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RAX - Q1 2013 Rackspace Hosting, Inc. Earnings Conference Call

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## PRESENTATION

**Operator**

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Hosting's first quarter 2013 earnings release conference call. As a reminder, this call is being recorded. At this time, all lines 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 Mr. Bryan McGrath, Director of Finance for Rackspace. Mr. McGrath, you may being.

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**Bryan McGrath** - *Rackspace Hosting Inc - Director of Finance*

Thanks, Brian, and hello, everyone. Welcome to Rackspace's first quarter 2013 earnings conference call. We hope that you've 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. Joining me on the call today will be Lanham Napier, our Chief Executive Officer, and Jason Luce, Vice President of Finance.

I need to remind you that some of the comments we'll make today are forward-looking statements including statements regarding expected operations and business results, our growth plans and strategies, the impact of new platforms, products, and 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 cloud platform services and products, two, the continued option 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, including our most recent annual report on Form 10-K. Please note that these forward-looking statements reflect our opinions only as of the date of this call. 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. Our GAAP results and GAAP to non-GAAP reconciliation can be found in earnings release for the quarter which is currently posted on the Investor page of our website. After our prepared remarks as afternoon, we'll be happy to take your questions. I will now turn the call over to Lanham. Lanham?

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

Good afternoon and thank you for joining us today. Jason is here with me filling in for Karl because Karl's wife's in the process of having a baby. I'll hand the call over to Jason later on to go through the financial results in detail.

Our first quarter results demonstrate that we're still working through a product cycle transition. Total revenue grew 2.6% sequentially in the quarter. The primary source of slower growth in the first quarter came from slower-than-expected sales to our enterprise customers. Specifically, net upgrade activity and new bookings from enterprise customers slowed. The vast majority of enterprise revenues for our dedicated service and a combination of fewer net upgrades and new sales resulted in dedicated revenue growth decelerating to a rate of 2.2% sequentially in the quarter. You can also see the effect of this trend in our install base growth metric that came in at 0.1% monthly for the quarter, down from 0.5% monthly in the fourth quarter. Although net upgrades were soft, revenue churn remains at a healthy level 0.8% per month, below its historical average of 1% per month.

Our public cloud growth rate was 4% sequentially in the first quarter, down from 10% sequentially in the previous quarter. The slower growth rate in the first quarter was due in part to the lower bandwidth pricing and tiered pricing for public cloud storage. While we are not satisfied with the total public cloud growth, we are encouraged by strong demand for our new OpenStack public cloud product which grew more than 75% sequentially in the quarter, and cloud growth did increase as we progressed through the quarter.

We completed the launch of our OpenStack cloud platform in November and since that launch, we've seen no incremental growth on our legacy public cloud platform. This is largely because customers running on the legacy public cloud platform aren't increasing activity. We will help customers migrate to new OpenStack public cloud platform so they can develop new applications and resume their growth. This product cycle transition will likely continue for some time, given the large number of customers still using the legacy public cloud platform. During this time, we expect our public cloud growth rate to continue to be less predictable until we complete the transition. The key to managing through this transition is to focus on customers and their specific needs so that their workloads run in the best possible environment, be it public cloud, private cloud, dedicated, or combination.

Last year, we devoted significant time (inaudible) attention and resources on ensuring that the OpenStack cloud rollout was completed successfully. We believe this intense focus on the public cloud launch was absolutely essential although it impacted our enterprise and dedicated results. We under-invested in some areas of our hybrid cloud and we have seen lower net upgrades growth in our enterprise customers as a result.

With the successful launch of the OpenStack public cloud platform, we are now able to re-balance our investments and expand our offering capability for customers across our hybrid cloud portfolio. We're focused on increasing our hybrid cloud capability by pulling together our public cloud, dedicated, and private cloud offers and creating offers that we think have the ability to improve the growth rate of our enterprise customers and dedicated products.

We recognize that all these trends occurring at the same time had made it more difficult for investors to forecast our business. So given the higher level of uncertainty in the current environment, we have decided to provide you with a revenue forecast for the second quarter. Based on the trends that we have experienced so far in the quarter, we expect to deliver second quarter revenue in a range of $369 million to $375 million, representing sequential growth between 2% and 3.5%.

While we are not satisfied with our growth rates in the first quarter, we are more optimistic than ever about our long-term position in the market and our future opportunities as the world moves to a new model of computing. Today, it really looks like OpenStack is the clear winner as the emerging open standard for cloud computing an our leadership within the OpenStack community is strong. Our hybrid cloud offering (inaudible) puts us in a great position to benefit from the changes that are reshaping the IT industry. We believe we are the best company to deliver world-class service experience across a portfolio of dedicated, public, and private clouds, spanning both on-premise and off-premise workloads. We believe that [marrying product-tied] technologies with Fanatical Support to deliver incredible customer outcomes is the right model for the cloud era.

During the past two-and-a-half years, we've made bold moves and aggressive investments in our open cloud strategy. We open sourced our valuable cloud technology and, in conjunction with NASA, we founded the OpenStack project. Last year, we doubled down our investment in OpenStack by re-architecting our public cloud platform so it was powered by the OpenStack technology. Our investments in OpenStack and our OpenStack public cloud product represent large, long-term investments designed to make Rackspace a much stronger competitor in the cloud computing market.

We've discussed these investments with you many times in recent calls and we are excited that they're starting to pay off. Our reputation as OpenStack founder and expert is generating more and more recognition. It looks to us that OpenStack is approaching a tipping point in the market. IBM, one of our fellow corporate sponsors of OpenStack, recently announced that it will base its new cloud products on OpenStack. At the recent OpenStack Summit in Portland, enterprise customers including Best Buy, Bloomberg, the Soren Research Institute, Comcast, the National Security Agency, PayPal, and Sony gave presentations about their use of OpenStack in their plans for further deployments on the open source platform. Clearly, OpenStack has reached a level of effectiveness and success that is increasingly attractive to enterprise customers.

Our involvement with OpenStack has expanded our addressable market by opening up new opportunities in new markets with the new types of customers. And most recently, our investments in OpenStack have enabled us to make public our first reference customer for a hybrid cloud offering powered by OpenStack. That customer's HubSpot. HubSpot is an inbound marketing software-as-a-service company that serves some 8,000 customers in 56 countries.

HubSpot's main production application was initially running on a proprietary public cloud platform but over time, the company's needs evolved. First, HubSpot needed to add a high-performance back end infrastructure to support high throughput databases. Second, as the deployment grew larger and larger, the inherent inefficiencies of a general purpose, one-size-fits-all proprietary public cloud platform became more pronounced. And finally, as the business became bigger, the [risks of vendor lock-in] and therefore the appeal of open source technology grew as well.

Given these considerations, HubSpot began evaluating alternative cloud platform-as-a-service providers. After a careful evaluation process and an extensive four-week migration period, HubSpot was processing workloads on OpenStack at Rackspace. Rackspace was able to leverage our portfolio solutions to assemble a customize infrastructure platform that was optimized for HubSpot's environment. HubSpot uses Rackspace's dedicated cloud offering for a high-performance database and large-scale Hadoop deployment. HubSpot's public-facing SaaS application is running on our OpenStack public cloud platform and the company's using our private cloud solution for internal applications, including test and development environments.

So far, the results of HubSpot's migration have gone very well. The company presented a detailed case study of its journey to the open cloud community at the OpenStack conference in April and according to its CIO, Jim O'Neill, HubSpot achieve a 4X efficiency improvement after moving to OpenStack hosted at Rackspace.

The HubSpot customer example not only represents a large-scale production app on our new OpenStack public cloud, it also illustrates the power of our hybrid cloud capability. As a reminder, our hybrid cloud service helps customers find the best fit for each of their applications across public cloud, private cloud, and dedicated hardware, in our data centers or in our customers' facilities.

Hybrid cloud is where we are best differentiated in the market and it is where we are winning new enterprise business today. Many of our competitors try to push customers into a one-size-fits-all solution and persuade them that all their workload should run on a public cloud, or on the private cloud, or on dedicated hardware. By contrast, we offer the productized solution that fits best for each customer's evolving needs. By using a mix of these services, we can optimize the infrastructure footprint for different applications and deliver superior performance, reliability, and cost efficiency for customers as they move to a cloud world.

While many new applications are written for the cloud world, we're seeing that applications grow they need more than what a public cloud can provide. Once the customer's deployment reaches a certain size, the benefits of a hybrid cloud architecture become very compelling. This was the case with HubSpot. This is also the case with many of our pilot deployments and we believe we will see more examples of this dynamic play out as a cloud market evolves.

Expect to see us increase the emphasis on our hybrid cloud capabilities in the market going forward. We have a truly unique offer in this market and we feel that maturation of OpenStack and our services around it will only grow that advantage. As you know, closing large referenceable customers like HubSpot is one of our key objectives for the year. And while we are proud of the HubSpot customer success, we need more. We believe there's no better way to help prospective customers become comfortable with OpenStack technology than have a portfolio of customer successful [introduction] on our platform.

The good news is that we have a robust pipeline of pilot deployments that we expect to move in production throughout the year. Conversations with prospective enterprise customers have increased and as the conversations convert to pilots, and eventually revenue, that will drive higher growth. We will update you on progress during the quarter and on our next call.

During the fourth quarter earnings call, we said that 2013 would be a transformational year for Rackspace. The Q1 growth is not what we hoped for but is also not outside the bounds of how we felt things could unfold, given the new platform we are building. Improving customer commitment on this platform is our primary objective this year and hence we are focused on improving our revenue growth right from the quarter we just reported. Our primary financial goal was to accelerate growth from here.

In 2012, we completed the launch of OpenStack public cloud platform that tremendously improve the technical capabilities of our offering. We're a much stronger company than we were last year at this time and multiple long-term growth drivers are in place for us to exploit. This year's all about leveraging the momentum of OpenStack to drive adoption of our products in hybrid cloud services. We shared a large-scale OpenStack hybrid cloud reference customer [with you] today. We have more in the pipeline and we are working on several initiatives that we will share with you later in the year. I look forward to updating you on our progress in August.

I will now turn the call over to Jason Luce for a more detailed review of our financial results. Jason?

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

Thank you, Lanham. For the first quarter, total revenue was $362 million, representing 2.6% sequential growth and 20.2% growth compared to the first quarter 2012. Exchange rates had a negative impact on revenue of approximately $2.9 million, compared to the fourth quarter of 2012 and a negative impact of $1 million compared to the first quarter of 2012. On a constant-currency basis, revenue grew 3.5% sequentially and 20.5% year-over-year.

Dedicated revenue increased to $271 million in the first quarter, representing 2.2% sequential growth and 15% growth on a year-over-year basis. Public cloud revenue for the quarter was $91 million, representing 4.1% sequential growth and 40% growth on a year-over-year basis. Monthly install base growth was 0.1% in the quarter, which is a decline from 0.5% monthly in the prior quarter and 0.7% monthly in the first quarter of 2012. Recall that the calculation of the installed base growth metric consists of two components, one, net upgrades, made up by the net spend from existing customers on a month-over-month basis, and two, churn, made up from revenue lost from customers taking workloads off-line, also on a month-over-month basis. The decline in our install base growth has been driven by lower net upgrades, primarily from our lack of generating more revenue by winning more business from our existing enterprise customers.

Average monthly net upgrades for the first quarter was 0.9%. This is about half of where we wanted to be. For context, monthly net upgrades average 1.9% in 2011 and 1.5% in 2012. Churn on the other hand as remained very healthy and came in at 0.8% in the first quarter. That's consistent with the average monthly churn for the past couple of years. Monthly churn averaged 0.9% and 2011 and 0.8% in 2012.

Historically, as you know, install base growth has been a critical part of our growth engine and that hasn't changed. We believe the long-term growth drivers are in place to drive this number higher again and we are focused and hard at work to make it happen. As Lanham mentioned, we expect to deliver second quarter revenue in a range of $369 million to $375 million, representing sequential growth between 2% and 3.5%. Beginning this quarter, we have removed customer count from our key metrics disclosure. Over time, the relevance of our total customer count has diminished in terms of analyzing or predicting revenue trends, given the ongoing growth of our public cloud, a broader set of products with different price points, the acquisitions we've made, and customers migrating from legacy platforms to new platforms. Since we [did not preview] our intention to remove this metric from our key metrics page, we want to share the statistic one last time. During the first quarter, we added approximately 9,800 customers. Total server count for the quarter increased to 94,122, up from 90,524 servers at the end of last year.

As you may have noticed, we also made some changes to the reporting of expenses on the income statement to provide additional disclosure with respect to our research and development activities. Certain costs that were previously included in the G&A expense line item have been reclassified to this new R&D category. Building out our own software development capabilities is an important investment area for our business and breaking this out is intended to provide you a more detailed view into our cost structure and the different investment areas we are funding.

In addition, there were some general expenses that we moved from the G&A expense line item to the cost of revenue and sales and marketing expense line items. This was done to more closely tie overhead costs to the people that are associated with cost of revenue and sales and marketing. In our earnings release filed earlier today and in our 10-Q that will be filed later this week, you'll notice that we have also reclassified expenses in past periods to conform to the new reporting structure in order to make it easier for you to compare trends over time. Please note that these changes do not affect the Company's previously reported net income, adjusted EBITDA, cash flow, or return on capital metrics.

Moving on to profitability, adjusted EBITDA for the quarter was $125 million, a 3.6% decrease compared to the fourth quarter of 2012 and a 24% increase compared to the first quarter 2012. The adjusted EBITDA margin for the quarter was 34.5%, compared to 36.8% in the previous quarter and 33.4% for the first quarter of 2012. Consistent with prior periods, adjusted EBITDA and adjusted EBITDA margin were negatively impacted by a non-cash charge relating to data center operating leases. During the first quarter of 2013, the non-cash data center lease charge was $4 million.

Adjusted EBITDA margins in the first quarter were impacted by one, the slower revenue growth, two, the increased hiring activity that started in the fourth quarter of 2012 and continued in the first quarter, three, increased marketing spend associated with the open cloud branding campaign, four, more product development work on the new OpenStack public cloud platform, five, investments for further expanding our reach into new geographies, as well as six, various internal systems to support all these growth initiatives. During this period while we are pursuing our growth re-acceleration plans, we are deliberately increasing investments that will lower adjusted EBITDA margins. In the near-term, expect adjusted EBITDA margins to be more in the 30% ballpark, compared to the 33% to 35% range we've average over the past several years.

Depreciation and amortization expense came to $70 million in the quarter, representing 19.4% of revenue which is consistent with the 19% to 20% that D&A has ranged since the beginning of 2009. Net income was $27 million for the quarter, down 8.8% from the previous quarter and up 17.6% from the first quarter of 2012. Net income margin for the quarter was 7.5%, compared to 8.5% for the previous quarter and 7.7% in the first quarter of 2012.

Capital expenditures totaled $125 million for the quarter. Of this amount, we spent approximately $86 million on customer gear, $13 million of data center build-out, $8 million on office facilities, and $19 million on capitalized software development and other projects. As a reminder, for the full year of 2013, we are forecasting to spend between $375 million to $445 dollars 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.

Adjusted free cash flow for the quarter was negative $1 million. Return on capital was 15.1% in the first quarter, compared to 16.9% in the prior quarter and 15% in the first quarter of 2012. The slight reduction in our return on capital was due to lower NOPAT margin at 7.7%, compared to 8.6% in the fourth quarter of last year. Capital turnovers in the quarter stayed constant relative to the fourth quarter of 2012 at 1.97 turns. At the end of the first quarter of 2013, cash and cash equivalents were $279 million while debt, including capital lease obligations, totaled $106 million.

As Lanham mentioned in his remarks, we got off to a slow start for the year. While we remain disciplined on the cost side of the business and focused on driving higher returns on the capital we deploy, restoring growth is the number one priority right now. We aspire to be the service leader in the open cloud revolution and we like our chances. We now have the product portfolio in place to serve an even larger part of the market and as our software platform built on OpenStack matures, we expect increased adoption to drive our growth ambitions.

This concludes our prepared remarks. We know you have a lot of questions and we'd like to give as many people as possible a chance to ask a question, so in the interest of time, we'd be grateful if you would limit your question to one. Thank you. Operator, please open the call for questions.

## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions)

We'll go now to our first question from James Breen with William Blair.

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

Thanks for taking the questions. On the embedded base growth within the managed services business, can you just give a little more color on why you think it was down so much? We've heard from a lot of other tech companies just in general enterprise spending being down and so forth. How much of that do you think is macro versus specific, to how you're targeting your customer base? Thanks.

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

Okay, sure. This is a Lanham. The question's about our install base growth and just providing some context around what we see there. When we look at the install base growth, Jason, in the prepared remarks, took you through how the metric's calculated. So there are few drivers in there. The one thing to look at is basically the net upgrade activity. This is where your question about, is this specific to us, is it more of a macro condition. Our perspective on net upgrade activity is really is more about what we're doing than anything from a macro. We believe we're in control of our outcomes here and it's up to us to improve our execution and capability to make it happen.

What we saw in the first quarter was really a slowdown in that process. We think that we have some good ideas and plans to turn that around. The nice thing about our enterprise business is that you have a greater visibility into things as customers are making decisions. We saw those decisions slow down. At the same time, we still have a lot of opportunity there. We just haven't gotten it across the finish line yet, in terms of turning it into actual revenue. With this metric, from our perspective, there's still just work to do to progress and work through it with these customers. It something we will continue to watch closely.

We are happy that our defection churn is still remaining at healthy levels because ultimately that churn number describes how customers feel about us and whether they're sticking with us. What we have to do to make that metric go up is qualify for more workloads. Do great work for them so they send more workloads to us over time. What we've experienced here lately is that enterprise has slowed down. And if you recall from some of our remarks and conferences that we attended in years past, our enterprise segment within that dedicated number was our fastest-growing segment. What we've seen here over the quarter is that slowed, so it's no longer our fastest growing segment and it had a meaningful impact on that install base growth metric.

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

Great, thank you.

**Operator**

We'll take our next question from Simon Flannery with Morgan Stanley.

**Unknown Participant** - - *Analyst*

Hi, this is [actually] Lisa for Simon. Thanks for taking the question. Maybe following along on that question, can you comment on how you see [your] revenue growth playing out throughout the year? I know you gave a range for the next quarter but do you see something similar in the latter half of the year? And maybe you can comment on whether FX is [playing] an impact on that as well? Thank you.

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

Could you repeat the question? I'm sorry, you were a little staticky. I just want to make sure I get it right.

**Unknown Participant** - - *Analyst*

Sure, my question was on the sequential revenue growth, over the remainder of the year, and just how that plays out. I know you gave a range of 2% to 3.5% for the next quarter. Should we be expecting something similar in the second half of the year?

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

Okay, so what we're doing in that forecast is, given the dip in our growth this quarter, we wanted to give investors in the marketplace some better data on how to model it and how to think about things going forward. What we've done in our remarks is really provide the most detailed commentary, I guess, in our Company's publicly traded history around what we think is going to happen. So I would say in terms of Q2, we've been pretty transparent on things. For the sake of this call, really all we wanted to talk about was Q2. We feel like what we're endeavoring to do here is to give you greater transparency around that, so you can start to see from the key metrics and the range that we've provided in this call how things are playing out and what we expect to have happen.

When we look at the growth from our Company's perspective, obviously Q1 and the growth we just posted was not something that we're happy with. We did not feel like we knocked it out of the park or anything, from a growth point of view. We did put in our prepared remarks that our primary financial goal is to accelerate our growth from here. That's what we're focused on improving around here everyday. When you look across our Company, the place where we felt the growth reduction was in our enterprise business, which is primarily on our dedicated [form] factor. If you look at some of the newer platforms and newer offerings inside the Company, those are growing quite nicely. We had in the prepared remarks a comment about the new OpenStack platform which we rolled out in stages last year. That grew 75% sequentially quarter-over-quarter. So we think that is an example of part of where our Company is headed, in terms of the marketplace and our competitiveness.

We have other hybrid cloud offerings where we link our dedicated and public cloud offering together. That is also still growing at a high rate. What's happened to us here is we lost the momentum in our net upgrade activity in our enterprise segment. That was our fastest growing segment in that chunk of the business, in our dedicated business, historically. We've got to get to work on that. We're providing you a revenue range to help analysts and investors model where we think things will be here in the second quarter. And we're focused on improving our results in dedicated. We're focused on increasing the investments in these high-growth hybrid cloud offers.

**Unknown Participant** - - *Analyst*

Great. Thank you.

**Operator**

Our next question is Pat Walravens with JMP Securities.

**Pat Walravens** - *JMP Securities - Analyst*

Great, thank you. Lanham, can you address what I think is one of the big question investors have, which is just how much of the revenue growth slowdown is due to the increasing competition, and to the price cuts that we're seeing coming out of Amazon Web Services?

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

Okay, so specifically let's talk more about revenue growth, and the competitive factors then. The number one growth impact for the Company [as a whole] really is the IBG metric, which we've talked about. The number one driver there is on the enterprise business. When you look at the public cloud sequential growth, that one also fell. So, there are a few factors going on with public cloud. I think one factor is the pricing changes that we talked about. We put that in the prepared remarks and basically when we do that, that certainly has an impact.

I think another factor is where we are in our product cycle. We have a product cycle here where we have first generation/legacy cloud platform that has been around for a few years here inside the Company. It was our primary cloud offer, up until the end of last year, call it last fall. It does not have all the technical capability that our new platform does. It was a platform that was really good for simple workloads but it didn't have all the features and services around it that our new platform has.

When you look at our cloud revenue, because the first-generation cloud is the biggest piece of that revenue, how that performs in the short-term will have a big impact on the sequential growth of our overall cloud. This is, I think, typical of any new product introduction and product cycle. What we can point to and are happy about is that the high growth we're experiencing on the new OpenStack cloud platform. That's growing at a rapid rate that we talked about in the prepared remarks. Our legacy cloud platform at this point, as we said in the prepared remarks, is basically adding zero incremental growth. But it is the largest piece of the cloud. What we have to work through here is this product cycle transition. We've got to give more investment and time to the new platform, to where it reaches an aggregate level of scale and mass, that basically drives the overall growth result in our cloud.

When it comes to the pricing that we made, pricing decision that we made in the first quarter, let's talk a second about just pricing in general, and how we think about it around here. Number one, we have a pretty strict EVA financial discipline about pricing. When we were looking to create economic value added with all of our pricing, we understand the cost base. We're charging a rate of capital return as we [figure out] the price.

As we increase our level of scale and become more efficient and effective, we do pass along that savings to our customers through that EVA pricing model. The way we position ourselves in the marketplace is that we do price at a premium. We believe this premium reflects the fact that we have a differentiated service that we call Fanatical Support. We have higher SOAs, better service outcomes, and generally better customer outcomes for people that want to higher service level experience in the cloud.

Our pricing strategy will continue to be a premium price player, differentiator [route] our services. As we get operational cost savings more commodity elements of our offering, we will continue to share part of those savings with customers, just like we always have. We think that's the customer loyalty building strategy we should follow. The margin and value created reflects our pricing premium, relative to others in the market. We will always be the premium to other people out there because we're the best service. We're the best customer outcome. You've got to pay the most for that.

**Pat Walravens** - *JMP Securities - Analyst*

Great. Thank you.

**Operator**

Our next question comes from Jonathan Atkin with RBC Capital Markets.

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

Yes, I wondered if you could comment on how much churn in Q2 to date might have informed your view, as to the revenue guidance and a slower growth rate. And then, the UK is a much more enterprise-centric market and I'm wondering what you're saying over there, that informs your view as to when you might be able to grow that segment again on a consolidated basis?

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

Okay. When you look at the Q2 forecast that we provided, that really reflects a lot of variables. Certainly churn is one of those variables. There are other variables in there like net upgrades, new bookings, cloud activity, what's going on with FX, and foreign exchange rates, because we are a global company that operates in multiple currencies. All of these impact the outlook. We would characterize the range we provided as reflecting a multi-variable equation and we've looked at different coefficients in front of those variables to provide that range to you.

I don't think we have really a fixed churn assumption to share with you on this call that we want to get into. What we wanted to do by providing you the range of $369 million to $375 million is give you our best thinking at the time about providing a reasonably probable range of where we think our second quarter revenue will come in.

With respect to the UK enterprise question, we've got a good team over there. I would echo some of the general IT enterprise comments that I said a minute ago with [most] of the questions we've already gotten about enterprise growth, enterprise slow down. We feel in here and see some of the same patterns in the UK that we see in the US on this. And our belief is it comes down to our ability to execute and deliver great value for these customers. So we've had a dip in our growth that we're feeling from our net install base growth metric here, primarily driven by enterprise net upgrades. We see similar patterns as the US in the UK on this, and we're going to get after correcting them.

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

And then just lastly, are there any one-timers then that are embedded in your Q2 outlook, on even margins are revenues? Or are these all just general business conditions that are driving you towards this range?

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

Hi, Jonathan. This is Jason. One of the things that we also talked about in the prepared remarks is that we want folks to understand that even though growth slowed in the first quarter, we're sticking with our investment plan. We talked about long-term growth drivers being in place and we're planting seeds today to harvest those, really, as soon as possible.

A lot of the timing of this stuff now, since we're talking about large enterprise class production environments that the new OpenStack software platform can handle. Because that platform is new, it really depends on when the customer is comfortable on moving that important workload onto our platform and that commitment becoming a revenue item and reflecting in our financials. On the cost side, when we talked about in the near-term thinking about the EBITDA margin, closer to the 30% ballpark instead of the 33% to 35% they we've been running in the last couple of years, I went through a list of -- I wouldn't say they're one timers -- but these are new things, like the branding campaign or the open cloud campaign. There are certainly things that are in there that are pushing that number down over the near-term. You've followed us for years now, and [you'll] understand that typically, at the beginning of the year, we make these types of investments and then we harvest them later.

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

Great. Thank you very much.

**Operator**

Next we have a question from Sterling Auty with JPMorgan.

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**Sterling Auty** - *JPMorgan - Analyst*

Yes, thanks. I want to follow on, in terms of the guide for the second quarter, if it contemplates any other price changes. I understand the description you gave before, but I still think there's an expectation about the possibility we would see a cloud server price cut.

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

Hi, Sterling. This is Jason. I'll tell you, pricing is fluid at Rackspace. Bryan and I were out on the road last quarter when some of the bandwidth pricing was announced. Some of the commentary was, why didn't you tell us on the last call. The reality is because the decision hadn't been made yet. I'll tell you that it's something that we always evaluate and we take feedback from our customers. We work with the folks in the different finance departments to try to figure out where we can scale our costs and what makes sense to pass on for the customer.

I would just say, don't be surprised if we're continually lowering price on certain products. Just know that we do follow a very strict EVA discipline. Pricing is set in the finance department at Rackspace. We obviously observe what others are doing in the market but we are a cost plus shop. I think that most of the surprise on the last price cut announcement was that it came out of the marketing department, which was really coupled with the branding campaign on the new OpenStack software platform. I would just look at it that way.

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**Sterling Auty** - *JPMorgan - Analyst*

Okay. One quick follow-up on gross margins. Given the cuts and the timing of it, would you expect gross margins to bottom in the June quarter?

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

I don't want to give piece parts on gross margin. I will tell you that, I'd go back to the commentary, think about those piece parts adding up to an EBITDA margin closer to the 30% ballpark range versus the 33% to 35%, where it's been running the last couple of years.

Obviously, in the target model we publish, we haven't yet broken down the R&D which we broke out of G&A, in the release we had today and in the Q that we'll file later this week. But I would still say that that holds true.

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

This is Lanham. One thing I'd like to add to the margin discussion, if you recall when we went public, we had an EBITDA margin in the mid-20s. And what we've done over the past four or five years is take that up to the mid-30s.

We feel right now we're in a really important investment period in our Company's history. Part of the disclosure we want to provide you around R&D and breaking out these investment amounts in the financials is to provide investors greater visibility into the investments we're making and how they're categorized. And we really feel like the OpenStack movement has hit a tipping point, that it basically has won in terms of creating the open source standard. We feel ourselves pulled into a lot of interesting conversations with CIOs and Fortune 100 companies that we didn't qualify for before OpenStack, and before we founded that project. So what we want to communicate to investors is, right now we're going for it. We're going to keep our investment levels up. We believe we have an incredible market opportunity so we want to be transparent around what we're doing.

Now, it's coming at a time where we just turned in a growth quarter that was not what we hoped for. It's not what we wanted. But we can see the opportunity in front of us. We have to manage through this product cycle and we're going to continue to push and go for it through our investment framework.

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**Sterling Auty** - *JPMorgan - Analyst*

Great. Thank you.

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**Operator**

Next we have a question from Gray Powell with Wells Fargo.

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

Great. Thank you very much. I just had a couple of questions. We've heard a lot of conjecture from industry contacts that cloud computing could be negatively impacting growth in managed hosting. It would be great to get your thoughts on the topic and a sense of what applications you see going in cloud versus managed hosting environments, and where you actually see overlap.

And then just as a follow-up, do you have confidence that managed hosting revenue growth can re-accelerate back into the high teens, or even the 20% range longer term?

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

Okay. Some good questions there. Let's talk about applications, how they're written, how they perform, and what architectures come into play here. If you look at our traditional managed hosting business, it is serving applications primarily that have already been written. These are applications the customers wrote to run their business, to serve their customers, et cetera. What's going on there, is that we have not, over the last 90 days, particularly in our enterprise customers, we haven't qualified for more of those existing applications. Our individual IT budget share for those existing customers across our enterprise base is small. We serve some massive companies. They pay us some pretty good money but we are just a small fraction of their overall IT spend and any customer's overall IT spend [today] reflects their current set of applications.

What cloud computing's about is new applications are written for the cloud world. When you talk to a start-up, when you talk to a developer inside of a mid-size company, the applications they're writing today -- not all of them but a lot of them -- are written for a cloud architecture, not the traditional architecture that's predominant inside of her managed hosting business.

What the cloud really attracts today, a lot of new things. As new apps get written, they're written for the cloud world. What we think we're uniquely positioned with, that can accelerate and add value to both our public cloud offering and our dedicated offering, is the ability to link these together. When we talk about a private cloud, a public cloud, and our dedicated offering\bare metal, this is what we're calling our hybrid cloud. The interesting thing about the hybrid cloud is it allows you to do very powerful things. It allows you to create a bridge for legacy applications into a cloud world. It basically, from a technical point of view, allows people to get the benefits of a cloud without having to rewrite their entire legacy app. It just makes it easier. It's a nice bridge along this journey for them.

What we're seeing with customers is that for legacy apps, they definitely want to have a dedicated offering. There's lots of legacy apps out there that we are not running. The ability to link those legacy apps in that environmental into a public cloud and make this applications more cloudy, for lack of a better word, is very compelling for customers. Those same customers want to write a new application for a cloud world. Sometimes that's great to the public cloud. Other times, they actually want a private cloud to do it.





THOMSON REUTERS

In our prepared remarks, we spoke about HubSpot. HubSpot is an example of the customer that's on the newer edge of things. They're a rapidly growing SaaS company and they're using the whole portfolio. They're using our private cloud for some test and dev. They're using dedicated for existing high-performance database requirements. They're running [a base] Hadoop deployment there on dedicated infrastructure and they're doing their public-facing stuff on our public cloud. So I think that you see how the hybrid cloud can hit different elements and the key to re-accelerating the managed hosting growth is to qualify for more of those existing applications, those legacy apps, through a hybrid cloud offering, make this legacy apps more relevant and cloud-like, by linking it to these other components.

The way we accelerate our public cloud traction inside these same customers is, once we've linked their legacy stuff to our public cloud, they know how the public cloud works. So it's easier for them to think about, now I want to set up a sandbox and a test and dev environment in your public cloud. Or people that really get into it want to have an on-premise private cloud that they can set up behind their firewall, that they want us to manage remotely. I think this is how we create synergy across the portfolio. This is a relatively new play for us. Our public cloud about a year ago didn't have the capability it has today. So we're only a few months into the whole power of this portfolio but we are seeing the foreshadowing and the pull from customers in the expansion of our qualifications and opportunities with them. We just have to manage our way through this enterprise IT slowdown that we've talked about on the phone. We have to qualify for more workloads. We have to use the power of our portfolio linking these components together and really create great outcomes for customers.

I do think there's an opportunity to accelerate our traditional managed hosting or dedicated business. The way we do that is we make it more relevant for the cloud world through our hybrid offers.

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

Got it. That's very helpful. Thanks.

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**Operator**

We'll take our next question from Jonathan Schildkraut with Evercore Partners.

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

Great. Thanks for taking the question, maybe two questions, if I may. One's a detail question and I know you guys gave us a lot of new information and guidance for the second quarter which I think is really helpful. I guess it would be, and you may not want to give this, but I guess it would be helpful from our perspective to maybe understand how big an impact the pricing changes had on the net upgrades. And then, I guess the second question I have is, enterprise is a little difficult in the quarter and you guys have been working to get some big customers here. I'm wondering if your approach to enterprise has evolved at all. I know that in the fourth quarter, you had changed some of the internal sales incentives. So I was wondering if you were making any other changes to your approach to that segment? Thanks.

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

Hi, Jonathan. Thanks for the questions. I'll take the pricing question and let Lanham take some of the org stuff. One of the things that we'd love to be able to do is, to tell you exactly the dollar amount that the pricing impacted, not only the IBG, but also the overall growth rate in the quarter. As you know, the pricing was basically focused on bandwidth and some tiered storage stuff. The reality is, we don't really want to break that out, for competitive reasons. Second, the other thing that I think is relevant is to understand that the pricing cut was implemented, call it, halfway through the quarter, in the first quarter. So it didn't impact the entire quarter but know that those price cuts will impact the entire second quarter. They'll run fully through the second quarter.

On the org changes, I'll hand it over to Lanham.

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

Good question, Jonathan, on the org changes. Yes, we have made some adjustments and changes in our strategies and tactics, with respect to growing the enterprise business. If you recall, you've known us for a long time. Our history has been, we've been an SMB volume operations model. We have in productized things and worked our way up into the enterprise marketplace and really had been pulled there by customers over time. We have made some adjustments in what we're doing. Last year, we went through a couple of different organizational moves to increase our customer intimacy with our enterprise segment, as well as our SMB segment. What we are discovering, now that we're getting closer to customers is that the way we need to approach them, and some of their asks of us, we haven't been honoring them as well as we should. And part of this is what you see in our net upgrade growth that we struggled with here in Q1. So we have made some changes about that.

We're pretty darn confident that we're being pulled in the right conversations with customers. Were getting some good at-bats. We just haven't won them all. And what we have to adjust here is our strategy around winning them. We've got to differentiate ourselves little bit more. We've got understand where strengths are and really just play that game, as opposed to stretching and getting outside of our capability and then we end up burning a lot of cycles.

I think the organizational changes we made just a few months ago now are increasing our focus on this. You had a specific point around incentives. What we know with enterprise customers today is the place that we are really strong. Where we feel like we are absolutely best in the world is when we get into conversations about hybrid cloud, in that we talk about their legacy applications and their existing apps, and how we help them journey into a cloud world over time, how we get them using a public cloud today with a high service level and great customer outcomes with Fanatical Support.

We are re-launching ourselves around that, as opposed to just our traditional product line. This is a big switch that we've been going through. Most of that work is complete but there's still some of it underway. I think we will continue to refine and polish and go deeper with enterprise customers as we learn had to do that more effectively. I think that we had some tremendous growth with our enterprise segment. We still see lots of pipeline and lots of opportunity there. Things have slowed down but you'll see is continued to tweak and enhance our approach to it.

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

Great. Thanks for taking the questions.

**Operator**

Our next question comes from Frank Louthan with Raymond James.

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

Thank you. Just a little bit more color on what do you think it's going to take to get the enterprises back in your business? Then looking forward, you always give a lot of detail on returns on capital and we're seeing the capital intensity increase. The margins decline. You're hinting that's a temporary thing but how should we think about the returns on capital of the long-term of your business? Is this more of a permanent downward trajectory on that? Or can you get back there and what's gong to drive that?

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

Hi, Frank. This is Jason. I'll take the CapEx portion and the capital efficiency and how to think about returns on capital over time. Then, in terms of our ability to drive increased growth in the enterprise segment, again, I'll let Lanham take that.

First off, when you talk about the capital efficiency decline, I think that what you recognize is that the CapEx for the quarter went up significantly compared to Q4. And in revenue per server, it went down to $1,308 compared to $1,310 and that's the first time in 15 quarters it's gone the other way. So we had 14 straight quarters where it increased.

There are a couple of factors there. One, we opened a new data center in Australia. And as you know, when we open a new data center in a new geography, we have to basically go and buy a bunch of servers up front. We added quite a few servers in the quarter. That affected it and then also the $2.9 million FX adjustment. That also affected that number. If you're looking at it from a turns perspective, that's one proxy that looks like it might've gone backwards. Actual capital turns stayed flat at 1.97.

Let's just talk for a second about CapEx in general, since the capital did go up meaningfully in the first quarter. The first thing to know, I think, is that almost all of our CapEx is success-based. The second thing is, we really do believe that the long-term growth drivers are in place today so we're making investments in order to harvest those down the road as we discussed earlier. If I think about the areas that went up, it was primarily customer gear, data center, and office were all larger in the first quarter. Some examples of why those numbers are driving higher, where we're making investments, I can think of, for instance, one customer gear, data center, office were higher because of the AsiaPac expansion with the opening of the Sydney office. Customer gear and data center CapEx were higher with the expansion [in] our existing DuPont campuses in Virginia and Chicago. Our office CapEx was higher in the quarter as we continue to grow our San Francisco and Austin offices to strengthen our software development capabilities. We recently opened an office in New York for some of our sales reps in the region. Last, as we [stand] up proof of concepts environments for some of our large OpenStack customers, we buy customers' gear in advance.

Those are a few examples. I think the take-away here is that we see the opportunities for growth so we're making the investments today. I'll Lanham take the enterprise growth question.

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

In short, I think we doing the right things to rekindle the enterprise growth and really it's pretty straightforward. Number one, it's about focusing our hybrid cloud offer. This is where we're really strong. This is where we have a thought leadership position with enterprise CIOs. These are the meetings we're in where they're talking to us about OpenStack, the capabilities of the technology. They want to [stand up] OpenStack private clouds in their facilities. They want to set up OpenStack private clouds inside our facilities to have a sandbox to do some test and dev and move to production.

The other thing we have to do here as we're displaying thought leadership is get really crisp on this, when we're visiting with them and provide incredible technical capability and outcomes as we serve them. So I think what you're seeing with their enterprise business is a couple things. We are shifting and increasing our capability. As we increase that capability, we have some internal changes we had to go through to really be able to deliver that at scale and in mass, in a way that moves the needle across the whole segment.

We also have some other market conditions going on around us that we have to deal with. What we believe is that information technology and tech spending is going through a shift, that it used to be, people bought a bunch packaged software and run it themselves. We believe in the future, this is going to be delivered as a service. We represent the new model for a 21st century tech company. We are creating technology through the OpenStack community. We are delivering that as a service to customers in our facilities or in their facilities.

I actually think we're doing the right things. When we look at our win rates on hybrid cloud, it's really pretty compelling. This is where we can link things together. We're in lots of conversations, where we go from conversations, to pilot, to production, and then ultimately into revenue. We'll continue to update you on our progress and so I think we're just going through a little bit of a cycle and transition here as we really get our capability built and delivered around hybrid cloud. We haven't had all this capability for that long. We continue to advance the road map and each time we take a step forward, we've got to integrate things to make sure we can deliver to customers reliably with high SOA.

So I would say, from a thought leadership position, I would check that box. Never before have we been able to deliver a tech vision and road map so compelling to enterprise customers. This is something that we're really proud of. We're delivering that service capability to back it up. We'll continue to advance on that and I think that's how we rekindle the enterprise growth.

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

Okay, thank you.

**Operator**

We do have just a few callers remaining in queue. We'll take our next question from Tim Horan with Oppenheimer.

**Tim Horan** - *Oppenheimer and Company - Analyst*

Thanks, guys, just one clarification, (inaudible) and one question. The 30 % margins, it sounds like that could be in place for a while, not just a one quarter, two quarter period. Just a clarification there.

Secondly, Lanham, how do you make the argument that with AWS here, a lot of developers are just telling me, we developed for AWS. It's working great. We don't really see the need to go develop for anybody else at this point. They see the growing, obviously, extremely rapidly and computing historically has been a winner-take-all kind of world. Thanks.

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

H, Tim. On the margin part, we're not running the business to grow at these rates, at call it, 30-ish percent adjusted EBITDA margin. I think the branding campaign for OpenStack, for the open cloud, is a great example. I'll tell you that the question is, how long will we be in this zip code. It really just matters on how fast these investments pay off.

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

Let's talk about the developer community and AWS and the traction associated with it. It's clear that Amazon Web Services is doing really well. There are lots of headlines about it. There's lots of buzz about it and so I think that is a clear data point for all of us to understand and think about.

With respect to developer activity, inside of tech categories, there are really vibrant open source communities. If you look at the OpenStack community, for example, which we founded and have a lot of leadership in, that community is booming. When I went to the first OpenStack Summit years ago, there were 70 people. At the one I was at a couple weeks ago, there were 3,000 people. It was sold out and we needed to get her a bigger venue. If you look at the developers that are contributing code to it, it's exploding in a positive way. For the first OpenStack release, Rackspace contributed the majority of the code. If you look at it today, we are not. We're not even number one anymore on that [thing]. We're still a top contributor, but what it communicates is the fact that there's a growing community here, that people are signing up for OpenStack. The one thing about open source communities is that there is a ton of passion for developers about it.

Our personal belief is that open source is a better development model and framework than a proprietary system is. So that AWS absolutely has a head start and has a lot of developer traction, personally I think over time OpenStack will have a larger aggregate [and work scale] than AWS will, that there will be more developers contributing code to the OpenStack than Amazon Web Services could hire. Over time, the developer traction for OpenStack will continue to grow. I just think right now they've got a developer head start and it's early in the game.

I'll accept your feedback that if you talk to a developer on AWS, they're please with it. That's why AWS is growing at such a high rate. I'd also tell you that the delta increase in developers into the OpenStack community is a really big number. Within technology categories, there tends to be a proprietary standard and an open standard. I think the proprietary standard for cloud computing, public computing, is AWS. I think the open standard for cloud computing, the open standard for framework for cloud computing, a cloud operating system, if you will, is OpenStack. And I think we're the leader of OpenStack. I believe the developer community we will cultivate, that will have lots of passion in it, for technologies that OpenStack community. And it's growing at a rapid rate.

I don't think it's an either, or. I don't think it's a winner-take-all thing. As markets mature, they tend to divide. We're seeing an emerging customer segmentation of customers that used to be at AWS, that find a better outcome with hybrid cloud. I think that will continue. Over time, you'll see more segmentation in the marketplace. We can develop quite a developer following to through the open community, through OpenStack, and I think you'll see each of these populations grow.

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**Tim Horan** - *Oppenheimer and Company - Analyst*

That's very helpful. Thank you.

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**Operator**

Next we have a question from Scott Goldman with Goldman Sachs.

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**Scott Goldman** - *Goldman Sachs - Analyst*

Hi, good afternoon. Thanks for taking the question. Again, I want to revisit the growth question that we talked about quite a bit already, but Lanham, I'm wondering how much you feel it's in your control the ability to accelerate growth at this time. The reason I ask that is because it seems to me you've done a lot of work on the product side. You've actually made some product acquisitions as well to strengthen the product. I agree with you OpenStack awareness is very high. Enterprises we've talked to, very enthusiastic about it.

I'm just wondering at this point in time, how much control you have? Is this just a matter of companies having to go through the proof of concept cycle that's taking a lot longer than maybe we on the street were anticipating, and maybe you guys that a little bit better visibility. What are you hearing from the pilot programs that have probably been in place now for six to nine months? Or are you guys losing share right now to Amazon and Microsoft in the interim?

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

Okay. There are a lot of questions in that. I don't have a whole lot more to add, based on what we've already said but we'll talk about it a little bit longer. I think in terms of, are we in control of it, I think the answer is yes. Certainly, we can't control customer decisions. They make decisions on their own pace. We endeavor to help them make great decisions but they're in charge of the meter on that.

What I would point you to is that our Company is becoming more of an integrated portfolio company so the things that we focused on over the past year, specifically our launch of the OpenStack public cloud platform, that's growing rapidly. We shared that in a prepared remarks. Things that we did not focus on as much are not growing rapidly. I think our strategy to increasing our growth rate across the Company truly is uniting these capabilities into a hybrid cloud offering. We have some of that in place today. We don't have all of that in place today. we'll have to keep investing on that.

With respect to losing share to people, when you talk about losing share to an AWS or to a Microsoft, I think AWS is growing at a pretty high rate. I think if you look at our public cloud, it's also growing at a pretty high rate. I don't really have data on the Microsoft cloud performance. If you look at our OpenStack public cloud it grew 75% quarter-over-quarter and that's I think representative of the capability of the new platform. I think that's a good indicator of the type of work and type of customer outcomes we can deliver there. I'd also say that today the vast majority of computing still sits behind a corporate firewall so there's plenty of secular growth to come in this industry. What we've got to do is be real clear about differentiation, understand what our sweet spot is, and deliver unmatched customer outcomes in that sweet spot. Our belief is that that's about high service levels, superior SOAs, a pricing premium that reflects the value of that service, a hybrid cloud architecture that has open source technologies at its foundation. We think that's our sweet spot in the market. That's not going to be the whole market. I think it would be a pretty good market. It ought to be a lot larger than where we are today and part of what we're trying to communicate in our conversation about the investments we're making is that we're playing long. We think this is a heck of a company with a big future so we do this is a short-term growth pick up that we've had here this first quarter. There's a lot of stuff going on in that. We feel like we know our winning strategy with respect to our hybrid cloud offer because we see the results today when we do it. We've just got to discover and run the Company as more of a integrated hybrid cloud Company and that's the work to do this year. This is what's going to transform customer outcomes and ultimately customers decide who wins in a marketplace. The previous question about developers and developer following, to me that's customer question and it's about, okay, let's be real clear on which customers we should target there and how we develop a passionate following. I think OpenStack's doing that. We have a lot of passion and affection in that community.

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**Scott Goldman** - *Goldman Sachs - Analyst*

Great. And just in terms of what you guys are seeing from the pilot programs, which I'm assuming has been up six to nine months, is there a high conversion rate on those? Are they still going through the proof of concept stage?

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

I forgot to mention that. Thank you for reminding me. The pilot program, the general framework we think about is we set up pilots and proof of concepts. Those proof of concepts end up being a test and dev environment at first and then migrating into production over time. We are actually making really good progress on that. It's something that, to me, is a glimpse and preview of what's to come.

In terms of adoption and how many of these things we can do, at one time this is where I think the scaling question starts to come in, which we still need to work on and figure out. If you look at the program today, I would tell you unequivocally that they're best thought leadership conversations we've had. Fortune 100 global companies are asking us to do really interesting things with them. The program's going really well. To move the revenue needle on this, we're going to have to do these for lots of people. Right now, we're doing this for a handful of people.

I think you will see us, as the year progresses, talk about more of these over time. We feel pretty good about our progress. And so the question is, when do we announced this is ready for prime time? We'll see. I don't want to commit to something yet that I'm not entirely certain about. What I am certain about with the programs, the conversations are good. We feel real thought leadership and that program's informing a lot of the remarks we've had earlier about our hybrid cloud. We see this as where we are super compelling to customers and when we link our private cloud capability with a public cloud and dedicated offering, we feel like we really are best in class on that, and this lighthouse program with these proof of concepts we've talked around private cloud in really informing a lot of that work.

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**Scott Goldman** - *Goldman Sachs - Analyst*

Great. I appreciate you addressing all the questions.

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

Sure, my pleasure.

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**Operator**

We have just a couple more questions in queue. And as a reminder, in the interest of time, we ask that you please limit yourself to one question.

We'll go next to Michael Bowen with Guggenheim.

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**Michael Bowen** - *Guggenheim Securities LLC - Analyst*

Thanks, guys, for squeezing me in. Lanham, I guess what I want to understand a bit is when you mentioned enterprise decisions were slowing down, do you think that that is more a result or byproduct of the environment? Or is it a combination or more weighted towards just not enough time and attention from your sales force to some of these enterprises? T

Then second question, I'm not sure if you could really address this, but can you talk a little bit, if possible, about your contemplated tiered pricing plans? Not specifically what you're going to do, but how are you thinking about that internally, relative to the competition? Thanks.

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

Let's start with the enterprise decisions. Our general point of view is that it's up to us to make these things happen and that when things don't go our way, we're responsible and accountable for it. Clearly, as enterprises make decisions, we aren't doing anything in a vacuum. Everybody has different pressures on them and so if there is a general enterprise slow down, that's absolutely something that will affect us. I just think we're a bit stubborn on this one, as an organization, as a team of people. And it's on us to battle through those things and figure it out.

What I would say is, sure, there's a general slowdown. Is that going to hit us? Yes. But I don't think that ought to be what we fall back on here. I think what we ought to fall back on is the fact that we have a really unique differentiated offer and that we need to communicate that to people. We need to help them achieve their business goals and the transformation that's taking place in IT is going to help that. A lot of the CIOs I talked to asked me about how they can run their IT department more like a cloud company, to be more like Rackspace. [They literally] asked me, how can I run my IT department like Rackspace? These are things that we're in a really special position to help people with. I accept the fact that it's a multi-variable equation any time somebody makes a decision. We're responsible for our [variable in there]. We need to do better than we've done. So we've got to keep working on that.

With respect to the tiered pricing, that not something I want to get into a bunch. I made some comments earlier in the call about our pricing positioning and strategically how we think about pricing and that it communicates the value of our differentiated service. And we want to use pricing as a way to inform customers and drive their behavior into a loyalty model that improves our economics. I do think that when you look at our offering, there are parts of our offering rather that are commodity-like elements. There are parts of our offering that are truly differentiated, high-service elements and we do think that pricing delivers information around each of those. We are offering an integrated hybrid cloud system that we'll continue to invest in and we will use pricing to reflect the value that we add. I think the place where we are most compelling is we link the things together. The magic is when we can help people take a legacy app and move into the cloud world and write their new apps into that same type of architecture and port it back on premise, our open cloud OpenStack system to run a private cloud on-premise. Our pricing will reflect the value that we add. We've shared with everybody on the call the we're a pretty disciplined EVA shop, that we look at the costs, we understand the return requirements in there. And then we think about the value that we're adding per customers. So that will driver our thinking more than anything else, when we make pricing moves. We think about the stuff regularly. We'll continue to think about it regularly as we move forward.

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**Michael Bowen** - *Guggenheim Securities LLC - Analyst*

Thank you.

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**Operator**

Our final question for today comes from Barry McCarver with Stephens.

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**Barry McCarver** - *Stephens Inc. - Analyst*

Good evening, guys. Thanks for squeezing me in last. My question is, when talking about your targeted enterprise growth, you think about the price cuts you've implemented. You think about the customer gear spend this quarter in the branding efforts. It certainly feels like you may be targeting an enterprise size that you've never done before. I guess, number one, is that understanding correct? And then secondly, what are your thoughts on the sales cycle to win and implement these sized customers that you really don't have many or never really targeted before? Thanks.

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

Sure. Great question. I think this gets a little bit back to the previous question, around enterprise decision-making, how much is a general thing, and how much is on us. I think there's some of both going on but we really pride ourselves on being able to [prop right] through that kind of stuff.

When you think about the enterprise journey that our Company's been on, a few years ago we basically had zero in this marketplace. Then what happened was, we started getting pulled there department by department. Over time, as we won multiple departments, we got pulled into divisional CIO or the CIO of the company. That's been the migration, I would say. That's been our relationship migration over time as a Company. What's happening now is we've gone through the relationship migration and we're going through a platform enhancement inside of Rackspace. And now, we have a lot more to talk about from a thought leadership point of view.

We can offer it in really significantly larger offering capability [through] our hybrid cloud but all this stuff is pretty darn new for us. Part of your question is, are you into a new opportunity and a new weight class with this? And I think the short answer to that is yes. We've moved from departments into the CIO. We've moved from a single product dedicated hosting capability, running legacy apps, into a hybrid cloud capability that we can run ourselves in our facilities or in your facility. So I think that kind of stuff is absolutely new for us. Basically, we have new capability and we're figuring out how to use that new capability and deliver it fanatically to customers. I do think there's some gearing and tuning that has to happen, in terms of our go-to-market, how we're talking to customers, and then how were serving them afterwards because we graduated into a larger opportunity. And the funny thing with larger opportunities is we have to elevate our game to really seize it.

That's part of the work we're doing now and we haven't finished all that work. We had questions earlier on the call about organizational changes. That's part of the work of tuning our offering and delivering go-to-market strategy with these customers. In one of these announcements Jason announced, we had some sales reps remarked on that, and in some of his previous comments. We are making more enterprise investments. We're doing it because we feel pull into it and when we win these, they're an order of magnitude larger than wins we've had in the past. We started in the SMB market and really it was a bunch of S's, a bunch of fellow entrepreneurs like ourselves. We then migrated into the mid-market and then we started winning departments of enterprises and enterprise departments really behave a lot like the mid-market.

Now with OpenStack and the thought leadership we have there and the hybrid cloud capability we have, we've graduated more into the CIO ranks. And that's been a pretty recent development because OpenStack only just got here. The question of, now that we are truly in the CIO suite, how does our seat at the table function? What thought leadership do would provide? How do we deliver all this capability? Some of this we have figured out and some of that we haven't. It's a lot of fun to work on it. It's a really big opportunity for us and it's exciting because I think we stand in this tectonic shift, where over time, these CIOs are saying they want to operate a lot more like a service company.

We are uniquely positioned to help them do that because we are a apps-scale, global service company and we have a unique value prop technology service delivery mechanism. These are things we had to figure out. There's a lot of promise in that. While we're figuring that out, we still have to increase our capability about running the rest of an integrated portfolio. This gets back to the dedicated conversation and the hybrid cloud conversation, specifically about enterprise, which is part of your question. So that's what I would say, in terms of giving you a little more context about what's going on there.

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**Barry McCarver** - *Stephens Inc. - Analyst*

Thanks. That's very helpful. And congratulations to Karl for keeping his priorities in order.

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

Yes, we still have not gotten a text message to know the outcome yet but I'm sure he'll text something or Tweet it.

I think that concludes our call. I wanted to thank everybody for dialing in. We wanted to take a little extra time on this call to answer everybody's questions so we appreciate the thoughtfulness in the series of questions we got. Obviously, we have some work to do around here. We're going to put our head down and get back after it. So we appreciate your support and look forward to updating you 90 days from now. Take care.

**Operator**

This does conclude our conference for today. We thank you again for your participation.