbank Offered Rate, or LIBOR. This market rate of interest is fluctuating and exposes our interest expense to risk. Our credit agreement obligates us to hedge part of that interest rate risk with appropriate instruments, such as interest rate swaps or interest rate options. On December 10, 2007, we entered into an at-the-market fixed-payer interest rate swap with a notional amount of $50.0 million at an annual rate of 4.135%. This swap essentially fixes the rate we pay on the first $50.0 million outstanding on our revolving credit facility. As we borrow more, we may enter into additional swaps to continuously control our interest rate risk. Generally, we do not hedge our complete exposure. As a result, we may be exposed to interest rate risk on the un-hedged portion of our borrowings. For example, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of March 31, 2010 we did not have exposure to interest rate risk as we only had $50.0 million outstanding on our revolving credit facility.

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

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

There may be intellectual property rights held by others, including issued or pending patents, trademarks, and service marks that cover significant aspects of our technologies, branding or business methods, including technologies and intellectual property we have licensed from third parties. Companies in the technology industry, and other patent and trademark holders seeking to profit from royalties in connection with grants of licenses, own large numbers of patents, copyrights, trademarks, service marks, and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. These or other parties could claim that we have misappropriated or misused intellectual property rights and any such intellectual property claim against us, regardless of merit, could be time consuming and expensive to settle or litigate and could divert the attention of our technical and management personnel. An adverse determination also could prevent us from offering our services to our customers and may require that we procure or develop substitute services that do not infringe. For any intellectual property rights claim against us or our customers, we may have to pay damages, indemnify our customers against damages or stop using technology or intellectual property found to be in violation of a third party's rights. We may be unable to replace those technologies with technologies that have the same features or functionality and that are of equal quality and performance standards on commercially reasonable terms or at all. Licensing replacement technologies and intellectual property may significantly increase our operating expenses or may require us to restrict our business activities in one or more respects. We may also be required to develop alternative non-infringing technology and intellectual property, which could require significant effort, time, and expense.

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

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

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

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

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

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

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

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

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

We are subject to varying degrees of regulation in each of the jurisdictions in which we provide services. Local laws and regulations, and their interpretation and enforcement, differ significantly among those jurisdictions. These laws can be costly to comply with, can be a significant diversion to management's time and effort, and can subject us to claims or other remedies, as well as negative publicity. Many of these laws were adopted prior to the advent of the internet and related technologies and, as a result, do not contemplate or address the unique issues that the internet and related technologies produce. Some of the laws that do reference the internet and related technologies have been and continue to be interpreted by the courts, but their applicability and scope remain largely uncertain.

In addition, future regulatory, judicial, and legislative changes may have a material adverse effect on our ability to deliver services within various jurisdictions. National regulatory frameworks that are consistent with the policies and requirements of the World Trade Organization have only recently been, or are still being, put in place in many countries. Accordingly, many countries are still in the early stages of providing for and adapting to a liberalized telecommunications market. As a result, in these markets we may encounter more protracted and difficult procedures to obtain any necessary licenses or negotiate interconnection agreements, which could negatively impact our ability to expand in these markets or increase our operating costs in these markets.

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Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our products and services.

Since our products and services are web based, we store substantial amounts of data for our customers on our servers (including personal information). Any systems failure or compromise of our security that results in the release of our customers' data could (i) subject us to substantial damage claims from our customers, (ii) expose us to costly regulatory remediation and (iii) harm our reputation and brand. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand our hosting footprint.

Regulatory authorities around the world are considering a number of legislative proposals concerning data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have an adverse effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

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

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

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

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

We rely on our Partner Network Program members for a significant portion of our revenues, and we benefit from our association with them. The loss of these members could adversely affect our business.

Our Partner Network Program drives a significant amount of revenue to our hosting services business. Most of our member partners offer services that are complementary to our hosting services. Some of the participants in our network, however, may actually compete with us in one or more of our product or service offerings. These network partners may decide in the future to terminate their agreements with us and to use a competitor's or their own services, which could cause our revenue to decline.

Also, we derive tangible and intangible benefits from our association with some of our network partners, particularly high profile partners that reach a large number of companies through the internet. If a substantial number of these partners terminate their relationship with us, our business could be adversely affected.

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

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

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

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

Concerns about greenhouse gas emissions and the global climate change may result in environmental taxes, charges, assessments or penalties.

The effects of human activity on the global climate change have attracted considerable public and scientific attention, as well as the attention of the United States government. Efforts are being made to reduce greenhouse emissions, particularly those from coal combustion by power plants, some of which we may rely upon for power. The added cost of any environmental taxes, charges, assessments or penalties levied on these power plants could be passed on to us, increasing the cost to run our data centers. Additionally, environmental taxes, charges, assessments or penalties could be levied directly on us in proportion to our carbon footprint. Any enactment of laws or passage of regulations regarding greenhouse gas emissions by the United States, or any domestic or foreign jurisdiction we perform business in, could adversely affect our operations and financial results.

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

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

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Risks Related to the Ownership of Our Common Stock

The trading price of our common stock may be volatile.

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

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

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

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

Our common stock has only been publicly traded since our initial public offering on August 7, 2008. The trading price of our common stock has fluctuated significantly since then. For example, between December 31, 2009 and March 31, 2010, the closing trading price of our common stock was very volatile, ranging between $17.11 and $23.09 per share, including single-day increases of up to 10.7% and declines up to 8.7%. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this quarterly report on Form 10-Q.

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

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

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

We have a large number of shares of common stock authorized but unissued and not reserved for issuance under our stock option plans or otherwise. We may issue all of these shares without any action or approval by our stockholders. We intend to continue to actively pursue strategic acquisitions. We may pay for such acquisitions, partly or in full, through the issuance of additional equity. In addition, our Amended and Restated 2007 Long-Term Incentive Plan contains an evergreen provision, which annually increases the number of shares issuable under the plan. Any issuance of shares in connection with our acquisitions, the exercise of stock options or otherwise would dilute the percentage ownership held by our then existing stockholders.

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

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

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

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

- Authorize the issuance of blank check preferred stock which can be created and issued by our board of directors without prior stockholder approval, with voting, liquidation, dividend, and other rights senior to those of our common stock;

- Provide for a classified board of directors, with each director serving a staggered three-year term;

- Prohibit our stockholders from filling board vacancies or increasing the size of our board, calling special stockholder meetings or taking action by written consent;

- Provide for the removal of a director only with cause and by the affirmative vote of the holders of a majority of the shares then entitled to vote at an election of our directors; and

- Require advance written notice of stockholder proposals and director nominations.

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

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

Sales of Unregistered Securities

On April 15, 2010, we issued 27,080 shares of our common stock to the former owner of Jungle Disk, Inc. as partial consideration for reaching an earn-out target related to our acquisition of the Jungle Disk business on October 22, 2008. The issuance of these shares of common stock was made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 – RESERVED

ITEM 5 – OTHER INFORMATION

Subsequent Event

On May 4, 2010, we entered into an agreement with Tarantula Ventures LLC, a subsidiary of DuPont Fabros Technology, Inc. to lease approximately 28,200 square feet of raised floor space and storage space in a data center facility located in the Chicago, Illinois area. The leased space will be provided with a maximum critical load power of 4.333 megawatts. The lease provides for a commencement date at the earlier of February 1, 2011 and the date on which Rackspace begins to conduct business at the site. The lease has a term of 15 years from the commencement date and a total estimated financial obligation of approximately $100 million to $110 million over the 15 year term, inclusive of base lease payments and Rackspace's pro-rata share of operating expenses. Upon the expiration of the 15 year term, Rackspace has the option to renew the lease for two successive five year periods. Upon renewal of the lease, the rent can be reviewed and adjusted to market level, as set out in the lease.

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ITEM 6 – EXHIBITS

Exhibit Number	Description
10.1 *	**Rules of The Rackspace Hosting Inc 2010 HM Revenue & Customs UK Approved Sub-Plan**
10.2 *	**Form of the 2010 HM Revenue & Customs UK Approved Sub-Plan Notice of Grant of Stock Option**
31.1 *	**Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**
31.2 *	**Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**
32.1 **	**Certifications of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**
32.2 **	**Certifications of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

* Filed herewith
** Furnished herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, on May 5, 2010.
Rackspace Hosting, Inc.

Date: May 5, 2010

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

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Exhibit 31.1

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

I, A. Lanham Napier, certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: May 5, 2010

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

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

I, Bruce R. Knooihuizen, certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: May 5, 2010

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

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Exhibit 32.1

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

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended March 31, 2010 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), A. Lanham Napier, as Principal Executive Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: May 5, 2010

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

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Exhibit 32.2

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

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended March 31, 2010 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Bruce R. Knooihuizen, as Principal Financial Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: May 5, 2010

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

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RACKSPACE HOSTING INC

RULES

OF

THE RACKSPACE HOSTING INC 2010 HM REVENUE & CUSTOMS UK APPROVED SUB-PLAN

Approved by the Administrator on: 28 January 2010

Approved by HM Revenue & Customs on: 10 March 2010

HM Revenue & Customs reference no: X105385

PricewaterhouseCoopers LLP
1 Harefield Road
The Atrium
Uxbridge UB8 1EX

Tel: 01895 522000
Fax: 01895 522020

THE RACKSPACE HOSTING INC 2010 HM REVENUE & CUSTOMS UK APPROVED SUB-PLAN

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THE RACKSPACE HOSTING INC 2010 HM REVENUE & CUSTOMS UK APPROVED SUB-PLAN

APPENDIX

1. General
This appendix to The Rackspace Inc 2007 Long Term Incentive Plan ("the Plan") sets out the rules of The Rackspace Hosting Inc HM Revenue & Customs UK Approved Sub-Plan ("the Sub-Plan").

2. Establishment of Sub-Plan
Rackspace Hosting Inc ("the Company") has established the Sub-Plan under Section 32(iv) of the Plan, which authorises the Administrator to establish sub-plans to the Plan.

3. Purpose of Sub-Plan
The primary purpose of the Sub-Plan is to enable the grant to, and subsequent exercise by, employees and directors in the United Kingdom, on a tax favoured basis, of options to acquire shares in the Company under the Plan within the provisions of Schedule 4.

4. HM Revenue & Customs approval of Sub-Plan
The Sub-Plan is intended to be approved by HM Revenue & Customs under Schedule 4 ITEPA 2003.

5. Rules of Sub-Plan
The provisions of the Plan, in their present form and as amended from time to time, shall, with the modifications set out in this appendix, form the rules of the Sub-Plan. In the event of any conflict between the provisions of the Plan and the Sub-Plan, the Sub-Plan shall prevail.

6. Relationship of Sub-Plan to Plan
The Sub-Plan shall form part of the Plan and shall not be a separate and independent plan.

7. Interpretation

7.1. Definitions and Interpretation
In this Sub-Plan, unless the context otherwise requires, the following words and expressions have the following meanings:

7.1.1. **Acquiring Company** means a company (including a New Holding Company) which obtains Control of the Company in the circumstances referred to in Rule 12;

7.1.2. **Approval Date** means the date on which the Plan is approved by HM Revenue & Customs under Schedule 4;

7.1.3. **Associated Company** has the meaning given to that expression by paragraph 35(1) of Schedule 4i;

7.1.4. **Close Company** has the meaning given to that expression by section 989 of ITA 2007, and paragraph 9(4) of Schedule 4ii;

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7.1.5. **Company** means Rackspace Hosting Inc incorporated in Delaware;

7.1.6. **Consortium** has the meaning given to that word by paragraph 36(2) of Schedule 4iii;

7.1.7. **Control** has the meaning given to that word by section 995 of ITA 2007;

7.1.8. **Eligible Employee** means an individual who is:

(a) an employee (other than a director) of a Group Member or

(b) a director of a Group Member who is contracted to work at least 25 hours per week for the Group (exclusive of meal breaks);

and who, in either case:

(i) is not eligible solely by reason that he is a non-executive director of a Group Member; and

(ii) does not have at the Grant Date, and has not had during the preceding twelve months, a Material Interest in a Close Company which is the Company or a company which has Control of the Company or a member of a Consortium which owns the Company.

7.1.9. **Employer's NIC** means employer's national insurance contributions liability;

7.1.10. **Exercise Price** means the amount per Plan Share payable on the exercise of an Option determined in accordance with Rule 6(e)(i) of the Plan, but shall not be less than the Market Value of a Plan Share on the Grant Date;

7.1.11. **Grant Date** means the date on which an Option is granted to an Eligible Employee determined in accordance with Section 23 of the Plan;

7.1.12. **Group** means the Company and its Subsidiaries from time to time, and "**Group Member**" shall be interpreted accordingly;

7.1.13. **ITA 2007** means the Income Tax Act 2007;

7.1.14. **ITEPA 2003** means the Income Tax (Earnings and Pensions) Act 2003;

7.1.15. **Key Feature** means a provision of the Plan or Sub-Plan which is necessary in order to meet the requirements of Schedule 4;

7.1.16. **Market Value** means notwithstanding Section 2(s) of the Plan,

(a) in the case of an Option granted under the Sub-Plan, if at the relevant time the Plan Shares are listed on the New York Stock Exchange the closing sale price of a Plan Share on the New York Stock Exchange for the the Grant Date of the Option;

(b) if paragraph (a) does not apply, and for the purposes of Rules 7.1.10 and 9.6, the market value of a Plan Share as determined in accordance with Part VIII of the Taxation of Chargeable Gains Act 1992 by the Company and agreed in advance with HM Revenue & Customs on the Grant Date or such earlier date or dates (not being more than thirty days before the Grant Date) as may be determined by the Company and agreed with HM Revenue & Customs; and

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(c) in the case of an option granted or award made under any stock option plan other than the Sub-Plan, the market value of an ordinary share in the capital of the Company determined under the rules of such plan for the purpose of the grant of the option or the making of the award.

7.1.17. **Material Interest** has the meaning given to that expression by paragraphs 9 to 14 of Schedule 4iv;

7.1.18. **New Option** means an option granted by way of exchange under Rule 12.1;

7.1.19. **New Plan Shares** means the shares subject to a New Option;

7.1.20. **Performance Goal** means a performance goal imposed as a condition of the exercise of an Option under Rule 10.1 and as substituted or varied in accordance with Rule 10.4;

7.1.21. **Plan Shares** means ordinary shares in the capital of the Company which satisfy the conditions in paragraphs 16 to 20 of Schedule 4;

7.1.22. **Share Certificate** means legal documentation certifying ownership of a specific number of shares in the Company;

7.1.23. **Schedule 4** means Schedule 4 to ITEPA 2003;

7.1.24. **Subsidiary** means a company over which the Company has Control;

7.2. Interpretation

In the Sub-Plan, unless otherwise specified:

7.2.1. words and expressions not defined above have the same meanings as are given to them in the Plan;

7.2.2. the contents and rule headings are inserted for ease of reference only and do not affect their interpretation;

7.2.3. a reference to a rule is a reference to a rule of this Sub-Plan;

7.2.4. the singular includes the plural and vice-versa and the masculine includes the feminine; and

7.2.5. a reference to a statutory provision is a reference to a United Kingdom statutory provision and includes any statutory modification, amendment or re-enactment thereof.

8. Companies participating in Sub-Plan

The companies participating in the Sub-Plan shall be the Company and any Subsidiary which has been nominated by the Company to participate in the Sub-Plan.

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9. Grant of Options

9.1. General

An Option shall be granted under and subject to the provisions of the Plan as modified by this Sub-Plan.

9.2. Contents of Award Agreement

An Award Agreement shall be in such form of document as the Administrator may determine from time to time, provided that it shall state all of the following which the Administrator shall determine at the Grant Date:

- the Grant Date;
- the number of Plan Shares subject to the Option or how that number may be calculated;
  - the Exercise Price or the method by which the Exercise Price will be determined;
  - when the Option will ordinarily become exercisable, and the number of Plan Shares over which the Option may then be exercised;
  - how the Option may be exercised;
  - that the Option is granted in accordance with Schedule 4; and
  - any Performance Goals or other conditions applicable to the Option.

9.3. Duration of Plan

An Option may not be granted earlier than the Approval Date.

9.4. Options non-transferable

Notwithstanding Section 14, an Option shall be personal to the Eligible Employee to whom it is granted and, subject to Rule 11.5, shall not be capable of being transferred, charged or otherwise alienated and shall lapse immediately if the Participant purports to transfer, charge or otherwise alienate the Option.

9.5. Persons to whom Options may be granted

No Option may be granted to an individual who is not an Eligible Employee on the Grant Date.

9.6. HM Revenue & Customs limit (£30,000)

An Option may not be granted to an Eligible Employee if the result of granting the Option would be that the aggregate Market Value of the shares subject to all outstanding options granted to him under the Plan or any other share option scheme established by the Company or an Associated Company and approved by HM Revenue & Customs under Schedule 4 would exceed £30,000 or such other limit as may from time to time be specified in paragraph 6 of Schedule 4. For the purpose of this limit, shares subject to an option which has been exercised, lapsed, renounced or otherwise become incapable of being exercised shall be disregarded.

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9.7. Foreign Currency Options

For the purpose of the limit contained in Rule 9.6, the United Kingdom sterling equivalent for the market value of a share on any day shall be determined by taking the spot sterling/US Dollar exchange rate for that day as shown in the Wall Street Journal.

9.8. Scaling down

If the grant of an Option would cause the limit in this Rule 9 to be exceeded, such Option shall take effect as an Option over the maximum number of Plan Shares which does not cause the limit to be exceeded. If more than one Option is granted on the same Grant Date, the number of Plan Shares which would otherwise be subject to each Option shall be reduced *pro rata*.

10. PERFORMANCE GOAL

10.1. Imposition of Performance Goal

On the grant of an Option, the Administrator may impose a Performance Goal under Section 12 of the Plan, and any further condition on the exercise of the Option that the Administrator determines to be appropriate under Sections 6(e)(ii) and/or 16 of the Plan.

10.2. Nature of Performance Goal

The Performance Goal and any further condition imposed under Rule 10.1 shall be:

10.2.1. objective;

10.2.2. capable of being fulfilled within the period of ten years from the Grant Date; and

10.2.3. such that, once satisfied, the exercise of the Option is not subject to the discretion of any person; and

10.2.4. set out in, or attached in the form of a schedule to, the Award Agreement.

10.3. Performance Goal can no longer be satisfied

If the Administrator determines that the Performance Goal or any further condition imposed under Rule 10.1 has not been satisfied either in whole or in part in relation to an Option and can no longer be satisfied either in whole or in part, the Option shall lapse immediately either in whole or as to such part as the Administrator determines in its discretion.

10.4. Substitution, variation or waiver of Performance Goal

If an event occurs which causes the Administrator to consider that the Performance Goal or any further condition imposed under Rule 10.1 subject to which an Option has been granted is no longer appropriate, the Administrator may substitute, vary or waive the Performance Goal or the condition under Section 4(b)(ix) of the Plan in such manner (and make such consequential amendments to the Rules) as:

10.4.1. is reasonable in the circumstances; and

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10.4.2. except in the case of waiver, produces a fairer measure of performance and is not materially more nor less difficult to satisfy and the Option shall then take effect subject to the Performance Goal or the condition as so substituted, varied or waived.

10.5. Notification of Participants

The Administrator shall, as soon as reasonably practicable, notify each Participant concerned of any determination made by it under Rule 10.3 or of any substitution, variation or waiver of the Performance Goal or a condition made by it under Rule 10.4 and explain how it affects his position under the Sub-Plan.

11. EXERCISE OF OPTIONS

11.1. Material Interest

An Option may not be exercised if the Participant then has, or has had within the preceding twelve months, a Material Interest in a Close Company which is the Company or which is a company which has Control of the Company or which is a member of a Consortium which owns the Company.

11.2. Procedure for exercise of Options

The amount due on the exercise of an Option shall be paid in cash or by cheque or banker's draft and may be paid out of funds provided to the Participant on loan by a bank, broker or other person. Notwithstanding Sections 6(e)(iii) and 6(f) of the Plan, the amount may not be paid by the transfer to the Company of Plan Shares or any other shares or securities. The amount may be paid by "cashless exercise" in accordance with Section 6(f) of the Plan provided HM Revenue & Customs have agreed this in advance. The date of exercise of an Option shall be the date on which the Company receives the amount due on the exercise of the Option.

11.3. Transfer of Employer's NIC

The Administrator may, at its discretion, impose requirements for the payment by the Participant of all or any part of the Employer's NIC which may arise as a result of the exercise of his Option. Such requirements shall be specified on the Grant Date and shall be a condition of exercise of the Option, provided that the Administrator may waive these requirements. They may include in particular, but not by way of limitation, a determination that the Option
may not be exercised unless the Participant has beforehand paid to the Company (or the Group Member which employs the Participant, if different) an amount sufficient to discharge all or any part of the Employer's NIC. Alternatively, the Participant may, by agreement with the Company or the Group Member (as the case may be), enter into some other arrangement to ensure that such amount is available to them or it (whether by authorising the sale of some or all of the Plan Shares subject to his Option and the payment to the Company or the Group Member (as the case may be) of the requisite amount out of the proceeds of sale or otherwise). Where this is the case the Option shall not be treated as exercised until the Company or the Group Member (as the case may be) determine that such arrangements are satisfactory to it.

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11.4. Issue or transfer of Plan Shares on exercise of Options

The Company shall, as soon as reasonably practicable and in any event not later than thirty days after the date of exercise of an Option, issue or transfer to the Particiapant, or procure the issue or transfer to the Participant of, the number of Plan Shares specified in the notice of exercise and shall deliver to the Participant, or procure the delivery to the Participant of, a Share Certificate or book or electronic entry in respect of such Plan Shares together with, in
the case of the partial exercise of an Option, an Award Agreement in respect of, or the original Award Agreement endorsed to show, the unexercised part of the Option, subject only to compliance by the Participant with the rules of the Sub-Plan and to any delay necessary to complete or obtain:

11.4.1. the listing of the Plan Shares on any stock exchange on which Plan Shares are then listed;

11.4.2. such registration or other qualification of the Plan Shares under any applicable law, rule or regulation as the Company determines is necessary or desirable; or

11.4.3. the making of provision for the payment or withholding of any taxes required to be withheld in accordance with the applicable law of any foreign jurisdiction in respect of the exercise of the Option or the receipt of the Plan Shares.

11.5. Death

Notwithstanding Section 6(f)(iv) of the Plan, if a Participant dies before the tenth anniversary of the Grant Date, his personal representatives shall be entitled to exercise, to the extent the Options have vested on the date of his death, his Options no later than the end of the twelve month period following his death. To the extent the Option is not so exercised, the Options shall lapse immediately.

11.6. Exercise of options by leavers

Notwithstanding Section 6(f)(ii)-(v) of the Plan the period during which the Option shall remain exercisable following termination of employment shall be stated in the Award Agreement and may not thereafter be altered.

12. EXCHANGE OF OPTIONS

12.1. Circumstances in which Exchange can occur
If a company ("the Acquiring Company") obtains Control of the Company as a result of:

12.1.1. making a general offer to acquire the whole of the issued ordinary share capital of the Company which is made on a condition such that if it is satisfied the person making the offer will have Control of the Company; or

12.1.2. making a general offer to acquire all the shares in the Company of the same class as the Plan Shares; or

12.1.3. a compromise or arrangement sanction by the court under Section 899 of the Companies Act 2006 ("Companies Act") or other local legislation which HM Revenue & Customs agrees is equivalent; or

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12.1.4. an Acquiring Company becomes bound or entitled to acquire Plan Shares under Sections 979 to 982 of the Companies Act or other local legislation which HM Revenue & Customs agrees is equivalent

a Participant may, at any time during the period set out in Rule 12.2, by agreement with the Acquiring Company, release his Option in whole or in part in consideration of the grant to him of a new option ("New Option") which is equivalent to the Option but which relates to shares ("New Plan Shares") in:

12.1.5. the Acquiring Company;

12.1.6. a company which has Control of the Acquiring Company; or

12.1.7. a company which either is, or has Control of, a company which is a member of a Consortium which owns either the Acquiring Company or a company having Control of the Acquiring Company.

12.2. Periods allowed for exchange of Options

The periods referred to in Rule 12.1 are:

12.2.1. in the case of Rules 12.1.1 and 12.1.2, the period of six months beginning with the time when the person making the offer or proposed acquisition (as the case may be) has obtained Control of the Company and any condition subject to which the offer or proposed acquisition is made has been satisfied;

12.2.2. in the case of Rule 12.1.3 the period of six months from the date of court sanction; and

12.2.3. in the case where a person becomes bound or entitled as set out in Rule 12.1.4 within the period during which the Acquiring Company remains bound or entitled.

12.3. Meaning of "equivalent"

The New Option shall not be regarded for the purpose of this Rule 12 as equivalent to the Option unless:

12.3.1. subject to the discretion of the Administrator as to whether the Performance Goal or any further condition imposed under Rule 10.1 should continue to apply to the New Option or be substituted, varied or waived under Rule 10.4, the New Option will be exercisable in the same manner as the Option and subject to the provisions of the Plan as it had effect immediately before the release of the Option;

12.3.2. the New Plan Shares satisfy the conditions in paragraphs 16 to 20 of Schedule 4; and

12.3.3. the total market value, immediately before the release of the Option, of the Plan Shares which were subject to the Option is as nearly as may be equal to the total market value, immediately after the grant of the New Option, of the New Plan Shares subject to the New Option (market value being determined for this purpose in accordance with Part VIII of the Taxation of Chargeable Gains Act 1992); and

12.3.4. the total amount payable by the Participant for the acquisition of the New Plan Shares under the New Option is as nearly as may be equal to the total amount that would have been payable by the Participant for the acquisition of the Plan Shares under the Option.

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12.4. Application of Sub-Plan to New Option

In the application of the Sub-Plan to the New Option, where appropriate, references to "Company" and "Plan Shares" shall be read as if they were references to the company to whose shares the New Option relates and the New Plan Shares, respectively, save that in the definition of "Administrator" the reference to "Company" shall be read as if it were a reference to Rackspace Hosting Inc.

12.5. Disapplication of Section 20(c) of the Plan

References in Section 20(c) of the Plan to assumption or substitution of the Options, shall be disapplied for the purposes of the Sub-Plan to the extent that they conflict with the provisions of this Rule 12. If an exchange of Options in accordance with this Rule 12 is not offered by the Acquiring Company, and an assumption or substitution under Section 20(c) of the Plan does not satisfy the requirements of paragraphs 26 and 27 of Schedule 4, the Option shall become exercisable in accordance with Section 20(c) of the Plan. The period allowed for this shall be 30 days from the date that the Participant is informed that no exchange is offered. If it is not possible to effect an exchange of Options in accordance with this Rule 12, the Option shall become exercisable in accordance with Section 20(c) of the Plan.

12.6. Rights attaching to Plan Shares

Notwithstanding Sections 6(c), 4(b)(v) and 18 of the Plan, all Plan Shares issued in respect of exercise of an Option shall, as to voting, dividend, transfer and other rights, including those arising on a liquidation of the Company, rank equally in all respects and as one class with the Plan Shares in issue at the date of such issue save as regards any rights attaching to such Plan Shares by reference to a record date prior to the date of such issue.

13. ADJUSTMENT OF OPTIONS

No adjustment or amendment of an Option as a result of Section 20(a) of the Plan shall be made under this Rule 13 unless the adjustment is permitted pursuant to paragraph 22(3) of Schedule 4.

13.1. HM Revenue & Customs approval

An adjustment shall not have effect until the adjustment has been approved by HM Revenue & Customs.

13.2. HM Revenue & Customs approval of amendments

Notwithstanding Section 35(a) of the Plan, an amendment to a Key Feature which is designed to apply to Options granted under the Sub-Plan shall not have effect at a time when the Sub-Plan is approved by HM Revenue & Customs, until the amendment has been approved by HM Revenue & Customs under Schedule 4.

14. EXERCISE OF DISCRETION BY COMPANY

In exercising any discretion that it may have under the Sub-Plan, the Administrator shall act fairly and reasonably.

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15. DISAPPLICATION OF CERTAIN PROVISIONS OF PLAN

The provisions of the Plan, where no such rights may be granted, dealing with:

- Full Value Award;
- Incentive Stock Options;
- Other stock or cash awards;
- Performance Shares;
- Performance Units;
- Restricted Stock;
- Restricted Stock Units; and
- Stock Appreciation Rights.

The following provisions of the Plan shall not apply to this Sub-Plan:

- Dividend Equivalents;
- Exchange Program;
- Modifications under Section 4(b)(v) and (ix) of the Plan;
- References to mandatory surrender of Options in exchange for cash under Section; 25(c)(ii) of the Plan;
- Section 4(b) (xii) of the Plan;
- Sections 21(b) (ii) and (iii) of the Plan, save that the Company may sell deliverable
- Shares on Participant's behalf having a Fair Market Value equal to the minimum statutory amount required to be withheld; and
- Section 36(b) of the Plan, save to the extent allowed by the Exchange Act (or other Applicable Laws);

shall not form part of, and no such rights may be granted under, the Sub-Plan.

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i An “Associated Company” would be a company which has control of the Company or is under common control. Control for these purposes means the following:

• control through voting power

• control through share capital or through issued share capital

• control over the income of the company or

• control over the assets of the company.

ii A close company is a company which is under the control (as defined in paragraph i above) of five or fewer participators (eg shareholders) or of any number of participators who are directors. There are attributed to a participator all the rights and powers (eg shares, voting power) of, inter alia, a company which he controls or of an “associate” (eg relative) of his. Ordinarily, a company is excluded from being a close company if it is non-UK resident or 35% of the voting power in the company is held by the public and its shares have been listed, and the subject of dealings, on a recognised stock exchange within the preceding 12 months. However, for the purpose of the material interest test (see paragraph iv below), this exclusion does not apply with the result that the normal definition of a “close company” is extended.

iii A company is a member of a consortium owning another company if it is one of a number of companies which between them beneficially own not less than 75% of the other company’s ordinary share capital and each of which beneficially owns not less than 5% of that capital.

iv A person has a “Material Interest” in a company if he, either on his own or with one or more associates, or if any associate of his with or without such other associates:

- is the beneficial owner of, or able, directly or through the medium of other companies, or by any other indirect means to control, more than 25 per cent of the ordinary share capital of the company; or

- where the company is a close company, possesses, or is entitled to acquire, such rights as would, in the event of the winding-up of the company or in any other circumstances, give an entitlement to receive more than 25 per cent of the assets which would then be available for distribution among the participators.

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THE RACKSPACE HOSTING, INC.

2010 HM REVENUE & CUSTOMS UK APPROVED SUB-PLAN

NOTICE OF GRANT OF STOCK OPTION

Unless otherwise defined herein, the terms defined in the 2010 HM Revenue & Customs UK Approved Sub-Plan (the "Sub-Plan") shall have the same defined meanings in this Notice of Grant of Stock Option (the "Notice of Grant") and Terms and Conditions of Stock Option Grant, attached hereto as Exhibit A (together, the "Agreement").

Participant: ______________________

Address: ______________________

____

Participant has been granted an Option to purchase Common Stock of the Company, subject to the terms and conditions of the Sub-Plan and this Agreement, as follows:

Grant Number	______________________
Date of Grant	______________________
Vesting Commencement Date	______________________
Number of Shares Granted	______________________
Exercise Price per Share	$ ______________________
Total Exercise Price	$ ______________________
Type of Option	Approved Share Option
Term/Expiration Date	______________________

Vesting Schedule:

Subject to accelerated vesting as set forth below or in the Sub-Plan, this Option will be exercisable, in whole or in part, in accordance with the following schedule:

____

____

____

Termination Period:

This Option will be exercisable for three (3) months after Participant ceases to be a Service Provider, unless such termination is due to Participant's death or Disability, in which case this Option will be exercisable for twelve (12) and six (6) months, respectively, after Participant ceases to be a Service Provider (the "***Post-Termination Exercise Period***"). To the extent not exercised during such Post-Termination Exercise Period, Options under the Option Agreement shall terminate. Notwithstanding the foregoing, in no event may this Option be exercised after the Term/Expiration Date as provided above and this Option may be subject to earlier termination as provided in Section 20(c) of the Plan.

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Income tax and social security:

Income tax and social security will not arise where Participant exercises this Option on or after the third anniversary of the Date of Grant or following termination of employment as a result of injury, Disability, retirement or redundancy before the third anniversary of the Date of Grant provided this Option is exercised within 6 months of leaving as a result of Disability, or within 3 months of leaving as a result of injury, retirement or redundancy or within 12 months of death.

For these purposes:

- "retirement" means retirement at or after the age at which Participant is bound or entitled to retire under the terms of their contract of employment which, for the purpose of this Agreement, will not be before the age of 55.

- "redundancy" means redundancy as defined within the Employment Rights Act 1996.

National Insurance:

In the event that any employer's national insurance contributions (the "***Employer's NIC***") arise pursuant to this Option, this Option may not be exercised unless Participant has beforehand paid to the Company or otherwise agreed to satisfy an amount sufficient to discharge all of the Employer's NIC. In signing this Agreement Participant agrees to pay, or otherwise satify, the Employer's NIC.

Participant and the Company agree that this Option is granted under and governed by the terms and conditions of the Sub-Plan and this Agreement. Participant has reviewed the Sub-Plan and this Agreement in their entirety, has had an opportunity to obtain the advice of counsel prior to accepting this Agreement and fully understands all provisions of the Sub-Plan and Agreement. Participant hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Administrator upon any questions relating to the Sub-Plan and Agreement. Participant further agrees to notify the Company upon any change in the residence address indicated above.

Notwithstanding anything herein to the contrary:

If, at any time while this Option remains outstanding, Participant provides services to a competitor of the Company or an Affiliate whether as an employee, officer, director, independent contractor, consultant, agent or otherwise, Participant lends to or makes an investment in any such competitor, or Participant competes with the products or services of the Company ("Engages in Competition"), then this Option shall terminate and be forfeited, subject only to a determination by the Administrator to the contrary. Participant agrees to notify the Company in writing of each employer of Participant and each person and entity to whom Participant provides services from and after the date hereof, so long as this Option remains outstanding. For all purposes of the Sub-Plan, the Option Agreement and the Exercise Notice, the Administrator shall have the right to determine the date on which Participant ceases to be a Service Provider and whether or not the Participant Engages in Competition and such determination shall be conclusive and binding on the Participant.

Electronic Signature:

Participant acknowledges and agrees that by clicking the "ACCEPT" button on the E*TRADE on-line grant agreement response page, it will act as Participant's electronic signature to this Agreement and will result in a contract between Participant and the Company with respect to this Option.

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EXHIBIT A

TERMS AND CONDITIONS OF STOCK OPTION GRANT

1. Grant of Option. The Company hereby grants to the Participant named in the Notice of Grant (the "Participant") an option (the "Option") to purchase the number of Shares, as set forth in the Notice of Grant, at the exercise price per Share set forth in the Notice of Grant (the "Exercise Price"), subject to all of the terms and conditions in this Agreement and the Sub-Plan, which is incorporated herein by reference. Subject to Section 35(c) of the Plan, in the event of a conflict between the terms and conditions of the Sub-Plan and the terms and conditions of this Agreement, the terms and conditions of the Sub-Plan will prevail.

2. Exercise of Option.

(a) Right to Exercise. This Option shall be exercisable during its term in accordance with the Vesting Schedule set out in the Notice of Grant and applicable provisions of the Sub-Plan. Shares scheduled to vest on a certain date or upon the occurrence of a certain condition will not vest in Participant in accordance with any of the provisions of this Agreement, unless Participant will have been continuously a Service Provider from the Date of Grant until the date such vesting occurs.

(b) Method of Exercise.

This Option shall be exercisable by delivery of an exercise notice in the form attached as Exhibit B (the "Exercise Notice") or in a manner and pursuant to such procedures as the Administrator may determine, including, without limitation, the establishment of procedures for the submission of the Exercise Notice through an online or electronic system, which shall state the election to exercise the Option, the number of Shares with respect to which the Option is being exercised, and such other representations and agreements as may be required by the Company. The Exercise Notice shall be accompanied by payment of the aggregate Exercise Price as to all Exercised Shares, together with any applicable tax withholding. This Option shall be deemed to be exercised upon receipt by the Company of such fully executed Exercise Notice accompanied by the aggregate Exercise Price, together with any applicable tax withholding.

3. Method of Payment. Payment of the aggregate Exercise Price shall be by any of the following, or a combination thereof, at the election of the Participant:

(a) cash;

(b) check; or

(c) consideration received by the Company under a formal cashless exercise program adopted by the Company in connection with the Sub-Plan.

4. Non-Transferability of Option. This Option may not be transferred in any manner otherwise than to Participant's personal representatives on death and may be exercised during the lifetime of Participant only by Participant. The terms of the Sub-Plan and this Agreement shall be binding upon the personal representatives of Participant.

5. Term of Option. This Option may be exercised only within the term set out in the Notice of Grant, and may be exercised during such term only in accordance with the Sub-Plan and the terms of this Option.

6. Tax Obligations. Notwithstanding any contrary provision of this Agreement, no certificate representing the Shares will be issued to Participant, unless and until satisfactory arrangements (as determined by the Administrator) will have been made by Participant with respect to the payment of income, employment and other taxes which the Company determines must be withheld with respect to such Shares. To the extent determined appropriate by the Company in its discretion, it will have the right (but not the obligation) to satisfy any tax withholding obligations by reducing the number of Shares otherwise deliverable to Participant. If Participant fails to make satisfactory arrangements for the payment of any required tax withholding obligations hereunder at the time of the Option exercise, Participant acknowledges and agrees that the Company may refuse to honor the exercise and refuse to deliver the Shares if such withholding amounts are not delivered at the time of exercise.

7. Electronic Delivery. The Company may, in its sole discretion, decide to deliver any documents related to Options awarded under the Sub-Plan or future Options that may be awarded under the Sub-Plan by electronic means or request Participant's consent to participate in the Sub-Plan by electronic means. Participant hereby consents to receive such documents by electronic delivery and agrees to participate in the Sub-Plan through any on-line or electronic system established and maintained by the Company or another third party designated by the Company.

8. Rights as Stockholder. Neither Participant nor any person claiming under or through Participant will have any of the rights or privileges of a stockholder of the Company in respect of any Shares deliverable hereunder unless and until certificates representing such Shares will have been issued, recorded on the records of the Company or its transfer agents or registrars, and delivered to Participant. After such issuance, recordation and delivery, Participant will have all the rights of a stockholder of the Company with respect to voting such Shares and receipt of dividends and distributions on such Shares.

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9. No Guarantee of Continued Service. PARTICIPANT ACKNOWLEDGES AND AGREES THAT THE VESTING OF SHARES PURSUANT TO THE VESTING SCHEDULE HEREOF IS EARNED ONLY BY CONTINUING AS A SERVICE PROVIDER AT THE WILL OF THE COMPANY (OR AN AFFILIATE EMPLOYING OR RETAINING PARTICIPANT) AND NOT THROUGH THE ACT OF BEING HIRED, BEING GRANTED THIS OPTION OR ACQUIRING SHARES HEREUNDER. PARTICIPANT FURTHER ACKNOWLEDGES AND AGREES THAT THIS AGREEMENT, THE TRANSACTIONS CONTEMPLATED HEREUNDER AND THE VESTING SCHEDULE SET FORTH HEREIN DO NOT CONSTITUTE AN EXPRESS OR IMPLIED PROMISE OF CONTINUED ENGAGEMENT AS A SERVICE PROVIDER FOR THE VESTING PERIOD, FOR ANY PERIOD, OR AT ALL, AND SHALL NOT INTERFERE IN ANY WAY WITH PARTICIPANT'S RIGHT OR THE RIGHT OF THE COMPANY (OR AN AFFILIATE EMPLOYING OR RETAINING PARTICIPANT) TO TERMINATE PARTICIPANT'S RELATIONSHIP AS A SERVICE PROVIDER AT ANY TIME, WITH OR WITHOUT CAUSE.

10. Address for Notices. Any notice to be given to the Company under the terms of this Agreement will be addressed to the Company, in care of its Stock Plan Administrator at Rackspace Hosting, Inc., 9725 Datapoint Drive, Suite 100, San Antonio, Texas 78229, or at such other address as the Company may hereafter designate in writing.

11. Binding Agreement. Subject to the limitation on the transferability of this grant contained herein, this Agreement will be binding upon and inure to the benefit of the personal representatives of the parties hereto.

12. Additional Conditions to Issuance of Stock. If at any time the Company will determine, in its discretion, that the listing, registration or qualification of the Shares upon any securities exchange or under any state or federal law, or the consent or approval of any governmental regulatory authority is necessary or desirable as a condition to the issuance of Shares to Participant (or his or her estate), such issuance will not occur unless and until such listing, registration, qualification, consent or approval will have been effected or obtained free of any conditions not acceptable to the Company. The Company will make all reasonable efforts to meet the requirements of any such state or federal law or securities exchange and to obtain any such consent or approval of any such governmental authority. Assuming such compliance, for income tax purposes the Exercised Shares will be considered transferred to Participant on the date the Option is exercised with respect to such Exercised Shares.

13. Acknowledgement. Participant acknowledges receipt of a copy of the Sub-Plan and represents that he or she is familiar with the terms and provisions thereof, and hereby accepts this Option subject to all of the terms and provisions thereof. Participant has reviewed the Sub-Plan and this Option in their entirety, has had an opportunity to obtain the advice of counsel prior to executing this Option and fully understands all provisions of the Option. Participant hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Administrator upon any questions arising under the Sub-Plan or this Option. Participant further agrees to notify the Company upon any change in the residence address.

14. Plan Governs. This Agreement is subject to all terms and provisions of the Sub-Plan. In the event of a conflict between one or more provisions of this Agreement and one or more provisions of the Sub-Plan, the provisions of the Sub-Plan will govern. Capitalized terms used and not defined in this Agreement will have the meaning set forth in the Sub-Plan.

15. Administrator Authority. The Administrator will have the power to interpret the Sub-Plan and this Agreement and to adopt such rules for the administration, interpretation and application of the Sub-Plan as are consistent therewith and to interpret or revoke any such rules (including, but not limited to, the determination of whether or not any Shares subject to the Option have vested). All actions taken and all interpretations and determinations made by the Administrator in good faith will be final and binding upon Participant, the Company and all other interested persons. No member of the Administrator will be personally liable for any action, determination or interpretation made in good faith with respect to the Sub-Plan or this Agreement.

16. Captions. Captions provided herein are for convenience only and are not to serve as a basis for interpretation or construction of this Agreement.

17. Agreement Severable. In the event that any provision in this Agreement will be held invalid or unenforceable, such provision will be severable from, and such invalidity or unenforceability will not be construed to have any effect on, the remaining provisions of this Agreement.

18. Modifications to the Agreement. This Agreement constitutes the entire understanding of the parties on the subjects covered. Participant expressly warrants that he or she is not accepting this Agreement in reliance on any promises, representations, or inducements other than those contained herein. Modifications to this Agreement or the Sub-Plan can be made only in an express written contract executed by a duly authorized officer of the Company.

19. Amendment, Suspension or Termination of the Sub-Plan. By accepting this award, Participant expressly warrants that he or she has received an Option under the Sub-Plan, and has received, read and understood a description of the Sub-Plan. Participant understands that the Sub-Plan is discretionary in nature and may be amended, suspended or terminated by the Company at any time.

20. Governing Law. This Agreement will be governed by the laws of the State of Delaware, without giving effect to the conflict of law principles thereof. For purposes of litigating any dispute that arises under this Option or this Agreement, the parties hereby submit to and consent to the jurisdiction of the State of Texas**,** and agree that such litigation will be conducted in the courts of Bexar County, Texas, or the federal courts for the United States for the Western District of Texas, and no other courts, where this Option is made and/or to be performed.

EXHIBIT B

THE RACKSPACE HOSTING INC 2010 HM REVENUE & CUSTOMS UK APPROVED SUB-PLAN

EXERCISE NOTICE

Rackspace Hosting, Inc.
9725 Datapoint Drive, Suite 100
San Antonio, TX 78229

Attention: Stock Plan Administrator

1. Exercise of Option. Effective as of today, ________________, ____, the undersigned ("Participant") hereby elects to exercise Participant's option (the "Option") to purchase ________________ shares of the Common Stock (the "Shares") of Rackspace Hosting, Inc. (the "Company") under and pursuant to the Company's 2010 HM Revenue & Customs UK Aproved Sub-Plan (the "Plan") and the Award Agreement dated ______________, _____ (the "Agreement").

2. Delivery of Payment. Participant herewith delivers to the Company the full purchase price of the Shares, as set forth in the Agreement, and any and all withholding taxes [and the Employer's NIC] due in connection with the exercise of the Option.

3. Representations of Participant. Participant acknowledges that Participant has received, read and understood the Sub-Plan and the Agreement and agrees to abide by and be bound by their terms and conditions.

4. Rights as Stockholder. Until the issuance of the Shares (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company), no right to vote or receive dividends or any other rights as a stockholder shall exist with respect to the Common Stock subject to an Award, notwithstanding the exercise of the Option. The Shares shall be issued to Participant as soon as practicable after the Option is exercised in accordance with the Agreement. No adjustment shall be made for a dividend or other right for which the record date is prior to the date of issuance except as provided in Section 20 of the Plan.

5. Tax Consultation. Participant understands that Participant may suffer adverse tax consequences as a result of Participant's purchase or disposition of the Shares. Participant represents that Participant has consulted with any tax consultants Participant deems advisable in connection with the purchase or disposition of the Shares and that Participant is not relying on the Company for any tax advice.

6. Notices. All notices and other communications required or permitted hereunder shall be in writing and shall be delivered personally by hand or by courier, mailed by United States first-class mail, postage prepaid, sent by facsimile or sent by electronic mail directed (a) if to the Participant, at the Participant's address, facsimile number or electronic mail address set forth on the signature page to the Notice of Grant, or at such other address, facsimile number or electronic mail address as the Participant may designate by ten (10) days' advance written notice to the Company or (b) if to the Company, to its principal executive office and directed to the attention of the President, or at such other address as the other address as the Company may designate by ten (10) days' advance written notice to the Participant. All such notices and other communications shall be deemed given upon personal delivery, on the date of mailing, upon confirmation of facsimile transfer or when directed to the electronic mail address set forth on the signature page to the Agreement. With respect to any notice given by the Company under any provision of the Delaware General Corporation Law or the Company's charter or bylaws, the Participant agrees that such notice may be given by facsimile or by electronic mail.

7. Governing Law; Severability. This Exercise Notice is governed by the internal substantive laws, but not the choice of law rules, of Delaware. In the event that any provision hereof becomes or is declared by a court of competent jurisdiction to be illegal, unenforceable or void, this Exercise Notice shall continue in full force and effect.

8. Entire Agreement. The Sub-Plan and Agreement are incorporated herein by reference. This Exercise Notice, the Sub-Plan and the Agreement constitute the entire agreement of the parties with respect to the subject matter hereof and supersede in their entirety all prior undertakings and agreements of the Company and Participant with respect to the subject matter hereof, and may not be modified adversely to the Participant's interest except by means of a writing signed by the Company and Participant.

[***Signature Page Follows***]

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Submitted by: PARTICIPANT	Accepted by: RACKSPACE HOSTING, INC.
Signature	By
Print Name	Print Name
	Title
Address:	Address:
	Date Received

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