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RAX - Q4 2011 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Well, good afternoon, ladies and gentlemen, and welcome to Rackspace fourth quarter 2011 earnings conference call. As a reminder, today's conference 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)

And now it is my pleasure to turn the conference over to Mr. Jason Luce, Vice President of Finance for Rackspace. Please go ahead, sir.

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

Thanks, Kelsey. Good afternoon. Thank you for joining Rackspace's fourth quarter 2011 earnings call.

I'm 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 fourth quarter of 2011. If you do not have a copy, please visit the Investors section of our website at www.rackspace.com, where 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-K for the year ended December 31, 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'll 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 my prepared remarks today, we will open the call for your questions.

Okay. Let's get started, Lanham.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Good afternoon, everyone, and thank you for joining us today.

2011 was an absolute break-out year for Rackspace that was accentuated by the strongest quarter prior to the recession hitting in mid-2008. During the year, we accelerated our revenue growth for the second year in a row, and crossed $1 billion in annual revenue, while simultaneously improving margins and returns. In short, we made tremendous progress towards our long-term goal of becoming the service leader in cloud computing. Before we dive in, we need to thank our army of Rackers that is now 4,000 strong and the 170,000 customers that have trusted Rackspace to run their mission-critical applications that drive their business.

At the beginning of last year, we shared our plans for 2011 -- to further increase our service-level capability and enhance our product portfolio. The goal of these investments was to help seize the massive market opportunity ahead of us by becoming more competitive and improving the capital efficiency of our business model. If we were able to achieve these goals, we say we would grow revenue faster than in 2010, maintain our margin profile, and generate cash flow or minimize cash burn. So let's get started reviewing our performance in 2011, and then outline our plan for 2012.

Number one -- revenue growth for the year accelerated to 31%, up from 24% in 2010 and 18% in 2009. The primary drivers for the increased growth trajectory are owed to continued growth in our public cloud offering. Our public cloud business grew 88% in 2011, and now represents more than 20% of our total revenue. Our monthly install base growth improved to 1.2% in the fourth quarter, up from the monthly average of 0.5% in 2010, and the highest level since 2007. This metric is the primary proof point that Fanatical Support continues to differentiate our (inaudible) in the marketplace, further traction growing our enterprise business, and customers continuing to leverage our enhanced portfolio products and services.

Number two -- adjusted EBITDA margins came to 33.9% for the year, up from 33.6% in 2010; and net income margins improved to 7.5% for the year, up from 5.9% in 2010. Number three -- return on capital grew to 14.7% for the full year, up from 11.6% in 2010. Fourth-quarter return on capital grew to 17.2%. And number four -- adjusted free cash flow was negative $7.4 million for the full year, but turned positive in the fourth quarter when we generated $19 million of adjusted free cash flow.

We executed well against the goals we shared with you for 2011, particularly in the areas of product development, as well as many critical behind-the-scenes activities crucial to supporting a growing business. Some of the new products include Cloud Load Balancers and the Managed Cloud Service, which has been very successful. After one year of availability, the Managed Cloud product has almost 3000 customers, and the average monthly revenue for those customers has almost doubled. In addition to the new product introductions, we launched our Managed Cloud and Critical Sites services in the UK, and improved our hybrid hosting capability by releasing version 2 of our RackConnect product. We also accelerated investments around OpenStack, resulting in two new service offerings, Rackspace Cloud Builders, and the Rackspace Cloud Private Edition.

Industry adoption of the OpenStack platform was extremely strong throughout the year. 149 organizations have joined the OpenStack project, including the most recent entry, AT&T, which is building an OpenStack-powered cloud aimed at developers. We also made good progress towards integrating many back-end systems, such as the advanced management and monitoring tools gained in the Cloudkick acquisition. We secured 18 megawatts of new data center capacity to provide for future growth, opened a new office in San Francisco to bolster our software development capabilities, consolidated two legacy data centers, and finally moved all of our San Antonio Rackers into our new headquarters facility. While we have much to celebrate with respect to our accomplishments in 2011, there are areas where we have more work to do in 2012. For example, the migration of our Cloud Servers business to OpenStack remained in beta at the end of the year. So that is an example of the work we need to accomplish to further our position as the dominant service leader of the cloud computing market.

Before we share our strategic plan and expectation around financial performance for 2012, we'd like to share the three factors that heavily influenced our thinking. Number one -- the opportunity ahead of us is massive, and we've only just begun to tap into the market. We believe the cloud computing era represents one of the biggest market opportunities in all technology, one that will change how businesses consume IT; and we want to extend our position as the service leader in cloud computing. While the overall size of the market opportunity for Rackspace is difficult to precisely calculate, we know that it is massive and growing rapidly. More and more corporations are discovering that using a specialized service provider is the most effective way to address their IT capacity needs. But the cloud is much more than just current IT workloads migrating out of legacy data centers. We believe the economics of the cloud will drive an explosion of new demand for computing, just as the iPhone has driven demand for new applications.

Number two -- the atmosphere across Rackspace has never felt better. Our culture is strong and Rackers are engaged. With over 2500 Rackers under one roof here in San Antonio, you can feel the excitement by just walking the floor. Rackers feel it when they come to work each day, and customers feel it when they come to tour the home of Fanatical Support. We encourage investors, customers, and prospects to come see Fanatical Support in action. The invitation to visit our headquarters is always open.

Number three -- our strategy to be the dominant service leader in the cloud computing market is working. Our strategy involves offering an expanding portfolio of products and services, all backed by our world-class customer service experience, known as Fanatical Support. This service delivery strategy is at the core of our differentiation in competitive advantage. Our portfolio approach allows us to service a larger share of our customer's IT needs, and enhances our ability to grow with them over time.

We believe that our strategy to differentiate with Fanatical Support and remain the dominant service leader in the 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 team that has expertise in a diverse range of technologies and is obsessed with customer outcomes. Fanatical Support combines these ingredients to deliver the best technology results in the industry to our customers. In short, Fanatical Support changes the way businesses consume IT. Instead of buying and assembling all of the various IT inputs, Rackspace customers can purchase IT as an output, as a service.

Given these factors, the massive untapped opportunity ahead of us, our energetic culture, and the fact that our current strategy is working, our plan for 2012 is to essentially run the same play we executed in 2011 and 2010. 2012 will be a year of execution for us, running our portfolio and adding higher service levels to our cloud platforms that address more and more of our customers needs. We know that Rackspace is strong where our competitors are weak, and we will continue to exploit this advantage as our path to market leadership. That is our path to becoming a much larger Company.

But we don't want to just be a big Company. We want to be a big and great Company. Very few companies have been able to accomplish both. We believe we have a once-in-a-lifetime opportunity to join that elite class of companies that are both big and great. We really do believe the market opportunity is there for us. So the number one objective in 2012 is the consistent focused execution of our strategy.

2012 will be an exceptionally important year for Rackspace. During the year we will invest in our portfolio products and service levels while making capital efficiency improvements to our business model. The world is rapidly shifting to cloud-based computing, and we need to bolster our systems, product, and service capabilities in order to help our customers make this transition. The product development work we are doing is all about delivering Fanatical Support across a portfolio of dedicated cloud and public cloud products that enable large, high-performance workloads to run on our cloud.

Fully adopting OpenStack will be a critical pillar of the 2012 plan. OpenStack technology will underpin many of the new cloud products we plan to introduce in the year, such as Cloud Block Storage, Cloud Database, and Cloud Firewall. In addition, OpenStack will be the infrastructure underneath many of the new service levels we plan to introduce on top of our public cloud platform going forward. In short, OpenStack is becoming the foundation to support a much bigger and better Business.

From a financial standpoint, we believe that successful execution of this plan in 2012 should result in a revenue growth and margin profile that is similar to our performance in 2011. We take a long-term view in building Rackspace. In our annual planning process, we set forth a minimum and maximum performance ranges for growth and profitability. The minimum range is an internal commitment that no matter what happens, we will achieve this level; and the maximum range is about not pushing beyond our limits and growing beyond our capability. We are working to build a truly great Company, and these minimum and maximum ranges are about building the Company in a disciplined and sustainable manner for years.

We are pleased to say that our 2011 results were within our internal range, and are consistent with the target models available in our Investor Relations presentation. As you can clearly see from our fourth-quarter and 2011 results, our model is scaling. We continue to believe that we can fund the strategic investments for our business by reinvesting incremental profit dollars from current operations, without materially impacting profitability. If something changes that causes us to decide to increase investments to a level that would materially impact margins, we will let you know.

In 2011, we achieved $1 billion revenue after 12 years in business. We are on pace to achieve another $1 billion in a fraction of the time that it took our Company to grow to its first billion. During 2012, we will continue building new muscles and putting in place infrastructure necessary to build a great Company. OpenStack is Rackspace's next-generation technology platform, and we believe it can help enable us to become a much larger business.

Finally, we would like to thank all of the Rackers for their hard work during the year. We set aggressive expectations, and we are proud of the way the entire organization respond to the challenge. Rackers have put in many hours of hard work, and it's because of their commitment that we were recognized as Employer of the Year at the 2011 UK National Business Awards, and once again named by Fortune as one of the top 100 best places to work in the United States.

With that, let me turn the call over to Karl.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Lanham.

Let me start by saying that we are very excited and pleased with the financial results we have generated for the fourth quarter and the full year. Our objectives were to grow revenue at a faster rate than in 2010, and to scale the operating model enough to fund our investments without depressing margins. We accomplished all of that and we ended the year really strong.

Q4 2011 was the best quarter we have ever had as a public Company. For the fourth quarter, total revenue was $283 million, representing 7.1% sequential growth, and 31.9% growth compared to the fourth quarter of 2010. Exchange rates had a negative impact on revenue of approximate $1.6 million compared to the third quarter, and a negative impact of $0.4 million compared to the fourth quarter of 2010. On a constant currency basis, revenue grew 7.7% sequentially, and 32.1% year-over-year in the fourth quarter. For the full year of 2011, total revenue was $1.025 billion. We are presenting an annual growth rate of 31%, which is higher than the 24% growth we reported in 2010. Exchange rates had a positive impact on annual revenue of approximately $8.6 million.

On a constant currency basis, year-over-year revenue growth was 30%. Install base growth was 1.2% in the fourth quarter, which is an improvement from 0.9% in the prior quarter and 0.6% in the fourth quarter of 2010. For the full year, install base growth averaged 1%, double than the average due in 2010. Dedicated revenue increased to $225 million, representing 5.1% sequential growth, and 23% year-over-year. Public cloud revenue for the quarter was $59 million, representing 15.4% sequential growth and 86% growth on a year-over-year basis. Overall, we added more than 11,000 new customers in the quarter, bringing our total count to more than 172,000.

Moving on to profitability. Adjusted EBITDA grew to $102 million, representing 16.2% sequential growth and 42% growth on a year-over-year basis. Adjusted EBITDA margin was 36.1% in the fourth quarter, 280 basis points higher than in the third quarter and 250 basis points higher than in the fourth quarter of 2010. Depreciation and amortization expense came to $55 million in the quarter, representing approximately 19.4% of revenue, which is consistent with the 19% to 20% range that it has been since the beginning of 2009. Net income came to $25 million in the fourth quarter, representing growth of 25.3% over the third quarter and 85% from the fourth quarter of 2010.

Capital expenditures totaled $79 million. Of this amount, we spent $47 million on custom gear, $7 million on data center buildout, $9 million on our optics facilities, and $15 million in capitalized software development and other projects. For the full year of 2011, total capital expenditures were $345 million. Adjusted free cash flow came in at positive $19 million for the quarter and negative $7 million for the full year.

Return on Capital grew to 17.2% in the fourth quarter, and 14.7% for the full year, compared to 14.8% in the third quarter and 11.6% in 2010. Average monthly revenue per server grew for the 10th consecutive quarter to $1,191 from $1,155 in the third quarter. We ended the quarter with a total cash balance of $160 million. Our total debts outstanding including capital leases was $139 million, which translates to a net cash position of proximally $21 million.

These are really great results, and we're proud of what would have collectively achieved here. A big thank you and congratulations to all the Rackers out there. Job well done.

What should we expect going forward? As in the past, we will not provide specific earnings guidance. As Lanham mentioned in his remarks, we will continue to execute our model, which means we will focus on organic continuous growth, and a disciplined allocation of resources and capital along the way. We will continue to fund important and strategic investment opportunities along the way, and we expect to be able to continue doing this while maintaining our margin profile relative to 2011.

As in previous years, we want to give you some explicit ranges around our expected capital spend for this year. For the full year of 2012, we are forecasting to spend between $335 million and $405 million in total capital expenditures. As in prior periods, we expect the bulk of capital expenditures to be in custom gear, which is prominently success-based spending to support revenue growth. Specifically, we expect to spend $210 million to $250 million on customer gear, $25 million to $35 million for data center buildout, $25 million to $35 million for our office facility, and $75 million to $85 million on software development to implement the systems, products, and service portfolio enhancements as we discussed earlier. These are ranges and it is early in the year. We will update you if necessary along the way.

This concludes my remarks with respect to our financial results.

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

Operator, let's open up the call for questions.

QUESTIONS AND ANSWERS

Operator

Will do. (Operator Instructions) And we'll go first to Chris Larsen with Piper Jaffray & Co.

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

Hello. Thanks for taking my question. Revenues were strong this quarter, but I think what really stood out were the margins were -- the material move up in the margins. Lanham, can you just talk a little bit about how you're going to manage growth versus profitability, especially as we see the install base now above 1% for the first time, I think since 2007, and how sustainable and how should we think about that as we go into 2012? Are both of those install base growth and the margin profile?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Thanks for the question. Generally, if you look at our business, the most profitable customers we serve are existing customers. And the longer we serve them, the more valuable and profitable they become for us. So when we look at install-base growth climbing, that is absolutely a tailwind for us in terms of profitability. The more growth we get from the install base, the more likely it is that we have an ability to increase our profitability as a Company.

In our prepared remarks, we talked about our desire to invest incremental profit back into the business to -- for the long term. When we think about building Rackspace, we really are trying to build a great Company, a Company that lasts for generations. And so we see it first as we want to invest back in the business to provide great services and outcomes for customers, we want to build a corporate culture where Rackers can volunteer their best, so all of these investment activities will continue and we protect those activities here inside the Company when we look at our investment frameworks in our annual plans. So we will continue to have that focus.

What we saw here in the fourth quarter was some nice results here in a couple different ways. We had a good-growth quarter, as you mentioned. The install-base growth certainly helped with that from a growth point of view, it also helped with a profitability point of view. As we look at the business, we care more about the long-term trends than any given quarter. All right? So if you go back and look at some of the targeted models that we've provided within our IR presentations, we've been tracking pretty clearly within one of those columns with growth rates between 25% and 30% over the past couple of years, the margins have fallen within that range. And what we've been able to do through the investments in our cloud business is improve the capital efficiency along the way as well.

So I think as we look out at 2012, we feel like we're hitting 2012 with a growth [leadership] position in the marketplace, we have some serious execution to do this year, with respect to our product work, on OpenStack, the systems work, to get the foundation in place to support a much larger Company, and the traction and sales opportunities inside of our enterprise business. So the faster we grow, there is some trade-off to take place between high growth and margin. The slower we grow, the more leverage we have to pull to improve margin in a quicker, quicker time period. So we look at the business as we are executing toward a set of metrics. We share many of those metrics in our key metrics page. We think we're building the Company in a sustainable manner. And we look at it over the long-term. So inside this Company, we don't get too excited about any great quarter. And we don't get too down if a quarter is a little bit soft. We anticipate there being future bumps as we go through the year, and we're confident we'll continue to execute at a good level and build a service leader on cloud computing.

So I guess to summarize, as we look at 2012, we just think we're running the same play. There are a few different variables this year in 2012 compared to a year ago, but we're going to stick with our playbook here and keep our head down and execute.

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

Thanks. If I could ask a second question, on the cap spend, how does the moving of OpenStack out into the public domain impact your spending on software? Will we see a noticeable difference in that? I noticed that you gave us guidance for that, but how do we think about that as it goes forward?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes, here's -- great question. If you think about how our business is evolving, we can dissect the CapEx into a few buckets. The hardware bucket in terms of customer gear, CapEx that we purchase as we build out a dedicated cloud environment, or a multi-tenant public cloud environment, or software CapEx as we are constructing the next generation service tools and capabilities on top of these environments. Over the past couple of years, looking at the trend line, one can see we've increased our software CapEx. This software CapEx is really our new product and service capability development functions. As we become a larger cloud player, our CapEx mix is shifting away from exclusively hardware-based to more of a mix between hardware and software. And this is great news for our stockholders and for our Company. As we invest in more software capability, we can actually increase our capital turns on the hardware itself.

So the code that we're writing today has a nice long life to it. We believe this code enhances our ability to drive superior customer outcomes, and so I think you will see this mix continue to shift towards software as we are building out the intellectual property around running a large, global cloud.

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

Thanks. That's very helpful.

Operator

Moving on to James Breen with William Blair & Company.

James Breen - *William Blair & Company - Analyst*

Thanks. Just a couple questions. One, Lanham, on the third-quarter call, you talked about sort of the hiring practices throughout 2011 and there's a challenge, frankly, to continue to hire the right people given the growth profiles. Can you talk to us a little bit about that now, and where your position from a workforce in terms of growing and throughout 2012?

And then secondly on your thoughts just on the hard asset side and data center buildout and so forth, where the theory is now, or where your strategy is with the results of those?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Sure. Let's start with the hiring processes. On the -- I don't remember exactly the call, but on the call for the third quarter, we talked about how we hired fewer people in the third quarter than we wanted to. And the gist of that was we were being selective in the process and hadn't lined up all the skills we wanted and our organizational bias is basically to -- we would rather limp than hire the wrong Racker in here. The wrong Racker is a cancer to our culture, so we would rather be very selective on that.

The good news here on the fourth quarter is that we were able to increase our hiring and are very comfortable with the hires that we made and we are confident about the decisions we made there. I mean, as recently as last week, I was visiting with the rookies in our rookie orientation class, and we had 100 plus folks in there going through it, and you can feel the energy and the talent in the room. So if you look at the Q4 hiring numbers, we feel good about that outcome and are optimistic about their future with us.

In terms of the data center question, our strategy there with the data center remains the same in that we will continue to lease data-center space. We are in continuous -- I would say conversations with multiple parties out there about future capacity. We believe we have a long-term growth trend that we are capitalizing on inside of our business as we build the service leader in cloud computing that the world wants Fanatical Support, so we are going to need more data-center capacity going forward. If you look over the past year, we entered into some transactions with DuPont Fabros, as well as Digital Realty. We believe we've gotten good performance in the -- our partnerships with those companies, we believe those companies will continue to be there for us and continue to do good work for us as we grow. And so our perspective on data centers is that we are a wholesale purchaser of data-center space. We transform that input into our business into a world-class technology experience with Fanatical Support.

So data-center space will continue to be an input to our business. We will run data centers and consume space ourselves. We will also, through OpenStack and other opportunities in the long run, do more work federating our data centers with our customers on-premise facilities. So our model will continue to evolve over time as we endeavor to generate better customer outcomes, and higher capital efficiency, but I think the makings of the play and our strategy are already documented and known at this point. I just think we're going to do more of it.

James Breen - *William Blair & Company - Analyst*

Great. Thanks. Then just one follow-up with respect to the customers that you added this quarter, any real change in terms of small, medium, large? Are you seeing different trends across the different groups? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Yes. Another good question. We haven't seen much of a difference. One of the themes for our Company here over the past -- call it the past year, has been the traction of our enterprise business. And we continue to have great traction with enterprise customers. I mean, one I would reference is Red Bull. So if you go out to the web today, we run all of Red Bull's marketing apps for their production environment, and this is a customer that uses our RackConnect technology to link together a dedicated environment to our public cloud. So that's an example of what's happening in the business in terms of our enterprise customers. We continue to see that trend go.

And then -- the nice thing is, if you look at our install-base growth, the big drivers in the install-base growth in our historical calls have been enterprise and cloud, and we are starting to see a bit of a lift here with SMBs as well. Now, our historical pattern with install-base growth, if you look back over the past couple of years has been one step forward, one step back. That metric really is a proxy for what's happening in the economy. So as macro conditions improve we still think that number has some upside to it, but we're pleased with where we were in the fourth quarter.

And I think the last thing I'd say, in our prepared remarks, we talked about managed cloud and the success we've had there with that offering. And what that really reinforces to us from a competitiveness perspective is our ability to increase the SLA on these technology form factors, deliver better value for customers, and capture it. Because that's really our long-term strategy around differentiation. We want to expand our set of products and services, we want to generate incredible customer outcomes, we measure this customer loyalty through the net-promoter score, and in the process we want to generate great economics. So the success of the managed cloud offering speaks to our ability to differentiate within the cloud world relative to the other offerings out there in the marketplace.

James Breen - *William Blair & Company - Analyst*

Terrific. Thank you very much.

Operator

We'll now hear from Jonathan Schildkraut with Evercore.

Jonathan Schildkraut - *Evercore - Analyst*

Great. Thanks for taking the questions. Just two if I may. First, Lanham, could you tell us about developments along the lines of hybrid infrastructure? I know that you guys are running a large, private -- public cloud. We have seen a lot of announcements about Amazon Web services creating a direct connect into their platform. You had made an announcement to work with Equinix. Just wondering about how your product is developing, matching up your public cloud with maybe some other of your customer's private deployments?

And then secondly, you do have a substantial amount of wholesale capacity, which you have signed leases for, which is yet to be untouched. How far out in advance do you feel the need to secure incremental capacity to support growth? And in that regard, are there any plans to take maybe existing infrastructure out of your data centers and move to that new capacity, or is this all reserved for growth? Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. All right. So a few questions there rolled into one.

So let's start with the product evolution and the infrastructure there, the announcements that have taken place in the marketplace. I think, as we see this today, we've talked about our public-cloud roadmap publicly and we can certainly get into more of that if people are interested in that. We've also talked publicly about the ability to link this multi-tenant infrastructure with dedicated infrastructure, whether we are running a dedicated private cloud for our customer and linking that back into our public cloud, and we've put that under the nomenclature of hybrid. Another definition of hybrid is to link our environment, customer environment, that we run inside of Rackspace DCs to a customer's on-premise data center as well. And part of our belief and optimism around OpenStack really enables that new definition of hybrid. So if you take the existing definition of hybrid, linking a dedicated cloud to our public cloud inside of a Rackspace data center, we are doing that today.

We are on, basically, gen two of that technology and capability, we are generating good customer results, and that is a segment of our customer base that's growing rapidly. When you talk about federating a Rackspace data center with a customer-owned data center, here we are on gen-one technology. These are computer science and product opportunities that we are working on with customers. We do have this stuff in the works, but we don't have a material amount of revenue showing up from that today inside of our numbers. We think that really these are future opportunities for us to grow the business, not near-term opportunities in our revenue-growth trajectory. So that's the product discussion.

I think on the wholesale capacity and what's happening there, yes, so a few rules of thumb. As we look at our utilization and run-rate today, we think -- depending on growth rates -- we have between a year and two years of capacity that we have either built out or almost built out that we can grow into. Beyond that, then we look to establish contractual opportunities for additional data centers over time.

In terms of our business model, what we want to do is make data-center costs as variable as possible. So we want to align our revenue growth with the commitments that we make under these data-center leases. So that means we want to have swing capacity that if we grow faster, we then want to have the ability to take down more capacity when we need it, and if we grow slower, we want to have the ability to stage and push out data-center capacity to when we actually need it. This way, we can align the capacity that we have built out ahead of us to our growth. So that's as we look at data-center capacity, it's one part of the performance we need, it's another part the alignment of our business model to make sure that we get this properly. That's why we've gone -- we really see it as an input to our business that we are consuming wholesale data-center space and then transforming that into technology as a service for our customers.

Jonathan Schildkraut - *Evercore - Analyst*

Thanks. Lanham, can I ask just one more question? You talked about the OpenStack transition. Is there any way to put some parameters around the timing of that move?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure.

Jonathan Schildkraut - *Evercore - Analyst*

From Slicehost to OpenStack, sorry.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes, okay. All right. So the Slicehost -- you're talking about a customer migration from Slicehost to our current cloud? Yes, we've been --.

Jonathan Schildkraut - *Evercore - Analyst*

That's correct.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes, okay. So, sorry, your prior question you also had migrating out of data centers and such?

Jonathan Schildkraut - *Evercore - Analyst*

Oh yes. I was just wondering if that was part of the reason why you were securing so much capacity?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes, okay. So an example -- an answer to your prior question that ties to this one, Jonathan, is we've been migrating Slicehost customers onto our cloud out of our St. Louis data center. Okay? So this is an example of part of taking down the additional capacity has been to migrate customers. We want to maintain that flexibility and get people on more economic data center terms for us. This is also migrating those customers onto the new cloud platform. Okay? So there's an example of consolidating space and getting into new platforms.

Directly on OpenStack, and our developments there, we have been in beta with customers. We will have announcements soon about the next step with that. And we feel pretty good with where we are. We are setting a high-quality standard with respect to releasing this on a general availability basis. Because when we get this, this is one of those first impressions last a long time situations. Where we're going to be operating the world's largest OpenStack cloud. People are going to be running production workloads on that, so we want to make sure it goes well. We've been making lots of investment there and we feel good about where we are with it.

Jonathan Schildkraut - *Evercore - Analyst*

Thank you.

Operator

Our next question will come from Gray Powell with Wells Fargo.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Hello. Thanks for taking the question. Just had a couple of quick ones. So, over the last few years, the ratio of, call it $0.50, in growth oriented customer gear CapEx to $1 in revenue growth held pretty consistently. How do you see that relationship changing as cloud becomes a bigger percentage of revenue?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay. So basically, there are a couple of different elements that drive into this. You have a service component that obviously drives the revenue that is somewhat connected, but also loosely connected only to service. So as we increase the service levels on top of the infrastructure layer, then that relationship between incremental growth and incremental CapEx will trend positively. And the mix between the service intensity and the infrastructure, if we think about selling pure raw compute, then the relationship would be very tight. If we think about a thick service layer, then the relationship will get much better over time.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Okay. That's helpful. And then just on the same subject, I just thought that the 17% ROIC that you guys produced in Q4 was particularly impressive, given your growth profile. To the extent that you can, I was wondering if you could help me dissect the ROIC between dedicated hosting and cloud, just because I would assume that cloud has higher costs associated with it given that it's growing closer to 90%, but then I'd also assume that a steady-state ROIC for the product is much higher. Can you just help us think through those moving parts?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. This is Lanham. When, when we think about ROC, we think about asset turns times margin. Okay? So this is going to be at a high level, because I don't want to get into all of the details for competitive reasons. But if you take turns times margin, for what cloud and that hardware form factor, allow us to provide are greater turns. Greater turns per giga compute, greater turns per box. Whatever metric we want to put on it, we have great turns opportunity with that technology.

Service layer is about providing the margin. Fanatical Support is about creating the customer outcomes that drive loyalty, that in the long run drive our profit margins as a Company. So when you think about ROC as asset turns times margin, the advances in technology, the software development investments that we mentioned earlier on the call, the movement to a multi-tenant infrastructure, all that helps with the base turns. Then Fanatical Support is about creating incremental value above that that we are able to capture and monetize that translates into the margin. So if you break down the ROC movement that we've had since we've been a public Company, we've had improvement in turns as well as margin.

Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Got it. That's helpful. Thank you very much.

Operator

We'll move on to Scott Goldman with Goldman Sachs

Scott Goldman - *Goldman Sachs - Analyst*

Hello, good afternoon. Thanks guys. Lanham, maybe you can just talk a little bit about the revenue per server on a quarter-over-quarter basis? It looks like it accelerated from where it had been running the last few quarters. Wonder if you maybe you can put that in context of what you're seeing in terms of uptake of the managed cloud, the critical sites, the services that are driving higher ARPU on that front? And then maybe talk a little bit about the product pipeline you see for 2012 and how that can affect the average revenue per server?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Yes. I think you've already connected most of the dots, okay, so I'll just reinforce some for you. The nested loop here really has to do with the more -- the higher service level a customer subscribes to from us, the more value we add on top of the base compute, so therefore the higher revenue per base compute, which in this instance is average revenue per server. So the reason average revenue per server is climbing is we have customers subscribing to higher service levels, whether it's managed cloud versus core cloud, critical sites versus an entry-level managed service level, and this drives the value we are adding. Okay? So I think what we've seen over time is we've had an acceleration in our enterprise business, a lot of that shows up in install-base growth. Okay? And these enterprise customers, by definition, they tend to be running more complicated environments for us that are in hybrid by nature, and as they grow, they consume high-service levels, and therefore high-average revenue per server.

The launch of the new products as well has had a similar impact. So in our prepared remarks, we talked about Cloud Firewall, Cloud Database, and Cloud Block storage as potential offerings here this year. And those fundamental offerings will help us provide higher service levels on our multi-tenant cloud. So as we increase the service levels across multi-tenant cloud and dedicated cloud, we think there is continued upside in their average revenue per server.

So it gets a little bit back to the ROC discussion we just had. Average revenue per server reflects the turns per server that we're experiencing. Adding more value, create -- through the service layer, creates more value that we create, we can capture that value, that drives up turns, it translates into customer loyalty and margin, so we get a better ROC. So I think that is our virtuous cycle that we experience here as we increased service level and drive loyalty, we kind of get the best of both worlds.

Scott Goldman - *Goldman Sachs - Analyst*

Great. Thanks. And then a follow-up, you mentioned earlier about maybe small business having a little bit of an impact on the install base-growth, this most recent quarter, which I think coincides with some of the recent macro data points we've been seeing on small business. Can you just talk a little bit about your revenue guidance, or expectations for 2012, and how small business fits into that guidance you gave?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Well, I don't think we gave revenue guidance. All right? So I think generally when we look at fourth-quarter install-base growth and performance, relative to the rest of the year, we've seen strengthening conditions. I would point to everybody that as the macroeconomic conditions change, we will see this play out through the install-base growth metric. And that over the last couple of years, really since the recession, Great Recession or whatever we're calling it, kicked in, the SMB business has been weak for our country, and then weak on a global basis as well. So I guess I'd point to the [sense] of your point, too, Scott, in that as the macroeconomic headlines have improved, we've seen a little bit of lift there. I think that, generally speaking, we should all keep our eye on that and not get too pumped up about one good result. Let's make sure we sustain it first.

Scott Goldman - *Goldman Sachs - Analyst*

Great. Thanks a lot.

Operator

Our next question will come from Simon Flannery with MS.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you very much. Good evening. Karl, if I can add -- talk more about the margins, very impressed result, we touched on it earlier. Looked like a lot of it came in the gross margin area where you had very nice operating leverage kicking in. And yet I think your guidance was margins would be similar in 2012 to 2011. So what was it that was going on in fourth quarter -- 4Q that you don't want us to project into 2012?

And then, Lanham, I think last quarter you were talking about some exciting conversations with your customers around OpenStack and adopting that and you managing their data-center assets for them? Maybe you can just update us on your thoughts in terms of monetizing OpenStack? Thanks.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay. Well, let me take the margin stuff first. So as we mentioned before, there's always a little bit of an inherent variability in our resourcing as we apply those resources to the business. So depending on how fast we hire people, depending on how fast they actually grow, whether install-base growth is a little faster or slower, that has different impact on the amount of resources that we need. So we already talked about that we had a relatively low hiring number in the third quarter. That salary impact really is in the fourth quarter. And in the fourth quarter we hired a lot of people -- or, a lot -- 240 people. So that is on the more, more continuous trend that will kind of be applied going forward in Q1 and subsequent quarters.

The other thing you mentioned, gross margin, we had -- we started to renew our power contracts both in the US and UK. And given where commodities prices are these days, we just were able to lock in at a much lower rate than we have historically seen. So that's going to be another boost. And cost of revenue growth was positively affected by both power and salary and benefits issues.

Really from a one-time perspective when you think about kind of one-timers, one-timers has a little bit of contribution to margin expansion, but not much.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

And then I guess on the OpenStack, Simon?

Simon Flannery - *Morgan Stanley - Analyst*

Yes.

Lanham Napier - *Rackspace Hosting Inc - CEO*

I would say, generally speaking, the conversations we are involved in that I've been involved in with customers continue to go exceptionally well around OpenStack, that the world sees OpenStack as the de facto open source standard in cloud computing, that the marketplace wants this standard to emerge. More companies in the community are jumping on the bandwagon. The announcement that we had in our prepared remarks around AT&T is an example of that. So I think the ecosystem in the acceptance of OpenStack as a standard in the marketplace continues to strengthen.

This accepted standard is what triggers the opportunity for us. The opportunity to put service levels on top of OpenStack, to run OpenStack cloud ourselves, the opportunity to put service levels on top of an OpenStack cloud that our customers run in their data centers. We have signed more customers onto pilot programs to deploy OpenStack clouds for them in their data center, we're working on those as we sit here on this call today. So I think the traction and progress continues to improve there.

There is obviously a big milestone this year, with our execution around completing our cloud's shift to OpenStack. Our cloud files object storage is already on the code. We need to get our compute code on OpenStack as well, and when we do that, we will by far be the largest OpenStack cloud (inaudible). So that's a big milestone in our year of execution this year, in 2012. I think with that milestone behind us, we will see a lot of these pilots continue to accelerate and generate more business for us inside the Company.

So I would say up to this point, knocking on this fake-wood conference table I'm sitting at, I mean we are very pleased with the adoption of OpenStack in the market place. It's an ecosystem that's supporting the emerging standard. I think that standard's pretty much in the market place's mind now as the de facto open-source standard for cloud. We're rolling out services on top of it, so we have a lot of interesting work to do this year to make all that happen, but the tone out of customers remains positive.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

Moving on to Frank Louthan with Raymond James.

Frank Louthan - *Raymond James & Associates - Analyst*

Great. Can you talk to us about the server trends in the quarter? Just average servers down a little bit, is that due to the little bit more of a mix shift towards cloud? How should we think about that going forward?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. So if you see, if you look at the longer-term trends, it was pretty consistent. Lanham mentioned before that we are, when we think about our data center strategy, that we're doing some consolidation work, and we have some technology transfers as well. That basically has led us to build up a little bit more excess capacity than we usually would use to run the business during the second and the third quarter, and in the fourth quarter, we just burn down on that excess capacity a little bit. So that's why the server increase in the fourth quarter was relatively small compared to the other four quarters. The longer-term trend is, is -- shows very nicely what's happening, and then obviously you have the relationship that we talked about before between incremental revenue growth and server CapEx.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay. Great. So you're pretty well through that trend and should -- and so starting first quarter we should start to see that start to reverse a bit?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. More than likely.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay. And then can you comment a little bit on enterprise sales going to larger businesses? Has that played a part in the larger increased ARPU per server? And where are you as far as the sales team there?

Lanham Napier - *Rackspace Hosting Inc - CEO*

The short answer is yes, it has had a positive impact on the average revenue per server. Our enterprise customers tend to subscribe to higher service levels with us than the SMBs do. And so the more enterprise growth we have, it tends to have a favorable impact on most of these metrics. Okay? So I think that definitely contributed.

In terms of our sales efforts there, we've been pushing and investing our enterprise business in earnest, call it a couple of years. Some of the important initiatives there have been our channel program, where we go to market with partners to pursue enterprise opportunities, as well as our own direct sales capability that we've built out.

Jim Lewandowski is the General Manager of our Enterprise segment. He has an enterprise sales background at IBM and BMC among others, and so he's really the mastermind here behind building out those teams. And I think we've continue to invest and continue to perform there. We are pleased with the consistent performance and growth we've gotten out of our enterprise sales teams.

We're optimistic and confident that we can continue to invest there and continue to drive results because the enterprise customers that we're in conversation with really are interested in looking for new ways to do things, and with the advent and rise of OpenStack, the advent and rise of cloud in the own -- our own growth in our brand and the confidence that we can project, we like our chances in enterprise. It's interesting that with enterprise customers, there really is a notion that these customers want to be safe, they want to have a trusted partner, and we can present ourselves in a way that's very different than most of the technology incumbents out there in that we do not have a dog in the hunt when it comes to a bunch of these proprietary infrastructures. We are a standards-based productized model. So these enterprise customers can sign up with us, we can knock it out for them real quickly, we were built for a Web world, and we move at Web speed. Whereas a lot of these people we are competing with, former EDSs and that type of activity, and so we can just move a whole lot faster than that.

Some of the proof in the pudding here is that a number of the ads that ran in the Super Bowl were running off of our infrastructure. So these are prime-time marketing opportunities, and our ability to turn this on with our public cloud, handle all the growth during the game and the hours after the game, and turn it back off and scale it appropriately so that they can scale down just to their ongoing persistent production environment, this is a really unique capability and this is something we can do because we're a cloud Company. This is our expertise.

So our feeling is we have a lot to offer enterprises. We're still growing into the market opportunity here. We've only been on it a couple of years. But that we have an offer advantage in the marketplace, and we believe that represents a continued growth opportunity for us.

Frank Louthan - *Raymond James & Associates - Analyst*

And what percentage of your revenue's coming from these enterprise customers versus your more traditional-sized businesses?

Lanham Napier - *Rackspace Hosting Inc - CEO*

That is a competitive detail we haven't disclosed. What we've talked about on these calls in the past has been that it's a rapidly-growing piece, and the one way to think about it is the average enterprise opportunity is absolutely a multiple of what we see in terms of monthly recurring revenue relative to our SMB opportunities. And today we've worked our way into serving about half of the Fortune 100. And typically, we have, of those enterprise customers, the way the adoption cycle works is we win one application, we earn their trust, they send us another. So this is something that these enterprise CIOs have data centers full of a long tail of applications, and we tend to work our way from the outside edge with a department app that's web-based, back into more at the center and core of their operations. So it's a fast-growing customer segment for us, and we are optimistic about our chances there.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay. Great. Thank you.

Operator

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

Pat Walravens - *JMP Securities - Analyst*

Oh, great. Thank you very much. Lanham, with 147 companies in OpenStack there has to be a lot of different agendas. What's the biggest challenge you're seeing in managing this community and how are you addressing it?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Well, okay, good question, Pat. We've taken a couple of different approaches to this. The first thing is to legitimize the project itself by putting it into a foundation. Right? And now that we've pulled that off, it's about making a good contribution to get people on the same page to focus on the technology layer itself, for the betterment of the marketplace, for the betterment of humanity. And so we've worked hard to do that with our teams.

If you look at the different boards, and the thought providers in the level of contribution that we are making to the project itself, in the early days of OpenStack, it was dominated by just a few companies, and individuals contributing. Now, as you identify, 149 companies contributing to this project, there's a bunch of different people doing a push and pull on this thing. So our model for this, really is what's happening in the Linux world with things like Apache as we want to go forward with this.

So I think that we will remain a consistent voice, we will absolutely be clear about what's happening there. We will continue to make really solid contributions to help shape this technology going forward. We think that it's becoming the open-source standard and it's just a matter of hashing it through. The nice thing about an open model like this is that in the long run, we believe that it will get to scale and innovate much quicker than closed proprietary models.

So the world 's going to settle on just a couple of standards. AWS is clearly a standard in the marketplace in terms of APIs. We think OpenStack will clearly be a standard in the marketplace in terms of APIs, and we think the pace of innovation around that marketplace will exceed what happens in that closed proprietary model. And so for the most part, as you go through the list of 149, almost all the big tech companies are in it and have a vested stake in seeing this standard emerge.

So you're right in that there could be different points of views and different directions and different push-pulls with respect to what specific members in the community want, but I think in general the community at large is pretty aligned around creating an open-source standard for the cloud computing and almost everybody's jumped in at this point.

Pat Walravens - *JMP Securities - Analyst*

Thank you.

Operator

We'll move on to Colby Synesael with Cowen & Co.

Colby Synesael - *Cowen and Company - Analyst*

Hello. Great. Most of my questions have been answered, but I just wanted to go back to the margins for a minute. It seems like from what I heard, the puts and takes were, it sounds like three big categories. Number one, the hiring being down in the third quarter and how that benefited you in the fourth, and I guess you don't necessarily expect that to occur again. So obviously we have the headcount ramp this quarter. And the power costs, they came down, but that should be something that's sustainable going forward.

And then the other one was server capacity. You obviously had some excess inventory that you used up in the fourth quarter. I guess we'll get back to more of a normalized server-count add in the first quarter. Are those the three big components that drove the difference in the margins this quarter versus the third quarter?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. Pretty much.

Colby Synesael - *Cowen and Company - Analyst*

And is there any seasonality that you typically see in the fourth quarter?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. I mean, there is some. Right? I mean -- Lanham just mentioned that there is some, obviously a lot of stuff happening in the fourth quarter around the holidays and a lot of online commerce, a lot of advertising, et cetera. So, so there is some seasonality that we observe, probably, in four years of five years, and in some years, it doesn't happen. Most of the years it does happen. You have a little bit stronger Q4, you have a little bit weaker Q1. But it doesn't happen every single time. When you go back through the long-term history of the Company.

Colby Synesael - *Cowen and Company - Analyst*

Okay. In the fourth quarter this year, you saw a little bit of seasonality in the commerce vertical as it relates to revenue, but there's no seasonal (multiple speakers). I'm sorry can you repeat that?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Install-base growth.

Colby Synesael - *Cowen and Company - Analyst*

In the install-base growth.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Positive. Yes. Because it's higher -- significantly higher than in the previous three quarters, as you can see.

Colby Synesael - *Cowen and Company - Analyst*

Okay. Great. Alright. Thank you.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sure.

Operator

Well, Mr. Luce, we have no further -- unfortunately, ladies and gentlemen, we have no time for further questions, so Mr. Luce, I'll turn it back to you for closing.

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

Okay, I'll hand it over to Lanham.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Well, we'd just like to thank everybody for dialing in and for your interest in our Company. For our customers, thank you for placing your trust in us. For Rackers, thanks for volunteering your best to make this happen. We are on a special mission here to build a truly great Company, and we're going to keep our head down and execute on that. Thank you very much. Bye-bye.

Operator

Well and again, ladies and gentlemen, that concludes our conference for today. We thank you all for your participation.
