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RAX - Q3 2010 Rackspace Hosting, Inc. Earnings Conference Call

Event Date/Time: Nov. 08. 2010 / 9:30PM GMT

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CORPORATE PARTICIPANTS

Bryan McGrath
Rackspace Hosting, Inc. - Director of Finance

Lanham Napier
Rackspace Hosting, Inc. - President, CEO

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

CONFERENCE CALL PARTICIPANTS

Christopher Larsen
Piper Jaffray & Co. - Analyst

James Breen
William Blair & Company - Analyst

Simon Flannery
Morgan Stanley - Analyst

Jonathan Hong
Goldman Sachs - Analyst

Greg Dunham
Credit Suisse - Analyst

Jonathan Schildkraut
Evercore partners - Analyst

Patrick Walravens
JMP Securities - Analyst

Brian Thackray
Deutsche Bank - Analyst

Ben Abramovitz
Kaufman Brothers, L.P. - Analyst

Michael Bowen
Guggenheim Securities LLC - Analyst

Gray Powell
Wells Fargo Securities - Analyst

Frank Louthan
Raymond James & Associates - Analyst

PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting third quarter earnings requesting. As a reminder this call is being recorded. At this time all lines are in a listen-only mode to prevent background noise. After the prepared remarks there will be a question-and-answer session. (Operator Instructions). At this time I would like to turn the call over to Bryan McGrath, Director of Finance at Rackspace. Please go ahead, sir.

Bryan McGrath - *Rackspace Hosting, Inc. - Director of Finance*

Thank you, and good afternoon. Welcome to Rackspace's third quarter 2010 earnings conference call. I'm here today with Lanham Napier, our Chief Executive Officer, and Bruce Knooihuizen, our Chief Financial Officer.

We issued a press release after the close of market today with our unaudited financial results for the third quarter of 2010. If you do not have a copy, please visit the Investors section our at www.rackspace.com, where this call is also being webcast.

The primary purpose of today's call is to discuss the third quarter of 2010 results. However, some of our comments today are forward-looking statements that involve risk, uncertainties an assumption. If these risks and uncertainties materialize or assumptions prove incorrect, our results could differ materially from those expressed or implied by forward-looking statements and assumptions. All times other than historical fact are statements that could be deemed forward-looking statements. These risks, uncertainties assumptions are described in our Form 10-K for the year ended December 31, 2009, which was filed with the SEC on February 26, 2010, and our third quarter Form 10-Q that will be filed this week. These forward-looking statements speak as of today. Except as required by law, we will assume no obligation top date these forward-looking statements publicly, even if new information becomes available in the future.

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

With that let's get started. Lanham?

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

Good afternoon, and thank you for joining us today. We are very excited to share our third quarter results with you, as well as the accomplishments that we have made in 2010.

Let's get started with the two key messages to take away from the call today. First, we are pleased with our third quarter results. We are delivering on the road map that we outlined for the year, and with three quarters completed, we expect to achieve our financial goals for 2010. Second, our efforts to improve the business model are working. We have been making investments to enhance the capital efficiency of our business, and we are beginning to see the early returns on those investments now. Our strategy to improve the business model primarily centers on enhancing the capabilities of our service portfolio.

Service capability is where we differentiate, and it is where we generate our returns. Whether by offering a higher service level agreement or extending our support to new technology platforms, our business becomes more capital efficient and our competitive advantage widens as our service capability expands. Our customers are asking us to it more, and our opportunity is to build a productized repeatable service to fulfill that demand. Executing on that opportunity enables our business to grow faster and general rate higher returns. For example, last year our Company grew 18% an generated $17 million in adjusted free cash flow. Through the third quarter of this year we are growing 23% year-over-year and have generated $29 million in adjusted free cash flow. So our adjusted free cash flow margin is on track to almost double this year compared to last year.

At the beginning of the year we told you that we would accelerate investing in order to improve our service delivery capabilities. As any mentioned earlier, those investments are beginning to pay off. Here are some highlights from the third quarter.

Number one, we had a record bookings quarter. Number two, adjusted EBITDA margins were strong. Number three, adjusted free cash flow remained high. Number four, average revenue per customer increased in Cloud and Managed. Number five, average revenue per server increased for the fifth consecutive quarter. Number six, return on capital increased for the fourth consecutive quarter. And number seven, we added just under 11,000 customers in the quarter.

In addition to the financial metrics, our investments are also bearing fruit in the form of new service capabilities. One example is the recent launch of a product that we call Critical Sites, which includes our most aggressive service level agreement. Critical Sites was created for applications that require the highest level of performance and availability. Critical Sites customers benefit from Rackspace's most advanced level of support and advanced monitoring suite and our most comprehensive service level agreement. Critical Sites recently became generally available, and we have already closed our first multi-year multi-million dollars opportunity. The customer one the world's largest media conglomerates that is using Critical Sites for a web property.

We are very encouraged by the early success and prospects for Critical Sites and expect to have more to say about the new service going forward.

Cloud Service for Windows is another service that became available during the quarter. After a successful beta program that began in February, Cloud Service for Windows launched to a healthy demand in the beginning of August. Although the service was only available for two months in the third quarter, revenue for the new service doubled and demand continues to be strong.

Another new capabilities that we are reading for launch is one that we call Managed Cloud. This new production extends our industry-leading support to Cloud customers. The Managed service level in Cloud is designed it help ensure performance through monitoring, support for the operating system and application infrastructure, as well as provide technical guidance.

In addition to Managed service level in Cloud, we are also nearing completion of our Hybrid hosting product. Hybrid will enable customers to run a managed environment of dedicate and Cloud infrastructure solutions. For example, a high performance database running on dedicated gear with a link to Cloud service to handle peak load spikes or unpredictable traffic.

As the market becomes more familiar with cloud technologies, we believe that nearly all businesses will use a mix of both dedicated and cloud platforms. And we believe Hybrid will become one of our largest differentiators in the market. We have a number of early adopter customers use Hybrid today, including GlobalSCAPE, PC Drivers, and Viewpoints, a leading provider for views an ratings.

Many of the capabilities underpinning these new enhanced service offerings are the direct result of the investments that we began making earlier in the year. Managed Cloud, Hybrid and UK Public Cloud should all help us start 2011 with strong growth momentum, extend our competitive advantage, and improve the returns profile of the business. We expect to begin releasing these new services shortly, so stay tuned for more details regarding launch events.

In summary, we are pleased with the financial performance that we have generated so far in 2010. We are delivering on our 2010 road map, and we expect our -- to achieve our financial goals for the year. Our strategy of improving the business model is working, and we believe we have meaningful opportunities in front of us. As we increase our service capabilities, our customers receive better value, and we improve our account at this position and capital efficiency. We have more details to share with you about our strategy and how we intend to measure our progress on improving the business during our fourth quarter earns call in February.

Until then we will be focused on delivering a strong end to a great year. As always I would like to end my prepared remarks by thanking our customers for putting their trust in us and our Rackers for their devotion to serving our customers.

With that, I will turn it over to Bruce to review our detailed financial results. Bruce?

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

Thank you, Lanham.

At the beginning of the year we outlined our objectives for 2010; to grow faster than 2009 while maintaining margins and investing in our business. We also said that we expected adjusted free cash flow to be positive at growth rate is below 35%. With three out of the four quarters complete, we believe that we will achieve these objectives for 2010.

Beginning with revenue and growth. Our total net revenue for the third quarter was $200 million, up approximately 7% sequentially from the second quarter and 23% year-over-year from the third quarter of 2009. Shifts in currency exchange rates had a positive impact on net revenue of $1.8 million on a quarter-over-quarter basis and a negative impact $2.9 million on a year-over-year basis. On a constant currency basis, revenue grew 5.7% quarter-over-quarter and 24.7% year-over-year.

Managed hosting revenue increase today $173 million, which translates to 5% sequential grow and 18% growth on a year-over-year basis. Cloud revenue for the third quarter was $27 million, representing 15% sequential growth and 75% growth on a year-over-year basis.

Our business is about providing high service levels on dedicated and cloud infrastructure, and a growing percentage of our customers are using both in. In essence, they are utilizing the power of our broad portfolio of service offerings, with a growing number of our customers purchasing service levels on both cloud and dedicated infrastructure. As this trend continues internally we are focusing more on our customer profitability using our four -- full portfolio set of products in total, making the breakout of this data between Cloud and Managed less relevant. And as such we will be evaluating the appropriate set of metrics we provide to you to make sure you are getting the relevant information to value and understand our Company.

Revenue growth was driven by a number of factors, including strong new customer additions, continued progress from our enterprise and channel sales groups, and continued growth within our installed base. We added approximately 11,000 new customers in the quarter. The Enterprise Group had another strong quarter, highlighted by the addition of CA technologies as a new customer and a significant upgrade from Anheuser-Busch.

Net upgrades for the third quarter remained at 1.6%,which is the highest level since the third quarter of 2008. And as we have said in the past, net upgrades are a key measure of our installed base growth, and we he are encouraged to see this metric remain robust in the quarter. Churn in the second quarter was 1.1%, which was up slightly from 1.0% in Q2. While this is within a healthy range, we believe we can improve this metric. Netting upgrades and churn resulted in installed base of 0.5% per month.

As a reminder, we have amended the way we calculate installed base growth to include the upgrades, downgrades and churn from customers of our Cloud Files, Cloud Servers and Private Cloud products. To date the difference between the new and the old methodology has been minimal. However, as Cloud products continue to represents a larger mix of revenue, we expect the differences to become more meaningful and the revised calculation more appropriate and relevant.

Shifting to profitability on the cost side of the business, adjusted EBITDA for the second quarter grew to $69 million, a sequential increase of approximately 10% and year-over-year increase of 33%. Adjusting only for noncash stock-based compensation, adjusted EBITDA margin grew to 34.3% from 33.2% in the first and second quarters.

As you may recall from prior periods, lease accounting rules under GAAP require outside to straight-line the full amount of rent expense for data centers, even though we structure the cash payments to match our expected demand. Because of GAAP requirements, we recognized $1 million of noncash rent expense in the third quarter. Excluding the noncash rent expense, adjusted EBITDA margins would have been 34.8% in Q3.

Looking ahead into Q4, we expect to incur over $1 million of incremental noncash data center expense as we move into the Chicago data center space that we announced in early May. While we are pleased with the adjusted EBITDA margin achieved in the third quarter, because of lower profit sharing costs in the third quarter and continued investments such as the DC investment above, we expect Q4 margins to be more in line with those in the first two quarters of the year. We will continue investing in the business to build out our service portfolio and increase our capital efficiency.

Net income grew to $12 million from $11 million in Q3. As you may recall from last quarter, Other income was positively impacted by a foreign currency remeasurement gain of approximately $800,000 on a pre-tax basis. This quarter, net income was negatively impacted by a higher tax rate as well as a foreign currency remeasurement loss of $1.4 million. In order to mitigate future volatility, we have implemented a structure that will limit further gains and losses from foreign health cash balances going forward.

Let's move on to capital expenditures. We spent $52 million in capital expenditures during the third quarter. Of this amount, we spent $36 million on customer gear, $6 million on data center build-outs, $1 million on office space, and $9 million on capitalized software development and other projects.

For the first three quarters of 2010 capital expenditures totaled $153 million. Of this amount, $98 million was spent on customer gear. During the same time we produced $106 million more revenue than in the same period last year. This equates to a 1.1 time revenue to customer gear CapEx ratio. The same measure was 0.9 last year during the same time period,illustrating the gains we are making in our capital efficiency.

For the full year we continue to expect total capital expenditures to fall close to the middle of the initial range that we provided at the beginning of the year, which was $185 million to $235 million.

Adjusted free cash flow came in strong at $12 million for the quarter. For the first three quarters of the year adjusted free cash flow totalled $29 million, consistent with our objective to generate free cash flow as long as growth rates were below 35%, and further reflecting the capital efficiency improvement of that Lanham discussed earlier.

Finally, I will move on to the balance sheet. Our cash balance increased to $167 million, and we continue to have access to an additional $194 million under our revolving credit facility. Our total debt outstanding, including capital leases, was $180 million, and net debt was $14 million. Net leverage at the end of the quarter was essentially zero.

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

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). Our first question today comes from Chris Larsen with Piper Jaffray.

Christopher Larsen - *Piper Jaffray & Co. - Analyst*

Hi, and thank you for taking the question. I wonder if you could talk a little bit about what you mean by increasing service level availability. And I think my -- within that it like that may be more employee intensive. Is that something that you think as you implement that, is that going to create incremental pressure on margins? And if you could just talk us through how we should think about modeling that out.

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

Okay. Thanks, Chris. This is Lanham.

Let's start with what we believe our core point of difference is in the marketplace, which is the notion of Fanatical Support. And this is about our Company providing incredible customer outcomes on a bed of IT infrastructure. When we discuss adding service level capability, what this means is we are increasing the quality of the outcomes we provide our customers by, number one, moving up the stack; number two, productizing new technologies; and number three, being a better trusted partner and guidance partner for them as they navigate this transition to a cloud world.

So was we look at the business today, we go back to our plans and road maps and would reiterate the fact that we have made direct investments improving the model with our Hybrid hosting offering, our Managed Cloud offering, our Critical Sites offering, and rolling the Cloud to the UK. What all of these do is basically increase value we add on a per box basis. So if we look at the metrics around average revenue per server, it's gone up every quarter this year. What's happening there is it reflects the fact that, as we roll out these new services, we're adding more value for customers. By adding more value they're paying us more. We are reinforcing our point of difference around generating Fanatical Support and incredible customer outcomes.

So we have a virtuous cycle here with the model, where the more point of difference, the more we can increase the outcomes to customers, the more value we can add, the more profit we will realize when we do this by capturing that value. So from a business model point of view it's really about productizing technology more so than it is about increasing the intensity of humans doing the work.

As we add the value to the stack, we think we actually have incremental opportunity to capture profit. Then the wonderful thing here is that the capital efficiency goes way up. So we're seeing that in our turns already. In Bruce's prepared remarks ratio of incremental revenue over customer gear CapEx, and we see that ratio is improving. So what we have here as we add more value, we can capture more profit, so this growth is self financing that regard. On top of that we make the model more capital efficient, so we're seeing our returns on capital go up as well.

Christopher Larsen - *Piper Jaffray & Co. - Analyst*

That's very help. Any thoughts as you go into the hybridized model, is that going to put any downward pressure on customer revenues or on average revenue per customer as they -- are customers going to expect to pay less because it's a Cloud service? Or how do you think about that?

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

We think about it in a couple different ways. Right now when we look at the results of the customers that we have had in beta, we have not experienced revenue pressure. Another way of putting that is, with the customers that are currently in the Hybrid offerings we have provided, they are growing with us not shrinking with us on a net-net basis.

Now it's early in the game, so we will see what happens. Our basic belief is that we have a huge opportunity in front of us. The addressable market is large and growing rapidly. So as we roll out these new service opportunities, these new service capabilities, most of the revenue growth here ought to be incremental. Today if we look at our run rate on the Company basis with the numbers we just posted, we're about an $800 million run rate company.

The market we're playing in is global in nature and many billions in size, so that we are very optimistic and forward looking around the total opportunity that we have out there. So the new service sets ought to add to our growth. In any -- in aggregate. In any given customer there may be a mix and match that we go through with them to get the right fit, but in aggregate for our customer it ought to be -- in aggregate for our Company this ought to be a net positive.

Christopher Larsen - *Piper Jaffray & Co. - Analyst*

Thank you. That's very helpful.

Operator

Our next question comes from James Breen with William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. I guess just, as we look at the numbers and some of the trends in the business, your free cash flow margins went -- they basically doubled up near 6% so far this year. Can you just talk about some of the initiatives you're taking to drive those higher up in the future? Alittle bit more specifically?Thanks.

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

Sure. This gets directly to our prepared remarks around adding more value on the stack. So much of this is what we just talked about in the previous question, but what's happening is our mix is changing. So with certain cloud technologies like virtualization we're able to get a higher capital turn on our fundamental compute input, which is a server.

So as we add more value through these new services like Critical Sites, as we increase our service levels on the Cloud, what's happening here is we are able to increase our turns across the business an across our compute footprint. So over time the higher the SLA, the more value we're adding, the higher the capital turns we will realize, so the better our free cash flow margin should become.

James Breen - *William Blair & Company - Analyst*

Thanks.

Operator

We'll take our next question from Simon Flannery with Morgan Stanley.

James Breen - *William Blair & Company - Analyst*

Thanks very much. Good evening. You talked a lot about the new products that you are rolling out in the next few weeks. Is it fair to saw that we really won't see much impact in terms of revenues in Q4, and that's more in early part of 2011, even if you launch in this quarter, but we shouldn't really be building much in the way of revenues? And then could you just update us on the competitive environment? A lot of announcements from competitors and so forth. How do you see any major changes in the way that you're seeing the competitive environment, the pricing environment right now?

Simon Flannery - *Morgan Stanley - Analyst*

Thanks.

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

Okay. Yes, greatquestions. On the first one here with the timing of the new products and when they will hit -- have a direct revenue impact, when we looked at Q3 certainly products we've already had in the marketplace had revenue impact. We talked a little bit in our prepared remarks about Windows Cloud Server, so we feel really good about those results. For the things that we still have yet to rollout, yes, the impact that they will have on 2011 will be larger than the impact that they will have on Q4

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at this point. We would net that out and say we feel pretty good about our execution on this and feel like these new services are increasing our market opportunity out there.

In terms of the competitive landscape, yes, there is certainly an announcement here from Amazon Web Services about offering a free development tier, which is really a micro-slice for free for a period of time for developer customers. Up to -- it's early in the game. Up to this we would say we have had no impact -- that has had no impact on us, and that what is happening here is really the market is starting to more clearly identify the different segments. So Amazon has done a great job, and the offerings they have out there are really a do-it-yourself offering. So it's about providing customers access to their infrastructure, and then the responsibility on customers to make the work happen and make the infrastructure generate the right results is really on the customers' shoulders.

When we look at our offerings out there, our core customer is going to be a customer that wants a partner, that values service, and is willing to pay for a world-class outcome. So as we look at the new offerings we have, for example, our Managed service layers on Cloud, we will be increasing the price in our offerings.

So what we believe is happening is the market is bifurcating here, and it's reinforcing the different segments in market opportunities. There will be a segment in the cloud market will people just want access to infrastructure, and it's going to be a commodity type experience, and Amazon is a great pick there. When we think about it, our core customer is that customer who is going to want to trusted partner, value the service, and be willing to pay a premium for a world-class customer outcome. That's who we're targeting.

If we look at the results in the third quarter, we added about 11 thousand of them. So we believe that the opportunity in the marketplace is there, the new products we're rolling will reinforce our point of difference, and I think the market is just starting to divide.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

Our next question crops from Jason Armstrong with Goldman Sachs.

Jonathan Hong - *Goldman Sachs - Analyst*

Thanks. It's actually [Jonathan Hong] for Jason. I just wanted to cover two things. The first being looks it looks like Cloud had a nice performance this quarter, with accelerating customer additions and growing revenue per customer from the Windows launch. Can you talk about which of the upcoming Cloud product launches you're most excited about and what this can do for the operating metric? And then overall, what the customer growth -- you guys added about 11,000 this quarter, but it looks like most of that came from the Cloud, with Managed hosting being essentially fat -- flat. Can you kind of talk us through what the disparity is a here and how we should think about this going forward?

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

Yes. Okay, so that's a hard question here in terms of which products are we more excited about. I would put two in a tie with Cloud. Okay?I think the first thing that we're very excited about is increasing the service levels on Cloud with a Managed Cloud offering. What this will do is have a direct impact on the metrics around revenue per cloud customer. By adding these service levels we will be increasing the price points meaningfully, and so that should have a direct impact on the revenue-per-customer metrics in our Cloud.

The next that we're really excited about is expanding our Cloud geography to EMEA. We've got an important portion of our business in Europe today. We have customers -- current customers as well as prospects in Europe asking for this from us, so we think that's a big horizontal opportunity for us to improve. And what you will see there as we roll that offering out is additional customer acquisition. By having it in Europe, European customers are more likely to buy from us. So that would have an impact on the metrics in terms of customers counts.

With respect to customer counts between our Managed hosting business and our Cloud business unit, you're correct. When we look at the customer count numbers today, we added more customers in Cloud in the quarter than we did request our Managed business. We also migrated a number of our simple customers and Managed over to Cloud. That number was about 150 customers in the quarter that we migrated interested from one to the other. Our strategy in our managed offering to move up the stack, add more value, and win bigger deals. This strategy is working. The proof point there is when you look at the average revenue per customer in that offering, it's going up as well.

The other thing that's happening here, Jonathan, which blurs the lines a little bit, is with the Hybrid hosting offering we have the same customer utilizing both form factors. From our perspective our Company is about providing high service level on IT infrastructure. With whether that IT infrastructure is dedicated to a customer or in a pooled environment like a Cloud, that doesn't drive our decision making and how we serve them. We're all about that high customer outcome. So what's happening now, the new architecture emerging insides of our Company, is we have the same customer, the same customer's application in fact, utilizing both form factors.

So when we get into hybrid environments like this, the metrics start to blur a little bit. So in our prepared remarks we wanted to let investors know that as these metrics blur, we'll be coming be back to the market to tell you how we evaluate ourselves and what the right way is to piece it apart. So our strategy will remain the same with Managed in we're adding more value, we're moving up the stack, we want to win bigger deals. From our customer point of view it's about providing world-class service outcomes on top of IT infrastructure. So from that perspective everything we do, from a customer point of view, it's a Cloud to them.

Jonathan Hong - *Goldman Sachs - Analyst*

Okay. That's helpful. And just a quick follow-up. Just in terms of looking at the transition between Managed hosting and Cloud, can you just quickly talk about any economics to help us kind of think through what the trade off is there for Rackspace?

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

Yes. Okay, thebest part of the economic switch from customer -- from a simple customer on a dedicated environment to a Cloud environment is an immediate increase in capital efficiency for Rackspace. Basically through cloud technologies we are able to realize a much higher asset utilization slash capital turns in Cloud for a very simple configures today. Okay?So what happens here from a capital point of view, putting them on the Cloud is a much better capital impact for us.

As we look at the offers we have in the pipe, like Managed Cloud for example, we believe that with these offers we're going to be able to give the customer great value, capture higher profit and margin than what we have serving that customer today on a dedicated server, as well as increase the capital efficiency. So that utilizing the new technology helps us to creates a better economic outcome for our stockholders.

Jonathan Hong - *Goldman Sachs - Analyst*

Thanks. That's very helpful.

Operator

We'll now hear from Greg Dunham with Credit Suisse.

Greg Dunham - *Credit Suisse - Analyst*

Yes. Thanks for taking my question. On the Managed Cloud offering that goes into effect this quarter, you mentioned that as kind of the one -- one of the ones that you're most excited about. What gives you -- what supports that excitement? Is it conversations with customers? Why do you think that there's a big appetite for it that Managed Clouds business today.

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

Okay. Yes, great question. We have been in beta with customers on it for months. The feedback we've gotten has been real positive. We also feel like our ability to differentiate by providing these service levels on Cloud infrastructure is strong. When we think about our Company, we want to build a company that's recognized as one of the world's greatest service companies. We do this through a combination of web scale technology and great human beings called Rackers. When we do this right we create incredible loyalty rates among our customers base.

So when we looked at the Managed Cloud offering specifically, it exactly hits that sweet spot. When we look at the change taking place in the market today, what customers talk to us about, the customers that we have won from Amazon's Cloud, for example, they want to have Fanatical Support on the Cloud. They want to have a world-class customer outcome on these emerging new technologies. What prospects want is they want to a trusted partner who is going to hold their hand and help them make this transition, so this is where a company like Rackspace ought to win the day. This is the spot in the market where we ought to have incredible brand recognition and great customer loyalty. So the data we have around it today is based on the beta results that we've received during the program, the feedback has been positive , and we feel like this launch in service set directly hits our sweet spot.

I would add to it that this first service level offering in the Cloud is step one. We have additional steps to take to where we can offer an SLA like we provide in Critical Sites onto Cloud infrastructure. So what we are seeing is the early returns from our strategy to improve the model. Each one of these offerings that we roll out that increases our service level reinforces our point of difference, increases customer loyalty, and gives us the opportunity to capture better economic returns.

Greg Dunham - *Credit Suisse - Analyst*

Thank you.

Operator

Our next question comes from Jonathan Schildkraut with Evercore.

Jonathan Schildkraut - *Evercore partners - Analyst*

Thank you for taking the questions. Just one housekeeping item. Lanham you were ripping through six reasons why you were proud of the quarters, and you want through them pretty quick and I was just wondering if you could walk though those again? And then I have some more specific questions. Thanks.

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

Jonathan, that the good news here is I have seven. Okay, so number one, was record bookings quarter. Number two was our adjusted EBITDA margin. Number three was the adjusted free cash flow. Number four was average revenue per customer increased across the business. Number five was the average revenue per server increased for fifth consecutive quarter. Number six was the return on capital increased for the fourth consecutive quarter. And number seven was we added just under 11,000 customers in the quarter.

Jonathan Schildkraut - *Evercore partners - Analyst*

Great. All right. Thank you. All right. A couple of questions here. First, we have seen some good movement in the revenues per Cloud customers. This is two quarters in a row, and I'm wondering if you could give us a little color as to what drives up revenue per Cloud customer in front of launching the managed Cloud, which I think we're all pretty excited to see what the impact on that metric is. The second question is, if you can give us some color, any update on your channel partner program. And then finally just in terms of what you guys are doing, kind of service layers on the public cloud, we hear a lot about the private cloud and it seems like you guys have kind of skipped right over that and focused on the economics of the public cloud with a service layer. So call it a virtual private cloud maybe that you guys are going after, and maybe what the approach there strategically was, and why -- what are the pros and cons of that decision? Thanks.

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

Okay. Yes. You gave me a lot there, so if I forget something, please just ask again. I did my best to take some notes.

Jonathan Schildkraut - *Evercore partners - Analyst*

You know I will.

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

Yes. In terms of the average revenue per customer in Cloud, the question of why is it going up before we have launched these additional service levels, the short answer is customers are just consuming more it. So the -- we would get a trial with a customer, they would enjoy and like the output, and they would buy more of it over time. That's what's driven the average revenue per customer on Cloud up -- increased it had up to this point.

With respect to what's going on in our channel program, we're still excited and thrilled about it. Robert Fuller and his team continue to do really good work. We have actually landed a couple more partners in our channel program during the quarter, one of them being [Sinex], another being Sitecore. So we feel like we continue to generate steady progress there. And when we look at the take rates in our channel work in terms of increasing our -- the number of at bats we have for enterprise customers and at bats with a high hitting percentage, we believe our channel is a force multiplier for us and allows us to compete in some important situations. It really gives us access to some opportunities that we wouldn't see on a direct basis, so we believe our team there -- I think our team there has done a great piece of work.

With respect to private cloud and the -- versus public cloud with a service layer, what are we doing architecturally, how does this stuff fit were our road map,here's how we think about that today. Today we do offer private clouds on a VMWare stack. We also believe that going forward we will incorporate private cloud capabilities into our OpenStack initiative. OpenStack up to this point is getting what we would say is incredible traction out in the marketplace. We had a code release on Thursday, October 21. Microsoft has announced it's intention to make Hyper-V virtualization technology compatible with OpenStack. We are seeing a lot of interest from enterprises and other service providers with it.

So the core of our strategy here is to create open standards for web scale infrastructure in the Cloud and then to roll our services around it, to apply our Fanatical Support to OpenStack and differentiate around those services. So that over time we will be investing the next iteration of private cloud technology within that OpenStack framework.

Jonathan Schildkraut - *Evercore partners - Analyst*

And given that you are using proprietary -- well, you're opening it up, but given that you are using your own technology for virtualization in the public cloud side of your business, do you think that there will be kind of economic advantage as you roll out products with service layers then to the customers relative to current private Cloud offerings?

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

Yes. What ought to happen here -- if you think about just the foundation layer of our offerings, it's basically driven by -- we use standard technologies, integrate them, and run them at scale. So the more scale we get as a business, the more we are able to generate economic advantage through those scale economies. We believe that will continue.

Then the next layer is, as we incorporate higher service levels to where we can add more value for customers, reinforce our point of difference, we ought to have better growth and profit opportunities coming out of it.

Jonathan Schildkraut - *Evercore partners - Analyst*

Awesome. Thank you for taking the questions.

Operator

We'll now hear from Patrick Walravens with JMP Securities.

Patrick Walravens - *JMP Securities - Analyst*

Great, thank you. I would like to focus on the revenue per server for a second, Lanham, if I could. So if I'm doing my math right you took it up to 12.7 in the quarter, up from 12.3 last quarter. So I have two questions, which is, one, looking out a couple years, where can that metric go? And, two -- and again, if my math is right, that was a 3% improvement quarters to quarter, and can we expect progress to continue at a level like that?

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

Okay. I have a little different math than you do, so let's synchronize on that. Basically if I look at our GAAP revenue for the quarter of $199.7 million, okay, divide that about 62,935 servers online okay, that's $1,058 a month. If you annualize that, it's $12,700 a year roughly.

Patrick Walravens - *JMP Securities - Analyst*

Okay.

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

Okay. So we're in -- that's the same math, we're in sync. I just want to make sure we're in sync.

Patrick Walravens - *JMP Securities - Analyst*

Yes, hat's the same.

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

Okay. All right. Perfect. So what we believe is happening here, this trend has been pretty steady here. Really, if you go back to a year ago, it was at $990. So we have increase it little by little as customers have consumed more from us in the cloud and as we have rolled out service offerings.

As we sit here today we believe there is still plenty of upside in our ability to increase service levels and capture higher price points as a result of those service outcomes and capabilities that we provide customers. All of this stuff gets communicated between Rackspace and the customer through our SLA. We think we have good SLAs today, but we do not think we have the greatest SLAs ever. All right?We are a work in progress as a Company, so we will continue to invest in thisand walk it up.

I don't want to give you a forecast on at what rate is this going to happen or high how is it going to get, but what I would leave you with is the fact that there are technology changes going on in the business that allow us to more efficiently utilize each server. So as we can more efficiently utilize servers, our ability to add more value on top of that basic compute through a higher service level increases, so we should have continued upside in this particular metric.

Patrick Walravens - *JMP Securities - Analyst*

Great. And can I just ask, is Managed Cloud live today?

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

We have it in beta today. We have not made it generally available.

Patrick Walravens - *JMP Securities - Analyst*

Okay. Thank you.

Operator

And, Brian Thackray with Deutsche Bank has our next question.

Brian Thackray - *Deutsche Bank - Analyst*

Hi. Thanks for taking the question, guys. First question is around the Enterprise. You've been at this initiative for I think a little over a year. Anheuser-Busch I thought was interesting. They are moving just I don't understand just the public facing websites. Can you talk a little bit more in terms of what the economic opportunity of that deal was, pushing deeper into their enterprise? And can you talk about your pipeline around the enterprise? Are there other enterprises that you feel like you're close with in terms of similar type of deals penetrating deeper into those enterprise accounts?

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

Sure. With respect to Anheuser-Busch, I mean, we don't want to get into any particulars about that customer on this call. We just have a policy to not really comment on specific customer situations like that, but in general why don't we talk about the adoption rate within enterprises, what that adoption rate looks like, and the economics that that adoption rate drives.

So in terms of the adoption rate, what happens here is enterprises -- we tends to win one application first. It could be an application in a department, it could be a revenue app, it could be an e-commerce app, it could be a logistics app, but it tends to be one app from one department insides of a Fortune 500 company. The next wave with the adoption is entirely driven by how well we've served them for that application, and how quickly we earn their trust. Because enterprises are very sophisticated buyers. They could do this themselves, so any time we enter into a situation like this, it has to be a good deal for them and it has to be a good deal for them.

Our unique magic that we bring to this is we are able to inject at web speed a high service level into their department. So what happens here is basically they experience the outcomes we can provide, we earn their trust with that first app, and then word-of-mouth starts to work for us inside of that CompanySo as we win one department, they talk to a colleagues who may be running IT in another department, they talk to the CIO in the company cafeteria, and we start to build a brand reputation inside of the customer, at which point we then start to follow up with our own sales efforts to try to stoke additional demand insides of that company.

What we have found so far is that every initial enterprise Fortune 500 company, when we have had leads to multiple opportunities insides of that company. For us -- for our customers, rather, Rackspace represents a new model. A new way of purchasing computing as a service. It's easier, it's faster, it's cheaper than doing it themselves, so for the IT department we can be a great partner for them. They're able to transfer infrastructure spend that doesn't create differentiation for their IT department to Rackspace. They can re allocate those resource into things that only that internal IT department can do, like write the code for one of their apps.

So what we have here is a really nice fit, and the more at bats we have with enterprises, we want to win that first app, then we want to do an incredible job earning their trust as rapidly as possible. That then leads to other wins. So our economics for our Company within our Enterprise business today start out really good, and they improve over time with additional wins.

Brian Thackray - *Deutsche Bank - Analyst*

Thanks and a quick follow-up for Bruce. Bruce, you talked about churn ticking up slightly this quarter, but that you had some initiatives to improve that next quarter and into the future. Can you just provide some more granularity around what that those improvements might be?

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

Sure. I almost hate to break in. Lanham has had such a roll here.

But one of the things that we talked about throughout the call is increasing our service level with customers and building tools to help our Rackers service customers better. And we're continuing a lot of those efforts, and we're constantly rolling out new systems, new programs, new initiatives for our Rackers to help our customers.

Now, keep in mind though, that our churn, while it went up a little bit this quarter, is still within healthy ranges of what we expect and what we hope to achieve, and we're still running significantly below what we averaged in the prior year. In our best years in 2006 and 2007, when the economy was still very strong, great churn rates for us were 0.9%. So we're still very close to what we think are some of the world-best churn rates that we achieved a few years ago.

Brian Thackray - *Deutsche Bank - Analyst*

Thanks for the guys.

Operator

Our next question comes from Ben Abramovitz with Kaufman Brothers.

Ben Abramovitz - *Kaufman Brothers, L.P. - Analyst*

Hi. Good evening. I guess a few questions. The first one is you added almost 11,000 customers in the quarter. Where do you believe most of the customers are coming from? Are they new to the cloud? Are they being taken from some competitors and may need more service after initially adopting the cloud? Or is there new company formation; i.e. is it GDP driven despite by the soft economic environment here?

And then the second question is are you seeing more enterprise or at least larger companies come in the customer mix that you're serving? Thank you.

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

Okay. Great. So the first part of the question about where are the 11,000 customers coming from, specifically around Cloud. These customers are really new to the category, by and large. What's happening here is the cloud is reaching a tipping point in that people are aware of it. They want to understand it. People are trying it. And when they try it, they like it an start buying more. So we are growing -- in terms of our customer acquisition, we are adding lots of customers in Cloud, and they are the early adopters into the category.

This leads into your next question of, are we serving more enterprises today? And the answer to that is yes. It's interesting that we have many enterprises also talking to us about cloud as well as coming to us through our channel programs an other marketing -- sales and marketing activities that we do. I think the enterprise adoption here is similar in that they are aware of cloud technologies. They want to talk to us about what's happening there. They want to understand how to use these technologies. And then our ability to combine dedicated equipment as well as cloud technologies for customers in a hybrid environment is something that enterprises are very interested in today.

So the adoption rate here is happening based on these new technologies save people money, they are interested in buying computing as a service, and they're looking for a company that can truly serve as a partner with them. At Rackspace we're trying to be that partner for them.

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Ben Abramovitz - *Kaufman Brothers, L.P. - Analyst*

Just a quick follow-up. How long do you think that sales conversion might take between when you start having that conversation with the interpose till they start to don't it?

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

Okay. The -- so let me give the spectrum. With many of the early adopters that we serve, specifically tech-savvy web-based company, man, it's an instant thing and they're buying it online. Okay? Where literally we're not even visiting with them in some instances upfront.

With enterprises it's different. The average enterprise here, we have a sales process with them. That process is really driven by discovery and helping to understand what problem they're trying to solve and what the right solution here at Rackspace is that we can provide for them to make sure the fit is right. Because for us its all about making sure we have the right fit, because we're trying to build customer loyalty. This process with enterprises on the short end of the equation will run three months. On the long end will go six, seven, or eight months.

Ben Abramovitz - *Kaufman Brothers, L.P. - Analyst*

Okay. Thank you.

Operator

And Michael Bowen with Guggenheim Securities has our next question.

Michael Bowen - *Guggenheim Securities LLC - Analyst*

Okay. Thank you very much for taking the questions. Lanham or Bruce, I just wanted to go back and just touch on something very quickly. I thought I heard you say that you expected margins in the fourth quarter to be more in line with first an second quarter?If you can just -- you were moving pretty fast here --if you can just repeat what the reasoning there was and whether you were talking about adjusted EBITDA margins.

Second question is can you give us an update on how many companies at this point are using OpenStack? I think when you announce it, you had about 25, including NASA, and then also I guess the same thing with Windows in the Cloud. If you can give us an update there that would be great. Thanks.

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

Yes, let me start in on the margins. And first of all, as we've communicated before, there's still a lot of leverage left in our model. And we're working hard at scaling the business, but we're doing it in order to free up dollars to continue the investment. That's how we've really maintained our margins through the first two quarters where they were.

Now, in the past quarter we've had lower bonus payments or profit-haring payments, we really set some targets for our Company on a 10% march each quarter. Now those may be pretty aggressive, but we're pretty hard on the folks here to be performance oriented. When we don't make our targets, we don't pay out the full profit-sharing plan. So that affected us in the third quarter.

In addition to that we've got some additional things like rent expense that we talked about in our data centers. Keep in mind, from a GAAP standpoint when we take possession of a data center, even though we've structured the deals where we pay based on our usage, we are required by GAAP to accrue for 100% of that cost beginning day one. And so in the fourth quarter we will have an incremental $1 million worth of expense that we're going to be recognizing on our books going forward.

Michael Bowen - *Guggenheim Securities LLC - Analyst*

Okay. Thanks. And with regard to the Cloud and OpenStack?

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

Yes. When we announced OpenStack, we talked about the number of partners that we had on it. That partner list has grown. I believe today we're up to around 35 technologies partners, and then if you go to the online forums are there are hundreds an hundreds of developers that are contributing code.

With respect to the number of customers using our Windows Cloud offering, we haven't broken that out specifically. In general, if you look at the adoption we've had in terms of number of customers this past quarter, what we tell you is that Windows Cloud customers number in the thousands.

Michael Bowen - *Guggenheim Securities LLC - Analyst*

Great. Thank you.

Operator

Ours Gray Powell with Wells Fargo Securities.

Gray Powell - *Wells Fargo Securities - Analyst*

Hey, guys. Thanks for taking my questions. Just had a few quick ones. What is Enterprise as percentage of revenue? And as you move into larger deal sizes, who do you compete against the most?

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

Okay. Great question. In terms of the size, a year ago we -- not quite a year ago, in our Analyst Day meeting, at that point in time we said Enterprise was roughly about 10% of our revenue. It's the fastest growing, so while we don't release numbers, it's going to be higher than 10% today . Do you want to --

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

Yes. In terms of competition as we compete in these situations, the first thing to figure out is really a substitute, which is the enterprise doing it themselves. Once they cross that decision point, it gets into some of our traditional competitors the likes of a Savvis, the likes of an AT&T, or an IBM, EDS/HP type situation.

What we find in these situations is when we get into the folks like an IBM, for example now -- obviously at Rackspace we cannot do everything that IBM can do, but relative to this infrastructure, moving at web speed we have a competitive advantage. So while we can't do everything that IBM can do, we can move faster, we can be more responsive, we can provide really strong SLAs on this infrastructure, and we can save our customers a lot of money. So that what happens here is some of the forward looking CIOs will end up using IBM for some stuff; for example, using IBM for their mainframe, because at Rackspace we don't do mainframes. But when you get onto web infrastructure, this is where we really shine, so they'll use us for their web infrastructure.

We have found this occurrence and this pattern to take place inside of many of our customers that we're serving today. So it's really a matter of these customers selecting us for the things we are excellent at and providing them a lens into moving into a new model and way of delivery.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay. Great. That's helpful. And then just as a couple of follow-ups. How do you think the potential level of new business wins over the next 12 compares to what you have seen over the last 12, and then do you see any room for improvement in the growth of your installed customer base going into 2011?

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

On our installed customer base, this quarter we grew at 0.5%, so when you think about the first six months, it's been averaging about 0.5% to 0.6% per month. That equates to about a 7% increase for the year in our revenue. Again, going back to when the economy was really growing quickly, we were growing that base, you know, close to 15%. And so we believe that as the economy continues to improve, or if it continues to improve, there's no reason that we shouldn't see some increases in our install base growth.

What we have seen lately is -- as you know the installed base growth has two components. There's the net increase growth of the existing customers less the churn. And what we have seen this year, and we're really happy too see it come back from last year, is the amount of upgrades -- net upgrades that are customers are coming to with us with has been growing. And, again, we see that very closely tied to the economy.

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

The last part of the question about new customer wins, what we would say there is we feel the opportunity in front of us expanding. When we look at specifically our enterprise business and how we have done there, it's the fastest growing piece inside of our managed business today, and we're only a year down the road. I mean we are still improving our game there and elevating it every month. So we like our chances for additional wins there.

And then generally speaking we are hitting a sweet spot in the market here as customers and prospects work to figure out how to use the cloud, how to help their companies make that transition to the cloud, and how to combine best-of-breed infrastructures on a dedicated and cloud basis. So we believe this market opportunity is expanding for us. And it comes down to our ability to execute insides of that environment around reinforcing our point of difference with the Fanatical Support, generating incredible customer outcomes, because as we generate great customer outcomes, that customer word-of-mouth really does the hard work for us.

So I think that we are optimistic about the market opportunity,its size in front of us. We like our competitive position, and it's going to come down do our ability to execute on it.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay. Great. That's very helpful. Thank you very much.

Operator

We'll take our next question from Frank Louthan with Raymond James.

Frank Louthan - *Raymond James & Associates - Analyst*

Great, thank you. Can you comment on the Enterprise sales force? What are the plans there as you continue to expand? Do you feel that you're going to need some more folks? And then how are you sets floor space with some of the recent expansion? How much longer do you think before you're going to need to expand to some more floor space for servers?

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

Okay. With the Enterprise sales force, we haven't made known specific targets in terms of hiring and all that stuff, but certainly as that business grows we will be investing in sales resources and adding additional capability. We have done that already this year and had good success with it. We determining and still work working on exactly the best way for us to do this. We want to do it in a Rackspace manner so we get high leverage on the activities. This is why the channel is an important element for us.

Some of our marketing that we're doing is an important element for us. And then we want to follow it up with a really strong enterprise sales capability. We have lots of stuff to talk about with these customers, from OpenStack to the Cloud to our higher service levels, and we find that when we're in the door and have an at bat, man, we've got a great chance. So our focus here is about increasing our number of at bats so that we can bring our portfolio to bear, because this year we're really making transition into a portfolio company.

With respect to space, some of the nice things that are happening here in the metrics is you are seeing that we are increasing our revenue per foot when we increase our revenue per server in such, so we are getting a more output -- more economic output from our investments and our infrastructure today. The way we structure our deals is that we basically pay for the rent as we needs the space. If you look at our utilization rates today and our key metrics, we still have quite a bit of run way here. So in terms of feeling in comfortable shape, we do feel like we are in comfortable shape. The factors that would change that over time is if our growth rate has continued upticks, right, we would have to be more aggressive about provisioning additional capacity.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay. Great. And what percentage of Enterprise sales are you targeting through sales channels? Where you now, and what is your long-term target for that?

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

Okay. Our philosophy on this is that we want to feed the programs that generate the best economics. Okay, so if that comes through the channel, we want it increase our investments in that. If it comes through other means and marketing programs, we'll do that. Today if you look at the effect of -- that our channel is producing for our enterprise business, it's turning in approximately a quarter of the growth we're having. Our aspirations and internal beliefs about those results is that, man, that's a huge improvement where we were a year ago, but we believe we can take it up even further from where it is today. So we see continued upside in those programs.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you.

Operator

Ladies and gentlemen, this conclude are the question-and-answer portion of the calling. Thank you, and have a good evening.