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RAX - Q2 2012 Rackspace Hosting, Inc. Earnings Conference Call

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## PRESENTATION

### Operator

Good afternoon, ladies and gentlemen, and welcome to Rackspace Hosting second-quarter 2012 earnings conference call. As a reminder, this call is being recorded. At this time, all participants 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 it is now my pleasure to introduce Jason Luce, Vice President of Finance for Rackspace. Mr. Luce, you may begin.

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

Hello, everyone, and welcome to Rackspace's quarterly conference call. Today we will cover Rackspace's second quarter ending June 30, 2012. We hope that you have had a chance to read our press release, which we issued earlier today. If you do not have a copy, please visit the Investor Relations page of our website at [IR.Rackspace.com](http://IR.Rackspace.com). This call is also being webcast online and can be accessed through our IR site. For Rackspace on the call today will be Lanham Napier, Chief Executive Officer, and Karl Pichler, Chief Financial Officer.

I need to remind you that some of the comments we will make today are forward-looking statements that involve risks, uncertainties, and assumptions. If such risks or uncertainties materialize, or such assumptions prove incorrect, our results will differ materially from those expressed or implied by such forward-looking statements and assumptions. All statements other than statements of historical fact are statements that could be deemed forward-looking statements, including any statements concerning expected operations and financial results; growth plans; the impact of new platforms, products, or services; any statements of expectation or belief; and any statements of assumptions underlying any of the foregoing. These risks, uncertainties, and assumptions include one, the market acceptance of our new public cloud platform and product set; two, the successful and timely launch of new platforms or products; three, increasing competition in our industry; four, the adoption of OpenStack as the open-source



cloud-computing platform standard; five, unfavorable economic conditions; and six, other risks that are described in our Form 10-Q for the quarter ended March 31, 2012, which was filed with the SEC on May 9, 2012, and our Form 10-Q for the quarter ended June 30, 2012, which will be filed with the SEC later this week.

These forward-looking statements speak as of today. Except as required by law, we assume no obligation to update these forward-looking statements publicly or to update the reason actual results differ materially from those anticipated to be forward-looking statements, even if new information becomes available in the future. Please also note that certain financial measures we will use during this call, such as adjusted EBITDA, are expressed on a non-GAAP basis. Our GAAP results and GAAP to non-GAAP reconciliation can be found in our earnings release for the second quarter of 2012, which is currently posted on the investors' page of our website at [www.Rackspace.com](http://www.Rackspace.com). After our prepared remarks this afternoon, we will be happy to take your questions. I will now turn the call over to Lanham. Lanham?

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Good afternoon, everyone, and thank you for joining us today. In February, we explained that 2012 will be an important year for Rackspace, as we manage the demands of a fast-growing \$1 billion business while simultaneously launching our new open cloud products. With just over half the year completed, we have made good progress on our development goals and expect to be largely through the product launches soon. The technology industry is in the early rounds of a massive secular shift that would change the way businesses consume IT. More and more companies are discovering that using a specialized service provider is the most effective way to address their IT capacity needs. In addition, we believe the economics of the cloud will drive an explosion of new demand for computing, just as iOS and Android have driven huge new demand for applications development. Massive technology disruptions like this create opportunities for companies to seize the moment, disrupt the status quo, and lead to revolution.

We believe Rackspace [space] is one of those opportunities in that we are in a position to lead this revolution. In order for us to capitalize on our long-term potential, we need to execute extremely well now. Our execution in 2012 will influence our competitive position for years to come. Amazon has been effective at attracting early adopters and evangelizing the potential of the public cloud. VMware pioneered the x86 virtualization market, and built a multi-billion-dollar business selling software to companies building their own small private clouds. However, both Amazon and VMware use the old model of proprietary technology to lock in their customers.

We are taking a different approach. Our strategy is to leverage the OpenStack technology to create a cloud operating system that can run anywhere, one that will give freedom and choice to customers and drive unconstrained innovation. We will adopt this powerful software system, integrate it with modern infrastructure, combine it with passionate knowledgeable Rackers, and back it up with service-level agreements, all to deliver world-class technology outcomes to our customers. In a world that uses proprietary technology to create lock-in, we will differentiate through a superior service experience and build a model based on customer loyalty and trust. As the pace of innovation continues to move rapidly, we believe companies will want a reliable partner to deliver the technology they need to run their business and help them navigate to the cloud. Our mission is to make sure that Rackspace is that partner.

Among Rackspace's newest customers is Circuit of The Americas in Austin, Texas, a new venue that will host the Formula 1 United States Grand Prix this November and a number of motorsports and entertainment events in the coming years. Rackspace hosts the company's website, [www.CircuitofTheAmericas.com](http://www.CircuitofTheAmericas.com), that is crucial to the Circuit's online ticket sales. Rackspace allows the company to quickly adjust compute capacity in conjunction with customer communications and sales offers that drive generate rapid spikes in visitor traffic to the site. That's just one example highlighting the importance of our new open cloud platform.

As of today, we are extremely proud to report that we are more than halfway through our product transition schedule for the year. Last week, we achieved a significant milestone in our 2012 plan by launching Cloud Servers powered by OpenStack. This new offering embeds the latest version of the OpenStack software to combine the on-demand scalability of modern cloud infrastructure with the flexibility benefits of open-source technology. This product launch represents the culmination of nearly two years of hard work by Rackers throughout the company, and it will serve as the core of our new open cloud platform. In addition to the new Cloud Servers, we also announced a general availability of Rackspace Cloud Database and the Rackspace Cloud Control Panel.



Taking the powerful capabilities of the OpenStack platform and productizing them into a service that is easy for businesses to use is one of the most difficult, exciting, and strategic challenges that Rackspace has ever pursued. It is the largest software investment we have ever made, and it has required us to build new competencies, particularly in the areas of product development. It will be the foundation for Rackspace to deliver Fanatical Support on a much larger scale and in a more capital efficient manner than currently possible. In short, OpenStack is the enabling technology for Rackspace to become a much larger business.

As you know, we don't simply aspire to be big, we are striving to become big and great. Very few companies have been able to accomplish both, and we believe the combination of rapidly growing cloud computing market, the capabilities of the OpenStack technology, and the power of Fanatical Support provide us with a once-in-a-lifetime opportunity to join that elite class of companies that are both big and great. While we are excited about the successful launch of the first three elements of the new open cloud platform, we haven't fully completed the rollout. Specifically, we plan to launch Cloud Monitoring, Cloud Backup, and Cloud Block Storage during the remainder of the third quarter, and Cloud Network early in the fourth quarter. The product development work we are doing is all about delivering Fanatical Support across a portfolio of dedicated and public cloud products that enable large, high-performance workloads to run on our cloud. The new open cloud platform has added features and eliminated bottlenecks that our larger customers found to be cumbersome on our previous cloud platform.

Given all the progress we have made up until now, we are confident that we will hit our product road map launch dates for the rest of the year. Although we expect the majority of the new open cloud platform to be released in the third quarter, we do not expect to begin capturing the financial benefit of the new offering until the fourth quarter at the earliest. From the adoption standpoint, given that the new offering was just released on August 1, we believe some customers may wait for us to publish performance metrics before they commit using the open cloud platform to run large-scale, mission-critical workloads. At the halfway point of the year, we have made good progress toward our 2012 plan. We have set an aggressive rollout schedule for 2012, and we are proud of the way Rackers have rallied to deliver on our commitments. We expect to complete the vast majority of the open cloud launch during the remainder of the third quarter, and we look forward to updating you on our progress in November. I will now hand this call off to Karl to review our financials results. Karl?

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**Karl Pichler** - Rackspace Hosting Inc - CFO

Thank you, Lanham. Let me review the detailed financial results. For the second quarter, total revenue was \$319 million, representing 5.9% growth from the first quarter and 29% growth compared to the second quarter of 2011. Exchange rates had a slightly positive impact on the revenue of approximately \$600,000 compared to the first quarter and a negative impact of \$2.3 million compared to the second quarter of 2011. On a constant-currency basis, revenue grew 5.7% sequentially and 30% year-over-year. As we have discussed in the past, sales to enterprise customers have provided a strong source of revenue growth for us, and this trend continued in the second quarter.

One recent example of this is Fox Networks Group. Fox Networks Group includes units that produce, program, and transmit many of America's most popular shows via TV networks, video on demand, and other media platforms. Fox selected Rackspace to host some of their top web properties, including FoxSports.com and AmericanIdol.com. Fox needed to ensure that these websites would not suffer performance degradation at times of peak load while maintaining flexibility during periods when traffic was lighter. Our hybrid hosting offering was the perfect solution for Fox's needs. Fox is leveraging our critical site service-level agreement to ensure the highest level of performance while also utilizing our public cloud platform to handle demand spikes across the different web properties. Fox is a great example of the progress of our enterprise sales effort and the success of our hybrid solution.

In addition to new sales to enterprises, sales to existing customers is another important growth driver for our company. During the second quarter, install base growth averaged 1.0%. This is an improvement from 0.7% in the first quarter and is in line with the monthly average for 2011. One notable upgrade in the quarter came from the United Service Organization. The USO is a nonprofit organization that provides programs, services, and light entertainment to United States troops and their families. The USO operates more than 160 locations in 14 countries, serving more than 8 million visitors. The USO initially chose Rackspace to host its main website in 2008. Since then, it has steadily expanded its footprint and is now moving its entire corporate infrastructure into our cloud. When completed, the USO configuration will include Dedicated Cloud, SharePoint exchange, and Private Cloud.



Moving onto revenue by product. Dedicated Cloud revenue increased to \$246 million, representing 4.1% sequential growth and 21% growth on a year-over-year basis. Public revenue cloud for the quarter was \$73 million, representing 12.1% sequential growth and 69% growth on a year-over-year basis. Although our new open cloud platform and products were not available in the second quarter, and we don't expect to begin to see the full revenue benefits until the fourth quarter at the earliest, we are seeing some early reasons to be optimistic about the new platform and products. One example of why we are optimistic is illustrated by a company called SOASTA. SOASTA is the leader in cloud testing and was one of the early adopters of our open cloud products. Our OpenStack-powered cloud allows them to simulate massive volumes of web traffic, which is used to ensure that its clients' web and mobile applications are ready for production. They have used our services to test application for the 2012 Olympic Games.

Moving on to profitability. Adjusted EBITDA came to \$112 million in the second quarter, representing growth of 11.1% from the first quarter and 37% on a year-over-year basis. Our adjusted EBITDA margin was 35.1% in the second quarter, up from 33.4% in the prior quarter and 33.0% in the second quarter of 2011. Depreciation amortization expense came to \$62 million in the quarter, representing approximately 19% of revenue. Although this is up from 18% of revenue in the first quarter, it is back in line with the 19% to 20% range that it has been tracking since the beginning of 2009. Net income came to \$25 million in the second quarter, representing growth of 8.3% from the first quarter and 43% from the second quarter of 2011. As we have indicated in the past, our profitability margins tend to fluctuate from quarter to quarter because of a variety of factors, including revenue growth, hiring performance, and resource prices. This is normal for our business, and we expect margins to continue to move around based on these factors.

Capital expenditures totaled \$82 million. Of this amount, we spent \$54 million on customer gear, \$3 million on data center build-outs, \$4 million on our consolidated headquarters facility, and \$21 million in capitalized software development and other projects. Return on capital came to 15.5% in the second quarter, compared to 15.0% in the prior quarter and 14.4% in the second quarter of 2011. Average monthly revenue per server grew for the twelfth consecutive quarter to \$1,270 from \$1,238 in the prior quarter. We generated a company record for adjusted free cash flow of \$29 million in the quarter. We ended the quarter with a total cash balance of \$215 million. Our total debt outstanding including capital leases was \$149 million, which translates to a net cash position of approximately \$66 million. Given our ability to generate free cash flow, our strong balance sheet, and through access to an additional \$200 million through our credit facility, we believe that we are well-funded to operate our business at these growth rates.

In summary, at the halfway point in the year, we have made a lot of progress in our plans to broaden our product and services portfolio while simultaneously managing a rapidly growing business. Keep your eyes open for more product announcements in the coming weeks, and we look forward to updating you on our progress in November. This concludes our prepared remarks. We are now ready to take your questions. Operator, please open the call for questions.

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## QUESTIONS AND ANSWERS

### Operator

Certainly.

(Operator Instructions)

Tom Seitz, Jefferies & Company.

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### Tom Seitz - Jefferies & Co. - Analyst

Yes, thanks. Two, if I could. The first is Citrix was really bullish on its call regarding the initial traction of CloudStack. And I'm wondering if you could update us on your views on the competitive environment for open-source platforms? And maybe give us a view on timing, as to when you think the winner will ultimately be decided? Then, secondly, how big of an impact to your conservative views regarding revenue recognition are due to the Stacks that have yet to be rolled out, such as monitoring and the like, that you mentioned? Thank you very much.



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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay, this is Lanham. Let's deal with the first question about Citrix and the comment -- the question really being about the competitive environment for open-source platforms in the cloud. As we sit here today, our belief is that OpenStack is rapidly emerging as the de facto standard for open-source technologies and cloud computing. Our belief here is based upon the traction in the community, the rate at which the code is advancing, the number of companies that have announced their intention to deploy OpenStack or that are deploying OpenStack. So we are seeing across the board from our perspective, (technical difficulty) in the community. We are seeing traction in the code. We are seeing the code advance, and the release cycle is pretty darn effective.

It's a big milestone for us, obviously, to roll out our open cloud powered by OpenStack. The community has been waiting for a big deployment like that. As we sit here today, we're running the largest open cloud in the world, to our knowledge. We think the community will continue to advance the code. And the community needs a big [surge] provider like us to do that. Right behind us, it's our understanding, is HP. So we're starting to see lots of traction in the community. This summer, the community picked up some great wins with Red Hat and IBM joining. From our perspective, CloudStack is absolutely in the marketplace. It just doesn't have the momentum and traction behind it that OpenStack does.

The second question, to make sure I get this right, is about our comments in the prepared remarks about when we receive the benefit of the new product launches and what are we thinking there. Okay, so from our perspective, it's the following. We recently launched the first wave of our open cloud. The second wave is approaching as we roll out the next batch of products. The timing on this is such that every 30 days or so, we are going to have another release. What that means is that really, until the fourth quarter, we don't have the whole platform in place. So we don't want to create confusion in the marketplace around the timing of when these things actually hit.

We have never been more proud of the products that we are producing. The feedback we're getting from customers is positive. If you go out to the Twitterverse and look at the streams talking about the new Control Panel and the ease of use of the interface and the comments coming out of customers, it's already really positive. We are pretty excited to be able to finish all this work. The reality is that we have some big work ahead of us. It's going to take us a few more months to complete everything. But by the end of this year, we should have it complete, and that should dramatically increase our competitive position in the marketplace.

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**Tom Seitz** - *Jefferies & Co. - Analyst*

Thanks. That's great color.

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**Operator**

Gray Powell, Wells Fargo.

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

Great. Thanks for taking the call. Just had a few questions. Can you help us frame up the longer-term opportunity with OpenStack? I know there are a number of things we can talk about. To start, can you give us a sense as to how we should think about the opportunity to address larger server deployments with OpenStack and how new features, such as database as a service and Cloud Block Storage, should drive new customer adoption and increase spending from existing customers?

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Yes, this is Lanham again. At a macro level, the investments we're making in OpenStack are really about driving differentiation. If you look at the cloud market today, there's an emerging segmentation. If you compare the competitive attributes that Rackspace brings to the market versus the competitive attributes of other players, let's just go through some of them. When you think about a company like AWS, who's done great, they are



a generalist in this game. They can sell you books. They can sell you microwaves. They can sell you videos. They can sell you social games, and they can sell you cloud services. We are a specialist. All we bring of a portfolio of dedicated and cloud services to customers. AWS is using closed technology. We are using open technology. They are playing a scale game, and we are playing a service game.

For us, this is about running an open portfolio, powered by OpenStack, backed with Fanatical Support. We believe that that positioning in the market gives us a lot of differentiation, a lot of power, and it's going to lead to a class of customer that's going to fit us very well. The investments we are making today are about reinforcing that point of position and differentiation in the marketplace. The results we are having on the products give us a lot of optimism, which Karl said in his remarks. Macro, it's about differentiation. If you want to boil it down to what does this mean for running more complex workloads on our cloud, what does it mean for serving bigger customers, what does it mean for handling larger apps.

To this point, if you looked at our legacy cloud platform, it was a platform that was excellent at doing simple things. It did not have all of the features and functionality for us to deliver high service levels for complex web apps. The platform and products that we are launching today give us a much better shot at doing that. In fact, they are critical to us being able to do it. As we continue to roll out this platform launch, we have a much greater ability to run complex workloads at a critical sites-type SLA, which we referenced in our prepared remarks earlier, on the new platform than we did on the old platform. I would say the differentiation around OpenStack, the capability of the new services and products we're rolling out, give us an ability to run much larger, complex apps.

The other thing that's exciting here is our ability to run private clouds on-premise for customers based on the same technology. It is early days in that game for us. But we are working on it through our cloud-building efforts that we've already have customers paying us to do this today. That's a whole [nother] option and avenue that's going to open up for us here. Right now, we have a saying around here, the main thing is the main thing. The main thing is continuing to execute around our product launches. We are very excited about that. As we execute these launches, we can run bigger workloads, which increases our market opportunity. This new platform is more capable, which gives us better scale and efficiency, which we believe translates into potentially better economics in the long run, and it's going to create some other avenues of growth for us. We recognize the opportunity in front. We realize we got a lot of work to do. I mean launching this stuff is complicated, so we got to keep our head down and keep doing it. But we have great confidence based on the recent progress and traction we've had.

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

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

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**Operator**

James Breen, William Blair.

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**James Breen** - William Blair & Company - Analyst

Thanks. Can you talk a little bit about your confidence level in launching the next phases for the products that you haven't launched yet? And then a little bit of color on EBITDA margins this quarter, as we saw a pretty good step up from the first-quarter numbers? Thanks.

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**Lanham Napier** - Rackspace Hosting Inc - CEO

Okay, this is Lanham. I'll handle the first piece about confidence level and launches and then let Karl do the margin stuff, because he is the margin guy around. So on a confidence level with product launches, our confidence is high. We base that upon the project-management plans we have in place, the progress and traction we have had on those plans here over months, so we feel very good about the technology itself. We feel very good about our ability to hit our timelines. Our Company is rallying on this in a significant manner. I would just sum her up by saying we feel confident about those timelines and like the spot where in. Karl, why don't you take the margins?



**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, sure. Our profitability margins tend to fluctuate from quarter to quarter. We have seen us this. As we all know, Q2 margins are higher than in Q1. In Q1, they were lower than in Q4. This is normal for our business, and we would certainly expect that to continue. Q2 was a good quarter, and it was driven by all three major cost categories, which is not usually the case. But in this case, cost of revenue got leveraged on our fixed-cost structure. But as we add new data center space in future periods, this can also go the other way. For sales and marketing, our Q2 spend was flat relative to Q1, where we had a significant step-up. That explains a little boost. And then in G&A, we continue to invest in our products capabilities but had some good expense-management opportunities within our corporate costs. So all these fluctuations are natural. Our general business strategy is to have those margins flat, but they fluctuate just as a matter of execution throughout the period.

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**James Breen** - *William Blair & Company - Analyst*

Great. Thank you.

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**Operator**

Patrick Walravens, JMP.

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**Patrick Walravens** - *JMP Securities - Analyst*

Great. Thank you. First of all, congratulations on launching the open Cloud Servers. My question, Lanham, is about VMware's acquisition of Nicira. And I'm wondering what does that acquisition mean for OpenStack? And is there a possibility at some point of VMware perhaps joining OpenStack?

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay, good question. It's one we've gotten a lot here lately. In general, so everybody understands, Nicira has done great work in OpenStack. If you go out to the community, you will see the code contributions they've been making. We are fans of that technology. We think it's great technology. We are pleased with all the work we've done with them. We have worked closely with them over time to [out] that technology and our network. We have also worked closely with VMware over time as well. If you go into our enterprise business, we run a lot of VMware environments for the large customers here at the Rack. From our perspective, we believe this could actually open up additional opportunity for us. As that transaction closes, it will pull VMware closer to us and to OpenStack. We look forward to having conversations with them about that at some point in the future. From our perspective, as we sit here today, we are optimistic that this can end up being a good thing for us and for OpenStack in general.

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**Patrick Walravens** - *JMP Securities - Analyst*

Great. Thank you.

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**Operator**

Chris Larsen. Piper Jaffray.

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

Thanks, and a couple questions. First, if you could talk a little bit about now the abilities of OpenStack today as it compares to Slicehost. I guess really what I'm thinking is are there any capabilities at Slicehost that had, or the old platform had, that you don't have today until you launch some



of the new products? Or will all these products be new and incremental on top of this? Then, is this consistent with what you anticipated all along? Secondly, there's some talk recently that eBay had adopted OpenStack. I wonder if you can just comment on that. And then a third question if I can, I apologize. But was there any delay in hiring or any slowdown in hiring that led to a higher margin this quarter? And I know, Karl, you gave really a lot of detail on that. But I'm wondering if there is any headcount issues that we should think about as having an impact on margins this quarter? Thanks.

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay. Let's start with OpenStack versus our legacy platform. The best way to generalize it today is that we are in territory that's all new and incremental capability from where we used to be. There are still a few look-and-feel things that we are working on. But generally speaking, where we sit today and going forward, it's all a new territory and new opportunity for us, which is part of the reason why we are pretty excited about it. Up to this point, we have had situations with large customers that we literally just couldn't deliver Fanatical Support to them running a large app in our cloud, because we didn't have all the features that we needed. If you roll the tape out here for just a few weeks, we are going to start to resolve and address a lot of those gaps, which means we are expanding our addressable market. Thus, from here on out, we think it's new and incremental, and we like our opportunity on that.

The second question was about eBay adopting OpenStack. There was a release. It was running in the news, I want to say just 48 hours ago, about eBay adopting OpenStack and running OpenStack internally. We think that's another great sign for the OpenStack community. Earlier in the call, I got a question about OpenStack versus CloudStack. What's going on in the competitive environment? How do you know OpenStack is emerging? I think any time you get a company like eBay running it, which is really a web giant, it reinforces the fact that this technology is real and that enterprise buyers are comfortable that it is production-ready. That just makes us really happy about eBay and others adopting this technology.

The last question you had was about a delay in hiring this quarter. Did that impact margin? I wish we had a crystal ball on hiring, but we don't. The reason we don't is we go after talent in the marketplace, and we put our best foot forward, and we try to attract as many as possible at any time. In the first-quarter call, we talked about how we had been more successful hiring people. This quarter, we hired fewer people. We were just under 200 Rackers joining for the quarter. There's always a few ancillary factors here. We have people wanting to move when school's out and get settled before school starts. People don't want to move in the holidays, that kind of stuff. I don't have any big, earth-shattering news to share with you other than we will continue to aggressively pursue talent.

Inside of the tech world, there's a battle for talent. We love our spot in San Antonio, because here in South Texas, we get our pick of the letter. We have expanded our talent pool by opening offices in San Francisco, Atlanta. You look at our data centers, that also provides an expansion in talent pool. We have a great development center right up the road in Austin, Texas. So we will continue to be aggressive on the talent realm. We actually think talent is a place where could create competitive advantage. If you recall, in prior meetings and earnings calls, we've talked about (technical difficulty) the importance of being recognized as a great culture. Our culture enables us to attract incredible talent. We think that advantage is important. The intellectual property in this business is the code we write for our cloud. It's the processes we have to deliver Fanatical Support, and it's the IQ points of Rackers. We will continue to be aggressive. I just can't point to you exactly how it's going to go in terms of how many we will hire per quarter. We've got our targets, and we're aggressive, but we just want to make sure we keep the right quality level and ever increase our talent base.

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

Thanks, Lanham. That's really helpful.

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**Operator**

Rob Sanderson, ABR Investment Strategies.

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**Rob Sanderson** - *ABR Investment Strategies - Analyst*

Thank you. Good afternoon. Thanks for taking my questions. Two questions. First, can you help us think about the public cloud revenue going through Q3 and Q4? Some tailwinds now that you have the initial products launched, but you've still got halfway to go. So there is [some array in] Q2, but still good 12% sequential. So how does that really -- how should we think about linearity Q3 versus Q4? Second question, on open cloud, can you comment on any early response from the Web 2.0, more complex-scale environment, these crowd of people? Do you feel there's a real big opportunity for any competitive displacement wins here going forward? Or is it really more about improving your position for new opportunities in this segment?

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay, good questions. I will start with the second one about the commentary around our competitive position, specifically with open cloud and its attraction to Web 2.0, big, complex workloads, and whether that is all for new opportunities or also some competitive displacement. At this time, I would say there's a little bit of each. In the long run, because cloud is in its early days, I think it's really about new opportunities. We are in the early innings of game one of a seven-game series as technology makes this shift into a cloud world where we consume technology as a service. Therefore, the future revenue is vastly larger than any current revenue taking place in the industry, which means it's really about new opportunity. I'd also tell you, though, because we have had to say no to customers up to this point in that we weren't able to serve all of their needs, I do think there is a competitive displacement opportunity. It's just not as big as all the new stuff we will get in the future. So that's how I would summarize that.

With respect to the linearity question around public cloud revenue for Q3 and Q4, I will let Karl talk about the outlook in general on an annual basis and how we're thinking about things. We have never gotten into the level of detail around trying to break out a segment's growth for one quarter versus another, and we don't want to start doing that today. The context here is that we have a \$1 billion business that is growing at a good rate while we're launching new products. We've got a lot going on here. We're proud of the progress. As your question said, we are halfway through. So we like our chances finishing the rest of this. So Karl, why don't you talk about the annual?

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, let's address how we see the full year evolving here. As you know, we're not giving specific earnings guidance, but we like you to know where we see the year and what we've seen so far. First off, we are pleased with the financial results we have generated year-to-date. We have managed the Company will financially and operationally, and we will continue to do so throughout the year. Second, we launched three critical parts of the next-gen cloud, one of which is Cloud Service, which is at the core of our offering. We are very excited to have this milestone behind us and see it perform in the marketplace.

Further exciting product launches are ahead of us during the second half of the year. Monitoring, Backup, and Block Storage are scheduled to be released during the third quarter, and Cloud Network is scheduled for fourth quarter. Since these products work together, we don't really expect any significant revenue benefits to materialize before the fourth quarter and that at the earliest. Third, from a full-year perspective, we would like to reconfirm our capital expenditure range. At the beginning of the year, we outlined our capital expenditures budget. Within that budget, we expect to spend between \$210 million and \$250 million in customer gear. As you know, we make these investments in customer gear primarily to provide for revenue growth, and with half of the year complete, we expect to be within that range, and more specifically, we think we are going to come in fairly closely to the midpoint of that range.

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

Thanks, Rob. Operator, do you have the next question?

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**Operator**

Jonathan Atkin, RBC Capital Markets.

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**Jonathan Atkin** - RBC Capital Markets - Analyst

I was wondering what drove the rebound in installed base growth during the quarter? And on the capacity side, or I guess on utilization side, the megawatts increased more than usual during the period, and I was wondering what drove that?

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**Lanham Napier** - Rackspace Hosting Inc - CEO

Okay, this is Lanham. I'll start with the IBG question. The IBG formula is a simple one. It's just upgrades minus churn. So if we look quarter-over-quarter here, a couple of things to point out. Number one, churn stayed at a pretty low level, and we are very happy about that. Churn is an indicator of how much our customers enjoy the service that we provide. It's a metric around customer loyalty. We are trying to build a loyalty advantage. Therefore, low levels of churn really matter for our economic model. The other thing that happened here relative to Q1 is that we had a uptick in that upgrades. It was up 0.2% per month, which was is what drove the IBG number growing from 0.7% to 1%. The factor driving this is really our enterprise business. This is where we experienced the highest levels of install base growth in the Company during the second quarter. Now I guess, Karl, you'll do the (multiple speakers)?

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**Karl Pichler** - Rackspace Hosting Inc - CFO

Yes, you have seen in the table that we have added about 9.75 megawatts of capacity from a contractual standpoint. We have extended our partnership with DFT, with DuPont Fabros, who has really been a proven and successful partner for us. We have signed up for another call it 10 megawatts of capacity, where we have two phases. The first commencement date is January 1 of 2013, where about a little bit, half of that, will come online. The second commencement date is the year after, so January 1 of 2014, so we continue to make these -- even in a lease model, we will continue to make these expenses success-based and align it with our capacity needs. The lease terms are -- is a 20-year term, and the total obligations are just under \$300 million.

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**Jonathan Atkin** - RBC Capital Markets - Analyst

And then I was wondering to what extent that you think that there was any kind of a slowdown in demand during the quarter ahead of the OpenStack launch? I think on the prior call you had indicated an expectation that demand might be somewhat volatile. And to what extent did you actually see that volatility?

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**Lanham Napier** - Rackspace Hosting Inc - CEO

I would say that it's hard to know precisely, okay? Really, it would be speculative for me to go a long way down that path. Here's what we do know, sir. We are halfway through the launches, that completing the launches increases our addressable market. We also know that the early feedback we have received on the launches has been overwhelmingly positive. So the hope here, and the belief here, is that we will start to create another level of growth for us and a driver of growth as we complete the platform. That's what we know for sure.

Anytime there's a new launch coming, I think it actually drives a lot of attention to what's happening. If we looked at our metrics around new stories and social media comments, et cetera, about Rackspace during the launches we can see all that stuff go up online. Anybody on the call can go out to TweetDeck and look at what people are saying and see the amount of buzz and energy and passion around the launches. I think the buzz out there just reflects the fact that the marketplace wants a choice. The marketplace wants to be able to pursue an open cloud versus these other closed proprietary technology systems. Our perspective is we will balance the equation to the best of our ability and keep our head down and launch these new products and continue to make money and build the Company the best we can.



**Jonathan Atkin** - RBC Capital Markets - Analyst

Last question is I was wondering over what time frame you are planning to migrate the legacy cloud deployments over to OpenStack?

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**Lanham Napier** - Rackspace Hosting Inc - CEO

That is still a to-be-determined for us. There are a couple of different constraints that we think about here. The first objective anytime we think about a migration is maximizing the customer outcome. How do we do a migration in a way that minimizes customer impact and maximizes their ability to utilize all the new capability? So that's one factor.

Another factor is doing that on a time frame that customers enjoy and appreciate, as opposed to dramatically interrupting their planning cycles and lives. Given that we have a stable legacy platform and a new platform and series of products that we are launching, we will balance that out over time. You will see us pursue this with rigor, but you won't see us rush. We've got the benefit of time here to be able to do it well and do it in a way that generates customer loyalty as opposed to customer interruptions. It will be something that plays out here over quarters. It's not going to be something that we try to knock out over 60 days or anything like that.

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**Jonathan Atkin** - RBC Capital Markets - Analyst

Makes sense. Thank you.

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**Operator**

Simon Flannery, Morgan Stanley.

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**Simon Flannery** - Morgan Stanley - Analyst

Thank you very much. Good evening. You talked about needing to publish performance metrics to get customers comfortable with OpenStack. Can you give us some sense of when you think you will have sufficient performance stats to really start having those strong dialogues and get people making purchase decisions? And then, Karl, there is obviously a great deal of software development going on, a lot of heavy lifting right now. If we think past the deployment of the major OpenStack offerings, is there an opportunity in 2013 for slower growth in software development or some OpEx categories? Is there any pig through the python right now this year related to this transition that maybe will give you some tailwind next year? Thanks.

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**Lanham Napier** - Rackspace Hosting Inc - CEO

Okay, great questions. I'll handle the first one and then Karl, the second. With respect to performance metrics and publishing that data around new product [launches], it really speaks to the segmentation in the business. When thinking about different customer groups, customers that are entrepreneurial, risk-seeking, and looking for a quick edge, which in our Company, tends to skew toward our SMB business. These are the early adopters. And they're jumping on the new stuff and not worried about performance criteria. They aren't worried about those statistics. They're looking for an edge and they have the risk profile, and competitive profile, that they are just going for it.

The place where performance data are more relevant is our enterprise business. These are customers that have rigorous SLA demands that we report on today in depth. They are the ones that are going to want to see more data before making all of their decisions. I suspect the adoption cycle will happen something like this. They will start trying it. They will gather the data. And when they are happy with it, they will put it all in production. We see some of this already taking place in conversations. I think more of it will play out here over the rest of the year. Then to put a



[crisp branch] around the timing of that, once we roll everything, because we generate so much data on the new platform, the new set of products are its own big data opportunity.

The data builds up real fast. So we will be able to show people definitively here's what SLAs look like on the API. Here's how many calls it can handle simultaneously. Here are the scaling requirements, et cetera. I think it's really about capturing a lot of that. What we can tell you so far,, with the products we've launched, all those metrics and performance data are very compelling and significantly better than what we had on the legacy platform. We are at a spot today where we can launch servers many multiple times faster. When you look at the API performance, the Control Panel performance, we have done a much better job on this. That's really a credit to the OpenStack community, because we are building on top of that technology. I think you'll see us build the data here pretty quickly, Simon. It's certainly a this-year type thing.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Great. Thank you. And on the OpEx, or the software cost?

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, sure. Hi, Simon. Right now, basically the way that we think about product, that's really our main investment area. If you think about it both from OpEx and a CapEx perspective, obviously depending on the work that they specifically perform, it's going to get categorized as one or the other. We have -- as Lanham said, we are pursuing aggressively opportunities to attract this talent, and we are very willing to invest in those areas and continue to grow that cost line, if you want. But it is a key investment that we are going to pursue, certainly this year. What -- the longer-term leverage will come really from two areas. At one point, we will have development muscle that is capable of delivering the product in a continuing manner, the way that we wanted. And then we also can leverage -- because the OpenStack platform is supported by a big community outside of Rackspace, we basically have leverage opportunities from both ends on our side and from the community.

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**Simon Flannery** - *Morgan Stanley - Analyst*

Great. Thank you.

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**Operator**

Jonathan Schildkraut, Evercore Partners.

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Great. Thanks for taking the questions. I actually have a few. The first question, and I guess this is a build-up of Jonathan's earlier question, is a quarter ago, you expressed some concern on the multi-tenant cloud growth in front of the transition. Maybe now with the quarter behind you, you can you give us some retrospective on how that played out against your expectations? And then I guess as a second part of that question, at the beginning of the year, the Company laid out some fairly ambitious goals, including growth in line with last year and potentially a similar margin profile. And I'm just wondering where we are tracking versus those initial expectations? And then I have a follow-up. Thanks.

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay, on the discussion about the cloud growth and how it's played out and what we are thinking today, I guess looking in the rear-view mirror versus what we may have been thinking three or six months ago, here's how I would summarize it. The launches that we have had here have, I would say, gone every bit as well as we would've hoped. The technology, we were conservative with respect to keeping the technology in beta

until we were really comfortable. We've launched it. That technology is in production. It's being hit with heavy usage, and it's standing up and performing well. I would say from a launch technology point of view, it has gone every bit as well as we would've hoped up to this point.

In terms of building up on what did we think three months ago versus what do we think today, I guess another way to think of that is say what have we learned over the past three months to six months. So here's some of the stuff we've learned. The investments we have made in this technology, and we have referenced this in our prepared remarks, literally are the biggest software investments we have made in our Company's history. It was a bet that we started in 2010 when the work was choppy. We said we were going to go for it with this community. We were going to fund it. We were going to invest in this code and make it work. I think one thing we learned is that having a clear sense of vision around what we are building matters.

The other thing we learned is that it's complicated technology, which is why it's taken us as long as it's taken us. When we first embarked on it, we thought it would go faster than it has. While it's taken longer than we wanted to get here, I am super happy to get here. I think that we will continue to operate the legacy platform. It's performing well. The customer feedback remains very consistent. It just doesn't have all the capability of the new one. So we feel -- so we really like our future, I guess is how I'd put it. It's taken us a while to get here. It's been a lot of work. We still have some important work ahead of us, but we are really confident about hitting those dates and releasing the products and such. On the annual question, I would just echo what Karl said a few minutes ago. And I think Karl affirmed the CapEx and commented on where we think -- how we see things going for the rest of the year. I'd just add onto it at the end. We are proud of what we are building here, and we are proud of the progress we've made so far.

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Great. So expectations haven't changed. In terms of -- there were a couple of questions I had for Karl. Karl, I was under the impression that there were some new leases that went live in the third quarter. And I was wondering if that was correct, and if there were any other seasonal costs we might think about as we project next quarter? And then it appears that there was another quarter of really impressive gains on the capital-efficiency side as it applies to revenue growth relative to customer gear. And I was wondering if that was just an issue of timing or if there was some underlying drivers that we could think about? Thanks.

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Nothing went live during the second quarter. And I said before, the first commencement date is January 1, 2013 for the next 10 megawatts. There will be a small portion of the facility being made available to us to basically get it prepped up for -- with respect to networking access and basically to get us ready to make it operational. There's not going to be any cost impact on that for the year. And then the second question was with respect to CapEx, you said, right?

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**Jonathan Schildkraut** - *Evercore Partners - Analyst*

Capital efficiency, actually.

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**Karl Pichler** - *Rackspace Hosting Inc - CFO*

Yes, capital efficiency. Overall, if you look at our turns, which our all-encompassing capital-efficiency number, we are pretty much flat relative to Q1. Generally, we want to drive this up, right? So we a couple of things going on. You mentioned timing. Timing has a lot of impact on how this actually goes. We had certain periods when we built up some capacity and then used it again, excess capacity, that is. In the current period, we have -- we are building for the launches for the new products. We have multiple locations that launch the same product, and there's a build up there a little bit. Then in later periods, it's used again. I think this is something that we continuously work on as a business. And we certainly expect to make continuous improvements, but they are not going to be any sea changes where you have significant step-ups anytime soon.



**Jonathan Schildkraut** - *Evercore Partners - Analyst*

All right. Thank you so much for taking the questions.

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**Operator**

Frank Louthan, Raymond James.

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**Frank Louthan** - *Raymond James & Associates - Analyst*

Okay, thank you. Can you comment a little bit on some of the overseas expansion and what's going on in the UK, any other markets outside the US that you are looking at growing in the next few years?

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Sure. Our business today, we have a European presence and an Asia-Pac presence. When we look at our growth opportunities, today we really like Asia-Pac. Now, Asia-Pac is a big word. There's a -- you fly around that place on 747s and 777s. Our perspective there is that it's a great demographic for cloud services. Those economies are strong. We have made investments increasing our -- the investment rate there over the past couple of years. That's an area that's attractive to us. So I think it's fair to say we will probably keep doing that. When you look at Europe, our business in Europe is really clustered -- or clustered is the wrong word -- concentrated in the UK. We have our largest presence in Europe in the UK. (technical difficulty) that cause all of us to scratch our heads and wonder what's going to happen to the euro (technical difficulty) and all that stuff.

I would say right now is that we don't have anything new to share publicly about what's going on in our UK business. I was in Europe just a few weeks ago. And I would tell you our business over there up to this point is performing real well, and we are proud of the work we're doing. I do think that OpenStack presents an opportunity for us to expand geographically at a high rate as that community grows more from an international perspective. Given that we are a leader in that technology and we have as much or more expertise in that technology than anybody else on the planet right now, we do feel an international pull as that technology becomes more of a market standard and [more] successful in the marketplace in general.

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**Frank Louthan** - *Raymond James & Associates - Analyst*

Okay, great. Thank you.

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**Operator**

That was all the time we had for questions. I'll turn it back over to our speakers for any closing or additional remarks.

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**Lanham Napier** - *Rackspace Hosting Inc - CEO*

Okay. Thanks to everybody for tuning in to the call. We appreciate your interest in our Company. I especially want to thank our customers that place their trust in us [on] their mission-critical workload. And I want to thank Rackers, who are doing incredible work, rallying to the open cloud and making this platform a reality. We look forward to updating you on our progress here in November. Take care.

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