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RAX - Q1 2012 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting's Q1 2012 earnings conference. As a reminder, this call is being recorded. At this time, all lines are in a listen-only mode to prevent any background noise. After the prepared remarks, there will be a question-and-answer session. (Operator Instructions). It is now my pleasure to introduce Jason Luce, Vice President of Finance for Rackspace. Mr. Luce, please go ahead.

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

Good afternoon. Thank you for joining Rackspace's first-quarter 2012 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 first quarter of 2012. If you do not have a copy, please visit the investors section of our website at Rackspace.com, where this call is also being webcast.

The primary purpose of today's call is too discuss the first quarter of 2012 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 from 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, 2011 and filed with the SEC on February 17, 2012, and in Rackspace Hosting's Form 10-Q for the quarter ended March 31, 2011, expected to be filed 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, 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 our prepared remarks today, we will open the call for your questions. Okay, Lanham?

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

Good afternoon, and thank you for joining us today. In February, we explained that 2012 will be an exceptionally important year for Rackspace. We are making huge investments across the Company to strengthen our competitive position in the market, solidify our position as the service leader in the cloud, and seize the massive opportunity that the cloud computing market provides us. This shift towards cloud computing represents a massive multi billion-dollar revenue opportunity that Rackspace has only just begun to tap. While we think the market has generally warmed to this view, we do not think the market fully appreciates the blistering pace of new innovation that is taking place, much less the scope of the disruption that these new technologies are bringing to the IT landscape in general, including the incumbent vendors and large IT customers.

We get a glance of the pace of new innovation every time we use one of many cutting edge application like Evernote, Dropbox, TripIt, or Facebook, but from the perspective of the end-user, applications represent the proverbial tip of the iceberg, absent from sight are the underlying infrastructure components that support user-facing applications. Virtually all of these systems are being revolutionized by new innovations in technology, including the way servers power applications, the way data are stored and backed up, the way networks connect devices and distribute data, and the way that data centers house all of these systems. These changes but pressure on legacy system vendors, and on the IT departments of companies large and small, as they struggle to keep up with the pace of change, and the complexity of providing and supporting cloud computing services. For many companies, major technology changes like these are daunting, because they bring with them the risk of disrupting business. But for Rackspace, rapid change and complexity represents an opportunity, a chance to make cloud computing simple and affordable for companies of all sizes to use.

Just as the introduction of the personal computer led to unimaginable new creations, and indeed entirely new industries, we believe the tectonic shift toward cloud computing will have equally vast and unimaginable implications on all of our lives, the US economy, the world. While we believe this trend will take multiple decades to play out, the implications for Rackspace right now are clear. The world is rapidly shifting to cloud computing architectures, and we need to be the trusted service provider to enable the transition.

This is why we have laid out such ambitious goals for the year. We are increasing investments across the Company to bolster our systems, products, and service capabilities, in order to help our customers make the transition to the cloud. The product development work we are working doing is all about delivering fanatical support across a portfolio of dedicated and public cloud products, that enable large high-performance workloads to run in our cloud. This year, our most essential development plans revolve around the open-source platform, OpenStack. OpenStack will be the key technology that will power new products, in higher service levels than our next-generation cloud platform, and we believe OpenStack will be the foundation to support a much bigger and better business.

If you analyze the cloud computing market in its current stage, a large portion of the growth is coming from new large-scale applications like Xynga, Pinterest, Netflix, or Instagram. These applications pull across large amounts of cloud infrastructure, and as we mentioned in our last call, we need to complete the transition to our next-generation cloud to compete for these opportunities. An important element of our investment in OpenStack and our next-generation cloud is to meet the needs of these large-scale applications, and increase our service levels in the marketplace. This is why we are moving rapidly to fully complete the transition of our cloud products to the OpenStack platform, and with our recent announcements at the OpenStack Summit, we have begun the transition phase to our next-generation cloud. We believe that once OpenStack is fully-deployed, it will tremendously improve the technical capabilities of our products, give us the ability to run large-scale apps, and bring fanatical support to the fastest-growing sector of the cloud computing market. Completing this transition is the number one product development milestone in 2012. The sooner we fully deploy OpenStack, the sooner we can serve large applications.

Let me review some of the progress we've already made in the year. Three weeks ago, at the OpenStack Design Summit, we announced the release of the following seven next-generation public cloud products. Number one. Cloud Servers powered by OpenStack. This new offering combined the on-demand scalability of modern cloud infrastructure, with the benefits of open source technology, which is based on the latest OpenStack compute release. Chief among those benefits is portability of workloads across vendors. By using open source technology, customers can eliminate the risk that they might get locked into a vendor who's unable to raise prices at will, cut back on support and features, and impede innovation.

Number two. Cloud database is powered by OpenStack. This product is based on familiar database architectures like MySQL. This is important because it is familiar technology and works with existing applications. This product uses container-based virtualization to deliver performance, comparable to databases on dedicated hardware. Rackspace automates many database administration functions like configuring, deploying, and patching the database server, and we have connected the product to our SAN array to provide built-in data replication, and ultimately higher uptime for applications running on the database.

Number three. A completely new control panel that provides a graphical user interface to our club that operates with a similar look and feel to modern consumer web applications. We built our new portal to be fast, familiar, and easy to use for our customers. This is one example of what we're doing to make cloud computing simple for companies of all sizes to use. Cloud networks powered by OpenStack is number four. This new offering is an example of one of the revolutionary new innovation trends that I touched on earlier, software defined networks. Our other cloud products, cloud networks abstract the underlying infrastructure complexity, in order to make it simple for our customers to build large, complex networks with our new control panel, or through the OpenStack APIs. Previously, this was published with a team of network engineers, upfront capital investment, and hours of upfront labor and maintenance.

Number five. Cloud block storage powered by OpenStack. This new solution improves the range of storage capabilities that we offer by giving customers a choice between high-performance storage using solid-state drives, or a standard lower-cost spinning disk arrays. Like cloud networks, cloud block storage makes it easy for our customers to build, deploy, and consume storage technology. Number six. Cloud monitoring. This new product is a distributed monitoring engine that provides customers the ability to fully monitor the performance and uptime of their cloud applications. The API makes it powerful, and a control panel makes it simple to use.

Number seven. We launched cloud backup, our next-generation server backup solution. Cloud backup combines the capabilities of scale and economics of cloud storage with the easy to use features of our Jungle Disk offering. We are currently in the final stages of testing and development on these products, and anticipate opening them up for wide scale usage in the third quarter. Today we offer limited availability on the Cloud service offering and control panel, and the remaining products are available only through our early access program. We are really pleased about the feedback and performance attributes of our next-generation cloud. These new services expand our service capability in the cloud, and once we are through the transition period, our next-generation cloud should be the largest OpenStack environment in the world. And of course, all of these capabilities are backed by our unmatched culture of customer service, known throughout the industry as fanatical support.

While fully deploying OpenStack internally is a important milestone, as cofounders of the project, we are also very interested in driving wide scale adoption of the technology. In April, we organized the third OpenStack Design Summit. Over 1,000 participants attended the conference, and the event was highlighted when both IBM and Red Hat announced their membership in the OpenStack foundation. At last count, there are 168 companies involved in the OpenStack community, which compares to just 60 companies at this time last y ear. We are very pleased by the strong partnership traction that the OpenStack movement has experienced, and we are now focusing our efforts on what we believe is the key to the next phase of adoption, large scale deployments. Referenceable deployments like Mercado Libre and eBay's X.Commerce Marketplace applications help demonstrate that the OpenStack technology is tested, mature and ready for production.

Shifting gear's a little bit away from product development, we significantly doubled down on our SharePoint franchise in the quarter, with the acquisition of privately-held SharePoint 911. As you may be aware, we have a strong and growing business running SharePoint environments for our customers. What you may not know is that SharePoint has been a great entry point, through which we are gaining more enterprise business. Also, our SharePoint customers tend to be more loyal, and faster-growing than our typical customer. SharePoint 911 is the recognized thought leader about all aspects of SharePoint, ranging from architectural design to customer deployment to user adoption. The Company literally wrote the book on SharePoint. In fact, it has published 10 books on the subject. This acquisition will add valuable domain expertise to our support organization, as well as 16 dedicated professionals to our army of Rackers. So welcome aboard, SharePoint 911. We are excited to dominate the SharePoint world with you.

While we have made a lot of progress so far in 2012, we have much more to do. We are executing through a very important platform shift to our next-generation cloud and we need to make this a great experience for our customers. As we complete this platform shift, it is important we improve the consistency and capability of the service levels we deliver to our customers, across the different architecture options that we offer. Delivering incredible customer outcomes on these technologies requires integrating world-class technology systems with fanatical Rackers that are passionate about serving our customers. We have proven this platform with specific design principles in mind to generate world-class customer outcomes. We believe the experience we provide on this new platform is superior to what we've done in the past, and will reinforce our differentiation in the market. Our next-generation cloud is a very strategic and exciting investment for us. If the largest software investing we've ever made, and it's a long-term bet for our Company. Navigating through this platform shift is our number-one focus.

A platform shift like this could introduce some short-term product cycle volatility, as we move to the next-generation platform. We will continue to keep our eye on the long-term products during this transition and focus our efforts on remaining the service leader in cloud computing. As we said back in February, 2012 will be a year of execution for Rackspace. Throughout the year, we will be focused on improving our capabilities, while laying the foundation to scale to a multi-billion dollar business and improved capital efficiency. The technology industry is in the midst of a tectonic architectural shift. Massive technology disruptions like this create once in a lifetime opportunities for companies to seize the moment, take the initiative, and lead the revolution. Our goal is too lead the revolution. I'll now hand this call off to Karl to review our financial results. Karl?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Lanham. At the beginning of the year, we outlined our plan for 2012, which is to essentially run the same play we executed in 2011 and 2010. During the year, we will continue broadening our products and services portfolio, while maintaining our disciplined allocation of resources and capital along the way. With the first quarter of the year completed, we believe we have made good progress toward our operational and financial goals.

Let me review the detailed financial results. For the first quarter, total revenue was $301 million, representing 6.4% growth from the fourth quarter, and 31% growth compared to the first quarter of 2011. Exchange rates had a negative impact on revenue of approximately $600,000, compared to the fourth quarter of 2011 with a negative impact of $2 million compared to the first quarter of 2011. On a constant currency basis, revenue grew 6.6% sequentially, and 31.9% year-over-year. Consolidated growth was 0.7% in the quarter, which compares to 1.2% in the prior quarter, 0.9% in the first quarter of 2011, and an average of 1% per month for all of 2011. We are pleased that churn remains at historically low levels. Dedicated cloud revenue increased to $237 million, representing 5.2% sequential growth and 23% growth on a year-over-year basis. Public cloud revenue for the quarter was $65 million, representing 10.8% sequential growth and 75% growth on a year-over-year basis. Overall, we added more than 8,000 customers in the quarter, running our total count to more than 180,000.

Moving on to profitability. Adjusted EBITDA came to $101 million in the first quarter, representing a 1.4% decline from the fourth quarter, and an increase of 33% on a year-over-year basis. Adjusted EBITDA margin was at 33.4% in the first quarter, down from 36.1% in the prior quarter, and up from 33% in the first quarter of 2011. Depreciation and amortization expense came to $55 million in the quarter, representing approximately 18.3% of revenue, which is slightly below the 19% to 20% range that it has tracked since the beginning of 2009. Net income came to $23 million in the first quarter. This represented a decline of 7.4% from the prior quarter and growth of 68% from the first quarter of 2011. As we indicated during our fourth-quarter earnings call, Q4 margins were exceptionally strong because of several factors that we did not expect to recur in the first quarter. Our profitability margins tend to fluctuate from quarter-to-quarter because of a variety of factors, intruding revenue growth, hiree performance, and resource pricing. This is normal for our business, and we expect margins to continue fluctuating on a short-term basis.

Moving on to capital expenditures and returns. Capital expenditures totaled $82 million. Of this amount, we spent $53 million on customer gear, $9 million on data center build outs, $5 million on our consolidated headquarters facility, and $15 million on capitalized software development and other projects. For the full year of 2012, we continue to forecast between $335 million and $405 million in total capital expenditures. As in prior periods, we expect the bulk of capital expenditures to be in customer gear, which is predominantly success-based spending to support revenue growth. Specifically, we expect to spend $210 million to $250 million in customer gear, $25 million to $35 million for data center build outs, $25 million to $35 million for our headquarters facility, and $75 million to $85 million on software development to implement systems, products, and service portfolio enhancements that we discussed earlier.

Our Q1 capital expenditures are in line with the expectations we shared with you at the beginning of the year, and our organic growth plans. Return on capital came to 15% in the first quarter, compared to 17.2% in the prior quarter and 11.9% in the first quarter of 2011. Average monthly revenue per server grew for the 11th consecutive quarter to $1,238 from $1,191 in the prior quarter. We ended the first year with a total cash balance of $187 million, our total debts outstanding, including capital leases was $144 million, which translates to a net cash position of approximately $43 million. In summary, we've made good progress toward achieving our objectives for the year. We have three quarters more to go, and we look forward to updating our progress in 90 days. This concludes our prepared remarks. We are now ready to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions). We'll go first to Chris Larsen with Piper Jaffray.

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

I guess the first question I'd like to talk a little bit about maybe -- you had a big jump in Rackers this quarter. I know you talked, Lanham, in the fourth quarter about the difficulty getting good Rackers in the third quarter. Maybe just a little bit about why you did add so many Rackers this quarter and what the expectations were there? Looks like perhaps a lot of the incremental expenses were from the higher headcount plus about a $700,000 increase in non-cash rent. That's my first question. Thanks.

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

Okay. Okay, Chris. Yes, when we entered this year, we had our eye on acquiring certain types of talent. Specifically within our investment framework, we look at the hiring of Rackers and the investment we make in human capital to be the largest investment here in the Company. When we make these investments, we are very focused on getting incredible talent, and talent that shares our values and fits our culture. Because it's one thing to have a great Python programmer, it's another thing to find a great Python programmer that actually wants to volunteer their best to deliver fanatical support. So when they go through our hiring process, we're trying to find both of those. We're trying to get both of those categories checked off in our box.

So if you look at what happened in the first quarter, we're pretty proud of the fact that we were able to hire what we believe are some exceptionally talented folks in a good quantity. And admittedly, and we do this, it does front-load our costs a bit. So if you look at the number of hires in Q4 of 2011 versus the number of hires in Q1 2012, we certainly increased our hiring in the first quarter of this year. We felt like that was a really good opportunistic investment that we made, and that we will get the return in benefits of those investments here throughout the rest of the year. So we expanded our operations here in the US, as well as internationally, specifically in some of our offices like San Francisco, as we were making investment in software developers.

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

Great. And then just a second follow-up if I may. Looked like installed base growth slowed a little bit from the fourth quarter, still above the average for the last several quarters. But anything to read into that?

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

Sure. Why don't we just talk generally about IBG and then I'll take you down into some additional details. So if you look at our average for install base growth in 2011, it was about 1%. So in the first quarter of this year, we turned in 0.7%, which was lower than the average for last year. So let's get into these details. Primarily, if you look at the breakdown here, you can see in our key metrics that churn remained very healthy at 0.8% per month. That's actually a little bit lower than what we averaged last year.

So the difference here in the IBG number isn't a churn issue, it's in a net upgrades issue. So if you recall how we do the math on this, it's basically our comp sales ratio, which is the growth out of existing customers that have been online with us, and what we calculate is the amount of new service they consume, minus any services that we lose from them. So when you look at this net upgrades number, what happened there is the difference in this quarter was based on some enterprise customer project downgrades. These were projects that they signed up for us, with us, on a short-term basis. A new that they were only going to be here for a limited period of time, and then we had a few of them spin offline here in the first quarter. So if you remember a lot of the value and running applications with us is that customers can spin workloads up and down, and just pay for what they use.

So when enterprises can trust us to run their applications like this and meet their variable computing needs, with a truly on-demand solution, we are a great fit for them. So being able to turn things on and turn applications off is part of the attraction to the cloud. I think as we have more success with our enterprise customers, in that enterprise segment, we can expect for this to continue going forward. In past calls, we've talked about how this is a metric I will take one step forward and one step back. So we think were doing great work for these customers. We think there's some variability in it, some of that variability showed up in this past quarter, but we also expect our enterprise customers to continue to be a fast-growing part of our revenue mix, because we are doing great work for them.

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

That's very helpful. Thank you, Lanham.

Operator

We'll go next to James Breen with William Blair.

James Breen - *William Blair & Company - Analyst*

Can you talk about how you think about EBITDA margins going forward? Even though it was down from the fourth quarter, it was up from the third quarter. Do you expect that to continue to increase throughout the year and you'll see the same progression, similar to last year with the spending overall?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. That's Karl speaking here. We're actually quite pleased with our margins result for the first quarter. I want to reiterate a couple of things we said on the first quarter and in prior calls. First, we do see a decline relative to Q4, but as we said in the prior call, the Q4 results were extraordinarily high, as margins were not expected to remain at those levels for various reasons that we laid out back then. Second, our first quarter has traditionally been front-loaded with costs. As you look back over our history, you can see that. The main driver for that is our sales and marketing muscle that we usually increase in the first two quarters, but primarily in the first quarter. You see that here as well. It's almost a percentage point increase in our sales and marketing costs relative to revenue relative to Q4. So that front loading of sales and marketing activities is basically what puts pressure on Q1 and possibly Q2.

Third, the results of Q1 are perfectly in line with our targets of delivering a similar margin profile for the full year 2011. That was our stated goal. And also if you look at our investor presentation, we are exactly in those ranges that we aim for. And last, as you mentioned that before, if you look at our long history, you will notice that actually Q1 was a very good profit quarter. Pretty much the second best ever depending on which profit margin you look like. So we're basically in line with our stated goals and in line with our range and expect that to kind of last going forward.

James Breen - *William Blair & Company - Analyst*

And just a follow-up to that, I know you're going to beat launching the block storage products. Are there additional costs that we will see in the first half of this year associated with that? And do you expect it to have an impact on your install base growth as we look throughout this year?

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

Okay. So let's talk a little bit about this transition to the next-gen platform. Based on the timing of the Summit, the products that we announced at the Summit here a few weeks ago, in terms of having real revenue traction and impacts on our growth rates, personally my belief is that the products we're launching into the next-gen platform, we won't really see in our numbers until the back half of the year, and more specifically I would say in Q4. Between here and there, we have a lot of transition work to do. We have opened these products up to different degrees to customers. The feedback has been fantastic so far. There's just a whole lot of work there to do, to get that all the way across the line. We are very focused on doing this properly, because we only get one chance to make a first impression on this next-gen platform. So while the feedback is positive today, we want to make it even better before we open it up on a broader basis.

This platform gives us a much greater capability to run these larger-scale apps, which we have referenced in our prepared remarks. So up to this point in time, with the transition, we are thrilled with where we are. We wish we were further ahead of where we are timeline wise, and we wanted this to go faster, but we've acted prudently here to make sure that we do it really well, and take great care of our customers. In terms of introducing incremental costs and such, any time we're running two platforms, the cost there is actually not a financial one, as much as it is one on Rackers. Its just harder to one two platforms at once than it is to run one platform by itself. We've been doing this for quite a while, so from a financial point of view, you're already seeing that in our numbers today. I think from an investment point of view, we've made really good investments around this. We're confident in our ability to pull it off, and we've got customer feedback already on it.

James Breen - *William Blair & Company - Analyst*

And lastly, just on the install base growth, can you talk about or give color around the customer segments in terms of the install base gross change in the small-medium versus the enterprise space?

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

No, generally, nothing has changed that's noteworthy. And the prior question about IBG, I referenced enterprise project downgrades. That's the one thing that I think is reflective of what happened in the quarter, that provides investors a greater level of context around what happened. But in terms of everything else in the Company, I would say it's very similar to the last time that we talked.

James Breen - *William Blair & Company - Analyst*

Thanks.

Operator

We'll go next to Gray Powell with Wells Fargo.

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

I just have a few here. So was there any impact on cloud revenue growth related to the pending migration to OpenStack? And once you get the new platform launched, would you expect cloud revenue growth to accelerate?

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

So a couple of questions there. On the first one, in terms of what's the impact on revenue today based on this transition, and then the second one being, once we get through the transition, what we think will happen with revenue growth going forward? So let's just deal with today and then we will get to the future. In terms of impact today, any time we are going through transition, yes, I think it introduces some volatility into the results.

We have referenced that in our prepared remarks. And the reason why, I think its like any other technology product cycle, that when we have new product cycles taking place, there's volatility around that. And so right now, we are doing everything we can to prudently migrate customers and get them to the new platform and get the new platform ready, because we think the new platform is going to generate incredible customer outcomes.

So I think when there's this much discussion about a new platform, there's naturally more interest in a new platform and we just have to manage that prudently and effectively. Our belief, after we get the new platform completely in place, and we're migrating people over to it and we're signing new customers up to it, as everyday course of business, our belief here is that new platform has greater capability to run larger and more complex apps on it than our current platform does. So we like our chances in terms of being able to serve bigger customers better, to increase their loyalty rates, and correspondingly grow faster.

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

Got it. That's helpful. And just to follow-up on the prior question, you mentioned enterprise project rollouts impacting the net upgrade number. Should we expect anything else in the next six months?

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

Well, we've never gotten that specific with people. I think generally what's happening in our business is that part of the reason enterprise customers select us is because we can run different environments for different discrete workloads, and then based on the use cases of those workloads, we can spin up resources and spin down resources pretty efficiently and effectively for them. Part of what happens in the first quarter is that you have an increasing set of resources on a seasonal basis for Internet retailers for Q4. So what naturally happens in Q1 is some of those things come off. Other things that happened in Q1 is that we had some specific projects with customers wind down, these projects were online for multiple months.

We knew about the timing there, so we just helped them migrate that down. So I think that basically when you look across things, with our IBG growth and net upgrades and churn, et cetera, we're pretty pleased with the way the churn came in. It's basically flat to slightly down to where it was a year ago. We knew about some of the variability that happened in Q1. If you look at Q4, Q4 was extra-large on some of these things. So any time have an extra-large Q4, it's slightly from a seasonality perspective that you'll feel a little bit more of that in Q1. And then we also had some of these projects come off-line.

So in the long-term, if we look at our IBG growth, for 2011, we were able to get it back to 1% per month. We are pleased with that result. Prior to the recession, we were north of that, we were 1.5% as a high water mark. We want to believe that when things get back to normal economic conditions, and we have got our product road map complete, that we have that type of upside in us. Again, right now, we're going through macro conditions that aren't as strong as they were a couple of years ago, okay? So we're going to continue to keep our head down and serve our customers well.

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

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

Operator

We'll go next to Colby Synesael with Cowen.

Colby Synesael - *Cowen and Company - Analyst*

I apologize to keep going back to the headcount, but I just want to make sure I understand potential impact in the second quarter. So if we look back last quarter, we talked about how the headcount ramp in the fourth quarter would had a negative impact on the first-quarter margins, and obviously we saw that. In the first quarter, I think you added the largest number quarter-over-quarter that we've seen, at least in a long time. And I'm curious if that's going to have another impact -- a meaningful reduction in margins going into the second quarter on a sequential basis? And then the second question, just a little bit more strategic and broad based, but we're learning more about big data. And I'm wondering if you can talk about what Rackspace's big data strategy is. I feel like there's part of the Cloudkick acquisition which may have actually gotten you more involved in that, and if that is actually going to lead you to a material potential impact on revenues. Thanks.

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

Okay. So a couple of questions there. Let's deal with headcount first and then will get into big data. On the headcount, the way we think about it is really within our investment framework. When we run the business and set forth our plans each year, we have a minimum and a maximum. The minimum is an internal commitment that is honored, no matter what. If it started snowing here in San Antonio, if it doesn't rain again a day in San Antonio, we're going to honor this minimum commitment in terms of growth and profitability. And the maximum threshold on our internal range is really around not growing faster than that maximum threshold, because we don't want to create a situation where we collapse under our own weight and create horrible customer outcomes.

So when you look at our headcount additions here in the first quarter, pardon me for a second, you look at our headcount additions in the first quarter, this was within our range. So when we look at our human capital planning, we are focused on getting the right talents into the right roles that share our values so that we can grow the business and provide fanatical support to customers. If you review our numbers over the past couple of years, we tend to have more luck hiring Rackers at the beginning of the year then we do the second half of the year. For whatever reason, people don't like to move in the fourth quarter because of the holidays. People like to get their moves done by the summer time before school starts again in the third quarter. So we tend to focus more of our hiring activity in the first half of the year because it tends to work out better for us.

So you see some of that in these numbers already, if you look at our metrics. In terms of short-term margin impacts, for Q2 and other ongoing periods, what I would say, if you look back at our numbers over time, when we do this planning range from minimum to max, consistent with what Karl said a few minutes ago, we believe we're on track and the middle of that profile today, is consistent with the IR ranges that we've published as well as our internal ranges here around a minimum and maximum performance with respect to growth and profitability. So as we sit here today, based on the investments we know about, the investments we see close, this OpenStack next-gen cloud, which we're really pumped up about, we think we're right in the middle of our range and feel good about where we sit.

Okay. So that's question one. Now let's deal with big data. Okay. So big data is an exciting topic around here. The first thing that we are doing with respect to big data is getting our next-gen cloud platform in place. Because anytime we have a big data opportunity, whether it's internal in terms of some of the data we're crunching around here or running it as a service for customers, ultimately it's about doing it on top of the right platform.

In terms of getting what technologies are we going to use, how are we going to sell this to the marketplace, in the long run, we think about the big data, it really is about the of delivering this capability as a service just like compute or network or other services that we outlined in our prepared remarks, that we're launching on our next generation cloud. We run big data systems here internally, so when you think about our company and the sheer amount of data we generate through our monitoring system, which you reference in your question, the acquisition of Cloudkick, we are in the big data business. And we track a lot of things, and we have to extrapolate from events. So we are crunching that already. So based on the fact that we are doing that for ourselves internally, we think a lot about how should we do that externally for customers.

In terms of the material or important revenue impact, I don't think you'll see an important revenue impact on an explicit big data service from us anytime soon, because right now we are more focused on getting our next-gen cloud platform in place, and being able to roll that out and do great work for customers. And I think after we get that in place, some of our internal capabilities that we already consume, and our big data needs, we will start to share with customers externally.

Colby Synesael - *Cowen and Company - Analyst*

Great. That's very helpful. Thank you.

Operator

We'll hear next from Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you very much. So if I can get into the revenue breakdown a little bit more, the dedicated cloud was about 65% of the growth versus 58% last quarter. Is that due to the enterprise customers stepping down on the public cloud side? And perhaps you can give a little bit more color around the mix of demand between enterprise and SMB? Is there any big change in where your new customer growth is coming from? Either by customer size or industry type? And any comments on the use of cash? Have you thought about any other acquisitions or any other use of the cash? Thanks.

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

Okay. I'll try to do that in reverse order. So use of the cash. We have not though about any additional novel uses of the cash. We did generate free cash again this quarter, so were proud of hat, Simon. I think at this point we still feel like we have a lot of growth ahead of us, and so our primary use of cash is too reinvest it in the business consistent with our investment frameworks. So that's the cash question.

The second question about customer mix, with enterprise versus SMB, I don't think there has been anything that's materially different here in the last 90 days versus the prior six months or anything with respect to that customer mix. We continue to experience pretty high levels of growth. I mean, rapid growth within our enterprise customer segment. I think this is really a function of a couple of things. Number one, enterprise customers tend to have big IT spending capability. They just have large IT budgets, and once we win their trust, we are able to accelerate our growth with them quite rapidly and they just have lots of dollars to invest, and we can be a great partner for them. So I think that enterprise growth rate considers to accelerate. When we look into the SMB customer segment here and the SMB customers that we're serving, I would say it tends to be pretty consistent with what we talked about on the last call and calls prior to that. More specifically, that we've had higher growth in enterprise customer segments than we have SMB customer segments. That has continued into this year.

We would just add the SMB customer segment today versus two years ago, it's stronger today. It's just not back to where it was prior to the recession. We still view the SMB customer segment as a growth opportunity for us. It is growing for us, and we expect that to continue. We do think that the next-gen cloud platform within that customer SMB, SMB customer segment is going to help us and expand the growth opportunity there. Okay.

Then in terms of revenue breakdown, you're looking at our metrics where we talked about dedicated revenue and cloud revenue and talked about the mix and what's changed there a little bit. So in this set of metrics, we're trying to convey to investors different form factors. A dedicated compute form factor or a cloud/shared or pooled compute form factor. So we have had some changes in that our pooled/cloud compute factor has been growing rapidly as you referenced in your question. We expect that to continue. We do think that we have a lot of transition there to go to get onto the new platform. And then in the dedicated compute platform, the dedicated line here, the fastest-growing segment there is, our enterprise customer segment, some of the fast-growing issues are there are when we're running dedicated clouds for people inside that segment, a dedicated private cloud is an offering here that's growing rapidly. And we do expect that to continue. We have good demand there.

Simon Flannery - *Morgan Stanley - Analyst*

That's not the Rackspace cloud privatization, is that included in there as well?

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

Yes, it is, Simon. The reality today is that offering is relatively newer than our traditional offering, which is VMware-based. So when we get into enterprise private clouds today, our offering based on m. where is going fast they then on a Rackspace Cloud private edition. We believe that is a result of where we are in maturity of that offering, and in the long run, we think will be able to provide all the capability on the Rackspace Cloud private edition that customers receive today on a VMware-based offering, and we think will be able to do it on a lower price because is going to be OpenStack driven.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you. That's very helpful.

Operator

We'll hear now from Jonathan Atkin, with RBC.

Jonathan Atkin - *RBC Capital Markets - Analyst*

I was wondering if you could comment on maybe how the IB growth trended in April, and as we think about enterprises either upgrading or downgrading their spends, are there any seasonal factors to consider?

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

Okay. First question about commenting on April, we've never done that in a mid-quarter. So I don't want to disclose that today. In terms of enterprise cycles and what's happening with respect to seasonality, I do think, and I talked about this a little bit in th an e answer a few minutes ago, the Q4 versus Q1 does create some potential seasonal factors. A classic example here is the Internet retailer, which we touched on a few minutes ago. In that instance, during Q4, these customers will consume and expand their footprint quite a bit to handle the volume in the fourth quarter. And is not just Internet retailers. Lots of web companies expect a higher push in Q4. And we see some of that resource coming off-line in Q1, based on how they choose to throttle their resources and how their business performs in the first quarter. So we did see some of that in the first quarter. That's the one thing that makes a Q4, Q1 comparison a little bit different, relative to other quarters in the year. If you go back and look at our historical numbers, this is an understood pattern here inside of our company.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then on capacity expansion, there was a recent announcement pertaining to Virginia. And are you considering new geographies perhaps on the West Coast or internationally in which you might enter into capacity commitments with wholesale data center operators?

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

Okay. Yes sir, we are. We had an announcement recently about expansion in our East Coast facility in Virginia. We are actively looking at other geographies as well. Ultimately, we are building out a global footprint so we have facilities in North America and Europe and Asia today. I would expect us to continue to work around -- part of what's happening in terms of picking a location is that in any given location, we want to reach a minimum scale, because at a minimum level of scale, we get great economics. So anyplace we go, we want it to develop into a long-term cluster for us. And our strategy here is really around being a wholesale consumer of data center space. We will continue to lease this space. We don't have plans on actually owning the data centers themselves.

We feel like in North America, we have a cluster in the Dallas region, we have a cluster around Chicago, we have a cluster on the East Coast. And so, your question is right on. The obvious next choice is to have a cluster on the West Coast or a facility on the West Coast that can reach the potential of the scale of a cluster for us. That is something that's on our mind, it's something we've looked at. So we will keep working on that. So that's how we see it today. So you'll see us want to invest in areas where we have demand, where we can be a wholesale buyer, where we can lease these assets on a long-term basis, and build them to a critical level of scale. And we will do that in North America, Europe, and Asia.

Jonathan Atkin - *RBC Capital Markets - Analyst*

But the commitment is fairly large on the East Coast, that was announced. And I wondered how does that kick in? Is it a phase-in in terms of how that will be reflected in your OpEx? And what's the time lag when a lease commences and you start to fill it with the revenue generating equipment?

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

So our strategic intent here is to make it our data center lease expense entirely variable to demand. Another way to put that is to match our lease expense to revenue growth. In order to that, we have to plan out our capacity, and then forecast within a reasonable out of accuracy what our growth is going to be. We then provide ourselves levers in option value in the agreements to where if we need to accelerate space, we can do that. If we need to delay space, we can do that, so we never take on too much space too soon, or taking too much risk by pushing space off to far. We will continue to optimize that process.

The bigger we get, at these type of growth rates, there are obviously more variables in this now than there was five years ago when we used to run a match list, but so far I think we've executed this pretty well, and we will continue to try to match it just right. An interesting calculation here is as we compound our growth out and we match that back to construction periods and facilities and power densities and facilities, there's a whole lot of optimization that can take place that can really improve our business model. We are actually optimistic around our ability to decrease our costs to compute on whatever compute service we want to look at, or whatever network service we want to look at, by taking up capacity at just the right time and enhancing the design and performance of these facilities as well.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks a lot.

Operator

We'll hear next from Scott Goldman with Goldman Sachs.

Scott Goldman - *Goldman Sachs - Analyst*

I guess one housekeeping and then a couple others. On the housekeeping front, just wondering if you know, the enterprise customer downgrade you talked about, if you have any way of quantifying what the impact there was on that net upgrade number? Was it 10 or 20 basis points step down, or does it account for the lions share of the step down mid-upgrades? And two, a bigger picture. One, going back some of the questions on head count, seems to be more focused on the impact on margins. I'm wondering if maybe there isn't a lag effect in terms of the timing of hiring on revenue growth, and whether now that you've picked up the hiring pace in 4Q and again 1Q, what impact that could have on revenue growth going forward. And lastly, I was wondering if you could talk a little bit about the OpenStack and just how you see the market for cloud operating systems developing? Thinking particularly here, there was one high-profile participant that talked about speed to market in terms of the development of cloud operations and just what your thoughts are there? Thanks.

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

So that's three in one. On the net upgrades, issue with the enterprise project, it wasn't one customer that had a big project. I sort of inferred that from your question, so I don't want that confusion to be out there. We have a handful of projects that we knew about. They just all happened to hit at once in the first quarter. So that's really what happened there. In terms of breaking it down, we don't want to specifically say 10 basis points, 20 basis points, to that level of granular detail. What we do want to say is when you look at that difference in the net upgrades number, the driving factor here, the biggest factor here was this handful of enterprise project downgrades.

So I guess the next question was about margins, the impact of headcount on margins, the impact of headcount on future revenue growth. So I would take us back to the way we go about planning and that we look at our annual plans. We have a minimum and maximum. We are executing within that performance zone today. The headcount investments we made in the first quarter, and you also referenced the headcount investments in the fourth quarter. These investments were within our investment framework, and were a mix of support, talent, software development talent, operations talent, and some sales and marketing talent. Today, most of our investment framework from a human talent perspective is focused on completing our next generation cloud and serving customers.

When we think about our opportunity in the marketplace, we really are trying to create a loyalty advantage in the cloud world. We express this as being the service leader in the cloud. So most of our investment hires, the headcount additions that you see in our metrics, are really about serving customers better and creating better offerings and products for customers. These hires absolutely have a revenue impact. They just tend to have a more delayed revenue impact than hiring 100 sales reps or something. So when you look at the headcount additions within our investment framework over the past six months, most of it has been about product capability and service capability, not about increasing our pool of sales reps inside the company.

So in terms of how are these heads going to impact margin and growth, the way it will work is these heads will generate better customer outcomes, better customer outcomes will show up in our net promoter score metrics as we drive loyalty to our customer base, and over time, this will provide a higher level of profitable growth for us. So that's our anticipation as we do this. The other thing that these headcount additions will do that for us is help us to create better technology in our foundation layer that drives our next-gen cloud. The last question you had was about OpenStack, time to market and what our belief is about the opportunity inside the OpenStack market. Generally speaking, we think that OpenStack has become the de facto standard for an open-source cloud computing system. And I will tell you today I think the cloud is open. We think that OpenStack, despite Cloud Stack and others launching out there, that the community and momentum around OpenStack really makes it be standard today. I mean, it was a thrill to be out at the Summit a couple of weeks ago and see people like IBM and Red Hat come in at a high sponsorship level into the foundation. To me, that really is a validation around the acceptance of OpenStack in the marketplace.

The next question is speed to market. And how our customers are adopting it, what's going on there. From our perspective, given that it is seen now as the open source standard, the traction and pull from customers in the OpenStack continues to increase. The number one validator from our perspective to make this happen is to get our next-gen cloud with wide availability, to pull off the limited availability moniker. As we sit here today, we've got customers, limited availability, that are receiving SLA's, we're starting to build those customers. The real stuff is real, and it's happening. We want to get to the point where we're doing that with hundreds of thousands of customers on our next-gen platform.

Once we get our cloud onto the next-gen OpenStack platform, I think the proof point around OpenStack being ready gets really strong. Today we can point to Mercado Libre and eBay X.commerce, and others that we are doing work with that are running on it. The reality is that once we're on it, we will be probably the world's largest OpenStack production environment, and this will give customers a lot of confidence when they're picking us, picking this new technology. Because of its functioning well enough to run the Rackspace Cloud, one of the world's largest clouds, people are going to have a great degree of confidence and peace of mind sleeping at night knowing that technology is rock solid. So I think our speed to market, certainly we always want to go faster around here. We do think that we're going to be the first ones through the chute here with having a massive large scale OpenStack production cloud.

Scott Goldman - *Goldman Sachs - Analyst*

That's very helpful. Thanks, Lanham.

Operator

And we appear to have no further questions. At this time, I will turn the conference back to you all for closing remarks.

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

First of all, we appreciate everyone's interest in us. And tuning into the call. We think we're off to a solid start this year. We've got a lot of work to do, and our number one focus is getting to our next-gen cloud. We think OpenStack is going to be a game changer for our Company. We look forward to updating you on our progress 90 days from now. Take care.

Operator

That concludes today's conference. Thank you all for joining us.