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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to Rackspace Hosting's Q4 earnings release 2012 call. As a reminder, this call is being recorded. At this time, all lines are in a listen-only mode to prevent background noise. After the prepared remarks there will be a question-and-answer session.

(Operator Instructions)

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 fourth quarter and fiscal year 2012 earnings conference call. We hope that you have had a chance to read our press release, which we issued earlier today. If you don't have a copy of the press release, please visit our 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 we'll 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 including statements regarding expected operations and business results, our growth plans, the impact of new platforms, products or services, and our expected level of capital expenditures. These statements involve a number of risks and uncertainties that could cause actual results to differ materially.

These risks and uncertainties include things like -- One, market acceptance of our public cloud platform and products. Two, the continued adoption of OpenStack as the open source cloud computing platform standard. Three, increasing competition in our industry. Four, unfavorable economic conditions. And five, other risks that are described in our SEC filings.



Please note that these forward-looking statements reflect our opinions only as of the date of this presentation. We undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events. Please also note that certain financial measures we will use during this call, such as adjusted EBITDA, are expressed on a non-GAAP basis and our GAAP results and GAAP to non-GAAP reconciliation can be found in our earnings release for 2012, which is currently posted on the Investors page of our website.

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

Good afternoon, everyone. Thank you for joining us today.

2013 will be transformational for Rackspace, a year when we will step up and lead the open cloud movement, while laying the foundation for massive growth ahead. As we think about 2013, there are four main themes. Number one, clouds technology paradigm shift that is happening now, and this shift is an incredible opportunity for our Company. Number two businesses of all sizes are demanding open cloud technologies in the new cloud world. Number three, OpenStack is the open cloud standard. Number four, as the cofounder of OpenStack Rackspace is well positioned to lead the open cloud movement.

Before we dig into the four themes for 2013, let's briefly review some of the operational and financial highlights from the 2012. First, our revenue grew 28% to just over \$1.3 billion in the year. We are on pace to generate \$2 billion of revenue in a fraction of the time it took us to achieve our first \$1 billion. Adjusted EBITDA margins came to 35.5% for the year. This compares to 33.9% in 2011 and 33.6% in 2010. Net income margins improved to 8.1% per the year, up from 7.5% in 2011 and 5.9% in 2010.

Third, adjusted free cash flow came in at a Company record \$119 million compared to negative \$8 million in 2011 and \$34 million in 2010. Fourth, return on capital grew to 15.9% for the full year, up from 14.7% in 2011 and 11.6% in 2010. Q4 return on Capital equaled 16.9%.

Looking back, 2012 was a year of execution and rebuilding as years spent in the lab. During 2012 we made significant investments across the Business to bolster our systems, products and service delivery capabilities. From a financial standpoint a year ago we shared our operational plan and we said if we executed successfully in 2012 we would expect a revenue growth and margin profile that was similar to our performance in 2011. We are very happy to report we accomplished these financial goals. One of the most important projects we completed in 2012 was the launch of our public Open Cloud whose products and services leverage the features and scalability advantages of the OpenStack software platform.

Our new Open Cloud platform was released at the end of October and consisted of seven new products including Cloud Servers, Cloud Database, Cloud Block Storage, Cloud Networks, Cloud Monitoring, Cloud Backup and a new Control Panel for managing the elements of the Open Cloud platform. This project was one of the most difficult, exciting and strategic challenges that our Company has ever pursued. It was the largest product investment the Company has ever made and we believe it has tremendously improved the technical capabilities of our offering. Our new Open Cloud has eliminated bottlenecks that prevented us from running large deployments on our legacy platform that inhibited some of our customers from growing larger. With these scaling barriers removed we believe we are now able to compete for and run very large and complex production and deployments.

This project also demonstrates how our Company is building significant software development capabilities as we grow into the open cloud leader. To successfully compete in the cloud era, companies must deliver incredible customer outcomes that are powered by infrastructure and software. We believe the launch of the Open Cloud is just one example of how a software we are writing a Rackspace will shape of the market moves to the cloud.

Successfully deploying Open Cloud was our number one operational goal last year. With the Open Cloud successfully up and running, we announced that our focus has shifted to reaccelerating cloud growth on the new platform and winning large reference customers to run important applications on the open cloud. We also expressed her view that accelerated growth isn't something that happens overnight or guaranteed to be linear given the variable on-demand nature of the cloud.



In the fourth quarter, we were pleased to see cloud growth accelerate. Today, we'd like to announce that Staples is using the Open Cloud platform and their deployment includes the Cloud Database and Cloud Block Storage products. We are getting pilot projects with enterprise customers and these projects come before revenue.

Now let's talk about the important themes for 2013. First, cloud is a technology paradigm shift that is happening now and this shift is an incredible opportunity for our Company. As we plan for the future, we believe it's important remember that the opportunity ahead of us is massive and we have only just begun to tap into the market.

We believe the cloud computing era represents one of the biggest opportunities in all technology, one that will change how the world consumes IT. This technology shift is a long-term trend and we approach our opportunity with a long-term view. The critical objective during this stage of the market's development is to create a powerful position for Company in the open cloud that is reinforced with fanatical customer outcomes.

While the overall size of the market opportunity for Rackspace is difficult to precisely calculate, we know that it is substantial and growing rapidly. More and more businesses are discovering that using a specialized service provider's the most effective way to address their IT needs. The cloud is much more than just current IT workloads migrating out of legacy data centers. We believe the economics of the cloud will drive an explosion of new demand for computing, just as the proliferation of smartphones has driven explosive demand for new applications.

The second and third themes are businesses of all sizes are demanding open technologies in this cloud world and OpenStack has been established as the de facto open cloud standard. If you recall, the open age started with Linux and Apache. Both gained market share at the expense of proprietary alternatives. Next came Android, which surpassed iOS units in the smartphone market. Then Rackspace and NASA created OpenStack and open sourced the biggest platform of them all.

OpenStack has since emerged to become the de facto standard for open cloud software and we believe that we're eventually eclipse to proprietary alternatives available in the market today. To date, each of the public and private cloud markets have been marginally pioneered by single vendor, Amazon and VMware respectively. Amazon capitalized on being first to market in public cloudness and executed extremely well, detaching 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 putting in their own small, private clouds.

However both Amazon and VMware embraced a legacy model of using proprietary technology to lock-in there customers. While these early public and private cloud pioneers have had great success in the market, we're hearing from customers that the world wants an alternative to these proprietary standards. We think the world wants more open technologies, less complexity, and fewer closed systems. We think the world wants a trusted partner that provides a financial customer experience to help them make the transition to the cloud.

Massive technology disruptions like this create rare and unique opportunities for companies to take the initiative, disrupt the status quo and change the world. We believe Rackspace is in a fantastic position to help customers tap into the power of an open cloud world. We are the only company that can deliver a service portfolio across dedicated public, private and hybrid clouds, expanding both on premise and off premise work loads.

We believe are design principle of open technologies with fanatical customer outcomes is the right model for us to become a global powerhouse in the cloud era. In short, we're at the right place at the right time to benefit from these market trends. And our challenge is to ensure we make the right investments to capitalize on our position and maximize the long-term potential of this Company.

The last theme is really around open cloud leadership. In 2013 we want to establish Rackspace as the company leading the open cloud. In building open cloud leadership, we take a long-term, multi-year approach in our investment framework. The investment plan is about creating incredible customer outcomes and building a powerful market position for our Company. Our investment plan for the year 2013 is about solidifying our leadership in the market today while laying the foundation for significant new growth opportunities for the future.

We have ambitious plans. Plans that involve making significant investments in new product and service development, Fanatical Support capability, branding, OpenStack community support and geographic expansion. Building disparate technologies and offering them as cohesive service has enabled us to build our first billion-dollar revenue business.

However, in the cloud era we will take a more proactive role in developing our technologies that we manage for our customers. What this means is that even though the Open Cloud is fully available, we still have more work to do to expand the features and capabilities of the platform, while also enabling the delivery of higher service levels. The product development work we are doing is all about enabling us to deliver Fanatical Support across dedicated and public and private cloud workloads running both in our data centers and customers' facilities.

Rackspace has dramatically improved its software development capabilities over the past few years. We expect to significantly grow our investments in this area again in 2013. As we've discussed in the past, we take a long-term view in building the Company. We are working to build a truly great Company. We are committed to building a Company in a disciplined and sustainable manner for years. And, consistent with the financial performance in last few years, if we execute well in 2013 we would expect a margin profile similar to the range we experienced in 2012.

Before we turn the call over to Karl to review our detailed financial results we want to thank the nearly 5,000 Rackers that worked tirelessly throughout 2012 to deliver on our commitments for the year and the 200,000 plus customers that have entrusted Rackspace to manage their most important business applications. Our success would not have been achievable without passionate Rackers and trusting customers. It is through the efforts of Rackers that Rackspace is once again listed on Fortune's list of the 100 best companies to work for in 2012. Rackspace has made the list for several years and was most recently ranked number 34.

Now, being a native Texan number 34 has a special place for me. It was worn by all of Texas' greatest sports heroes, people like Earl Campbell, Nolan Ryan and Akeem Olajuwon. That is the end of my prepared remarks.

I will turn the call over to Karl.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Lanham.

Let me start by saying that we are pleased with the financial results we generated here in 2012. We were able to deliver on our financial objectives of producing similar revenue growth and margins as in 2011 while accomplishing many of our operational goals in the year including the launch of our new Open Cloud product. For the fourth quarter, total revenue was \$353 million representing 5% growth from the third quarter and 25% growth compared to the fourth quarter of 2011. Exchange rates had a positive impact on revenue of approximately \$1.4 million compared to the third quarter of 2012 and a positive impact of \$1.8 million compared to the fourth quarter of 2011. On a constant-currency basis, revenue grew 4.6% sequentially and 24% year over year. For the full year of 2012, total revenue was just over \$1.3 billion representing an annual growth rate of 28%.

Exchange rates had a negative impact on annual revenue of approximately \$3.4 million. On a constant-currency basis, revenue growth came to 28% in 2012 compared to 30% in 2011. Dedicated cloud revenue increased to \$266 million in the fourth quarter, representing 3.5% sequential growth and 18.1% growth on a year-over-year basis. Public cloud revenue for the quarter was \$87 million representing 9.9% sequential growth and 49.4% growth on a year-over-year basis.

Installed base growth was 0.5% in the quarter, which is a decline from 0.8% in the prior quarter and 1.2% in the fourth quarter of 2011. For the full year, installed base growth averaged 0.8% down from the 1.0% average during 2011. Overall we added approximately 8,000 new customers in the quarter, bringing our total customer count to more than 205,000.

Moving on to profitability. Adjusted EBITDA grew to \$130 million representing 6.6% sequential growth and 27% growth on a year-over-year basis. Adjusted EBITDA margin was at 36.8% in the fourth quarter, 60 basis points higher than in the third quarter and 70 basis points higher than in the fourth quarter of 2011. Depreciation and amortization expense came to \$69 million in the quarter representing approximately 19.5% of revenue, which is consistent with its 19% to 20% range that it has been in since the beginning of 2009. Net income came in at the record \$20.9 million for the fourth quarter representing growth of 10% over the third quarter and 19.4% from the fourth quarter of 2011.



Capital expenditure's totaled \$88 million for the quarter. Of this amount we spent \$60 million on customer gear, \$8 million on data center build outs, \$2 million on our office facility and \$18 million on capitalized software development and other projects. For the full year of 2012, total capital expenditures were \$338 million.

Adjusted free cash flow came in at \$39 million for the quarter and \$119 million for the full year. Return on capital grew to 16.9% in the fourth quarter and 15.9% for the full year compared to 16.0% in the third quarter and 14.7% in 2011. Average monthly revenue per server grew for the fourteenth consecutive quarter to \$1,310 from \$1,287 in the third quarter. We ended the year with a total cash balance of \$292 million, our total debt outstanding including capital leases was \$125 million, which translates to a net cash position of approximately \$167 million.

Before I review some of our plans for 2013, I want to congratulate all of the Rackers for pulling together to deliver another strong year. We have more work to do in 2013 but many of the projects we completed in 2012 position us well for success again in this year.

As Lanham mentioned in his remarks we have ambitious investment plans for 2013 that are focused on further enhancing our product and service portfolio, improving awareness of our capabilities in the marketplace and providing the foundation for more growth opportunities ahead. Our business has scaled nicely of years and this has enabled us to fund investments throughout the organization while allowing EBITDA margins to rise over 1,000 basis points over the past five years. Although we believe our model allows for additional margin expansion from current levels, our view is that given the massive essentially unlimited size of the cloud computing market opportunity before us, we believe that the best use of incremental profits is to use them to aggressively fund initiatives designed to help us dominate a larger share of market.

For the full year of 2013, we are forecasting to spend between \$375 million to \$445 million in total capital expenditures. We expect the bulk of capital expenditures to be on customer gear, which continues to be predominantly success based spending to support revenue growth. Specifically, we expect to spend \$235 million to \$275 million on customer gear, \$30 million to \$40 million for data center build outs, \$20 million to \$30 million for our office facility and \$90 million to \$100 million on software development.

This concludes our prepared remarks. We are now ready for Q&A. Operator please open the call for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

James Breen, William Blair.

James Breen - William Blair & Company - Analyst

I was just wondering if you'd talk a little bit about the CapEx guidance relative to this year. Your CapEx was actually down sequentially -- year over year, sorry, in 2012 versus 2013 it shows it up a little, but you seem to be continuing to get better efficiencies out of that CapEx. Can you talk a little bit about that?

And then, Lanham, on the big picture side you definitely saw a cloud revenue accelerate this quarter, the absolute amount of cloud revenue went up I think \$1 million more in the fourth quarter than it did in the third. Can you talk about how much of that trend is tied into some of the new products you launched and how you expect that to move going forward? Thanks



Karl Pichler - *Rackspace Hosting Inc - CFO*

Okay, I'll take the first one on the CapEx side. We've talked a little bit in the past about the nature of those capital deployments, especially with customer gear. It's fair to say that whenever you have either geographic launches or new product launches or a combination of both, that we will send up a growth capacity or launch capacity, so to speak, to basically support that launch. And that means that you have a little bit of variability, or lumpiness, as we would say, in terms of how we deploy that CapEx and capital over time.

On the other hand, you also have the move or the further proportion of cloud revenue that comes into our Company, which basically means from a capital deployment standpoint, that the cloud resources are deployed in advance of revenue where as the dedicated resources are deployed more concurrently with the revenue generation.

While we work on minimizing those incremental steps, there is an upfront deployment of capital that's more so in the cloud world than in the dedicated world. Over time we see to smoothen that out, but there is some lumpiness, especially with respect to new geographies, new data centers and product launches. And last but not least, the -- I just lost my thread.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Let me talk about the second part of the question around cloud revenue growth and how much is the new platform. Let's just take a step back and discuss where we are with respect to our cloud investments and cloud in general as a technology movement. With respect to our place in the market, obviously OpenStack is really starting to catch its stride. It's still a young technology movement but it's moving at a good pace. We believe we are uniquely positioned to assume our role as the open cloud leader, which we talked about in our prepared remarks.

Last year was an important year for us in launching the new Open Cloud platform. We're really proud of the platform that we built. We will continue to enhance and iterate and improve on that platform. But we feel like we've got a great one in the market now. When you ask the question about the growth and the growth we're seeing how much of that growth is on the new platform. Today we would say virtually all of it is on the new platform. We have our legacy cloud platform that we are still operating today.

In prior calls we've talked about customers on that legacy platform naturally migrating to the new platform. We are seeing that. But what we're really seeing is traction around the new platform. I think the growth that you see here in these numbers are really about the new platform and its traction in the marketplace. So I think that's where we'll continue to see the growth, will be on the new platform.

Now I issue that with a caveat around we've also talked in the past that growth in cloud is not linear. Given it's very nature cloud is a consumption model and so it's not a linear progression. Here you can look at the fourth quarter and say well we had a linear progression that time. I just don't think it's always going to go that way moving forward.

The other comment I want to make on cloud traction is, in prior calls we discussed that we were having conversations with CIOs and enterprises about the open cloud. I think what I'd say this time is that those conversations have progressed into pilots. In the prepared remarks we talked about Staples as an example. We have -- the vast majority of the conversations that we referenced in prior calls have turned into pilot projects with us.

These pilot projects are about these enterprise customers testing our cloud, putting some workloads on it, figuring out how to write to our APIs and really optimize the performance on those workloads. This is a very interesting and exciting period for us with our cloud, because now that the platform is in place we qualify for these new opportunities. We're talking to enterprise customers about it. The conversations have turned into pilots, and now we're truly in a test phase and performance phase with those customers.

We like the progress that we've made there and we're excited about it. When we talk about cloud growth going forward, I believe it's going to be on a new platform. We're in a pilot phase today with enterprise customers. We're going to do everything we can to have successful pilots with them so they turn into long-term complex production workloads ran on our cloud.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Sorry, I'm back. The last comment I wanted to make on the CapEx side was that with respect to the two platforms that we ran concurrently in 2012, which obviously required us to build up that capacity upfront and now what you see is that the marginal productivity -- the CapEx productivity has improved as we grow into that capital base.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Jonathan Schildkraut, Evercore Partners.

Jonathan Schildkraut - *Evercore Partners - Analyst*

I just actually have one question on the CapEx side. I was just wondering what it cost to facilitate a megawatt of critical load inside your facilities as I look at your data center CapEx for the year? Thanks.

Karl Pichler - *Rackspace Hosting Inc - CFO*

About \$5 million.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thank you.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Karl, you mentioned the install base growth, looked like the churn was okay but the net upgrades were a little bit light. Can you comment on what was driving that and any outlook on that item? And then, Lanham, you talked about geographic expansion a couple of times, I don't know if you can give us more color around what we expect and when over this coming year? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure. On the install base growth, you're correct, the churn it was down a little bit and call it flat, but the net upgrades were softer. And so the question around what's driving that, what's happening. The stuff we've talked about in prior calls is we have talked about a macro effect and this being tied to the economy. So, there's probably a little bit of that in there. But, really I think the story here is just our execution. I just think we didn't do a good job on it, as well as we'd like in the quarter, and I think it's more about our execution than anything else.

We continue to see plenty of opportunity inside of our base and when we talk about 2013 in the investment framework, and more aggressively investing for the long term growth in the Company one of the things that's on our minds specifically is the upgrade activity inside of our customer

base. We have been really hyper focused on our cloud platform rollout. We've put a lot of resources on that. We're going to add more resources on it because we feel a tremendous pull.

I just think we need to increase the investment in our base as well this year, so that's part of the framework. Right now, I don't have any big underlying trend to talk about in it. I think it was our execution more than anything. We're going to improve that. The way we're going to improve it is we're going to invest in it. That's the IBG question.

In terms of the geographic expansion, in prior calls we've talked about Asia Pac expansion. For example, here end of the week I'm flying to Australia. We're opening facility in Australia. I'm going down there for the kickoff. We're going to talk about our road map plans in Australia. The geographic expansion for us really slants more Asia Pac now versus Western Europe.

Historically in our Company our incremental expansion went into Europe. Given the headlines over there that we've all watched for a long time, I just think we're putting our margin dollars into Asia Pac. Our European business continues to perform very well. It's within our financial plans and all that, so we're not seeing bad outcomes over there. In fact, we're seeing the opposite. Our business is doing well.

I just think when you look at the long-term demographic trends and technology trends around the populations and consumption profiles in Asia Pac, it's really compelling. We feel a tremendous pull there from the limited presence we have today and we're going to -- this is part of the investment framework where we are going to aggressively increase our investment in 2013.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

Gray Powell, Wells Fargo.

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

Obviously, there's been a lot of speculation on the potential for you all to sign a large reference customer on OpenStack and we're glad to hear about the Staples deal. Can you give us a sense as to the size of that deployment? Or if you don't want to talk about just one specific deal, can you talk about the size of the largest deal that you have signed to date on OpenStack? As a follow-up, what kind of feedback have you been getting from the larger potential customers on the platform? How do you make those customers feel comfortable choosing Rackspace?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Let's talk generally about the adoption cycle, because that will help you understand what's going on there. This is a discovery process with customers around how to deploy and utilize an open cloud platform. The open cloud platform is a recent arrival on the technology scene. There's a lot of education and training that needs to take place to coach customers on how to use the API, to coach customers how to architect applications.

The most interesting parts about this tend to be what we would call hybrid. In that we have an opportunity to do an on-premise, private cloud for a customer as well as an open cloud -- public cloud environment with us inside of our facilities. A lot of the conversation really stresses and digs deep into how we make those things work.

If you work at the workloads or the applications that we are running for customers today in this pilot phase, it is a little bit of a spectrum so I will give you the end points here. Some of it are new applications that they're writing for a cloud environment. Things they've wanted to do for a while and now they want to test it and pilot it on our cloud, on our public cloud.



Other elements are programs where we are deploying on-premise private cloud for them. They want to have a big internal private cloud further developers to utilize as they're creating new apps that they want to run in their data center. So when you look at the complexity of these things, I think what happens is the applications that they're setting up are public cloud. Assuming successful conclusion of the piloting and testing phase of these conversations, we'll grow and take on complexity as the application grows.

In the remarks we talk about how the Staples example is using a few of the services we launched over the last year. That's an example of one type of application that we're running for people. When you look at the on-premise private cloud deployments that we've talked about in prior calls, these are customers that want to set up fairly sizable on-premise private clouds for utilization of their teams in their facilities. Some of these private clouds will be application development sand boxes for their teams and we'll see how they morph over time.

All of these are early days for us, so I don't want to get too speculative with respect to how it will end up working and how it will play out. I think that the way we would characterize it today is that we're pretty encouraged by the quality of conversations we're having with CIOs and IT leaders and development leaders inside of these companies. We believe that we have a technology offering that they are very interested in. They are in a pilot phase with us in that -- in their assessment. So we're learning a ton as they go through it.

The pilot phase here gives us a chance to tweak things on the platform so that it's more consumable for them. I think that's a good characterization of where we are today and we have this going on with lots of customers at the moment.

Gray Powell - Wells Fargo Securities, LLC - Analyst

Got it, that's very helpful, thank you.

Operator

Chris Larsen, Piper Jaffray.

Chris Larsen - Piper Jaffray & Co. - Analyst

First margins were better this quarter. In the past you've talked about slower rack adds. Was at a contributor? Did you have less headcount additions? And then as we talk to a lot of CIOs, the number one reason for -- they give or concern for going into the cloud is security. How do you get over that hump? Do need to do a security software acquisition or how do you think about security in the cloud and addressing that concern?

Karl Pichler - Rackspace Hosting Inc - CFO

On the margin side. You are right, we had a significantly lower number of net adds in terms of headcount during the third quarter. We had -- we added 67 net adds in that period. And that's certainly contributed to the 60 basis points increase that we've seen quarter over quarter. We had 256 net adds in the fourth quarter, which is more like our normal take rates or longer-term average take rate and so that together with some seasonal moves around people-related costs that we'd seen also last year happening, will have some impact on margins in Q1.

Lanham Napier - Rackspace Hosting Inc - CEO

In terms of the CIO question about security in the cloud and how do we address that, this is where we need to use the power of our portfolio and that's where we use it today. It's true that CIOs have security concerns about the cloud and the cloud is a relatively new technology. The architecture of it is not as well-established as server/client architecture, for example, and the ecosystem around that. There are naturally questions.

Part of what we've rented apart here is our hybrid offering where we can bridge between cloud and dedicated infrastructure and that bridge gives us some security capabilities that you don't find in cloud all by itself per se. That is one way we solve the problem for customers today. I also think



that over time, our security capability on the cloud itself and looking at security capability on just the cloud will improve. Part of the promise of the open cloud and the advancement of that road map is addressing some of these problems.

So today I think we have a solution -- a hybrid solution that fits the bill. I think in the future the security framework around OpenStack and our Open Cloud continues to advance. So that'll solve it as well.

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

Thank you.

Operator

Scott Goldman, Goldman Sachs.

Scott Goldman - *Goldman Sachs - Analyst*

A couple questions around OpenStack. On the product side of things, I think, Lanham, you've talked a lot about the increased scale and feature set that OpenStack delivers and I think part of that was really to help narrow the gap between yourselves and some of the other players that were out there, namely AWS. So you rode out a lot of stuff in the back half of 2012. How do you feel about how you stack up now vis a vis AWS or even others that are out there from a product standpoint? And what products might you be missing there that we might see come on in 2013?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Thank you, good question. The products we launched that are embedded in the platform, toward the end of last year, closed the vast majority of the gaps. If you look at these basic scaling and feature sets that we need to have in our cloud, we feel like we've covered that. The stuff that we'll iterate on and refine are more nuanced, niche, feature benefits for particular customer segments. To put in place the foundation that we established, that was heavy lifting, that OpenStack launched in 2010. We implemented that two years later. That was a big piece of work.

When you look at the feature sets that we're rolling now, instead of taking years, they take weeks. Some of them six weeks, some of them eight weeks, some just a couple weeks. I think what's happened is now that we have a foundation in place, we can iterate and add capability on top of that foundation at a much faster pace. The trade-off is the incremental feature isn't as game-changing as the Cloud Block Storage service that we rolled out here in the last year. These are enhancements for specific use cases and specific customer needs rather than tectonic paradigm shift movements in terms of what we're capable of delivering.

Part of the question was how do we feel about this, how do we feel in terms of how we stack up on this. I think we feel pretty confident. One of the things that we are really proud of is that over the year 2012 we dramatically increased our power in the market and our competitive position. That doesn't always show up in the numbers right away.

We feel like what we have done in the marketplace is position ourselves as a real candidate to lead the open cloud movement. We feel like the portfolio we have on the ground is the best portfolio on a global basis. That we can scan -- we span public cloud, private cloud, on-premise, off-premise, and a traditional dedicated offering. That's pretty powerful. We feel like that's unique in the marketplace today.

I think from a cloud point of view, we feel very capable and we're confident about where we are. We think the portfolio is powerful and we think our path to greatness is around open technologies and Fanatical outcomes. That's why we talked about we're going to continue to increase our investments in it. Now that we have the foundation in place, I think we can keep moving forward at maybe even a faster pace than we have historically.



Scott Goldman - *Goldman Sachs - Analyst*

Great. And then, one follow-up and some of the answer you gave there may apply here, but as you're dealing with a lot of these enterprises and they're engaging you in pilot projects and talking to you about what you can do, do you get the sense just from a competitive standpoint, are these enterprises also looking at some of the other alternatives that are out there? Whether it's a Cloud Stack or Eucalyptus or do you get the sense that they're also looking at some of the other clouds that are powered by OpenStack that are being deployed by some of your peer OpenStack followers as well? Or are they really coming to Rackspace and looking at it from the support angle?

Lanham Napier - *Rackspace Hosting Inc - CEO*

I think that, at least the conversations I'm in, we have pole position with respect to OpenStack. The consideration set, for I would say vast majority of the customer conversations we're having, are there's an incumbent way of doing things in there. And this is based on all the traditional technology companies that are out there in the marketplace. There's that incumbent path. People want to know what to do about cloud. There are other public clouds out there. We're one of them, Amazon's one of them.

Then people want to talk about open versus closed platforms. And when they have the platform conversation, this is where OpenStack' is powerful. And right now we're running the largest OpenStack cloud in the world. We have tremendous expertise and perspective around how the technology works and how we can deploy it for people. So I think that consideration set tends to be pretty common.

Our point of difference in it is the Fanatical outcomes on top of the cloud expertise that we provide. We have a brand reputation in the market place around Fanatical Support so customers are looking for that. And its an exciting time for us.

We are an SNB company that has grown into enterprise. We're still the relative newcomer on the block when it comes to enterprise. I can remember being on investor call talking about the launch of our enterprise segment just a little while ago. We see tremendous opportunity in there and the pull we feel is these customers are looking for an alternative. The old lock-in model of proprietary technology and expensive enterprise license agreements is waning. People are looking for a new model with respect to building out their technology to introduce a real new capability inside of their companies. I like our chances in this. We're still learning and we got a lot to do. We can see the opportunity ahead.

Scott Goldman - *Goldman Sachs - Analyst*

Great. Thanks, Lanham.

Operator

Sterling Auty, JPMorgan.

Sterling Auty - *JPMorgan - Analyst*

You talked about in an earlier question that this is a discovery process for customers. Do you think that there was any hesitation or stall in the number of customer adds you had in the quarter as customers were kicking the tires and trying to understand the solution through the education process?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Good question. I think when you look at customer counts, it went from 197,000 to 205,000. The vast majority of those customers are coming to us online through digital properties. The education process there is around the site experience, there's going to be some human touch with Rackers in there as we assist them to figure out how to get things going. That's the vast majority of those customer adds.

When I was talking earlier about the discovery process with customers and the education, the training taking place, there's an element of that with the vast majority of SMBs that are showing up online. But in the back of my mind the picture I had was really of enterprise customers. The enterprise customers are the ones that we are spending more time helping educate them on how to use the open cloud to get a pilot going, understand what to test for, assess the right metrics for performance to really understand the performance of the underlying platform and how it's going to make a difference for their company.

I certainly think that anytime you have a new technology, education and discovery matters. People are going to try to figure out what it means, how do I use it, how am I successful, what do I need to worry about. All that stuff. So we absolutely need to improve our game on that and we'll continue to improve our game in that. The big discovery that has a little more complexity to it are those customers that are doing more complicated things, which right now for us tends to be those enterprise conversations.

Sterling Auty - *JPMorgan - Analyst*

In those enterprise pilots is there a natural use case that's low-hanging fruit for you to enter? Think about the early days of putting a QA server in a colo facility or hosted facility. Is there a natural pilot that you can start these guys on to get your toe in the door and then land and expand?

Lanham Napier - *Rackspace Hosting Inc - CEO*

There are a couple. We need to be thoughtful here and segmented based on on-prem and off-prem. When you look at the apps they're running inside of our facility, these are in some cases apps they're running themselves that they want to move over, so they want to rearchitect it. Others are apps they've always wanted to write and now they want to write for a cloud world. Each of those, I think, are pretty straightforward things where we can help them with.

When you get into on premise there are things like big on-premise data stores that are interesting because of the open cloud technology, as well as on-premise test and dev sand boxes for their internal developers with respect to how their developers want to launch apps and start to get a cloud capability inside. Those are a couple of things that we're pretty excited about and we're talking to people about.

Sterling Auty - *JPMorgan - Analyst*

Got it, thank you.

Operator

Tom Seitz, Jefferies.

Tom Seitz - *Jefferies & Co. - Analyst*

Yes, can I follow up on Scott's question? I'm interested in whether or not any of your OpenStack brethren are showing up yet? And if they are, are they running pilot programs alongside yours as the company tests the platform? Just curious about the competitive environment with OpenStack within itself?



Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. The good news on OpenStack is the community is growing and strong. You can look at HP's launched a general availability, their OpenStack public cloud. IBM's part of OpenStack, VMware's showing OpenStack, Red Hat's part of OpenStack, so we've certainly got a lot of folks in there. When you reference, are we seeing those people in these accounts, in these customers that we're serving what's the dialogue like? I'm sure they have to be in there somewhere. From my experience in the conversations, I'm not seeing a bunch that.

Part of what we have is that we just have real powerful credibility around the fact that we're running the world's largest open cloud, that we co-created OpenStack with NASA, so we have a unique perspective on how to do this. When you look at the performance of our cloud, it's very reliable. We're proud of -- if you go to our performance metrics page online, you can see the status of our systems.

We're proud of the reliability that we've produced. I think we're in a powerful position there. I think it's good for the ecosystem that these other companies are out there and from a distance they seem to be doing well. I'm sure they are in some customers as well. Part of the situation here is we are growing a product into enterprise.

We serve a chunk of the Fortune 1,000, but we don't serve all of them. I think there's plenty of room for these other companies to be making traction there as well. When we talked about leading the open cloud movement, we believe that we're going to be the company that ought to do the best here. That with respect to setting up OpenStack clouds and running the world's largest OpenStack cloud, we believe we are uniquely positioned to seize that as our future. We think we drive a lot of Mindshare today with the developer community. If you look at the contributions were made to OpenStack historically, we are one of the most prolific contributors.

Other people in the community are stepping up. I think this will continue to be a pretty rich fabric, where you'll have companies investing in OpenStack and that's just all good news because it will advance the technology faster. The opportunity for us is to continue to differentiate around Fanatical outcomes and to still seize thought leadership with how it all operates.

Tom Seitz - *Jefferies & Co. - Analyst*

Thank you very much for the color

Lanham Napier - *Rackspace Hosting Inc - CEO*

Sure, in this ecosystem there's room for multiple players. It's going to be a big market and we want to dominate that niche and segment where people want a Fanatical outcome. This is where we think we are uniquely capable of doing.

Tom Seitz - *Jefferies & Co. - Analyst*

Great.

Lanham Napier - *Rackspace Hosting Inc - CEO*

(music) Thank you to the investor community tune in to our call. I want to thank the Rackers for all the work they're doing and we're going to get back to work.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you.



Operator

That does conclude today's conference. We thank you for your participation.

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