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RAX - Q3 2011 Rackspace Hosting Inc Earnings Conference Call

Event Date/Time: Nov. 07. 2011 / 9:30PM GMT

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting's quarter-3 earnings release 2011 conference call. As a reminder, this call is being recorded. At this time, all lines are in listen-only mode to prevent background noise.

After the prepared remarks, there will be a question-and-answer session. (Operator Instructions)

It is now my pleasure to introduce Jason Luce, Vice President of Finance for Rackspace. Mr. Luce, you may begin.

Jason Luce - *Rackspace Hosting - VP of Finance*

Good afternoon. Thank you for joining Rackspace's third-quarter 2011 earnings call. I am here today with Lanham Napier, our CEO, and Karl Pichler, our CFO. We issued a press release after the close of the market today with our unaudited financial results for the third quarter of 2011. If you do not have a copy, please visit the investor section of our website at www.rackspace.com, or this call is also being webcast.

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

All statements other than historical facts are statements that could be deemed forward-looking statements. These risks, uncertainties, and assumptions are described in Rackspace Hosting's form 10-K for the year ended December 31, 2010, filed with the SEC on February 22, 2011, and in Rackspace Hosting's form 10-Q for the quarter ended September 30, 2011 expected to be filed shortly. These forward-looking statements speak as of today. Except as required by law, we assume no obligation to update 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 as non-GAAP financial measures, such as adjusted EBITDA. Our GAAP results and GAAP to non-GAAP reconciliations can be found in the earnings release we issued earlier today, which is posted on our website, as mentioned previously.

Following our prepared remarks today, we will open the call for your questions.

Okay, let's get started. Lanham?

Lanham Napier - *Rackspace Hosting - President & CEO*

Thanks, Jason. Good afternoon, and thank you for joining our third-quarter earnings call. In the third quarter, we improved upon the solid results that we delivered in the first and second quarters, by continuing our strong pace of revenue growth, while boosting margins and returns. In short, Q3 was the strongest quarter so far in 2011.

Here are the highlights. First, our revenue growth rate adjusted for currency improved to 7.3% sequentially, and 31.3% year over year. Several factors have enabled us to increase growth in 2011, including -- continued rapid growth in our public cloud business, which grew 89% year over year in Q3; improved traction in serving large enterprises; customers leveraging our enhanced portfolio of products and services; and a significant pickup in sales to existing customers. Monthly install base growth remained at 0.9% per month for the quarter. Although we are not at pre-recession levels on install base growth, which was approximately 1.5% per month on average, our rate of 0.9% for the first 9 months of 2011 is higher than the 0.2% that we achieved in 2009, and the 0.5% that we averaged in 2010.

Our second highlight for Q3 is that both adjusted EBITDA margins and net income margins improved sequentially. Our final highlight is that revenue per server increased for the 9th consecutive quarter, and our fully burdened return on capital increased for the 8th consecutive quarter to 14.8%.

As you are all aware, the results we've generated in the first 9 months of 2011 have occurred during a time of tremendous macroeconomic uncertainty, punctuated by the fear of a double-dip recession and a decline in the overall demand environment. We have heard these concerns first-hand throughout the year in meetings with customers and prospects, as well as investors, and one of our biggest concerns was that at some point, the persistent fear of recession would become self-fulfilling. With 9 months of the year behind us, we are not seeing any significant slowdown in demand for our services. We are successfully executing on our internal growth and profit plan.

So, today, demand for cloud computing backed by fanatical support is not our constraint for growth. We believe the cloud computing era represents the biggest market opportunity in all of tech. More and more corporations are discovering that using a specialized service provider is the faster, cheaper, more effective way to address their IT needs -- basically, pay less and get more. We are beneficiaries of the massive secular shift toward cloud computing, and believe it could represent a multi-billion dollar revenue stream for Rackspace.

What accounts for our success is the fanatical support that our employees, called Rackers, deliver to our customers. We believe that our strategy to be the dominant service leader on cloud computing market will drive sustained growth. Running mission-critical IT systems requires a complex combination of computing hardware, software management tools, and a technical staff that has expertise on a diverse range of technologies, and is obsessed with customer service. Fanatical support combines these ingredients to deliver the best technology service results in the industry to our customers. In short, fanatical support changes the way businesses consume IT.

Instead of buying and assembling all the various IT inputs, Rackspace customers can purchase IT as an output, as a service. This service delivery strategy is the core of our differentiation. It is a complex business process that offers us a sustainable competitive advantage. We will continue to invest in this core, and improve the value delivered to customers. We believe the investments we make today will help us take full advantage of the huge market opportunity in cloud computing.

During the quarter, demand from enterprise customers was strong, both from a new customer acquisition and install base growth standpoint. During the early years of Rackspace, our services were adopted and validated, mainly by small- and medium-sized businesses. And those companies remain a vibrant part of our Company. At the same time, more and more large corporations today are discovering that using a specialized service provider like Rackspace is the better, faster, cheaper way to address their IT needs. And we are optimistic that enterprises will represent a larger share of our revenue going forward.

One notable example from the quarter is a new deployment from CA Technologies, a $5 billion enterprise software company. CA selected Rackspace to host its cloud IT management application called Nimsoft, a software-as-a-service monitoring and reporting application that CA customers use to proactively track the performance and availability of their IT infrastructure. High levels of availability are important for any SaaS application, but they are especially critical for one that is used to ensure the uptime of an organization's underlying IT infrastructure. Ensuring that applications are available on a 24 by seven by 365 basis is Rackspace's expertise, and we are pleased that CA has trusted us to run this mission-critical application for them.

Another pillar of our growth strategy is to build out our product portfolio to include higher service levels and additional capabilities. We are investing heavily in this strategy. And Rackers in our product development groups are creating new technologies to help businesses leverage the benefits of the cloud. Hosted Virtual Desktop, our managed cloud service, the UK Cloud, and Cloud Load Balancers are a few of the recent examples of new capabilities developed by Rackers that are available in the market today that make us more competitive, drive revenue growth, and improve returns.

Our product road map includes a variety of new capabilities and features, including Cloud Block Storage, enhancements to RackConnect, and of course, building a support business around the open stack Cloud Computing Platform. Back in March, we launched Rackspace Cloud Builders, a new service offering certification and deployment support for organizations that need help building open-stack environments. The primary goal of Cloud Builders was to help drive widespread adoption of the OpenStack platform, while investigating the feasibility of building a new service offering. Since the launch of OpenStack, more than 130 companies have joined the project, and Rackspace has been involved with proof-of-concept implementations with large enterprises and service providers.

Based on the experience we have gained working with customers running OpenStack. As well as the strong adoption of the software platform in the market, we are ready to move into the next phase of our OpenStack strategy with the introduction of a new service we call Rackspace Cloud Private Edition. This new offering will enable Rackspace to extend Fanatical Support beyond the bounds of our data centers, by remotely supporting and managing OpenStack environments that run in almost any data center. We've already helped more than a dozen customers build and/or manage OpenStack clouds, including eBay, for its X.commerce venture. We believe that Rackspace Cloud Private Edition has the potential to revolutionize IT organizations worldwide, while dramatically improving the capital efficiency of our business.

This initiative is still in its early stages of development. We have much to learn about delivering Fanatical Support outside of our data centers. There are still issues that need to be addressed, holes to be filled, and unforeseen obstacles to overcome;

however, we see the Rackspace Private Cloud Edition as an important opportunity to drive massive incremental demand. Expect to hear a lot more about this new capability going forward.

Before I turn the call over to Karl to review our detailed financial results, let me summarize our results through September. In the first quarter, we set the bar high with a strong start to the year. In the second quarter, we achieved $1 billion in annualized revenue. In the third quarter, we began our journey towards the $2 billion revenue milestone. And we did it while growing rapidly with services that we expect to significantly improve the capital efficiency of our business model. In the fourth quarter, we will be focused on delivering a strong ending to a great year.

Karl?

Karl Pichler - *Rackspace Hosting - Interim CFO*

Thank you, Lanham. For the third quarter, total revenue was $265 million, representing 7.0% growth from the second quarter, and 32.5% growth compared to the third quarter of 2010. Exchange rates had a negative impact on revenue of approximately $793,000 compared to the second quarter of this year, and a positive impact of $2.4 million compared to the third quarter of 2010. On a constant-currency basis, revenue grew 7.3% sequentially, and 31.3% year over year. Install base growth was 0.9% in the quarter, which is in line with the previous 2 quarters and an improvement from 0.5% that we saw in the third quarter of 2010.

Managed hosting revenues increased to $214 million, representing 4.7% sequential growth, and 24% growth on a year-over-year basis. Growth in managed hosting continues to be driven by strong upgrade activity and new sales to enterprise customers. Cloud revenue for the quarter was $51 million, representing 18% sequential growth, and 89% growth on a year-over-year basis. Cloud growth is driven by a combination of new subscribers, increased usage from existing customers, and contribution from newer services such as [load balances as a service]. Overall, we added more than 8,800 new customers in the quarter, bringing our total count to more than 161,000.

Moving on to profitability. Adjusted EBITDA grew to $88 million, representing 7.8% sequential growth, and 29% growth on a year-over-year basis. Adjusted EBITDA margin was 33.3% in the third quarter, 0.3% higher than the first and second quarters of this year, but below the 34.3% margin we saw in the third quarter of 2010.

Depreciation and amortization expense came to $50 million in the quarter, representing approximately 18.7% of revenue, slightly below the 19% to 20% range that it has been since the beginning of 2009. Net income came to $20 million in the third quarter, representing growth of 13.8% over the second quarter and 69% from the third quarter of 2010. Third-quarter net income was positively impacted by a lower effective tax rate compared to the first and second quarters of the year. Although our tax rate has fluctuated on a quarter-to-quarter basis, it has remained flat at approximately 35% for the prior 2 years. And we continue to expect it to be close to that rate for the full year in 2011.

Capital expenditures totaled $94 million. Of this amount, we spent $54 million on customer gear, $17 million on data center buildout, $9 million in our office facility, and $14 million on capitalized software development and other projects. For the 9 months ending in September, total capital expenditures were $266 million.

Looking ahead for the full year of 2011, we now expect total capital expenditures to be in the range of $350 million to $360 million. This is above the high end of the previously stated range, and is due to higher demand. As we have indicated previously, our total capital expenditure budget for 2011 includes approximately $20 million of CapEx for building out of the final phase of our London data center, which will be finished in the year. Going forward, we plan to lease future data center capacity instead of building, which should result in data center CapEx moderating over time. Additionally, beginning in the first quarter of 2012, we will modify the way we measure and report data center utilization to better reflect available capacity.

Moving on to cash flow and returns. Adjusted free cash flow came in at a negative $5 million, and capital turns decreased sequentially to 1.84 times during the quarter, primarily due to the higher capital expenditures for the London data center and consolidation of our headquarters here in San Antonio. As Lanham indicated during his prepared remarks, return on capital improved to 14.8%. This was driven by a combination of a lower tax rate, improved margins, average monthly revenue per server grew to $1,155 from $1,141 in the second quarter, and $1,058 in the third quarter of 2010. We ended the quarter with a total cash balance of $125 million. Our total debt outstanding including capital leases was $144 million, which translates to a net debt position of approximately $20 million or net leverage of essentially zero.

Last but not least, we renewed our revolving credit facility in September. This facility replaces our previous credit facility, which was due to expire in August 2012. The new credit facility has a total commitment of $200 million, and matures in September 2016. This agreement is no longer secured by our tangible assets. Our marginal borrowing costs on the facility are 125 basis points over LIBOR. The agreement further includes an accordion feature, which allows for an increase in the commitments to a total of $400 million under the same terms and conditions, subject to credit approval of the participating banks.

In summary, we are very pleased with this quarter's results. We are focused on finishing the year on a strong note, and we will give you a more in-depth look into our 2012 plans when we report our full year results in February. This is the end of our prepared remarks.

Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Scott Goldman with Goldman Sachs.

Scott Goldman - *Goldman Sachs - Analyst*

Hi, guys. Good afternoon. Thanks for taking the questions. A couple questions. One just on the revenue growth accelerating again this quarter, both reported in FX adjusted basis, and in part I would assume driven by the install base growth stability. As you guys look at enterprise continuing to grow at a very healthy pace, Cloud reaccelerating growth there, is there any reason why potentially installed base growth may not be able to go above where it currently is today, or at least stay stable at the current levels despite broader macro concerns?

Secondly, on the margins, I was surprised to see the 30 basis point improvement sequentially. I think as I look at it, you brought a lot of square footage on in the quarter, perhaps timing of that may have had an impact, but would think that would bring some incremental expense without bringing all of the revenue benefits of that. And then offset there might have been a little bit slower hiring in the quarter. Just help us think through some of the puts and takes on the margins on the quarter, and what it may look like going forward.

Lanham Napier - *Rackspace Hosting - President & CEO*

Okay. Thanks for the questions. This is Lanham. I will take the first question about revenue growth and what's happening there. Specifically with install-base growth. Install base growth is a measure of existing customers consuming more services from us. It is net of churn, so it takes into account customers upgrading and then any customers that we may lose on a revenue basis. Your question gets to the heart of in today's macro environment, what do we expect to happen here? Do we have upside in this number? Is this number stable? Are we at risk of it moving lower? Generally speaking, install base growth is the best proxy inside of our business for what is happening in the macro environment.

If you look at install base growth this year, it has stayed real consistent. It is not at that prerecession level of 1.5%, but it is pretty strong at 0.9%. It is almost double this year versus what it was last year. The question becomes, what is causing this? Why has it stabilized, given all of the macro economics choppiness out there? A couple things are driving it. The number one thing driving it is our enterprise business. As we win an enterprise customer, the adoption rate tends to follow along the following path. We win an initial application from them. Once we earn their trust, these customers then send additional applications to us. Our share of wallet today with any one of our enterprise customers is actually pretty low. Another way of putting that is we have a lot of installed base growth ahead of us with the existing enterprise customers we serve.

We launched our enterprise segment focus in earnest a year-and-a-half to two years ago. This means that we are still in the early days of this business for us. So, not only do we have a lot of install base growth opportunity in our enterprise business, we also have a lot of new customer opportunity in our enterprise business. ¶

The second piece that is driving our install base growth rate to these levels is our cloud business. Our cloud business is growing at a rapid rate. We mentioned in our remarks, it's almost 90% year-over-year. So these two pieces of our business, enterprise and cloud, are really what is driving that install base growth metric where it is. Install base growth is not as it used to be pre-recession. We don't have any indicator to believe that in an expansion area, economic environment, we expect it to go back to the previous levels we've achieved. We don't have any indicator telling us that those previous levels are now unattainable. We think it is really driven by the macro economic conditions. What we've been able to do over the past couple years is launch new products and services to position ourselves into the growing parts of the market. Karl, why don't you address the margins.

Karl Pichler - *Rackspace Hosting - Interim CFO*

On the margins, let's differentiate a little bit the different components that drive these margins. I guess the first two components on the cost of revenue side, the major ones there are the money that we spend on supporting our customers directly through our support teams. The second piece is our infrastructure costs. As you rightfully pointed out, when we add capacity and the way that the county treats the leases, you have the expense immediately hitting, even if you don't use the space yet.

We also have a very strong intention to further build out our service leadership and differentiate ourselves from our competitors. It is probably likely to say that we are going to invest more in Fanatical Support to further drive that differentiation, but then we should get some leverage over -- on the cost of revenue side from decreased deficiencies of larger scale data centers.

On the sales and marketing side, I think it's fair to say that in the process where we are right now where we are going through an accelerated revenue phase that the sales and marketing contribution to the total cost basis is roughly flat from a revenue perspective. And then on the corporate cost side, we expect scale to happen over time. So depending on how all of these different things come together in the quarter, that's why you see the fluctuation. In some situations when the things come together all at the same time, you see a couple of basis point lips or the other way around. That's really what drives the variabilities on the margins these days.

Scott Goldman - *Goldman Sachs - Analyst*

Great. If I could just follow up very quickly with Lanham. Going back on the enterprise side, wondering if you can refresh for us what the growth of enterprise was this quarter, and whether or not you are seeing a change in the types of applications that enterprises are putting within Racks.

Lanham Napier - *Rackspace Hosting - President & CEO*

Okay, from a metrics perspective, we have not broken out the enterprise growth rate on an individual basis. What I would tell you is that if you look across our business, it's one of the fastest-growing pieces of our business today. In terms of the adoption

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rate and the different types of applications that enterprise customers are sending to us, I would characterize it this way. The early adoption that we win from enterprise customers, it tends to be a mission-critical Web app that their IT department is not tailor-made to run. Inside of every enterprise CIO's IT department today, there is a long tail of applications. The IT department itself is tailor-made to run a handful of those applications, the billing system, the ERP system, the manufacturing system, et cetera. The information and the proliferation of apps has happened further outside the IT department down that long tail in the Web app space.

This is where Rackspace comes in. This is where Rackspace comes in. This is where we are a perfect fit to serve these customers. So, whether it is a SharePoint application or another web application that the customer created to help run their business, we start winning those apps. Then, once we earn that first one, they send us additional ones to run for them, simply because we are fast, we can save them money and we can provide a high service level experience for them. The enterprise business starts for that first half. The enterprise growth component of it is driven by the adoption of those incremental applications. When we talked a few minutes ago about installed base growth, the enterprise contribution to this is driven by those additional applications coming in, which is why enterprise is such an important component of our install base growth today.

Scott Goldman - *Goldman Sachs - Analyst*

Great. Thanks, Lanham.

Lanham Napier - *Rackspace Hosting - President & CEO*

Thank you.

Operator

Your next question comes from Chris Larson with Piper Jaffray.

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

Hi. Thanks. I guess, Lanham, you are seeing this terrific growth, and boy, I think we all certainly hope it keeps continuing. How quickly, if you needed to, could you adjust this down? How closely can you monitor how rapidly you are growing, just make sure? And one of the comments you made was that demand is not the constraint. Maybe you could touch on what that constraint is today. Is it just getting enough Rackers in position?

Lanham Napier - *Rackspace Hosting - President & CEO*

Okay. A couple things here for you, Chris. The first things, in terms of the growth and what we would do to respond in the event that there was a crazy financial crisis or something like that again. I would point back to the performance that we generated right after we went public. Our timing to go public was impeccable from a go-public right before the world gets really tough.

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

Yes, I remember that one.

Lanham Napier - *Rackspace Hosting - President & CEO*

We went public on 08/08/2008. If you need to know who can call a market, it's us. So, what happened there was we recognized the financial crisis and that the world was shifting, so we went to work on margins. I won't get this exactly right off the top of my head, but basically, I believe over the next 18 months, we increased our margins by 300 basis points to 400 basis points. The question is, how in the world did we do that? Our business has some really good cost levers for us to control, whether it is customer acquisition or productivity with respect to how much -- how well we serve customers and what type of economical leverage we get, as well as the fact that the vast majority of our investments around here are success based. So when times got tough in 2009, we were able to respond very rapidly to those changing conditions, maintaining that high level of agility I think is important for all businesses to have, because let's face it, we are going to operate in a world of uncertainty for quite a while.

As a Company, we take a long-term perspective on this, so as we do our plannings, we have no doubt that 15 years or 20 years from now, we will continue to be the service leader in cloud computing. As we get there, we will continue to be nimble and agile with respect to any financial crisis that shows up. Within our operating and CapEx budgets, there are absolutely items that we would review thoroughly to understand what moves we would need to make. Obviously, like the rest of the world, we would much prefer a growing, expansionary economic time as opposed to all the choppiness.

The only thing I would tell you is that choppiness does have a silver lining to it. And that silver lining is a relative benchmark in competitiveness. I believe that the actions and leadership moves we've made as a Company during 2008, 2009 and 2010 are the reason we are emerging as the service leader in cloud computing today. So there are some investment around here that we will not cut. There are other investments around here that will work hard if things get really choppy. We will keep our eyes on the prize. The prize here being, let's construct a service leader here in cloud computing. In terms of the risk to that, I would say the number one risk is our ability to execute.

If you go through our product road map in our plans, we have a lot of stuff on our plate that we want to do. Everything from our -- we call it cloud 2.0, getting our cloud onto Open Stack, completing that work to increasing our service levels in the cloud, to enriching our hybrid portfolio experience for customers. These are meaningful projects. In many ways, these are projects that require computer scientists to make it happen. So the intellectual property we are building inside of our Company really does put us on the cutting edge of technology in cloud computing world. So the number one risk from our perspective is the ability to execute that.

You mentioned in your question, getting Rackers online and finding Rackers to do this. We are absolutely, as crazy as it sounds, in the technology world, specifically in the big data, big web app cloud world we're in a talent war. This is where our culture really matters and gives us a competitive advantage over other players in the market place. So I think the number one risk is our ability to execute.

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

That's great. That's really helpful. Just a housekeeping -- a clarification. On the CA project you just won, is going to be considered a direct customer, or are they going to be partner customers as they bring on new clients, those clients will be transferred over to you.

Lanham Napier - *Rackspace Hosting - President & CEO*

Right now, the deployment we talked about on the call is a direct customer.

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

Thanks a lot.

Lanham Napier - *Rackspace Hosting - President & CEO*

Yes, sir. Thank you.

Operator

We will take our next question from James Brand with William Blair.

James Brand - *William Blair & Company - Analyst*

Thank you very much. Just a couple questions. One related to what you are talking about with Mr. Larson. If you look from 2007, 2008 until now, you said you've made some changes. Can you give us a little bit more color in terms of how is your Company now different than it was two years ago relative to the environment that we are in and how the environment has changed?

Secondly, with respect to hiring, you've been hiring a couple hundred employees a quarter for the last several quarters. This quarter it looks like you hired around 70 or 80. You are seeing good scale in the business. Just how do you guys think about bringing employees on as revenue growth gets up north of 32%, 33%? Thanks.

Lanham Napier - *Rackspace Hosting - President & CEO*

Sure. So how are we different? We are different in a lot of ways. I think the number one way that we are different is during this choppy time, we've launched new businesses. The work we have done in the cloud is a great demonstration of this. If you looked at our Company three or four years ago, we were not all in on that form factor yet. I'd say really starting 2008 is when we went and really got serious about that form factor in technology solution.

Another way that we are very different is the investments that we have made in enterprise. This is another area where if you look back three or four years ago, we were not as significant a player in that market segment as we are today. What happened is during 2008, 2009 as things got choppy, other people pulled back, and our Company just leaned forward and made the investments to keep going. We've increased our service levels across each of those form factors. If you recall, we've done everything from launching UK Cloud to Manage Cloud to Critical Sites in enterprise. And we will continue to march up the stack across those different form factors. I think what has happened is as our SMB business was impacted by the financial recession, we were able to innovate and invest in new growth areas and position ourselves for that growth.

Part of the remarks I made a minute ago around having corporate agility, this agility is reflected in our investment framework and how we were able to invest in these high-growth areas and then deliver on it. When I was asked earlier about what is the number one risk I, think it's our ability to execute on a road map. We have the right road map. It's just about, do we roll it out in a fanatical fashion? Those are ways that we are different.

In terms of hiring and what's going on there, you are right. If you look at our key metrics page, we did not hire as many people in Q3 as we did Q2. I would tell you, that is us being selective; we wanted to hire more people. When we think about hiring people, the first thing we think about is our culture and their values. Basically, from a values perspective, are they going to fit inside of our culture? Then we think about their aptitude and specific skills that they bring to it. Our perspective is we want to build this Company in sustainable fashion. We think our culture is the number one secret sauce ingredient to making Fanatical Support real. So, as we hire people, we want to hire for fit on that. We would rather limp than put the wrong person in a seat.

If you look at our different hiring numbers, these numbers have always ebbed and flowed, based on what's going on. But this talent war that we are in as a Company is a real thing. We like our position in it because of the culture we have and the work that we are doing, we have been able to attract some incredibly talented folks here over the last quarter to join our Company in some specific technology areas. One of the things we are doing now in the hiring is we are hiring up in our San Francisco office, in addition to our Austin, San Antonio, Blacksburg and other offices here in the states. So our approach to hiring will remain the same. We want to do it in a world-class fashion. We want to do it in a way that's consistent with our culture.

James Brand - *William Blair & Company - Analyst*

Thanks, and then just one follow up. Equinext just put out a press release saying that they'll providing your Rackspace Cloud, the private edition services. Can you talk about that overall environment for infrastructure, and how you guys are thinking about it going forward in terms of leasing space or owning your own space, and how that environment may have changed in the last couple quarters? Thanks.

Lanham Napier - *Rackspace Hosting - President & CEO*

Sure. There is a couple different nuances in your question there. Let's start, I guess that's just the infrastructure environment in general. Our intention, consistent with the prepared remarks, is that we will be leasing space. The reason we want to do that is to just better align to the timing of the expense with the investment with the revenue we received from it. Basically, it turns it into a variable nature instead of a fixed nature that's all up front for us. Nothing has changed in the marketplace to make us deviate from that plan. That is core to our strategy going forward. If you look at the infrastructure expansion we have had over the last call it year and a half, a vast majority of it has been within this lease model. We believe it is very effective. We've been able to deliver great results to our customers in it.

Specifically, with what is happening with the Equinext press release, we are pretty excited about the Rackspace Private Edition. For us, this is the first step for us to take Fanatical Support outside of our data centers, which is consistent with our long-term vision of managing and running OpenStack powered clouds anywhere. Basically, if a customer wants to deploy an environment just for themselves inside of an Equinext data center, we want to be able to provide Fanatical Support for them. We see it real simply, is that if there are two primary layers in our business, an infrastructure layer and a service layer. This Rackspace Cloud Private Edition, based on the OpenStack technology, the customer would be purchasing the infrastructure, paying Equinext rent for that data center infrastructure, and then they would be paying us a service fee to manage it remotely on top of that infrastructure. This is a business model innovation for us, which has minimal capital involved in all of the profit margin of our service layer. We like this innovation. We are just getting started with it. There will be a lot more work to do. We believe this is a good, solid first step.

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

Terrific. Thanks a lot.

Lanham Napier - *Rackspace Hosting - President & CEO*

Sir, thank you.

Operator

Our next question comes from Jonathan Atkin with RBC.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Just on the last question, given the rapid build out of wholesale space in many regions of the country, I am wondering if you are expecting to get similar or better leasing terms as you expand to additional sites over time? And then just on the product mix, I am just wondering if you could provide a little bit more specifics around the particular cloud and manage products that you are seeing the greatest demand for and how that might differ in the US versus the UK?

Lanham Napier - *Rackspace Hosting - President & CEO*

Okay. Let's start with the wholesale space question. Let's take a step back to look at our approach to infrastructure, where it ought to be located, et cetera. For us, location matters. The reason it matters is when it comes to infrastructure, we are a performance and economic-driven Company. Location drives economics and performance on infrastructure. I will give you some examples.

There are high cost marketplaces like New York City. It doesn't matter how much wholesale space is in New York City, I think we will probably never have a facility there. We are looking at places to where we are going to get a combination of the right climate, a good tax environment, green power, and the right infrastructure to deliver a good performance for our customers. We want to combine that with the right wholesale DC partner. We will continue down that path. That is how we think about it. The more wholesale space in general available in the marketplace, that's a good thing for us. And then more specifically, the more wholesale space available in geographies that we are very interested in is a even better thing for us. We are about optimizing that relationship around a cost and performance of the facility relative to location. So, that's how we think about the wholesale space. In terms of --

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Jonathan Atkin - *RBC Capital Markets - Analyst*

If I could just interject briefly, I think it is 36,000 square feet of unused capacity at this point, so how long does that last you, and how soon then would you be looking to make additional decisions on leasing?

Lanham Napier - *Rackspace Hosting - President & CEO*

We are constantly looking at new space. If you look at our growth rate today, call it 30%-plus year-over-year, we are now thinking in space in terms of megawatts and what we are going to require going forward more and more. We are reaching a scale that very few other companies and providers in the marketplace address. So from our perspective, we are in a perpetual state of expansion. We believe humanities thirst for a compute and storage in a cloud world is almost insatiable. Underpinning all of that will be infrastructure investments that we have to make, so the 36,000 feet will carry us for a while. But from our perspective, Jonathan, we are really focused around having an ongoing plan and program for infrastructure expansion.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks. And then on the product mix?

Lanham Napier - *Rackspace Hosting - President & CEO*

Yes. And your question there was about the mix between our traditional managed business versus cloud business. Did I get that right?

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then specific products within those categories that you are seeing the most demand for, and if there is any geographic difference between the US and the more enterprise-focused UK market?

Lanham Napier - *Rackspace Hosting - President & CEO*

Yes, I would say our -- the trends here go along the following lines. If you look at our cloud business, for example, it has been established here in the States longer than in the UK. We had a big launch last year, just a few months ago now, for our managed cloud. We are pleased with the take rates on managed cloud, and those continue to climb within our cloud business. We are seeing a similar trend in the UK. Part of what happens here is we understand how these products works, we roll them out in the US, then we roll them out globally. So we have a good experience curve with understanding what the right performance ought to be.

I would say the new products that we launch we expect to become a growing share of our revenue. Most of the new products that we have launched here, by definition, haven't been out very long. So, they are still a minority of that revenue stream. We expect that to change over time. When you look inside our managed business with enterprise, we have talked about that already on the call a fair amount in that enterprise is a high-growth opportunity for us. We just talked about Rackspace Cloud Private Edition. This is an interesting business model innovation. From a realistic perspective, we are a $1 billion revenue business today. So Rackspace Cloud Private Edition will not move the revenue needle, from a mix perspective for some period of time. I would guess it's a couple years until it's really large enough to make a meaningful difference on the top line for us.

We have the rest of our mix issues that will continue to carry us. But what you will see from us with continued execution of our road map, is on a regular basis, the arrival of new service sets and products for customers that we just want to keep adding to our mix to serve customers better and continue executing on our path to being the service leader in cloud computing.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Finally, on Open Stack, I wonder to what extent you view Amazon as a stumbling block to growth in terms of the features of the two APIs?

Lanham Napier - *Rackspace Hosting - President & CEO*

I think that there is room for two. You are talking about the AWS compute API?

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes.

Lanham Napier - *Rackspace Hosting - President & CEO*

I think there is going to be room for multiple APIs in the marketplace. I don't think there are going to be 20 compute APIs in the marketplace. I think the reality is there are three platform standards emerging in the cloud today. One being AWS, one being VMware, another being OpenStack. Today, our hunch and belief is that OpenStack is the de facto open source cloud computing standard that the traction around that standard in the ecosystem that is forming really validates it. The demand we have had already in our Rackspace Cloud Builders to deploy it Open Stack clouds that drove us to this launch today in announcement of the Rackspace Cloud Private Edition. We think that because of the ecosystem around OpenStack, that API is validated. We believe the market will have room for multiple APIs. So, we feel good about our position.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you.

Operator

We will take our next question from Jonathan Schildkraut with Evercore.

Jonathan Schildkraut - *Evercore - Analyst*

Good evening. Just two questions here. First from Karl. I was just wondering if you might dive a little bit more into the implications on expected free cash flow generation or burn this year based on the increased CapEx guide. Secondly, maybe if you guys could talk a little bit more broadly about a longer-term perspective on capital efficiencies. In particular, Rackspace Private Edition preferentially providing Rackspace-managed hosting on top of say an HP or Dell, a very large public cloud. And also in terms of the open stack transition where we are relative to new customers and moving the embedded base over from [slice-os]

Karl Pichler - *Rackspace Hosting - Interim CFO*

Okay to let me take the capital piece first. So we want to build on from some comments made earlier on the vast majority of our capitals spend is really also success based, right. So we have, basically, three layers on the tangible side, which is equipment that is very closely directly related to revenue. It's very close also in terms of lead times. The cloud actually has a little bit more lead time because you're basically roll in three configured racks. Whereas managed hosting, you basically it's very, very close to revenue. Insignificant difference of a couple days, maybe weeks.

On the DC side, as we get bigger and continue to basically grow at constant percentage rates, we are always going to be in DC expansion mode, which now more and more goes into the OpEx line. As we saw, it often has significant CapEx requirements as well.

And then the third one is the office. Based on the comments that were made before, we had significant intake of employees in Q1 and Q2. The low number in Q3 is probably as much a reflection of that huge intake in Q1 and Q2. Overall, we continue to add more people. If we don't have to, then we won't hire the individuals. That doesn't require us to, basically, build out office space.

And then the second part of CapEx, which is really spend on software and IT development, some of these investments that we really need to make and want to make to build the product side of future and to build the systems that allow us to scale our business in the future. All of that, really what happens this year to us is that we are on the high range and above really in most of these categories, because as I said, the vast majority of these are success-based. There is no speculative build, there's no betting on the future in response to the demand we are facing.

The other little curveball is our supply-chain consideration. For example, I am sure you know about the issues that we have in Thailand and the associated supply-chain considerations for hard drive manufacturers, and so we respond a little bit to that. And then there are some other minor items in terms of adjusted free cash flow. For example, if we do a prepay on certain equipment purchases or license purchases, which we have done in the second quarter -- in the third quarter, sorry, that has an impact on operating cash flow and then reduces your burn.

In the grand scheme of things, the business model doesn't change. We do the same thing as we have always done. Overall, we are probably going to have burned somewhere in the area of $30 million for this year. This is where we think we are going to be. It's slightly higher than the number that we originally talked about, but if you think about it, it is basically a direct result of the areas that we constantly mentioned, which is the office and the (inaudible) data center.

Lanham Napier - *Rackspace Hosting - President & CEO*

I will take the second half of your question, Jonathan, with respect to capital efficiency, and a business model OpenStack transition, et cetera. Broadly speaking, as the market place shifts to a cloud world, there are going to be a handful of major cloud platforms. AWS is one; Rackspace is one. So we will probably always be in the business of running a large multi-tenant public cloud here on behalf of customers. What open stack allows us to do, because open stack creates an open source standard, is it allows us to put our service layer on top of other open-stack environments on a global basis. So, while we will continue to run a large cloud ourselves to the extent customers want to run an open stack cloud inside of their data center, under the prescriptive architecture that we provide, we can then layer Fanatical Support on top. We have customers asking us to do this for them today, which is why we have started the Rackspace Cloud Private Edition.

We believe that this revenue opportunity, from a return on capital perspective, is superior to our current business. In the long-term, what you basically have is our business model shifting a bit. Today, if we look at our pricing structure and value add, it's about 25% infrastructure, 75% service, if you break it down. In a world where we are providing Fanatical Support on top of OpenStack deployments inside of our customer's data center, obviously, that capital is the customer's capital and not our capital. The return on capital looks a whole lot better, because we are still capturing the Fanatical Support service margin without having to make the capital investment and the infrastructure and gear itself.

We will always be running a large cloud inside our Company's facilities. Then it is just about how far we extend our reach inside our customers' environments, how we can federate their OpenStack deployment with an OpenStack cloud that we are running here at Rackspace. And over time, we believe we will improve our business model. We feel if we have a good business model today. We want to build a great one. We believe that extending Fanatical Support into our customers' data centers really reinforces our standards as the service leader in cloud computing. We think providing that service layer helps customers sleep at night. Customers are looking for a partner they can trust, while they make this shift. We see it as a business model shift. Over time, it makes our business more capital efficient as well.

Jonathan Schildkraut - *Evercore - Analyst*

Lanham, maybe if you could dive a little deeper into what you were talking about between matching up say OpenStack or Rackspace Private Cloud Edition, with your public cloud architecture. What are the challenges with managing across a private and public cloud architecture. Is it something you are prepared to do today? How important is geographic proximity in that type of situation? Okay. For a lot of those questions, the answer is it depends. So it depends on the app; it depends on the customer requirements. The way to characterize it at this moment in time is it's early days. This is a vision that when we share it with customers, customers want it. It's a vision that has a lot of value to them, so we want to provide it for them. This Rackspace Cloud Private Edition is our first step to figuring that out. A critical element here is getting all of our cloud on to OpenStack, having the customers run that architecture as well. When we get the architectures aligned, it enables this in a way that is repeatable for us. We want to stick with our discipline of building a repeatable lean services model. We don't want to end up with everything custom as a job shop. We want to have a standard series and processes that we can stamp out at a high-quality level. So, it's important that we get the architecture right. This is why our sponsorship of the OpenStack project itself in partnership with NASA and now 130 other companies really gives us an intellectual advantage as we roll this out. So these are interesting, challenging technology problems. We understand where we need to go on the path. We are just early on the path. Great. Lanham, if you could just tell us where we are on the slice-OS to OpenStack transition.

Lanham Napier - *Rackspace Hosting - President & CEO*

Short answer is we are still working on it. Jonathan, we continue to make progress on it. We have some elements in alpha; we have some elements in beta. This will continue here for the near period of time. Right now, we go through the road maps, we are confident in our ability to deliver it. We are just going to make sure that when we deliver it, it's in a fanatical fashion.

Jonathan Schildkraut - *Evercore - Analyst*

All right. Great. We will circle back on that next quarter. Thank you for your time and questions.

Lanham Napier - *Rackspace Hosting - President & CEO*

Yes. Thank you.

Operator

On next question comes from Mitesh Dhruv with Banc of America.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Thank you so much for taking my questions. Lanham, if you can just comment a little bit more on the managed cloud side. Just give us some growth parameters around that. Last quarter, you did say that the new business in managed cloud was up 2x. This time around, just frame it for us, how that business was on managed cloud and all. And also now that you've had a couple of quarters of managed cloud under your belt, what are the typical use cases you are seeing for the manage cloud?

Lanham Napier - *Rackspace Hosting - President & CEO*

Okay. So, lets start with some basics. If you look at the RPU rate for managed cloud, versus our core cloud, managed customers are paying two to three times the typical core cloud customer. What is driving this is the value we are adding at the service layer. That relationship has been consistent throughout the couple quarters that we have had managed cloud in the marketplace.

Second point is that the take rate of managed cloud has increased each quarter that it has been in the marketplace as well. If you look at manage cloud as a percentage of our income and cloud revenue, we continue to make progress on that. We are proud of that. Generally speaking, when you look at the use case, it hasn't changed a lot from the last time we were on the call. These are customers that want additional level and amount of help, so it tends to be who the end-user is at the customer that requires the assistant. This skews toward a more technical system administrator who requires a managed level inside their cloud experience.

I will give you some customers. For example, one recent customer is Tom's Shoes. They are a recent win for us in the manage cloud environment. I think that gives you a feel for it. I would say generally speaking, it is progressing like we thought it would. This is an important business for us, because it's really an offering that gets to the heart of our differentiation in the marketplace, in that we are able to sustain a two to three-X RPU level here with managed cloud, which has proved positive that Fanatical Support matters.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Understood. If you look at the enterprises as well, the growth in the enterprise segment, are they also looking at manage cloud or deploying managed cloud, or is that segment growth coming more from the managed hosting site?

Lanham Napier - *Rackspace Hosting - President & CEO*

They are looking at both. If you look at it today in terms of total dollars, I think more of the enterprise business is coming from our traditional managed hosting side. Really what they are doing is it is a hybrid environment. It is one part dedicated gear, one part cloud infrastructure in their solutions. The best way to characterize it is they are tapping the whole portfolio. This is part of the reason they select us is that we can bring dedicated environments on gear dedicated just to them and cloud environment, stitch those together for them in a hybrid environment to where they end up getting the best of both worlds. We expect that will continue to be a big driver in enterprise.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Got it. One question for you, Karl. If I look at the return on capital, very, very good incremental results there. This is one of the metrics people used to look at a lot when you guys went public, I remember. Just talk to us all a bit more on, how should we think about incremental return on capital from this point on? Because as you move the cloud on the one hand, you get better returns per box. Also, on the other hand, you also have to make investments there in the cloud. In some sense, I regard this return on capital a rather incremental return on capital as a precursor to your future profitability. Just help us frame where you think this metric could go. That's it for me. Thank you so much.

Karl Pichler - *Rackspace Hosting - Interim CFO*

Okay. We mentioned this a couple times. Basically, the biggest driver for future change is in our ROC will be the way that we layer service on top of infrastructure, if you want. So all the capital that goes into our business that is around the bottom end of the layers, around the DC, around the dedicated equipment is really probably changes in that business model, and those business model perspectives will change our, will make our ROC changes. We are a service Company that has a capital intensive layer in its business, so as we work on decoupling those two things, you can see massive changes in ROC.

At the same time, software development costs are capitalized, so they basically hit our capital account, if you want. They flow into our ROC calculation, as you know. So it is, basically, a combination then, as we develop those huge products. And we spend today, you really have a capital base that does not really reflect current revenue. And so this is when you see incremental capital from an economics perspective, the transition from managed to cloud sees higher capital utilization. The transition from everything doing our own to leasing models sees higher capital utilization. The Rackspace Private Cloud Edition that Lanham talked about is another potential for very much higher ROC components in our business.

Then at the same time, we spend to build those products, and they hit the capital base as well. Depending on the time and momentum and the revenue of these new products and business lines, almost more so than products, is really what derives the happening of those ROC increases to take place.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Just one clarification. That was very helpful, actually, by the way. One clarification on the balance sheet side, you had a big spike in non-current assets. I think you did allude to that you prepaid some of the licenses. Just if you could clarify a little bit more, that would be great.

Karl Pichler - *Rackspace Hosting - Interim CFO*

Yes. We prepaid some licenses that we deployed on behalf of our customers.

Mitesh Dhruv - *BofA Merrill Lynch - Analyst*

Got it. Thank you so much.

Operator

Our next question comes from Henry Alan Logan with (inaudible). Our next question comes from Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks, a lot. Good afternoon. Karl, if we can stay on the CapEx, very helpful in terms of thinking about the drivers going forward. When do we start to see this turn? You've obviously just raised your CapEx guidance with strong growth. You are indicating that for next year, we won't see the data center spend that we saw this year. As you migrate to your private edition and more OpenStack, that's going to be less capital intensive. So are we in this latter half of 2011, the early part of 2012, is that when the capital intensity peeks? When can we start to see this really starting to feed through the numbers materially? And then I think you said in your comments that you were looking at changing the utilization calculation. Perhaps you can just give us a bite more clarity on that. Thanks.

Karl Pichler - *Rackspace Hosting - Interim CFO*

On the current business model, the couple of components that we've always mentioned is if we basically perform or execute on the same type of business model that we have done in the past, we have this relationship where, basically, the free cash flow mutual growth rate is roughly around 35%, depending on margins and economics, et cetera of the underlying business. And then this is a general relationship that does not necessarily hold, for example, if we do a prepay for our customer licenses because that's reducing operating cash flow, and it's a little bit outside of this general relationship.

As Lanham before said, it will take time before those newer type business models will actually contribute a significant contribution to revenue. Therefore, it will take time for those to really significantly drive the cash flow that the CapEx needs done. However, if you look at any of the efficiency metrics for revenue per server, it continues to go up, the utilization rates low up. Both the contribution of cloud, the bigger contribution of cloud into our business with inherently higher capital turns and then the continued addition of services to our customers on top of existing infrastructures is what drives those productivity metrics, if you want, up. So it is a constant steady path, and then you have a couple of transforming business model changes, but they will take time. Because we have such a big revenue base, that until the new models start taking on, really changing the economics, it will take some time.

Simon Flannery - *Morgan Stanley - Analyst*

And on the utilization calculation?

Karl Pichler - *Rackspace Hosting - Interim CFO*

The utilization, basically, what we are going to do, is we are going to switch to a power-based utilization. Both capacity and demand is going to be megawatt spaced rather than space based, which is not very relevant. So, it's megawatts available versus megawatts utilized.

Simon Flannery - *Morgan Stanley - Analyst*

And that will be next quarter?

Karl Pichler - *Rackspace Hosting - Interim CFO*

Yes, we will start doing that for 2012.

Simon Flannery - *Morgan Stanley - Analyst*

Great. Thanks a lot.

Karl Pichler - *Rackspace Hosting - Interim CFO*

Sure.

Operator

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

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you. On the private edition cloud, can you give us an idea of how -- how have you approached this from a business model standpoint where in the past you have shied away from operating customers infrastructure in your data centers, now you are going to have to take on some of their disparate and different architectures and builds? What have you built into the approach there that will avoid some potential issues from a hardware perspective working with the customers' equipment.

Lanham Napier - *Rackspace Hosting - President & CEO*

Sure. Okay. The first thing is that we are using a reference architecture for the deployment of OpenStack. The way to think about this is through the open stack project, we have published a code. We are now sharing with customers the software and hardware architectures that we use in practice. This reinforces our commitment to OpenSource. It also, because it also helps the customers get inside a sweet spot where we can serve them. Basically, if they are using our prescriptive architectures, we will be doing things like updating the versions and upgrades for Open Stack. We will be performance tuning the customer deployments so they can run their cloud optimally. We will be looking at system issues and developing fixes when there is an OpenStack bug. We will be doing security patches.

Basically, what happens is once you get customers on that reference architecture, from a remote location, we can do a lot of things for them. The physical part of it, the customer will be doing because it's inside their own facility. So, provisioning that gear, setting up that gear, they can hire Rackspace cloud builders to help them do that. They can line up with other partners to keep it running. Specifically, when we talk about Rackspace Cloud Private Edition, it's that service layer on top when we talk about OpenStack updates and version upgrades and helping performance tune that environment. The key that unlocks this is the fact that they are running our reference architecture.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay. So that's a requirement to be able to take them on as a customer?

Lanham Napier - *Rackspace Hosting - President & CEO*

That's correct. Without that reference architecture, it's a amalgamation of a bunch of different form factors that we would not be able to run reliably.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you. From a customer concentration standpoint, has that shifted any change in your largest customers as a percentage of revenue? What are your top 10 customers as a percentage of revenue running, currently.

Lanham Napier - *Rackspace Hosting - President & CEO*

No, sir. Nothing has changed here. We don't have a large concentration in any given customer. I think our lowest customer today is still fewer than 2% of sales. There you have it.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Thank you.

Operator

This concludes the Q&A portion of the call. Thank you, and have a good evening.