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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to the Rackspace Second-Quarter 2013 Earnings Release Conference 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 second-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. For Rackspace on the call today will be Lanham Napier, Chief Executive Officer, and Karl Pichler, Chief Financial Officer.

I need to remind you that some of the comments we will make today are forward-looking statements, including statements regarding expected operations and business results, our growth plans and expectations, 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, continued 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, and 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 the call today, such as adjusted EBITDA, are expressed on a non-GAAP basis, and that our GAAP results, and GAAP to non-GAAP reconciliation, can be found in our Earnings Release, which is currently posted on the Investor 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. Thank you for joining us today. At the beginning of the year, we said that 2013 would be a transformational year for Rackspace. With the first half of the year complete, I think we have made good progress on our journey to build the greatest hybrid cloud company in the industry. As you can see from our second-quarter results, most of our key growth metrics improved on a sequential basis. Our spending increased, reflecting our decision to continue our aggressive investment plans aimed at accelerating the growth rate of our Company.

Before I turn the call over to Karl to review the financial details, let's review the strategy behind our investments, as well as some of the progress we've made so far. In short, our investment plan is all about increasing our hybrid cloud capabilities. Rackspace is the home of [the navral] support, and we have the world's best and largest managed hosting business. We have the world's largest OpenStack based public cloud, and the second largest public cloud business behind Amazon Web Services.

In addition, we are the founder and a key leader of the OpenStack cloud ecosystem, and we are the leader in providing OpenStack-based private clouds. Our hybrid cloud strategy is all about leveraging those unique assets to deliver a world-class service experience across a portfolio of dedicated, public, and private clouds, spanning both on-premise and off-premise workloads. We believe that customers achieve the best performance at the lowest total cost when we marry open, productized technologies with fanatical support. While the majority of media attention is focused on public cloud, we believe hybrid cloud will be the mainstream infrastructure platform in the future.

This is not to say we are downplaying the capabilities of a public cloud. In fact, we believe that the public cloud is truly revolutionary, and worthy of all of the attention it is receiving in the IT market. We think public cloud changes the economics of bringing new applications to market, which will in turn increase demand for the infrastructure to support those applications. Rackspace was one of the first companies to offer a public cloud service, and we are continuing to invest heavily in our public cloud capabilities.

However, we are a customer-centric company. And we have learned from our customers that public cloud has its limitations, particularly with large, complicated apps running at scale. While many new applications start out on the public cloud, as the applications grow, customers have to engage in costly overprovisioning to achieve the level of performance that they need. That's when the benefits of a hybrid cloud become compelling.

The HubSpot case study that we shared with you last quarter is one example of this trend. And we are seeing it more and more often. This is why we believe that the hybrid cloud architecture will be the best choice for the vast majority of large workloads going forward. And this is why we have made the choice to continue investing heavily in our hybrid cloud capabilities.

Hybrid cloud differentiates us in the market, and is where we are winning new business today. Many of our competitors try to push customers into a one-size-fits-all solution, and persuade them that they should run their workloads all in the public cloud, or all in the private cloud, or all on dedicated hardware. Rather than one-size-fits-all, we offer the best fit for each customer. We offer the productized solution that best meets each customer's evolving needs.

By using a mix of these public cloud, private cloud, and dedicated servers, we can optimize the infrastructure that underlies our customers' applications, and deliver superior performance, reliability and cost efficiency for customers as they move to a cloud world. While we are the only company that can deliver a complete hybrid cloud solution today, we are moving to make our offering even better. We need to improve the capabilities of our products, enhance the fanatical support experience in the hybrid environment, and tighten the integration of our numerous cloud services.

In addition to improving our products, we also need to educate the market on the superior value proposition of Rackspace's hybrid cloud model, as well as refine our go-to-market strategy. The general perception in the market is that public cloud is always the cheapest way to run applications, but that is rarely true on a cost-for-performance basis. There are multiple factors that go into choosing the best infrastructure for your application, including performance, reliability, technical support, security, price, and ease of use. For many workloads, including many databases, dedicated infrastructure may be the best option. For highly variable workloads, such as eCommerce sites that see spikes in their traffic, public cloud may be the best option. For steadier workloads, such as many back-office functions, private cloud may be preferable.

For most customers, we believe the answer will be to run each workload where it runs best, in a hybrid cloud. We don't think most IT buyers understand this dynamic, and our challenge is to make sure this information is much more widely disseminated. These are all examples of areas where Rackspace needs to improve and are areas where we are investing aggressively.

Although we have a lot to accomplish in our journey to build the hybrid cloud market leader, we are making good progress. In June, we launched the OpenStack-based public cloud in Australia. This will be followed shortly by new OpenStack cloud deployments in Virginia and Hong Kong. On July 19, OpenStack celebrated its 3rd birthday. As a reminder, OpenStack's mission is to provide the ubiquitous open source cloud computing platform that will meet the needs of public and private clouds regardless of size, by being simple to implement and massively scalable.

In just three years, 231 companies have joined the OpenStack community, along with more than 1,000 developers who have contributed more than 1 million lines of code to the project. From an adoption standpoint, many large organizations are using OpenStack for production applications. These include Best Buy, Bloomberg, Comcast, Fidelity and PayPal. As you know, closing large referenceable customers is one of our key objectives for the year. We believe there's no better way to help the market become comfortable with our services and the OpenStack technology than to have examples of customers successfully in production on our platform.

Last quarter, we talked about HubSpot. This quarter, we are pleased to announce some new enterprise customers, including CERN, Emerson Electric, Fidelity, Mazda and Sony PlayStation. We announced recently at GigaOm Structure Conference that Fidelity and Rackspace are actively collaborating on an OpenStack private cloud implementation.

Also utilizing OpenStack is CERN, the European Organization for Nuclear Research. CERN announced a research partnership with Rackspace to co-develop enhanced intra-operability capabilities between CERN on-premise OpenStack clouds, Rackspace private cloud, and Rackspace public cloud. This partnership will help advance CERN's expanding goals for the OpenStack platform, as well as Rackspace's product road map. Through the new collaborative agreement, the Rackspace private cloud platform will now be deployed onto servers that CERN utilizes for production physics experiments. Rackspace and CERN open lab will test and ensure a seamless federation between private and public cloud platforms to accommodate fluctuating workloads and to let users experience the true value of the hybrid cloud.

Another well-known company who's in our hybrid cloud offering is Emerson Electric. Its deployment leverages our public cloud servers, cloud files, and dedicated cloud products. Emerson climate controls offer solutions for residential, commercial and industrial applications. Emerson's hardware and software control solutions are designed to improve system performance and save energy, while lowering downtime and maintenance costs.

A new mobile application for the Emerson climate controls business unit provides monitoring on compressors, cooling and refrigeration, heating and furnace, hydraulic controls, and even mechanical controls. The system's patented algorithms extend equipment life with clear displays in communicating conditions. By using our cloud servers, Emerson customers are able to remotely view the performance of their controlled equipment. They're able to diagnose performance problems remotely, saving them time and money.

Mazda recently announced it has chosen to build its web presence in the United States, Mexico and Canada, along with its mymazda application, on Rackspace technologies, allowing it to service 2.1 million unique monthly visitors. Mazda has adopted a Rackspace critical application services, with its proactive monitoring function. Using a combination of dedicated servers and managed virtualization resources, Mazda is able to improve reliability for its mission-critical sites, and handle increased performance requirements during national and broadcast advertising campaigns. For example, during a recent campaign, when website traffic spiked by more than 50% to an average of 130,000 daily unique visitors.

And finally, Sony PlayStation recently signed a services agreement with Rackspace under which our developers and architects will be consulting and supporting the PlayStation team with their OpenStack private cloud deployment.

In addition to these enterprise customers, we have a number of new customers that represent a new generation of companies that are starting out on the cloud to build their businesses. Even though they are not yet household names, these web application customers are driving tremendous growth in the cloud. eSupply is a software as a service expense management solutions company for real estate property managers. We host its customer-facing application, including an SQL database, as well as a test and development environment.

Clean Power Finance is another example. It runs an online business-to-business marketplace that enables solar panel vendors to offer financing to residential customers.

Hearsay Social is another internet company using our hybrid cloud. Hearsay Social provides a new type of service known as social selling, which enables companies to use social networks to attract prospects, retain customers, and grow their business. Sales people use the service to personalize promotions to potential customers based on comments individuals make on social networking sites.

In addition to these new customer wins, we also made some key enhancements to our leadership team by adding industry veterans Rick Jackson, and Todd Cione. Rick Jackson has over 25 years of experience in the IT industry, most recently as Chief Marketing Officer at VMWare. Rick led the Company's global marketing strategy starting in early 2009. Prior to joining VMWare, Rick held Chief Marketing roles at Borland Software and BEA Systems.

Todd Cione joined Rackspace from Microsoft where he was a General Manager and Managing Director of Marketing Operations in the Asia-Pac region. Todd will lead Rackspace's North American sales organization. We are excited to have both Rick and Todd on the team, and we plan to extensively leverage their industry experience to improve awareness of the unique value prop of Rackspace's hybrid cloud offerings, as well as our go-to-market strategy.

In closing, I'd like to reiterate that our primary financial goal is to accelerate revenue growth. We believe that hybrid cloud is the future of computing, and Rackspace is extremely well positioned to capitalize on that opportunity given our unmatched capabilities across dedicated servers, public cloud, and private cloud, as well as our expertise and leadership in OpenStack, and our proud tradition of providing our customers with fanatical support. We are making good progress, while investing heavily in new capabilities, and at making the Company more competitive in the market. I've shared with you some of the notable accomplishments we've made so far in the year, and I look forward to updating you with more of this in 90 days.

I'll now hand the call over to Karl to review our financial results. Karl?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Thank you, Lanham. As you can see from our second-quarter results, growth improved relative to the first quarter. However, the improvement was minor, especially on a constant-currency basis. While we are confident in our long-term marketing growth opportunities, we still have more work ahead of us during this transition.

Consistent with our goal to re-accelerate revenue growth, we are making a series of operating and capital investments during the year. As previously mentioned, the investment focus on branding, expanding our global data center reach, and building out the capabilities of our hybrid cloud portfolio. As a consequence, margins and returns were and will remain lower than they were in 2011 and 2012.

Moving on to the specific results. Total revenue was $376 million, representing 3.8% sequential growth and 17.8% growth compared to the second quarter of 2012. For the third quarter, we expect our sequential revenue growth rate to range between 2% and 3.5%, consistent with our Q2 guidance, which would result in revenues between $383 million to $389 million. The current street revenue consensus of $385 million happens to fall at the midpoint of our new range.

Exchange rates had a negative impact on revenue of approximately $1 million compared to the first quarter of 2013, and a negative impact of $2.7 million compared to the second quarter of 2012. On a constant-currency basis, revenue grew 4% sequentially and 18.7% year over year.

Dedicated revenue increased to $277 million in the second quarter, representing 2% sequential growth, and 12% growth on a year-over-year basis. Public cloud revenue for the quarter was $99 million, representing 8.9% sequential growth, and 36% growth on a year-over-year basis. Installed base growth was 0.7% in the quarter, which is an increase from 0.1% in the prior quarter. The improvement was driven by an increase in net upgrades, while churn remained constant at 0.8%.

Moving on to profitability, adjusted EBITDA for the quarter was $123 million, a 1.5% decrease compared to the first quarter of 2013, and a 10% increase compared to the second quarter of 2012. The adjusted EBITDA margin for the quarter was 32.8%, compared to 34.5% in the previous quarter, and 35.1% for the second quarter of 2012. Adjusted EBITDA margins in the second quarter were impacted primarily by research and development spending around software development, particularly on the OpenStack public cloud platform, as well as the data center infrastructure investments, which includes taking on additional data center capacity through operating leases.

Additionally, there was an increase in G&A expenses for various hiring and professional service initiatives. Depreciation and amortization expense came to $74 million in the quarter, representing 19.8% of revenue. Net income was $22 million for the quarter, down 18% from the previous quarter, and down 11% from the second quarter of 2012. Net income margin for the quarter was 6% compared to 7.5% for the previous quarter, and 7.9% in the second quarter of 2012. Earnings per share came to $0.16 in the quarter both on a basic and diluted basis.

Capital expenditures totaled $107 million for the quarter. Of this amount, we spent approximately $73 million on customer gear, $10 million on data center build outs, $2 million on our office facility, and $22 million on capitalized software development and other projects. Total server count increased to 98,884 in the quarter, up from 94,122 servers at the end of last year. The adjusted free cash flow for the quarter was $11 million.

Return on capital was 11.9% in the second quarter compared to 15.1% in the prior quarter, and 15.5% in the second quarter of 2012. The reduction in our ROC was mainly due to lower profit margins, capital turnover in the second quarter slightly decreased to 1.93 from 1.97 in the prior quarter.

This concludes the review of our second-quarter results; let me turn the call back to Lanham.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Thanks, Karl. On August 8, 2008, we completed our IPO. So today is our five-year anniversary as a public company. We've met some big challenges over the past few years, and have scored some good wins. We've also taken a few bruises as can be expected when you take big risks to accomplish big things.

I want to thank our customers for placing their confidence in us, and our rackers for their devotion and hard work over the past five years. Our Company is becoming more of a global company every day, and this gives us the opportunity to build a company that literally impacts the whole planet. This is a once-in-a-lifetime opportunity for our rackers.

We are the right people to build out the next computing platform for humanity. The work we're doing to refine our strategy and hybrid cloud offering really will change the world. We aspire to live in a world with fanatical support. We aspire to live in a world with a new technology model powered by a hybrid cloud; we're the change agents. We're the geeks that envision a better world, and we're going to build this world together.

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, preferably with just one question with one part. Thank you.

Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

James Breen with William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. So my one question is looking at the net server adds this quarter was a level that we haven't seen, I'm not sure we've ever seen. So I was just wondering if you could provide some color around sort of what drove that? Was it the change in the sales force structure again? Are there other fundamental factors that pushing that number up? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

This is Lanham. A couple things are driving that number. So if you look at the key metrics, when you look at the number of servers deployed at period end, you can see the increase in Q2 versus Q1. There are a couple things here. Number one, in our prepared remarks, we referenced the fact that we just completed a new cloud build out in Australia. When we build a new cloud, obviously we create capacity up front, we have an investment in that, and that cloud launched during the quarter, and so we had a number of servers going online for that. In our prepared remarks, we also referenced the fact that we're building a new cloud in Virginia, as well as to follow in Hong Kong.

So part of what's driving this number is that we just flat out have capacity expansion and increases here as we add these new clouds on a global basis. The other element that drives this number is that it's basically success-based with our growth, though we did a little better growth wise this quarter so we're going to add a few more servers as a result. I think the primary factor here is the new cloud infrastructure we're building as we roll out these clouds between Sydney, Australia, Virginia, and Hong Kong. The second factor is that is success-based growth, and as we grow a little bit faster we add more servers.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Gray Powell with Wells Fargo.

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

Hello. Thanks for taking the question. So you guys had a good re-acceleration on the cloud revenue growth this quarter, can you talk about the main driver there and just how we should think about that trend going forward?

Lanham Napier - *Rackspace Hosting Inc - CEO*

This is Lanham. I'll take that one. We did our cloud revenue when you look at the sequential growth rate it certainly did improve here in Q2. What's driving that is really just a handful of things. When we look at growth, number one, we think we're in the middle of a big market opportunity for cloud in general. In our prepared remarks, we talked about the opportunity for hybrid cloud. We really do believe that humanity is building its next computing platform, and so we're pretty excited to be in the middle of that. When we look at the work that we're doing to make our cloud more attractive to customers, in the previous question I gave you some data around the new clouds that we're building, and so I think that is something that supports new customer adoption and usage.

And so what happens, is we look at all of those factors and then we bake them into the revenue guidance that Karl just provided you. So I think though what we want to do in this when we're providing the revenue guidance, is basically look at all these different variables, whether it's cloud growth, or dedicated hosting growth, upcoming churn. W look at our pipelines, so we consider FX. It's a multi-variable equation there. We bake all that into it, and come into our revenue guidance range. So the feedback we've given you here on guidance for Q3, which Karl just went over, bakes all that in. And within that guidance, we are taking into account things we are seeing in the cloud business. We continue to believe that cloud is in a hot spot for market growth, and we need to do our part to build out our offerings. Some of it's a geographical expansion, we talked about in the prepared remarks, other things we're doing here is advancing our road map, and continuing to offer more features and capabilities for customers in our cloud along with higher service levels.

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

Got it. Thank you very much.

Operator

Pat Walravens from JMP Group.

Pat Walravens - *JMP Securities - Analyst*

Great, thank you. So Lanham, as we think about the growth acceleration, how fast can you accelerate to? Can you get back to the kind of growth that you saw in 2011? Okay. I thought you were going to keep going there. It sounded like you cut you submission off halfway through Pat. No, can you get -- we're just wondering can you get back to 30%?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, so here's where we are. So tactically we've provided you guidance for Q3. So that is my specific answer on what we think is going to happen over the next 90 days as we progress as a Company. Now let's zoom out a little bit from a macro level. At a macro level, to give you a little more context in what our thinking is, so if you ask can we get back to 2011 growth, can we get back to 2012 growth, pick a year. The short answer is, man we sure hope so. We are working hard to make that happen. Obviously we have not put all the pieces in place to deliver that yet. Where we find ourselves today as a Company is that we are navigating through a transition period. This transition period has some external factors going on, it's got some internal factors going on. External factors we've talked about in the previous call are macro conditions for example. Internal factors, really are where we are in a product cycle and the transition going on in our cloud.

So on the last call we talked about our first-generation cloud, its performance relative to the next generation cloud we've built on OpenStack. And we find ourselves at a point where our newer cloud technology base don OpenStack continues to grow at a real high rate. So what we have to do is manage our way through this to where we are looking at how we manage from our traditional first-generation cloud to a newer higher growth OpenStack cloud. Obviously as we get bigger, the law of large numbers kicks in a little bit and we've got to get the growth of the ground to continue to accelerate to get back to those aspirational levels that you put in your question. And we see is right now as we are doing the heavy lifting to migrate through this transition period to get our Company's growth rate back up to a higher level.

We are playing in a very high growth part of the technology market. So when we look at our performance that we just turned in, if you look at the macro opportunity ahead of us, personally, I think we can do better than this. I think we can grow faster than this. And we've got to prove it to you. We've got to deliver the results, and we've got to do a better job across our Company. We have to make our hybrid cloud powerful. So that I think what we're trying to do in terms of transparency here is we want to be very clear and candid with investors in the marketplace on what we think we're going to do over the next 90 days. This is why we started providing guidance. We did it for the first time last quarter, because we wanted to really share that data with everybody.

At the same time, we're going long. We are making long-term bets around here for example, launching a cloud in Australia, building a cloud in Hong Kong, doing collaborative research with CERN on hybrid cloud federation across different geographies. Is a long-term moves designed to increase our power in the marketplace and deliver better outcomes for customers. So short-term, the guidance is the guidance. That's what we think it is. That's a baked multi-variable equation. Long-term, I think we're playing in a ginormous growth opportunity in technology, and we need to do a better job of execution in long-term investing in order to achieve the aspirational growth levels that we've put up historically.

Pat Walravens - *JMP Securities - Analyst*

That's great, thank you Lanham.

Operator

Simon Flannery with Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thanks very much. Karl, thanks for the revenue guidance for Q3. Is this a good EBITDA margin to take through the rest of the year, or have you seen those costs from those new data centers? Were there any other big step functions in [Allpex] as we go into the second half? Thanks.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes, I think we've previously commented on that that we see margins currently in the low 30%s range. That we see them now, it came down a little bit. We would not expect them to go up in the near term, we're going to continue to invest. We had the branding spend in the first half of the year. We had the data center spend kicking up the second quarter in earnest, and we have continued to increase our R&D spending as you can tell from the P&L. So we're going to continue with that investment program throughout the year.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. So fairly similar levels to Q2?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Yes.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Simon, this is Lanham. If I could just add one point to that. I think what you see us going through here is we have increased investment levels to play for a bigger long-term outcome. We feel we have the opportunity to build a really important global company, and now is the time to make those investments. So part of what we want to do in terms of providing clarity to investors in the marketplace from a financial point of view, is the guidance is meant to communicate here's where we think we are over the next 90 days. And then when Karl is talking about margins, we want to make sure we are giving ourselves the proper funding to make the investments necessary to build a great long-term Company. And so this is how we see things right now.

In the long run, we've published target models, and we do think that those models are relevant again in the long term. But in the short-term here, we see ourselves as navigating through a transition period in our Company's development. We want to be clear about each step of that transition with respect to revenue guidance. And Karl is providing margin data to get more contextual information about the investments we're making, and the critical nature of those investments. Because we think now is the time to really go for it.

Simon Flannery - *Morgan Stanley - Analyst*

All right. That's helpful, thanks.

Operator

Sterling Auty with JPMorgan.

Sterling Auty - *JPMorgan Chase & Co. - Analyst*

Yes, thanks. Hello guys. I'm wondering, how much of the performance and the managed hosting part of the business in the quarter was a result of the changes that you made in go to market in focus versus external factors in terms of the balance between managed hosting and cloud?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, this is Lanham. We haven't quantified that in our prepared remarks, or in our key metrics or anything. So let me talk about how these things interrelate and what's going on. One of the things I talked about in the prepared remarks was the addition of two new sales and marketing leaders in our Company. The addition of Rick Jackson and Todd Cione. So I believe these two humans are super talented, and I think they will have a tremendous impact on our Company, but they did just get here. So as much as I think they're really talented, I can't give them a whole lot of credit on what we just turned in. Okay, they just arrived.

So I think that we will see Todd's impact and Rick's impact roll through the Company more going forward, than what we've just seen so far. I do think that what's happening here is that the prices where we feel real traction in the market place in areas where we can deliver great outcomes for customers, is in hybrid cloud. And so I think what I would say, if you look at the prepared remarks, is that this notion of one hybrid cloud system where you have dedicated infrastructure, multi-tenant infrastructure in a public cloud or singleton in architecture with a private cloud in the customer's facility or on the facility, the integration of this system is actually really powerful. The place where we feel like we do the best work and deliver the best customer outcomes is when we have customers consuming more than one of those services, more than one of those technology form factors. And when they do, we believe we can provide an application best it, which we touched on in our remarks.

So when we talk about the performance of the Company, I think the long-term upside in our Company, the long-term strength, and the capabilities we provide is really in this hybrid cloud scenario, and we're making investments to do more of that in our road map. We're winning customers from (inaudible) and other places talking to us about that outcome. Now I would tell you as I'm excited about that, it's also early days and we have a ton of work to do to make that truly seamless and truly integrated and super powerful. We see the promise, but we're not there yet. So I think what you see in our numbers here to an extent, do you see these little green shoots of -- the hybrid cloud is a growing piece of our Company. It's where we do our best work, and we're going to continue to work through that. I think if you look at the OpenStack community, and the number of projects going on in the OpenStack community, that continues to accelerate.

We are able to draft and participate in that community in a way that advances our technology faster than if we were dong it by ourselves. So there's a lot of inter-dependencies between these variables. I think our Company is a work in progress, and we have a tremendous opportunity in front of us. But we see some of the illuminated green shoots about what we need to do to deliver great outcomes for customers. We've just got to be very disciplined in our financial approach, which is why Karl talked about the margins, and we've got to execute it. The investments we're making in R&D and our product road map are about making this hybrid cloud system real. As we do that, I think you will see more dedicated growth potential in our business. And what happens is the lines blur pretty quickly.

So right now, in our metrics for example, we can delineate dedicated revenue versus multi-tenant or public cloud revenue pretty easily. As applications start to utilize both, it gets a little trickier about how we want to break that out for you exactly. So this is something that as the business changes, we will continue to provide as much information and transparency as possible on it. and we'll be clear with investors about how it's changing. I think that's what's going on today.

Sterling Auty - *JPMorgan Chase & Co. - Analyst*

Thank you.

Operator

Tom Seitz with Jefferies.

Thomas Seitz - *Jefferies & Company - Analyst*

Yes, thanks for taking the question. Our survey word suggests that OpenStack acceptance today is affected by platform stability. I think we're on the I think grisly release. As you get the features and functionality for most workloads on par with what the competition is doing, are you at the point now where the platform is stable enough? Do you think that companies more and more are going to be comfortable moving to your version of OpenStack?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, great question. Obviously, any time we're dealing with new technology stability matters, I think that OpenStack itself, although it just had its third birthday. We celebrated the three year birthday at Rackspace just a little while ago. I think that the technologies continue to advance, certainly grisly is a lot better than Diablo and prior versions. I think that technology continues to mature. To give you a more shorter answer, on do we think we have the stability necessary today? I think we're proud of what we've built, and I do that the stability has improved a bunch. We will continue to make investments in the platform. Particularly some of the network layers, because a lot of what unlocks the capability in multiple services is the network capability in the platform. So I think that's where we will continue to work the kinks out of the technology, and improve it going forward.

I think you'll continue to see OpenStack's innovation and capability accelerate. I was at the Portland Summit just a few months ago, and the energy at that Summit was better than the previous one, and a lot better than the ones a year or two before. So I believe that community is accelerating.

We will continue to make investments in it. And the stability is improving. Generally speaking, we'll run some pretty complicated stuff on it now and I think we're just scratching the surface. Because as you mentioned in your question, a key to adoption, particularly on enterprise buyers is to make sure that it's rock solid. A lot of the enterprise buyers, depending on what type of workload or application you're talking about, are willing to take some risk around a vision for a longer-term technology framework that's different than their historical one.

Okay. But I think as OpenStack matures, it really reduces the risk for them, and so you'll see it move even faster. The thing that gives us an advantage in is, is we have an operational and technology advantage in that we are running the largest OpenStack cloud on the planet. So when you talk about running things at scale and you think about the integration of software technologies along with operational capability and process to run an OpenStack cloud of scale, we are the largest on the planet. So we feel that gives us a unique perspective in how to help customers achieve it. In the prepared remarks, we talked a little bit about OpenStack on premise private clouds. The conversations that I'm with customers is they are looking to our experience and understanding in this endeavor. So I think OpenStack community as it advances, helps us. And then I think [rash] which we bring a little something special to it in that we're running the largest OpenStack deployment on the planet, which just gives us a little more unique insight into how these things ought to be conducted.

Thomas Seitz - *Jefferies & Company - Analyst*

Thanks very much for the color.

Operator

Jaimin Soni with Bank of America.

Jaimin Soni - *BofA Merrill Lynch - Analyst*

Thanks. Hello. My question is for Lanham. I wanted to just talk a little bit about the monthly installed base growth. That did pick up nicely this quarter from last quarter. And I wanted to just inquire about what you think drove that uptick. And Lanham, you'd mentioned from that the enterprise business last quarter was not growing as fast. I wanted to just get an update on that this quarter. Thank you.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay, yes. So it's monthly IDG and enterprise are the two topics. Okay. With respect to monthly IDB, if you look at just the piece components, the biggest thing here, number one, our churn space is basically flat. So we're happy with that. It's important that churn as an economic input to our business is something that's tightly controlled. That's running flat, so nothing changed there. What changed here was the net upgrades. So if you look at the net upgrades monthly, that increased. The other thing that changed here is our cloud growth accelerated sequentially and picked up. So I think the number one factor in the net upgrades here really was that performance. When you looked at our performance in Q1, net upgrades had declined. So Q1 we had a poor net upgrades quarter, Q2 I think net upgrades got back to a more normal condition for us. So I think we just took a step back to where we should have been.

So I think that 0.74% for installed base growth on a monthly basis is certainly an improvement over Q1, a big improvement over Q1. If you look at our history, this number bounces around a little bit. All right, so we'll keep focused on it and we'll keep our head down and keep executing to the best of our ability. Specifically with enterprise, the enterprise segment was a topic of the conversation last call. In that call, we had shared in our prepared remarks that our enterprise segment had been the fastest growing piece of our dedicated business, and that that growth had slowed down. I don't have a whole lot of color to add to that right now. I'd tell you generally speaking, with the addition of Rick Jackson and Todd Cione, some of the work we've done here recently in the Company and around getting better aligned on things, I do think that our body language feels a bit better on our enterprise business today. I'd also tell you it's still a work in progress, so I'm not here declaring victory or anything. We've got a lot of work to do inside of our Company. I just think that in Q2, we took a good step forward, we just have many more steps to do before we achieve our dreams.

Jaimin Soni - *BofA Merrill Lynch - Analyst*

Got it. Appreciate the color, thanks Lanham.

Operator

Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, I wondered if you could comment a bit on CapEx levels (inaudible) forward given the Virginia and Hong Kong cloud deployments?

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes. So we have shared the CapEx range on the original call, we're happy to reconfirm that. We basically see no reason to change that range. So on a [custimate] year we expect to come in between $235 million and $295 million. On the DC build outs, between $30 million and $45 million. On office, between $20 million and $30 million, sand on software and other between $85 million and $105 million. This is capturing all of our anticipated build out programs and planned build out programs. There's not a lot of change that we would expect to happen here, because those are obviously programs that have lead times, that have contractors involved that are basically taking place.

So there's very little reason to be surprised. Customer gear is always is heavily success based. And as Lanham mentioned, though, there is capacity build out associated with product launches and geo launches, and that certainly was received. So that has an impact on the CapEx number right now on the customer gear side that has an impact on the server count. It has an impact on revenue per server. That's just all a reflection of the same thing which is the capacity build out to capture more revenue opportunities.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then, just on the last question, you talked about the increase from cloud. And I wondered if you could maybe comment on how much of your new business was new versus existing? It sounds like the growth came from managed hosting customers adopting more cloud, so it was maybe a fewer new logos and more upsell of existing customers, is that fair to say?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Well I think that's a level of granularity we've stayed away from in these calls. But I would tell you in general, the cloud it is a pretty new technology So certainly existing customers tapping into that capability drives revenue, but I would not discount just the amount of new entrants into the category. I think new applications today are written for a cloud world. So as people are writing new apps, I think it's written for an OpenStack cloud. And I think these really represent new customer opportunities for us, so I would just say it's a mix. In that and when we think about technology adoption over time, because cloud is new, I think a big chunk of the growth there is going to be new customers, and then I think what we endeavor to do is to pull our traditional base and tap into that movement as well.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you very much.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Let me just add here quickly, we did continue [throwing] a customer count number, but we're happy to give you a little bit of color commentary here. So we've had a good add quarter here. We added over 13,000 customers. And at the same time it's also true what Lanham initially said which is that the IBP uptick was well driven by the cloud acceleration and reacceleration as well. So we are happy to see that we have momentum from both levers.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. Thank you.

Operator

Jonathan Schildkraut with Evercore Partners.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thanks for fitting me in. Lanham, I was wondering if maybe we could get a little bit more color around the dedicated hosting revenue line. One of the things that you had mentioned previously that some of the business, kind of the most basic bare metal dedicated business was being commoditized and that you guys were bringing fanatical support higher in the stack. And when we look at the dedicated hosting business, there might be some change in wave underneath the top here, which is that more of the business on the dedicated could be coming from higher levels of fanatical support, and less on the racking and stacking of basic servers, and you can't tell that from the top line. So I was wondering whether there was any incremental color underneath that line that you could share with us? Thanks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Yes, let's talk about dedicated hosting with respect to the technology opportunities around cloud and how these two interplay. When we talk about hybrid cloud, and we've talked about the specific customer lens and we've delineated for you what services those customers are purchasing from us. Dedicateds rule and that really matters. So let me explain. The opportunity here in a hybrid cloud world is to make dedicated hosting as if it is a cloud. The first iteration of cloud technologies, everything was virtualized. What we have discovered is that programmatic API driven single tenant dedicated provisioning is actually really powerful. And that in some ways, sorry let me take that back. In specific use cases, it blows multi-tenant cloud infrastructure away from a performance point of view. So that the investment work we're doing in dedicated is to make dedicated look more cloud like.

What I would tell you is that if you look at the evolution of our Company over the last 15 years, our dedicated hosting business it's powerful, and it's going to be here. It's still going to be around. It's going to grow, we expect great things from it. Over time, what I think happens is that the first iteration of dedicated will still be in existence, it's going to look much more like a custom dedicated business and that the rest of dedicated we're are going to pull into a hybrid cloud world by making it programmatic and auto provisioned. Because single tenant architecture in a cloud world with highly complex applications is very powerful. So the investments we're making in dedicated is to enhance that custom dedicated business, and then make that custom business more relevant in a cloud world by integrating it into our hybrid cloud system. And we have the makings of that today. Jonathan, we don't have it all done, but we have the makings of it.

And as we continue to invest in that, I think we make dedicated a very powerful part of our hybrid cloud system. And as you survey the providers out there in the marketplace, I think we're best positioned to provide that. I think we are the best positioned Company on the planet to provide this hybrid cloud system. It's all going to work within the OpenStack technology framework, and it makes our traditional dedicated business more relevant in a cloud world. There's some very important investments to do there, but when you talk just at the infrastructure layer, I think that's the future of dedicated. And in order to re-accelerate that dedicated line in our key metrics, we have to make this part of the programmable hybrid cloud system. So that's the infrastructure.

When you talk about the service levels above that base infrastructure, I agree with your comment/question. In that going forward, we are moving up the stack. The nice thing about a hybrid cloud is we automate things and frees up rackers to do more value added things on top of that infrastructure stack. So I do believe that fanatical support will continue to evolve, that we will move up the stack, that the automated capability of the infrastructure layer allows rackers to take on more application and responsibility, and more responsibility from the environment around the application.

So when we talk about moving up the stack, one of the ways we [frighten] this today internally, is we talk about a dead ops offering. And our customers tend to do a lot of the development themselves, and we need to be the ops. And we need to automate the provision of ops, when you automate the processes around ops. And we have to help customers get over this hump into a cloud world. So I think you'll see us make investments in dedicated to pull into hybrid. I think you'll see a more traditional/classic custom dedicated business that will be tailored and purpose built for specific applications, and then you'll see a hybrid cloud system develop that pulls dedicated technologies into it for the new modern architecture for cloud apps.

Jonathan Schildkraut - *Evercore Partners - Analyst*

Thank you.

Operator

Frank Louthan with Raymond James.

Frank Louthan - *Raymond James & Associates - Analyst*

Great, thank you. Can you give us an idea with some of the new customers and any larger logos sort of a ballpark revenue per month that they're in? And with some of the servers that you added, I'm assuming that the negative impact on server ARPU was due to forward deployment and maybe some of those servers as you're waiting for the demand to come, and can you talk a little bit about the trend in the ARPU per server?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. So let me start with the answer you're going to like. On the server ARPU number, yes, that's due to increased capacity as we build out these clouds and infrastructure ahead of time. So that's what's run. Even though we moved a little bit and it's driven by that capacity. Okay, so yes sir on that one. On the customer specific data, my answer is I'm not able to provide that to you. We haven't ever shared customer revenue data. Obviously if we've put them in this call, we're proud of the work we're doing with them. We think they are interesting technology use cases, and interesting brands. But I'm not at liberty to get into the revenue data around those customers.

Frank Louthan - *Raymond James & Associates - Analyst*

But are they materially above what has historically been your larger end of your customer base? Do you think that's what people are thinking of when they think of an enterprise customer? I just wanted to see are these substantially large customers, or large enterprises that are taking more traditional sized deployments with you?

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. Well the customers we talked about here, just to give you a little more data, the customers we talked about here are hybrid customers. Hybrid customers means they're using multiple services, or at least a couple services with us. So, not to give you a number, but if people are doing a couple things with us it tends to mean they're important to us, and we want to do great work for them. And so what I say is that it's our product road map and the capability advances we have an capability to run more complicated interesting applications for customers and bring really powerful set up technologies to serve them. I think these customers point to that direction, in that we can do interesting work for them, but I don't want to get into specific financial data around it.

Frank Louthan - *Raymond James & Associates - Analyst*

Okay, thank you.

Operator

Michael Bowen with Pacific Crest.

Michael Bowen - *Pacific Crest Securities - Analyst*

Okay. Thanks for squeezing me in. So it looks like you've re-accelerated your revenue growth, and the enterprise is sounding better. A couple of the co-location providers during the quarter talked about and also some of our survey work indicated that the enterprise CIO's are having a more difficult time and are taking a longer time to make decisions on migrating to the cloud. It doesn't seem like you're experiencing that, so I was hoping you could tie that together for us. I realize that a couple of the other companies are not direct competitors with you, but given their commentary about enterprise slowness in migrating to the cloud, I'm wondering if you're seeing any of those trends at all although it's not indicated in your numbers? And then secondly, with regard to margins, obviously better than we expected and the street expected. You indicated that margin is going to remain low, or in the low 30%s for the foreseeable future. You had indicated last quarter that you're going to continue to spend toward the opportunity I guess wrapping that around to the first question then, if you are seeing or hearing some enterprise slowness in migration, do you foresee perhaps that you'll have to increase your spending further down the road and that could impact margins as well? Thanks.

Karl Pichler - *Rackspace Hosting Inc - CFO*

Yes, let me start with the margin thing. I guess the way that we think about this, and we talked about this in the past, is that we have basically two large categories of resource pools that are being consumed. One is really very closely related to revenue, which is a high degree of success base. And then there are certain things that we're building out that are, as Lanham said, long-term bets on large future growth opportunities. And I think what we have to do as a team is really making sure that we're building this Company for the long-term, but also obviously manage it responsibly in the short-term.

So there are certain elements that we're trusting to the specific revenue potential, and then there are certain elements that we're just running like program regardless of the revenue fluctuations that we see in a given quarter. And I think this explains a little bit the margin fluctuations that we see this year. So we simply did not decide to cut back on our data center expansion just because it's revenue was slow. Because if you want to accelerate and expand your reach, you make those investments and then you start selling. And the initial feedback from those facilities and from those [nutrographic] areas is very positive, so we're happy to see that. So it obviously works. And then generally, we are bullish about the long-term opportunities that we have, and we're building a Company that can handle the business volume that's associated with it.

Lanham Napier - *Rackspace Hosting Inc - CEO*

In terms of the enterprise CIO adoption of cloud, let me just share with you our experience and what we see, because I'm not familiar with the comments that the other companies may have made. So if you rewind to our call 90 days ago, we shared with you one example, HubSpot, which is a really cool company of really cool technology use case that we're providing for them in terms of its complexity and capability online. And when we talked on the call 90 days ago, we said we were going to other customers. That we were going from proof of pilots to proof of concepts, into production, and what you see on this call is us sharing with you some of those wins that we've been working on.

So in terms of do I think it's accelerating or slowing down? From my view, it's just the same. We've been working on this for a while now. I think when you look at enterprise customers, at least in our world, the Rackspace world, I think these are customers that make decisions, six to eight to nine months for something like this whereas I think the upper mid market or the mid market makes a decision like that in six to eight weeks. So I do think these things are very different. That's been our experience with it. I couldn't tell you whether I think that's slowing down or accelerating for us. It's been pretty consistent. So that's what I'd offer up for you on that one.

Michael Bowen - *Pacific Crest Securities - Analyst*

Okay, thanks.

Operator

And that does conclude our question and answer session today. And at this time, I'd like to turn the call over Lanham Napier for closing remarks.

Lanham Napier - *Rackspace Hosting Inc - CEO*

Okay. I'd like to thank everybody for tuning in to the call. We feel like we have plenty of work to do here at Rackspace. We're happy to celebrate our fifth anniversary as a public company, and we're committed to our stockholders. We've got plenty of work to do around here. The quarter was a good step forward, we're still a work in progress as we navigate through this transition. So we will keep our heads down and get back to work. I want to thank our customers for placing their confidence and trust in us, and I want to thank the 5,000 rackers around the globe who actually make it happen every day. So we will tune back in with you here in 90 days to give you an update on our progress, we'll talk to you then. Bye-bye.

Operator

That does conclude our conference for today. Thank you for your participation. You may now disconnect.
