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RAX - Q3 2012 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to Rackspace Hosting's Q3 earnings release. As a reminder, this call is being recorded. At this time, all lines are in listen-only mode to prevent background noise. After the prepared remarks, there will be a question-and-answer session.

(Operator Instructions)

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

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

Hello, everyone. Welcome to Rackspace's quarterly conference call. Today we will cover Rackspace's third quarter ending September 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. This call is also being webcast online and can be accessed through our Investor Relations 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 or assumptions underlining 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 June 30, 2012, which was filed with the SEC on August 9, 2012, and our Form 10-Q for the quarter ended September 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. After our prepared remarks this afternoon, we will be happy to take your questions. I will now turn the call over to Lanham. Lanham?

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

Good afternoon, everyone, and thank you for joining us today. In our previous calls this year, we told you that our number one priority for the year would be our platform shift to OpenStack and open sourcing the Cloud. We explained that the Open Cloud would become the largest, most strategic technology investment that Rackspace has ever made. And, we also explained that there could be short-term product cycle fluctuations as we introduced the new platform.

We're excited to report that the rollout of our new Open Cloud platform is finally complete and that the Cloud is now open. The open age started with Lennox. Next came Android, then Rackspace and NASA created OpenStack and open sourced the biggest platform of them all. It's called the Open Cloud.

Now, you're not locked into the pricing, the strategy, or pace of innovation of any one vendor. You're free to run your own Cloud anywhere you want. In your data center, in our data centers, or with any other provider. Only open source platforms allow you to keep up in the open age. Now, we all have a choice. Welcome, to the Open Cloud.

Beginning in August, and culminating last week with the launch of Cloud networks, we have released the following seven new products that comprise the Rackspace Open Cloud platform. Number one, Cloud servers powered by OpenStack. Number two, Cloud database powered by OpenStack.

Number three, Cloud monitoring. Number four, Cloud backup. Number five, Cloud block storage powered by OpenStack. Number six, Cloud networks powered by OpenStack. And, finally, number seven, a completely new control panel for managing the elements of the new Open Cloud platform.

With these products and offerings now in production, Rackspace offers a better, faster, and more valuable Cloud experience built on an open platform that gives our customers true choice and control without the fear of being locked into one vendor's technology. Rackspace customers can choose how, where, and with whom they deploy applications, as well as the deployment option that best fits their needs.

Whether that's public, private, or a hybrid Cloud infrastructure, all backed by our unmatched culture of customer service known throughout the industry as Fanatical Support. We have gone all-in on the OpenStack technology because we believe it, number one, enhances our differentiation and competitive position in the market. Number two, advances the technical capabilities of our public Cloud platform.

Number three, greatly expands our addressable market by allowing us to extend Fanatical Support to on-premise work loads. Number four, improves the capital efficiency of our model. And, number five, enables us to deliver our solutions the way businesses want to consume technology, ie, in an open format.

Looking at the competitive landscape today, the public and private Cloud markets have each been largely pioneered by single vendors, Amazon and VMware respectively. Amazon capitalized on being first to market in public Cloud and has executed extremely well at attracting early adopters and evangelizing the potential of public Cloud infrastructure.

VMware pioneered the x86 virtualization market and built a multi-billion dollar business selling proprietary software to companies building their own small private Clouds. However, both Amazon and VMware are pushing the legacy model of using proprietary technology to lock-in their customers. We think the world is moving in a different direction.

We think the world wants choice. We think the world wants more open technologies and less complexity. This is why we are taking the Open Cloud approach. We believe the Cloud computing era will be characterized by customers that want IT outcomes, not inputs, a superior service experience, not vendor lock-in, and a partner whose business model is built on loyalty and trust, not proprietary technology.

Our mission is to make sure that Rackspace is that partner. We are going to aggressively seize the leadership position in OpenStack and that will include investing boldly for the long-term. We believe that fully leveraging the OpenStack platform tremendously improves the technical capabilities of our offerings.

From just a scaling perspective alone, our new open Cloud has eliminated bottlenecks that prevented us from running large deployments on our legacy platform and inhibited some of our customers from growing bigger with us. With these scaling barriers removed, we believe we are now able to compete for and run very large and complex production deployments.

Our confidence in the scalability of our Open Cloud offering originates from the extensive testing regimen we put the platform through prior to production. And, it is further supported by the early performance metrics. For example, our customers have built more than $1 million instances on the new platform and we've handled more than 120 million API calls since the alpha release of the product.

During this period, we have added thousands of customers and the platform has delivered its targeted uptime SLA. We believe large, complex work loads represent the fastest growing sector of the Cloud computing market. And, for the first time since the markets inception, businesses have a viable alternative to Amazon.

Although our offering has only been available since August, early indications of demand have been strong. In the first month of its availability, we added about as many new Cloud server units as we did in the best months with the legacy platform. To be clear, it's still very early and units do not always track directly to revenue.

Even though the full product offering is now fully available, we still have more work to do. Specifically, we're now working on building muscle around higher service levels on the Cloud. This is really the never-ending work of evolving to meet the performance needs of our customers.

So, any acceleration of growth isn't guaranteed to be overnight. That said, given all the information available to us through the end of September, we feel as if the launch of the new platform is going very well. Of course, our strategy for OpenStack is not just limited to the public Cloud. Our strategy is to enable customers to run applications on any combination of public, private, or hybrid Cloud resources.

That means in our data center, in their data center, or in a third party's facility, all controlled by the same OpenStack layer and backed by Fanatical Support. Toward this initiative, on August 15 we announced the release of Rackspace Private Cloud software. This product, which is available as a free download from our website, is the same open source software that powers our public Cloud platform.

And, makes it easy for our customers to deploy OpenStack based private Clouds in their data centers. And, because we are already experts in running this software, we can provide escalation support or even managed support off-premise, private Cloud deployments if the customer desires. Prior to the introduction of OpenStack, the private Cloud market was essentially limited to VMware software.

However, we believe there is tremendous demand for more options, especially open source alternatives. Taking the powerful capabilities of the OpenStack platform and productizing them into a service that is easy for businesses to use has been one of the most difficult, exciting, and strategic challenges that Rackspace has ever pursued.

Completing the project was more complex than we initially envisioned and it took us longer than we thought it would. It required us to significantly improve our software development and deployment capabilities and I'm proud of the way our company rallied to meet this challenge. Teams at Rackers throughout the organization have worked extremely hard to make the dream of the Open Cloud a reality.

And, I want to make sure to recognize all of their contributions and thank them for helping us deliver on our commitments. Successfully deploying Open Cloud has been our number one priority. With the Open Cloud successfully up and running, and the product transition squarely in the past, our focus now shifts to growing the new platform.

This is our new number one priority. To that end, we are planning a number of new campaigns to make sure the entire world knows that Rackspace just open sourced the cloud. We need to make sure that everyone in the IT field, from new startups to Fortune 100 CIOs, knows about our capabilities.

We need to make sure that the CEO of every retail business that uses Amazon web services knows that they don't have to continue funding their biggest competitor. We need to make sure the world knows that the Rackspace Cloud is here. It's open, and it's ready for big applications. Having delivered on our number one priority of executing our product launch commitments, we think it's fitting to highlight some near-term goals on the table.

They are, number one, getting large reference customers to run important applications on our Cloud. And, number two, re-accelerating the growth of our public Cloud offerings. So, those are the milestones that we will be focused on and working towards. Now, I'll turn the call over to Karl to review our financial results for the quarter. Karl?

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

Thank you, Lanham. Let me review the financial results in detail. For the third quarter, total revenue was $336 million, representing 5.3% growth from the second quarter and 27% growth compared to the third quarter of 2011. Exchange rates had a negative impact on revenue, both compared to the previous quarter and compared to the third quarter of 2011.

On a constant currency basis, revenue grew 5.4% sequentially and 28% year-over-year. During the third quarter, install base growth averaged 0.8%. This is down from the 1.0% monthly average in the second quarter and the monthly 1.0% we averaged for the full year of 2011.

To put some context around the difference of a monthly average of 1.0% compared to 0.8%, the revenue difference for the third quarter would have been higher by approximately $430,000 per month, or less than $1.3 million higher for the full third quarter. Moving on to revenue by product, dedicated Cloud revenue increased to $257 million, representing 4.1% sequential growth, and 20% growth on a year-over-year basis.

As we have indicated in the past, large enterprise-type customers are one of the big growth drivers of our dedicated Cloud product. One example from the quarter was Southwest Airlines. Southwest drove Rackspace's intensive service level around the AirTran mobile application on dedicated infrastructure.

Public Cloud revenue for the quarter was $79 million, representing 9.4% sequential growth and 57% growth on a year-over-year basis. Third quarter public Cloud revenue includes revenue from our new Open Cloud platform. However, it does not include the full quarter of revenue as our Open Cloud product were released throughout the quarter.

Third quarter results also do not include any revenue from Cloud block storage or Cloud networks, because these products were not released until the fourth quarter. As Lanham indicated in his prepared remarks, the early data points suggest that our new public Cloud product is off to a strong start.

Net units added in the month of August were consistent with the best month of our prior Cloud offering. And, more than 1 million instances have been created on the new platform. One interesting customer engagement from the quarter that exemplifies the power of Cloud computing is a company called Villy Custom Bikes. They chose Rackspace Cloud sites to power their website.

When the company was featured on ABC's television show Shark Tank, traffic increased dramatically to 3.2 million hits in 25 minutes, as well as a 120,000 visitors in one minute. Handling such a huge amount of traffic in a very short amount of time required a strong collaboration between Villy Custom Bikes and the Rackspace Cloud site's team.

We ensured that the website had the robust infrastructure needed to host this event with multiple web servers, load balancers, and redundancy. We even hosted images on Cloud files to ensure the event went well. Another customer example from the quarter is a company named gdgt, which is pronounced gadget. On gadget you can find reviews, recommendations, and pricing for almost all the latest electronic products and gadgets available.

Gadget also hosts live stream events, including the new product announcements, and they chose Rackspace's public Cloud platform to handle the live stream of Apple's launch of the iPhone 5. The event produced a massive volume of traffic. Approximately 55.4 million page hits, and more than 500,000 live blog updates per minute, all without any degradation in website performance.

These are just two examples of the type of capabilities that we can enable with our Cloud product offerings. In the future, we would like to share more of these case studies and we are working on winning some very large deployments. We are pursuing various opportunities for larger production apps that our legacy production could not handle and we are excited to have a shot at winning these new prospects.

We'll keep you informed on how these play out throughout 2013. Moving on to profitability, adjusted EBITDA came to $122 million in the third quarter, representing growth of 8.8% from the second quarter, and 38% on a year-over-year basis. Our adjusted EBITDA margin was 36.2% in the third quarter, up from 35.1% in the prior quarter, and 33.3% in the third quarter of 2011.

Depreciation and amortization expense came to $64 million in the quarter, representing approximately 19% of revenue, in line with the 19% to 20% range that it has been tracking since the beginning of 2009. Net income came to $27 million in the third quarter representing growth of 8.2% from the second quarter and 36% from the third 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 $85 million. Of this amount, we spent $51 million on customer gear, $6 million on data center buildouts, $3 million on our consolidated headquarters facility, and $25 million in capitalized software development and other projects. Return on capital improved to 16% in the third quarter compared to 15.5% in the prior quarter, and 14.8% in the third quarter of 2011.

Average monthly revenue per server continued to increase to $1,287, from $1,270 in the prior quarter and $1,155 in the third quarter of 2011. We continue to generate strong cash flows, adjusted free cash flow was at $34 million for the quarter, which was our best result ever and which pushed our cash balance up to $258 million.

Our total debt to outstanding, including capital leases, was $150 million, which translates to a net cash position of approximately $108 million. Given our ability to generate free cash flow, our strong balance sheet, and our access to an additional $200 million through our credit facility, we believe that we are well funded to operate our business at current growth rates.

In summary, we are very pleased with our execution and the results we have delivered so far in the year. We have successfully enhanced our product and services portfolio, while managing a rapidly growing business and building a better economic model. We believe the work we've accomplished so far in 2012 increases our competitiveness in this massive Cloud opportunity.

We look forward to updating you on our progress in February of next year and sharing our annual goals for 2013 at that time. This concludes our prepared remarks. We are now ready to take your questions. Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

Certainly, thank you.

(Operator Instructions)

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks, for taking the question. Lanham, can you just talk about what's happened over the last few months? It seems like you're closing the product gap with Amazon, which potentially is allowing to you do some larger deals in the Cloud space.

Can you talk about the focus on serving that larger -- the larger web scale apps. And then, maybe, from a financial standpoint, if you think about a guy like a NetFlix doing a couple million dollars a month with an Amazon, do you think you could be headed in that direction in terms of the enterprise penetration? Thanks.

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

Sure. Let's go back a little bit in time and talk about how we've gotten here. If you recall, in prior calls we discussed how our original Cloud platform was really good at scaling out simple things. But, that it lacked some of the capabilities to serve more complex work loads and applications.

The Genesis of OpenStack, and our thesis there, was really about how do we create a collaborative community to help with the development and creation of an open source standard in a Cloud. Our belief being that with the establishment of that standard, the community can innovate faster than we could on our own and that we could capitalize on that to expand our addressable market.

So, that work started in 2010. Here we sit in November of 2012, the OpenStack community is thriving. The new products we released, the seven that I went over in our prepared remarks, are all based upon the OpenStack community and the development of that code. Within that code and technology set, we've expanded our ability to serve complex work loads dramatically.

Whether you want to look at the network capability or the storage capability as two prime examples, we've now put in place the necessary ingredients to be able to run a much more complex work load for customers. What's happened here inside of our company the past couple months is with the execution of that road map, we've started some conversations with large enterprise customers that we just weren't having a year ago.

A year ago, the conversation would pop up and we would gracefully bow out because we couldn't look them in the eye and tell them we could serve them appropriately. Now, we can. Some of these conversations, I am involved in personally. And, when we look at what's happening in the marketplace today -- for example, I was on the East Coast a couple weeks ago, right before the storm hit.

During those conversations with CIOs, CIOs are looking for someone to come in there and teach them how to get to the Cloud. It's no longer about why should I use the Cloud, why should I think about it, it's about how can I get to the Cloud, how should I start implementing these tools. This is where our expertise as running the largest Open Cloud in the world and our position as a service provider really work effectively.

The reality is, with the rise of digital commerce, IT departments need to become tech engines in the business. And, the Cloud is a great tool to do that. So, as CIOs are thinking about how do I become innovative in the company, how do I deliver more value for my internal customers, Open Cloud hits a lot of those primary items on their check list.

I feel like our company now, given the execution of the road map, and the conversations we're having, we now have a seat at the table from a thought leadership position that we haven't had historically. It used to be that our company integrated the technology of others and productized it to deliver it as a service. We still do a lot of that.

It turns out we also create a lot of technology now ourselves. And, this is showing up in the OpenStack community in all the work we've done there. So, I feel like now we qualify for these larger applications. We have a thought leadership position in the mind of CIOs when we talk about open Cloud technologies. We're running the largest Open Cloud in the world.

This should all translate into Rackspace earning their trust to run more complicated work loads. In the question you reference NetFlix and potentially paying millions of dollars a month. The analog there being does our new service set position us for that type of work load? I think the answer is yes.

Have we won any of those yet? No, sir, we haven't. But, we are in conversations with some. I think this is a traditional enterprise sales cycle with some of this stuff. These customers are testing us today, okay, but we don't have that big reference win to tell everybody on the call about yet.

But, we are focused on it. That's why we put it in our prepared remarks as one of our near-term priorities. I think your question around how's the addressable market changed, I think the new product set positions us to serve these larger work loads. It is a strategic focus of ours to win some of these customers.

At what pace will they come? I don't know exactly. We've literally just completed the rollout here over the last week or so. These are big decisions that people are making. The test in depth stuff comes pretty quickly. I think the larger apps take longer to germinate on the platform.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Chris Larsen, Piper Jaffray.

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

Hi, thanks, couple questions. First, your ROI continues to move up. I don't want to read too much into it. I know you've talked a lot about the capital efficiency of the Cloud. We've only really gotten two-thirds of a quarter with the OpenStack.

But, is this a function of OpenStack and allowing you to do more with less capital? And, if that's the case, where can this go as you, at some point, have greater than half your revenues coming from the Cloud? And then, secondly, wonder if you could talk a little bit about pacing through the quarter, in terms of where did you see the revenues?

I would imagine that you saw slower revenue growth in, say, July, as you were preparing for the OpenStack rollouts and possibly faster in September. Or if you could just talk about the pacing for the Cloud revenues came in through the quarter. Thanks.

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

Okay, this is Lanham, I'll start and then Karl can chime in on this. When you look at return on capital, an easy way to think about it is return on capital equals turns times margin. In our business, the technology advances of the Cloud help us with the turns. So, in the question when you're talking about capital efficiency, for example, we believe that part of what OpenStack is going to deliver here at Rackspace is a more capital efficient foundation for a compute.

That drives turns and helps us capture that efficiency in the metric. The second component is margin. Margin around here is really driven by the service levels that we deliver to customers. The higher service level we provide, the more value we create, the more potential and opportunity we have for capturing that value, which shows up in our margin.

We've been able to increase ROC meaningfully here since we've been a public company. If you look over the last four years of being a public company, we've gone from high single digits to now we're in the comfortable mid-teens from an ROC point of view.

That's been driven by a few things. Number one, I would look at our product map and point out the incremental service levels we've added over time, things like Critical Sites. I would look at the turns and look to the growth of our Cloud and the expansion of our Cloud.

And, the revenue stream on a global basis, whether it's in North America or Europe, for example. We certainly have a lot more work to do there. We look at ROC in a disciplined manner. Today, we are not trying to maximize or optimize ROC when we do our financial planning.

At the same time, we're an EVA shop and so we're going to be real disciplined about it. In the long-term, when we think about this, I mean, we are here to create economic value for our stockholders. ROC is absolutely an important metric to us, when we look at our ability to create economic value added above our cost of capital.

So, we will continue to focus on that. I think it's still early. I think we could do a lot better on this metric. Ultimately, for us, it's not necessarily about the rates of return. It's about the aggregate economic value that we can add.

So, that gets into how large of a capital base can we deploy, how much incremental returns can we create on top of that capital base, and how do we optimize those outcomes. So, I think ROC is a good indicator of progress. It's just not the whole story yet.

We feel like our company is just a fraction of the size that it can become when we hit our potential. And, we want to hold ourselves to creating value along the way, which is why we publish ROC in our key metrics. The way we will invest in this is we'll continue to try to get more efficiently in our base compute foundation and storage levels, which you'll see in the turns, and then we'll try to increase the margin through service levels.

And, ultimately, the mix here gets determined not necessarily by what we roll out, but what customers buy and drive loyalty around. So, we will shape this to the best of our ability. But, ultimately, customers get to decide which services they like the most. That would be my thought around ROC. Do you want to talk about quarterly revenue?

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

Yes, sure. So, as you pointed out, we've made a couple of comments over the last two quarters that we expect some volatility in the Cloud as we go through this transition and that's exactly what we're seeing. We had an increase in sequential growth rate in second quarter and a slight decrease in the third quarter.

And, this third quarter is really where this transition took place. And, the key parts of the new Cloud are now launched, as Lanham pointed out. Everything is out there to be consumed. And, we will now work towards acceleration again. And, that's how our stated number one goal.

Operator

Gray Powell, Wells Fargo.

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

Hi, thanks for taking the questions. I just had a couple of them. I know you guys touched on this in the prepared remarks but I just wanted to circle up on it again.

It definitely seems like there are some verticals, particularly on the retail side where customers may not want to use Amazon AWS because they compete directly against Amazon. Are you having any meaningful preliminary discussions with existing AWS customers today? And, is there a potential to market more around this message?

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

Okay. So, the short answer is yes. We are having conversations in some of the -- in the vertical you referenced specifically. Is there an opportunity to have some competitive wins there? Yes, I think there is.

I mean, we are working hard on it. We're having some great conversations. We just don't have that final win on a silver platter to talk about right now. I do think that all of the activities that generally lead to good outcomes are taking place. We're excited about the traction we've had and the conversations we're having. We're just not all the way through it yet.

In terms of additional marketing activity, and we talked about this in our prepared remarks, we think there's a category opportunity right now and position ourselves as the company that open sourced the Cloud and leading the Open Cloud revolution. We are the birth mother of OpenStack. And so, that is absolutely a marketing initiative that's on our mind that we're talking about every day with existing customers and prospects.

So, I definitely see that as a marketing activity. I think our current line of thought on this is to start with the category itself around Open Cloud and then tailor messaging more specifically to other verticals. This is just all work that we have to do. When we talk in our prepared remarks about investing boldly to seize the leadership position in Open Cloud, these are some of the thoughts that occur to us and that we are contemplating.

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

Got it, that's very helpful, and, just one more, if I may. In our field checks, we've heard some discussions from pure play colocation providers looking to deploy OpenStack and potentially Rackspace private cloud additions into their data centers as a way to differentiate themselves from other providers that purely provide space and power. Is there anything you can say there? And, do you see a meaningful opportunity to partner with pure play colocation providers in this manner?

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

Okay. In our prepared remarks, we referenced this notion of customers being able to use the Open Cloud in their data centers, in our data centers, or in a third party facility. The colocation example you're using right now is really that third party facility. What this does for our company is dramatically expand our addressable market.

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Up until just recently, our company, we were only relevant in running work loads that ran in our -- in Rackspace data centers. I think with the standard architecture of OpenStack and our expertise in OpenStack, we can now provide services and on-premise infrastructure. So, when you talk about a colocation company wanting to enter into the Cloud opportunity and running OpenStack Cloud, we can now extend our service set and extend Fanatical Support to that infrastructure.

This is, for us, we believe, an exciting opportunity. It's admittedly brand-new. And, so this going to take awhile before it has a big impact around here. But, in terms of increasing our reach and scope of the company into relevant services that we could provide, this is a meaningful step for us. It's a big expansion in our addressable market.

It started with the availability of downloading our Cloud software off of our website. So, if you go to rackspace.com today, you can go out there and download the Open Source bits that are running our Cloud. That is a really cool proposition for customers. It's been downloaded thousands and thousands of times. It's triggered a series of conversations.

And, this allows us to start having that on-premise conversation with customers. And, now you're doing channel checks that pick up colocation companies that are also interested in running OpenStack clouds in their facilities. And then, we can extend our Fanatical Service set to keep that up and running inside that facility.

This is an exciting expansion in our market opportunity for the company. It's early days in it, so I don't want everybody to get too pumped up and get ahead of themselves. It's just something that we view as strategic that we will make meaningful investments in.

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

All right. Thank you, very much. That makes a lot of sense.

Operator

Rob Sanderson, ABR Investment Strategy.

Rob Sanderson - *ABR Investment Strategy - Analyst*

Yes, thanks, good afternoon. Congratulations on getting all of these great products out. Question on -- just extending on that private Cloud thought there. So, you just mentioned thousands of downloads of your code. Where is it going?

Is it S&Bs, web sets of companies, Fortune 100, potential competitors maybe? That's the first part. Second, how should we think about that opportunity you mentioned? Is that something that you think will be a material component of your business in maybe a three-year timeframe? And then, finally, are there any instances where this is actually happening today?

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

Okay. Yes, you had lots of questions there. I'll try to hit them all. If I forget any, please just jump back in and remind me.

Rob Sanderson - *ABR Investment Strategy - Analyst*

Sure, no problem.

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

With respect to the private Cloud opportunity and the horizon, who is downloading all of this stuff, the downloads I would say are a good cross section of just about everywhere. There are a lot of downloads in North America. There are downloads internationally. There are downloads in Fortune 100 companies and there are downloads in S&Bs.

I haven't personally studied the list of downloads in a while. So, I couldn't tell you everybody who has downloaded it. The last time I looked, it's a good cross section of the global economy that are looking at it. I thank that just speaks to the fact that this is a technology that has a lot of interest and following.

It's on people's minds. So, they want to go investigate. By opening this up, we've made it easy for people to consume it and investigate it. And, that naturally triggers some interesting conversations. So, that's what I would say in terms of the downloads.

With respect to the timing of when this will have a material impact on our company from a financial point of view, given this is our stockholder call, investor call, I think you're absolutely right. I think it's a few years out. We're a company growing at a good pace today. Our sales are north of $1 billion.

To get to a material threshold where this business alone is hundreds of millions of dollars, which is what I would say that materiality threshold is from a financial point of view, I think that takes a few years out. I think if you look at from a market influencing point of view, and when it becomes an important element of our strategy, I think that's happening right now. And, the evidence is the downloads and the conversations we're having with people.

So, I think it's one of those things that we believe there's an opportunity to differentiate in the marketplace by taking a long-term view and building the open Cloud leader. So that even though it may not generate material financial gains for a few years, I think the strategic gains we're having with the quality of conversations with prospects, as well as existing customers around this technology, it's already paying off for us today.

Rob Sanderson - *ABR Investment Strategy - Analyst*

Any instances where you're selling Fanatical Support outside your data centers today?

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

Yes. We announced on a call, I won't get the timing exactly right, a little while back, the creation of Rackspace Cloud builders. And, this is a unit inside our company has that been deploying OpenStack private clouds on-premise for customers. And then, we have support offerings that follow that. And, we are doing that and we are doing that for a number of customers today. So, it is in place.

Rob Sanderson - *ABR Investment Strategy - Analyst*

Great. Thanks, for the color.

Operator

Tom Seitz, Jefferies.

Tom Seitz - *Jefferies & Co. - Analyst*

Yes, thanks for taking the question. Can you talk a little bit about your strategy related to getting that first marquis customer or several of them, even better? Given how aggressive AWS is on price, do you think you'll have to pull that lever initially? Or is the OpenStack capability enough in itself to win customers? I guess what I'm asking is, should we expect any material change in the margin profile as you launch the full blown sales effort behind OpenStack?

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

Okay. This is Lanham, I'll start with this one, and Karl, if you want to chime in about margins. The strategy is pretty simple and straightforward. We believe that with OpenStack, we have a unique and compelling and differentiated offering.

When you look at the position of Rackspace versus Amazon, Rackspace uses closed and proprietary technology, we're using open. Amazon is a generalist. We are a specialist. Amazon's playing a scale game. We are playing a service game.

So, from our perspective, it's really playing this service game and delivering incredible value to these large wins. So, -- and these large opportunities. So, I think what's happening here, from our perspective, is it's a really cool conversation around though leadership and how we can help CIOs make the leap into the cloud.

And, move their incremental work loads onto the cloud so that they can deliver real innovations inside of their companies. And, being able to do that in a private Cloud inside of our facility or a private Cloud inside of their facility, it's basically saying, look, you can have your Cloud wherever you want it.

The nice thing about it, because of the OpenStack community, there's no vendor lock-in. You can run it at Rackspace, you can run it at other OpenStack companies. This gives CIOs a pretty compelling proposition to compare relative to other offerings out there, whether it's an AWS offering or an offering based on some other technology that's available.

I think that difference is more than enough to get people's interest. We're seeing that today. Now, it's just about execution and where people are in their decision-making. We're running up to end of year stuff. Do they want to go for it this year, do they want to wait until next year? We're going to have all those types of variables that start to come into play.

The answer on those variables really just depends on the customer and what they have going inside of their company versus what we can line up and do for them. So my -- our basic belief is that OpenStack, an open offering, no vendor lock-in, a specialization in playing the service game is going to be what wins the day here. And, it won't be based on price, or pulling a price lever. Karl, do you want to make any comment on margins?

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

Yes, let me take a step back and talk a little bit more broadly around the way we think about margins. I think there are three things here that come together in our operating model. On the one hand, internally and operationally, we constantly work on improving our cost structure.

That has to do with excess capacity, utilization, it has to do with doing things simpler and in a more automated manner, a less humanized manner, public Cloud is a much more efficient sales and marketing place. So, there are lots of levers that create financial leverage, if you want, on the core operating model.

And, we work on that constantly, basically, to release funds, if you want, so we can invest aggressively and pursue profitable growth opportunities. And thirdly, the comments we're making around with our margin objectives are, like in this year, for example, that we keep margins flat. That is a self-imposed discipline.

And, the commitment to the company and to the stockholders, that we will execute on. And, basically, having said that, the outcome of all of this is that we're not interested in pursuing loss leaders or growth for the sake of growth. We're very much determined to pursue profitable growth opportunities. And, that's how we're -- an operating mode that we'll continue to pursue.

Tom Seitz - *Jefferies & Co. - Analyst*

Thanks, very much. That's great color.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks, a lot. You talked about some of the interest, Lanham, from international downloads of the code. Could you talk a little bit about how your international business performed this quarter?

And, how you are thinking about expanding further internationally now that you've got this new product set. And then, just a quick question on the costs for Karl, the Rackers, I think it was 68 added in the quarter, a little bit below the pace of the last couple of quarters. Anything notable driving that, any change in pacing that we expect in Q4? Thanks.

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

One quick commentary on the hiring. This is Lanham. I would just say in the last quarter, we didn't hire as many people as we wanted to. We still all of our thresholds on critical areas like product development and engineering, and some of the other areas. We just didn't get everything done that we wanted to.

Karl could talk about the cost impact of that going forward. From a hiring point of view, we're going to stay on it. We're going to keep going. That number has fluctuated a little bit, historically. We've had some bigger quarters, some smaller quarters. So, I would say that's just where we are.

Simon Flannery - *Morgan Stanley - Analyst*

Was that a qualified problem? There weren't enough qualified people?

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

I think we are very obsessed about the engineering software, OpenStack, and development hires and investments we're making. As a company, we are putting a lot of focus on it. I think what happened to us is we did really well in that area. We put our focus there and not on some other areas. And, the areas we didn't focus on as much we didn't hit all our targets.

I think that's a good trade to make, given where we are. It's just not what we want. I call it the lesser outcome there. Still okay, because we hit our critical thresholds in the OpenStack area, specifically. But, we just didn't get everything done we wanted.

Then, on international, if you look back at the quarter, you look back to our call that we had three months ago, there was a lot of talk about Europe and what was happening in Europe, what was going to happen to our business, et cetera. And, what we said is we -- we're hanging in there and we'll let you know if things changes -- if things change. I would just echo it -- that on this call.

Our international business in the quarter performed well. It's doing what we thought it would be doing. When we planned the company year-over-year, we have a max and a min. The maximum is about we're not going to grow faster than that and do things that are unstable.

And, the minimum is about an internal commitment that we're going to honor each other no matter what. And, international is within that range. From our perspective, international is performing well. We're excited about it. Today, if you look at our international revenue bar, we have a higher concentration in Western Europe, for example, than we do Asia-Pac.

We opened our offices in London, England over a decade ago, hence the legacy of the business and the growth of the business there. The question you asked about international expansion going forward, what's on our mind today is when we look across our portfolio of businesses, Asia-Pac's doing really well. And, if we had a marginal dollar of investment, we are more likely to invest that in Asia-Pac going forward than we are Europe, for example.

I think you'll see us get more aggressive in Asia-Pac over time. Europe's an important business to us, it's a growing business. We will continue to invest in it. It's just the incremental international expansion, given all the facts out there in the macroeconomic environment, pulls us toward Asia-Pac because we have a higher growth rate there anyway.

Simon Flannery - *Morgan Stanley - Analyst*

Great, thank you.

Operator

Jonathan Schildkraut, Evercore Partners.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Great, thanks, for taking the questions. A couple here. I'll just ask one at a time, though. At the beginning of the year, on first quarter results, we saw some seasonality in the business.

And, that's something that you guys had highlighted even going back to your IPO days, about a fourth quarter bump and a first quarter rolloff. What are your expectations for seasonality this year and how might we think about it?

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

You're talking about margins?

Jonathan Schildkraut - *Evercore Partners - Analyst*

I'm just talking about the business in general, whether there's a bump up in holiday-related demands for services, whether there is an impact on margins, IBG? That type of stuff.

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

Yes, so, a lot of our customers that are in the E-tailing business, obviously, have a huge volume increase, demand increase over the holiday. So, that's a typical thing. And then, also, in the enterprise side, I think there is a little bit of -- bigger corporations are just working a little bit less over the holiday. So, there's a little bit of less activity there. So, those two things come together in Q4 and Q1.

And, that would explain the numbers that we have seen in the past. How this will play out this year around, or this year, next year around, we'll talk about it after it happened. In terms of margins, I think that also, to Simon's point before, the 67 adds that we've seen during the third quarter has already contributed a little bit to margin increases relative to the second quarter and about 110 basis points.

And, we'll certainly have a little bit upward lift to the margins in Q4 as well, just that people side alone. Then, on the other hand, Lanham alluded to a stronger marketing campaign coming. And, we may see some spend here towards the end of the fourth quarter that may counter some of this uplift.

Jonathan Schildkraut - *Evercore Partners - Analyst*

That makes sense, could you give us some color on -- you talked about customers -- new customers moving on to the OpenStack platform. I was wondering if you could give us a little color about whether you're seeing any transition, voluntary obviously, transition of existing customers off of Slicehost onto OpenStack? Maybe to take advantage of some of the incremental service offerings? And, if you are seeing some of that transition, is it changing RPU levels or spend levels with you?

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

Okay, good question. The short answer is yes. We are seeing some organic migration within our customer base. Whether they were on Slicehost or a legacy Cloud platform onto the new open platform.

This is driven, number one, I think by the future set out there. Number two, the performance of the platform is superior to the old platform. So, there's just a natural pull. So, we are seeing some of that stuff. We don't want to get into all of the RPU data and stuff right now for a couple reasons.

Number one, I think it's still pretty early. So, I wouldn't want investors to draw any conclusions prematurely on what the customer behavior dynamic is and how it differs from the old platform. It's pretty intuitive to say with more capability we can run more complex work loads.

And therefore, customer RPU ought to climb over time when they are on the new platform. I think that logic holds together real well and makes a lot of sense. It's just still early to where we don't want to dig deep into that stuff yet. And, that we've figured that one out. I think there's still plenty of work to do there on it.

Jonathan Schildkraut - *Evercore Partners - Analyst*

All right. Well, maybe we come back to that one in a quarter or so. If I could sneak one last question in here. Two years ago you guys were doing 90% plus of the development on OpenStack. And, Jim and Brett have indicated that other people's contributions have really stepped up.

Maybe -- I don't know what the percent is today, 50% or 60% or less, I don't know what the number is, in terms of your contribution to the development OpenStack. You've now transitioned OpenStack to an independent organization. There seems to be a tremendous amount of momentum around the community and the development and even the implementation.

When we think about the investment that Rackspace is making, should we think, in terms of capitalized software, should we think that the levels that we've seen you spend are good levels to think about? Or do we -- or should we believe that, over time, given increasing contributions from other parties that that level could level out or it could fall down -- or come down, rather? Thanks.

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

Okay. Yes, let's spend a minute just talking about the community, and the progress the community is making. I think the progress within the OpenStack world points to the fact this is a viable ecosystem now, that it's become the Open Source standard in Cloud computing. And, your question around Rackspace used to be the number one provider of code, we're now something else, is proof around it.

The OpenStack Summit was just a matter of weeks ago. At the Summit, Rackspace still has an important presence. We still make a lot of valuable contributions to the code. But, we are no longer the number one contributor of code. What happened is -- what I mean by that, is we are no longer providing the majority of code, okay? We are now doing less than the majority of code contribution.

So, other companies have stepped into it. We're still a hugely important factor and probably always will be. We love OpenStack. We think it's cool technology. We think humanity needs it.

So, we will continue to invest in it. From our perspective, on a strategic level, the more investment we can make in OpenStack that accelerates the community, that accelerates our leadership position in it, I think, the better. So, I'll let Karl talk about specific numbers.

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

Yes. So, right now, Lanham said before that this is not the time to optimize. And, product is exactly -- product development scale is one of those muscles that we are in the process of building. And, we're very happy with the success we've had so far. And, we continue building that.

The point here, I guess, with the contributions of the community and of Rackspace is really to accelerate the pace of innovation. Not to create any financial leverage on that. And, I think that's the name of the game at this moment. So, our product development efforts will increase commensurably with revenue over the next couple of quarters.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Karl, did you update or confirm the prior CapEx guidance?

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

Sorry, was that -- say again?

Jonathan Schildkraut - *Evercore Partners - Analyst*

I was just wondering if you had updated or confirmed the prior CapEx guidance?

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

No, we're still confirming the ranges as originally indicated. Total of $335 million to $405 million. And, on the customer gear, $210 million to $250 million. And, we see ourselves coming in at the mid to low point of that range.

Jonathan Schildkraut - *Evercore Partners - Analyst*

All right. Thanks, so much, for taking all of those questions.

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

Sure.

Operator

Jonathan Atkin, RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, a couple questions. On the customer gear CapEx, does the low $200 million range, is that something we might be thinking about for 2013 as well?

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

Well, we're going to talk about that in three months from now, when we share our 2013 outlook.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Okay. If you look at the incremental revenues coming from Cloud, it seems like it's bounced around between the mid-30% to mid 40% range. And, I'm wondering if that's the range we could expect going forward, or could that potentially ramp up a little bit higher due to OpenStack or maybe just other factors?

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

Okay. Well, thinking about it, generally when you look across our portfolio of customer offerings, I think that what -- and, we talked about this in our prepared remarks. We believe we have a platform in place now that positions us to serve larger work loads.

We have not qualified for these larger work loads in the past. Now we do. And, we've had some conversation here in the Q&A session about what we have to do to win some of those customers, how long it would take, et cetera. I think from our perspective right now as we continue this work, obviously we want to grow the company at a sustainable rate for as long as possible. With Cloud, it's still early days and we're still figuring some of this our.

One way to look at our expansion opportunity here with the new product platform is that we've got the platform in place. However, to build on a question a minute ago, there's still a lot of investment to do to increase our service levels on that platform. And, as we get those service levels in place, we can walk the margin up and the value creation opportunity up as well.

So, with respect to the growth ahead of us, we made one of our priority stated goals in our prepared remarks accelerating the growth from where we are right now. If you look at the sequential growth for Cloud, it's traded within a band over the past year. Obviously, the bigger the company gets, the harder it is to maintain that band. So, we're going to push hard to stay in band.

What we're talking about with the new platform is that the new platform expands the opportunity set. So, we think there's a potential to stay within that band and maybe even do a little bit better. The short answer on it is we'll know when we get there. We'll know based on the adoption that we have and we've only just launched it.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Got it. And then, on OpenStack, I'm interested in your read on the Telco efforts to offer OpenStack based services. There's a number of large Telcos that are members. And, are they -- do you see some of them moving more quickly than others? Or is this not going to be really noticeable for the next several quarters?

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

Okay. Great question. Generally, I think the more adoption of OpenStack and the more interest in it, the more investment in it by established companies, the better it is for all of us. So, tech is in this weird moment in time where across a lot of tech, everybody competes with everybody else in different lines of business.

The lines of the stack are being redrawn. The competitive framework around the stack's being redrawn as a result. I think from a community point of view, as you have the big Telcos enter the community, that's nothing but a positive. In the long run, could they turn out to be competitors of ours? Sure, they could.

So, how does that hit me? Well, what I know in my heart is that we can outserve all of them. You know, there's a viable Open Source community out there. If there's a viable open source community out there, and OpenStack becomes the open source standard in Cloud computing, which we think it is today.

I love our position and opportunity to build the service leader in that segment. We're a specialist in this. We're playing a service game. Our brand reputation in the marketplace is fantastic around Fanatical Support. So, I think our secret sauce is around Fanatical Support and the service outcomes that we can provide.

Telcos, in our experience, struggle to deliver great service outcomes. They have a lot of money. They got a lot of people. But, they don't have the heart of a servant. Their organization doesn't move at web speed. They weren't born to be a Cloud company.

They have all sorts of businesses that they are acting in and the cadence is different. So, I think we have a cadence advantage and a service advantage as it comes. I agree with the question that different Telcos, from our perspective, are adopting OpenStack at different rates. I think that's natural.

I think every company has its own set of vision and adaptability and ability to make investments going forward. So, I do expect them to progress at different rates in the community. We want to be an ally for them in their progression. We want to help them get on OpenStack. And, there may be an opportunity for us to turn them into our customers as well.

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

Operator, I think we have time for one more question.

Operator

Colby Synesael, Cowen & Company.

Colby Synesael - *Cowen and Company - Analyst*

Great, I appreciate it. Just two questions, if I may. One, just a point of clarification on margins. I think the previous guidance was for flat in 2012 versus 2011. I think you may have said that on today's call.

But, I also thought on one of the responses to a question you may have suggested that we could see an uplift in margins in the fourth quarter based on the lower head count we saw in the third quarter. I just wanted to make sure I understood that correctly. Then the second question has to do with M&A. Historically, you've done a lot of small, what I would call bolt-on acquisitions. I'm curious if the company is open to doing larger acquisitions.

Obviously, you have a very strong stock, right now, in terms of valuation, which would most likely lead to some pretty accretive deals, if you thought you were interested in doing that. I obviously know you guys are focused on your culture there. Does the focus on the culture prohibit you from even thinking about wanting to do some of these larger deals? Thanks.

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

Okay, this is Karl. I'll take the first one on the margins. Yes, that's a good clarifying question. My comment, with respect to the head count, was really the head count related impact on current and future margin.

What happens on a corporate basis depends on all the things coming together in the fourth quarter. And so, it's not clear, at this point, whether we clearly expect an uplift or downlift. It's just -- we'll see what the outcome will be. But, the uplift was really related to the 67 heads we hired in Q3.

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

On the M&A, you referenced doing smaller acquisitions in our past. I think we will absolutely continue to do that. And, you didn't explicitly state it, but certainly the culture risk of a smaller acquisition is a much easier thing for us to manage as a company. Since we've been a public company, we've done a number of acquisitions. They have been very successful for us.

We've been able to build on their technology. I mean, really the acquisitions we've done have been technology and capability acquisitions that we could integrate into our portfolio and offer to customers. The acquisitions we've done, like Slicehost and Cloudkick and others have basically been found -- technology foundation elements. That makes our Cloud what it is today.

So, we've been very proud of our track record on that. I would say we will absolutely continue to do those going forward as part of our strategic plan. The second part of your question was, okay, so are we going to do bigger deals? And, how would a bigger deal fit with our culture were we in the never going to happen here camp.

With respect to larger deals, I am not one to say never, but the risk sure does go up on them. Statistically, if you look at big M&A deals, they rarely fulfill their potential. The reality is in our company, we are a leadership team in a company full of people that know how to grow organically.

And, an organic flywheel of growth is a precious thing that -- so the first level of investment, inside of our investment framework, is always going to be around more organic growth. The wonderful thing about organic growth is we get to pick the customers. They select to be with us. And then, we build Rackers around it.

The problem with M&A growth of a big magnitude, where you buy a big company, or a company that is half the size of Rackspace or something like that, those customers didn't choose to be here. They chose to go someplace else. And, now we're going to treat them like cattle and pull them into our fold. So, that's a level of risk.

And, another level of risk is the same thing with the employees. If you come visit our company here and our refurnished mall technology campus, we have an interesting, unique, powerful way of doing things. So, I do worry about the culture risk of a larger deal. I'm not going to tell you never.

But, I think it's unlikely we would ever do something real large. As our company grows, the ability to do a larger transaction that's technology-based, that increases. But, are we going to do a deal that doubles the size of our company and we take on 4,000 more employees, man, highly unlikely.

Colby Synesael - *Cowen and Company - Analyst*

Yes, I think what I was referencing, and I think you touched on it, though, is that from a technology perspective, as you continue to expand out the product set, there's also additional adjacent industries, such as Cloud management companies, as an example, that are arguably larger in scope than maybe some of the deals you've done in the past. And, whether or not you would be interested in those. But, sounds like you could be.

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

Yes. I think the answer on that one is yes, we would have an interest in those types of opportunities. We would not have an interest in something that's dramatic, that's half the size of Rackspace with 3,000 employees or something. That would be hard. We would get indigestion on that one probably.

Colby Synesael - *Cowen and Company - Analyst*

Okay, great. Thanks, Lanham.

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

Yes, thank you. So, that's the end of our Q&A and prepared remarks. I want to thank you all for tuning in today. We appreciate your interest in our company and we'll go get back to work.

Operator

Again, ladies and gentlemen, this does conclude today's conference call. Thank you all for your participation. You may now disconnect.