RACKSPACE HOSTING, INC. (RAX)

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10−Q

Quarterly report pursuant to sections 13 or 15(d)
Filed on 8/9/2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10−Q

(Mark one)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2010.

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 (No Fee Required)

For the transition period from ______ to ______.

Commission file number 001−34143

RACKSPACE HOSTING, INC.
(Exact Name of Registrant as Specified in its Charter)

Delaware (State or Other Jurisdiction of Incorporation or Organization)	74−3016523 (IRS Employer Identification No.)

5000 Walzem Rd.
San Antonio, Texas 78218
(Address of principal executive offices, including Zip Code)
(210) 312−4000
(Registrant’s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S−T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).Yes ¨ No¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non−accelerated filer or a smaller reporting company. See definition of “accelerated filer, large accelerated filer and a smaller reporting company” in Rule 12b−2 of the Exchange Act. (Check one):

Large accelerated filer ☑ Accelerated filer ¨ Non−accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b−2 of the Exchange Act). Yes ¨ No ☑

On July 30, 2010, 124,974,297 shares of the registrant’s Common Stock, $0.001 par value, were outstanding.

RACKSPACE HOSTING, INC.

TABLE OF CONTENTS

Part I − Financial Information		
Item 1.	Financial Statements:	
	Condensed Consolidated Balance Sheets as of December 31, 2009 and June 30, 2010 (unaudited)	3
	Unaudited Condensed Consolidated Statements of Income for the Three and Six Months Ended June 30, 2009 and 2010	4
	Unaudited Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2009 and 2010	5
	Notes to the Unaudited Condensed Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3.	Quantitiatve and Qualitative Disclosures About Market Risk	36
Item 4.	Controls and Procedures	37
Part II − Other Information		
Item 1.	Legal Proceedings	38
Item 1A.	Risk Factors	39
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	55
Item 3.	Defaults Upon Senior Securities	55
Item 3.	Reserved	55
Item 5.	Other Information	55
Item 6.	Exhibits	56
Signatures		57

PART I – FINANCIAL INFORMATION

ITEM 1 − FINANCIAL STATEMENTS

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	December 31, 2009	June 30, 2010
		(Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 125,425	$ 148,496
Accounts receivable, net of allowance for doubtful accounts and customer credits of $4,298 as of December 31, 2009, and $3,151 as of June 30, 2010	38,732	43,577
Income taxes receivable	7,509	10,801
Deferred income taxes	9,764	7,894
Prepaid expenses and other current assets	10,239	10,901
Total current assets	191,669	221,669
Property and equipment, net	432,971	456,650
Goodwill	22,329	23,329
Intangible assets, net	10,790	7,879
Other non−current assets	10,886	10,930
Total assets	$ 668,645	$ 720,457
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 89,773	$ 97,711
Current portion of deferred revenue	17,113	14,996
Current portion of obligations under capital leases	46,415	51,549
Current portion of debt	4,893	2,589
Total current liabilities	158,194	166,845
Non−current deferred revenue	2,331	1,644
Non−current obligations under capital leases	63,287	63,959
Non−current debt	52,791	51,750
Non−current deferred income taxes	30,850	22,796
Other non−current liabilities	11,765	15,469
Total liabilities	319,218	322,463
COMMITMENTS AND CONTINGENCIES		
Stockholders' equity:		
Common stock, $0.001 par value per share: 300,000,000 shares authorized; 123,773,977 shares issued and outstanding as of December 31, 2009, 124,937,742 shares issued and outstanding as of June 30, 2010	124	125
Additional paid−in capital	251,337	284,912
Accumulated other comprehensive loss	(10,257)	(16,276)
Retained earnings	108,223	129,233
Total stockholders’ equity	349,427	397,994
Total liabilities and stockholders’ equity	$ 668,645	$ 720,457

See accompanying notes to the unaudited condensed consolidated financial statements.

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—

CONDENSED CONSOLIDATED STATEMENTS OF INCOME – (Unaudited)

(In thousands, except per share data)	Three Months Ended June 30, 2009	Three Months Ended June 30, 2010	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Net revenue	$ 151,995	$ 187,314	$ 297,072	$ 366,119
Costs and expenses:				
Cost of revenue	48,235	61,470	94,445	118,477
Sales and marketing	19,080	23,285	39,582	45,262
General and administrative	41,566	46,737	79,106	93,132
Depreciation and amortization	29,711	37,991	57,515	74,689
Total costs and expenses	138,592	169,483	270,648	331,560
Income from operations	13,403	17,831	26,424	34,559
Other income (expense):				
Interest expense	(2,172)	(1,875)	(4,707)	(4,019)
Interest and other income (expense)	(267)	814	(358)	999
Total other income (expense)	(2,439)	(1,061)	(5,065)	(3,020)
Income before income taxes	10,964	16,770	21,359	31,539
Income taxes	3,973	5,572	7,780	10,529
Net income	$ 6,991	$ 11,198	$ 13,579	$ 21,010
Net income per share				
Basic	$ 0.06	$ 0.09	$ 0.11	$ 0.17
Diluted	$ 0.06	$ 0.08	$ 0.11	$ 0.16
Weighted average number of shares outstanding				
Basic	120,214	124,592	118,918	124,288
Diluted	126,442	132,660	124,007	132,562

See accompanying notes to the unaudited condensed consolidated financial statements.

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS – (Unaudited)

(In thousands)	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Cash Flows From Operating Activities		
Net income	$ 13,579	$ 21,010
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	57,515	74,689
Loss on disposal of equipment, net	487	274
Provision for bad debts and customer credits	6,382	1,384
Deferred income taxes	5,317	(6,632)
Deferred rent	124	3,120
Share−based compensation expense	9,254	12,354
Other non−cash compensation expense	409	209
Excess tax benefits from share−based compensation arrangements	−	(15,453)
Changes in certain assets and liabilities		
Accounts receivable	(12,858)	(6,728)
Income taxes receivable	(1,035)	11,985
Accounts payable and accrued expenses	12,054	9,861
Deferred revenue	(792)	(2,425)
All other operating activities	(1,588)	(793)
Net cash provided by operating activities	88,848	102,855
Cash Flows From Investing Activities		
Purchases of property and equipment, net	(56,616)	(68,672)
Earnout payments for acquisitions	(5,622)	(490)
Other investing activities	−	(75)
Net cash used in investing activities	(62,238)	(69,237)
Cash Flows From Financing Activities		
Principal payments of capital leases	(20,922)	(25,753)
Principal payments of notes payable	(4,527)	(3,345)
Payments on line of credit	(100,000)	−
Payments for debt issuance costs	(328)	−
Proceeds from employee stock plans	6,230	5,050
Excess tax benefits from share−based compensation arrangements	−	15,453
Net cash used in financing activities	(119,547)	(8,595)
Effect of exchange rate changes on cash and cash equivalents	2,407	(1,952)
Increase (decrease) in cash and cash equivalents	(90,530)	23,071
Cash and cash equivalents, beginning of period	238,407	125,425
Cash and cash equivalents, end of period	$ 147,877	$ 148,496
Supplemental cash flow information:		
Acquisition of property and equipment by capital leases	$ 35,320	$ 31,559
Shares issued in business combinations	$ 1,880	$ 510
Cash payments for interest, net of amount capitalized	$ 4,857	$ 4,005
Cash payments for income taxes	$ 2,938	$ 11,939

See accompanying notes to the unaudited condensed consolidated financial statements.

NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Overview and Basis of Presentation

Nature of Operations

As used in this report, the terms “Rackspace”, “Rackspace Hosting”, “we”, “our company”, “the company”, “us,” or “our” refer to Rackspace Hosting, Inc. and its subsidiaries. Rackspace Hosting, Inc., through its operating subsidiaries, is a provider of hosting solutions. We provide IT as a service, managing web−based IT systems for small and medium−sized businesses as well as large enterprises. We focus on providing a service experience for our customers, which we call Fanatical Support®.

Rackspace Hosting, Inc. was incorporated in Delaware on March 7, 2000. However, our operations began in 1998 as a limited partnership which became our subsidiary through a corporate reorganization completed on August 21, 2001.

We operate consolidated subsidiaries which include, among others, Rackspace US, Inc., our domestic operating entity, and Rackspace Limited, our United Kingdom operating entity.

Basis of Consolidation

The consolidated financial statements include the accounts of our wholly owned subsidiaries located in the United States of America (U.S.), the United Kingdom (U.K.), the Netherlands, and Hong Kong. Intercompany transactions and balances have been eliminated in consolidation.

Basis of Presentation

The accompanying consolidated financial statements as of June 30, 2010, and for the three and six months ended June 30, 2009 and 2010, are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and Rule 10−01 of Regulation S−X. Accordingly, they do not include all financial information and disclosures required by GAAP for complete financial statements and certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary for a fair statement of our financial position as of June 30, 2010, our results of operations for the three and six months ended June 30, 2009 and 2010, and our cash flows for the six months ended June 30, 2009 and 2010.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2009 included in our Annual Report on Form 10−K filed with the Securities and Exchange Commission on February 26, 2010, as amended. The results of the three and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the year ending December 31, 2010, or for any other interim period, or for any other future year.

Certain reclassifications have been made to prior year balances in order to conform to the current year’s presentation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, we evaluate our estimates, including those related to accounts receivable and customer credits, property and equipment, fair values of intangible assets and goodwill, useful lives of intangible assets, fair value of stock options, contingencies, and income taxes, among others. We base our estimates on historical experience and on other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. We engaged third party valuation consultants to assist management in the purchase price allocation of significant acquisitions.

2. Summary of Significant Accounting Policies

The accompanying financial statements reflect the application of certain significant accounting policies. There have been no material changes to our significant accounting policies that are disclosed in our audited consolidated financial statements and notes thereto as of December 31, 2009 included in our Annual Report on Form 10−K, as amended.

Recently Adopted Accounting Pronouncements

In December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2009−17, which codified Statement of Financial Accounting Standard (SFAS) 167, Amendments to FASB Interpretation No. 46(R), issued in June 2009. This guidance amends FASB Interpretation No. 46 (revised December 2003) to address the elimination of the concept of a qualifying special purpose entity. ASU 2009−17 also replaces the quantitative−based risks and rewards calculation for determining which enterprise has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity and the obligation to absorb losses of the entity or the right to receive benefits from the entity. Additionally, ASU 2009−17 provides more timely and useful information about an enterprise's involvement with a variable interest entity. ASU 2009−17 became effective for us last quarter. This ASU did not have a material impact on our consolidated financial statements.

In January 2010, the FASB issued ASU 2010−06, "Fair Value Measurements and Disclosures," which amends the disclosure requirements related to recurring and nonrecurring fair value measurements. The guidance requires new disclosures on the transfers of assets and liabilities between Level 1 (quoted prices in active market for identical assets or liabilities) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy, including the reasons and the timing of the transfers. Additionally, the guidance requires a roll forward of activities on purchases, sales, issuance, and settlements of the assets and liabilities measured using significant unobservable inputs (Level 3 fair value measurements). ASU 2010−06 became effective for us last quarter, except for the disclosure on the roll forward activities for Level 3 fair value measurements, which will become effective for us in the first annual reporting period that begins after December 15, 2010 and for interim periods within that annual reporting period. This ASU did not have a material impact on our consolidated financial statements.

Recent Accounting Pronouncements

In September 2009, the FASB issued two Accounting Standards Updates (ASU): (i) ASU 2009−13 (EITF 08−1), Multiple−Deliverable Revenue Arrangements, and (ii) ASU 2009−14 (EITF 09−3), Certain Revenue Arrangements that Include Software Elements, which will be effective prospectively for revenue arrangements, entered into or materially modified in fiscal years beginning on or after June 15, 2010. ASU 2009−13 amends ASC Subtopic 605−25 to eliminate the requirement that all undelivered elements in a multiple−element revenue arrangement have vendor−specific objective evidence (VSOE) or third−party evidence (TPE) before an entity can recognize the portion of an overall arrangement fee that is attributable to items that already have been delivered. In the absence of VSOE or TPE of the standalone selling price for one or more delivered or undelivered elements in a multiple−element arrangement, entities will be required to estimate the selling prices of those elements. The overall arrangement fee will be allocated to each element (both delivered and undelivered items) based on their relative selling prices, regardless of whether those selling prices are evidenced by VSOE or TPE or are based on the entity's estimated selling price. Application of the "residual method" of allocating an overall arrangement fee between delivered and undelivered elements will no longer be permitted upon adoption. ASU 2009−14 amends ASC Subtopic 985−605 to exclude from its scope tangible products that contain both software and non−software components that function together to deliver a product's essential functionality. We do not expect the adoption of ASU 2009−13 or 2009−14 to have a material impact on our consolidated financial statements.

3. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per share data)	Three Months Ended June 30, 2009	Three Months Ended June 30, 2010	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Basic net income per share:				
Net income	$ 6,991	$ 11,198	$ 13,579	$ 21,010
Weighted average shares outstanding:				
Common stock	120,214	124,592	118,918	124,288
Number of shares used in per share computations	120,214	124,592	118,918	124,288
Earnings per share	$ 0.06	$ 0.09	$ 0.11	$ 0.17
Diluted net income per share:				
Net income	$ 6,991	$ 11,198	$ 13,579	$ 21,010
Weighted average shares outstanding:				
Common stock	120,214	124,592	118,918	124,288
Stock options, awards and employee share purchase plan	6,228	8,068	5,089	8,274
Number of shares used in per share computations	126,442	132,660	124,007	132,562
Earnings per share	$ 0.06	$ 0.08	$ 0.11	$ 0.16

We excluded 5.2 million and 1.6 million potential common shares from the computation of dilutive earnings per share for the three months ended June 30, 2009 and 2010, respectively, and 6.5 million and 920 thousand potential shares for the six months ended June 30, 2009 and 2010, respectively, because the effect would have been anti−dilutive.

4. Cash and Cash Equivalents

Cash and cash equivalents consisted of:

(In thousands)	December 31, 2009	June 30, 2010
Cash deposits	$ 64,716	$ 87,776
Money market funds	60,709	60,720
Cash and cash equivalents	$ 125,425	$ 148,496

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. We actively monitor the third−party depository institutions that hold our deposits. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds.

Our money market mutual funds invest exclusively in high−quality, short−term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies.

5. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. There is a three−tier fair value of hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – Observable inputs such as quoted prices in active markets for identical assets or liabilities;

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 – Unobservable inputs that are supported by little or no market activity, which require management judgment or estimation.

There have been no material changes to the valuation techniques utilized in the fair value measurement of assets and liabilities presented on our balance sheet as disclosed in our Form 10−K, as amended, for the year ended December 31, 2009.

Assets and liabilities measured at fair value on a recurring basis are summarized by level below. The table does not include assets and liabilities which are measured at historical costs or any other basis other than fair value.

(In thousands)	December 31, 2009			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 60,709	$ −	$ −	$ 60,709
Rabbi trust (3)	576	−	−	576
Total	$ 61,285	$ −	$ −	$ 61,285
Liabilities:				
Interest rate swap agreement (1)	$ −	$ 1,818	$ −	$ 1,818
Deferred compensation (2)	586	−	−	586
Total	$ 586	$ 1,818	$ −	$ 2,404

(In thousands)	June 30, 2010			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 60,720	$ −	$ −	$ 60,720
Rabbi trust (3)	661	−	−	661
Total	$ 61,381	$ −	$ −	$ 61,381
Liabilities:				
Interest rate swap agreement (1)	$ −	$ 942	$ −	$ 942
Deferred compensation (2)	633	−	−	633
Total	$ 633	$ 942	$ −	$ 1,575

(1) Money market funds are classified in cash and cash equivalents and the interest rate swap agreement is classified in accounts payable and accrued expenses.
(2) Obligations to pay benefits under a non−qualified deferred compensation plan are classified in other non−current liabilities.
(3) Investments in marketable securities held in a Rabbi Trust associated with a non−qualified deferred compensation plan located in other non−current assets.

6. Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consisted of:

(In thousands)	December 31, 2009	June 30, 2010
Prepaid expenses	$ 7,505	$ 8,258
Other current assets	2,734	2,643
Prepaid expenses and other current assets	$ 10,239	$ 10,901

7. Property and Equipment, net

Property and equipment consisted of:

(In thousands)	Estimated Useful Lives	December 31, 2009	June 30, 2010
Computers, software and equipment	1−5 years	$ 511,279	$ 577,020
Furniture and fixtures	7 years	22,311	23,673
Buildings and leasehold improvements	2−30 years	134,045	133,726
Land	−−	13,860	13,860
Property and equipment, at cost		681,495	748,279
Less accumulated depreciation and amortization		(298,369)	(353,062)
Work in process		49,845	61,433
Property and equipment, net		$ 432,971	$ 456,650

Depreciation and leasehold amortization expense, not including amortization expense for intangible assets, was $28.1 million and $36.4 million for the three months ended June 30, 2009 and 2010, respectively, and $54.4 million and $71.5 million for the six months ended June 30, 2009 and 2010, respectively.

At December 31, 2009, the work in process balance consisted of build outs of $35.7 million for office facilities, $8.0 million for data centers, and $6.1 million for capitalized software and other projects. At June 30, 2010, the work in process balance consisted of build outs of $35.9 million for office facilities, $12.8 million for data centers, and $12.7 million for capitalized software and other projects.

Capitalized interest was $0.2 million and $0.3 million for the three months ended June 30, 2009 and 2010, respectively, and $0.5 million and $0.3 million for the six months ended June 30, 2009 and 2010, respectively.

8. Business Combinations and Goodwill

In October 2008, we acquired two companies for a total purchase price of $28.0 million, which were accounted for as business combinations. The initial purchase price of the combined acquisitions was $11.5 million paid in cash and stock, with up to $16.5 million in additional payouts of cash and stock based on certain earn−out provisions. As of December 31, 2009 earn−outs totaling $15.5 million had been achieved and paid in a combination of cash and stock. The final $1.0 million earn−out was achieved in March 2010 and was paid in April 2010 in a combination of cash and stock. The earn−out was accounted for as additional goodwill.

The following table provides a roll forward of our goodwill balance.

(In thousands)	
Balance at December 31, 2009	$ 22,329
Earn−out payment for acquisition	1,000
Balance at June 30, 2010	$ 23,329

9. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consisted of:

(In thousands)	December 31, 2009	June 30, 2010
Trade payables	$ 24,597	$ 24,181
Accrued compensation and benefits	28,469	30,125
Foreign income taxes payable	6,340	8,025
Vendor accruals	17,806	23,582
Other liabilities	12,561	11,798
Accounts payable and accrued expenses	$ 89,773	$ 97,711

10. Debt

Debt outstanding consisted of:

(In thousands)	December 31, 2009	June 30, 2010
Revolving credit facility	$ 50,000	$ 50,000
Notes payable	7,684	4,339
Total debt	57,684	54,339
Less current portion of debt	(4,893)	(2,589)
Total non−current debt	$ 52,791	$ 51,750

Revolving Credit Facility

Our revolving credit facility includes an aggregate commitment of $245.0 million. The facility provides for letters of credit up to $25.0 million. The interest is based on a floating rate, generally the London Interbank Offered Rate (LIBOR) plus a margin spread, which changes ratably from 0.675% to 1.55% dependent on the total funded debt to adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA) ratio. We are required to pay a facility fee of 0.2% per annum on the full amount committed under the facility and a quarterly administrative fee. The facility has a 5−year term and matures in August 2012, and is fully secured by our domestic assets and a portion of our foreign subsidiary equity holdings and governed by financial and non−financial covenants. Financial covenants under our facility include a minimum fixed charge coverage ratio of at least 1.50 to 1.00 and a maximum total funded debt to EBITDA ratio of not greater than 3.00 to 1.00. Also, our foreign cash balance is limited to a balance of $25 million. As of June 30, 2010, we were in compliance with all of the covenants under our facility.

The revolving credit facility agreement provides us with the ability to borrow under our credit facility in pounds sterling and euros in addition to U.S. dollars; however, we are limited to borrowings of $75 million in these alternate currencies. As of June 30, 2010 we did not have any borrowings on our credit facility in alternate currencies.

As of June 30, 2010, the amount outstanding under the facility was $50.0 million, with an outstanding letter of credit of $0.6 million, resulting in an additional $194.4 million available for future borrowings.

Interest Rate Swap

We have a cash flow hedge to limit our exposure that may result from the variability of floating interest rates. Effective December 10, 2007, we entered into an interest rate swap agreement with a notional amount of $50.0 million. The interest rate swap hedges the first $50.0 million of our outstanding floating−rate debt. This swap converts floating rate interest based on the LIBOR into fixed−rate interest as part of the arrangement with our primary lender and expires in December 2010.

We are required to pay the counterparty a stream of fixed interest payments at a rate of 4.135%, and in turn, receive variable interest payments based on 1−month LIBOR. The margin spread as of June 30, 2010 was 1.05% resulting in an effective fixed rate of 5.185%. The net receipts or payments from the swap are recorded as interest expense. The swap is designated and qualifies as a cash flow hedge. As such, the swap is accounted for as an asset or a liability in the accompanying consolidated balance sheets at fair value. We are utilizing the dollar offset method to assess the effectiveness of the swap. Under this methodology, the swap was deemed to be highly effective for the six months ended June 30, 2009 and 2010. There was no hedge ineffectiveness recognized in earnings for either period. If the hedge becomes ineffective, or if certain terms of the facility change, the facility is extinguished, or if the swap is terminated prior to maturity, the fair value of the swap and subsequent changes in fair value may be recognized in the accompanying consolidated statements of income. The fair value of the swap was estimated based on the yield curve as of December 31, 2009 and June 30, 2010, and represents its carrying value. See Note 5 for further disclosure on the fair value of the interest rate swap and Note 15 for further information on comprehensive income.

The following table presents the impact of the interest rate swap on the consolidated balance sheets:

(In thousands)	December 31, 2009	June 30, 2010
Accounts payable and accrued expenses	$ 1,818	$ 942
Accumulated other comprehensive income (loss), net of tax	$ (1,182)	$ (612)

(In thousands)	Three Months Ended June 30, 2009	Three Months Ended June 30, 2010	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Effective gain (loss) recognized in accumulated other comprehensive income, net of tax	$ 260	$ 327	$ 326	$ 570

As the interest rate swap expires in December 2010, the full amount of other comprehensive income related to the interest rate swap as of June 30, 2010 is expected to be reclassified to expense within the next 6 months.

As of June 30, 2010, we were in a liability position to the counterparty of the swap and therefore had limited counterparty credit risk.

11. Other Non−Current Liabilities

Other non−current liabilities consisted of:

(In thousands)	December 31, 2009	June 30, 2010
Texas Enterprise Fund Grant	$ 5,000	$ 5,000
Deferred rent	5,391	9,111
Other	1,374	1,358
Other non−current liabilities	$ 11,765	$ 15,469

12. Commitments and Contingencies

Legal Proceedings

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. In addition, on October 22, 2008, Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston, was filed in the 37 th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us. We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

On March 26, 2010 Bedrock Computer Technologies LLC's filed its First Amended Answer and Counterclaim to Red Hat, Inc.'s Complaint for Declaratory Judgment (Red Hat, Inc., v Bedrock Computer Technologies, LLC Cause No. 6:09−CV−00549 –LED, United States District Court for the Eastern District of Texas). In its answer and counterclaim, Bedrock has named Rackspace as a third party defendant in a civil action by asserting cross claims against Rackspace and several other companies alleging direct and indirect infringement of United States Patent No. 5,893,120 based on the use of computer equipment configured with or utilizing software based on various versions of the Linux operating system. Bedrock is seeking a finding that the third party defendants, including Rackspace, be enjoined from selling any infringing product, and that Bedrock be awarded actual damages, pre and post judgment interest and attorney's fees. We believe that we have meritorious defenses to the claims and intend to defend ourselves vigorously against these infringement claims. At this time, we do not anticipate that the claims will have a material adverse effect on our business, financial position or results of operations. There can be no assurance, however, that we will be successful in our defense.

13. Share−Based Compensation

In January 2010, an additional 5.7 million shares became available for future grant pursuant to the automatic share reserve increase or "evergreen" provision under our Amended and Restated 2007 Long−Term Incentive Plan. As of June 30, 2010, the total number of shares authorized under all of our plans was 48.5 million shares, of which approximately 10.8 million shares were available for future grants.

Outstanding stock awards were as follows:

	December 31, 2009	June 30, 2010
Restricted stock units	2,087,500	2,518,375
Stock options	16,841,232	16,217,209
Total outstanding awards	18,928,732	18,735,584

The following table summarizes our restricted stock unit activity for the six months ended June 30, 2010:

	Number of Units	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2009	2,087,500	$ 5.47
Granted	438,558	$ 19.19
Released	−	$ −
Cancelled	(7,683)	$ 19.51
Outstanding at June 30, 2010	2,518,375	$ 7.82
Expected to vest after June 30, 2010 *	2,423,487	$ 7.39

* Includes reduction of shares outstanding due to estimated forfeitures

The restricted stock units (RSUs) granted in 2010 vest as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date. Stock−based compensation expense for these service vesting RSUs is measured based on the closing fair market value of the company's common stock on the date of grant and is recognized ratably over the service period.

As of June 30, 2010, there were 2.0 million RSUs outstanding that were granted in 2009 to our chief executive officer and another member of the executive team. The vesting of these RSUs is dependent on the company's total shareholder return (TSR) on its common stock compared to other companies in the Russell 2000 Index. In addition, the company's TSR must be positive for vesting to occur.

As of June 30, 2010, there was $13.3 million of total unrecognized compensation cost related to non−vested RSUs that we have granted, which will be amortized using the straight line method over a remaining weighted average period of 2.8 years.

The following table summarizes the stock option activity for the six months ended June 30, 2010:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2009	16,841,232	$ 6.02	7.56	$ 249,801
Granted	981,844	$ 19.08		
Exercised	(1,110,202)	$ 4.31		
Cancelled	(495,665)	$ 9.23		
Outstanding at June 30, 2010	16,217,209	$ 6.83	7.22	$ 187,817
Vested and exercisable at June 30, 2010	6,866,983	$ 3.65	6.01	$ 100,889
Vested and exercisable at June 30, 2010 and expected to vest thereafter *	15,402,446	$ 6.63	7.15	$ 181,311

* Includes reduction of shares outstanding due to estimated forfeitures

The stock options that were granted in 2010 vest as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date and have a term of 10 years.

The total pre−tax intrinsic value of the stock options exercised during the three months ended June 30, 2009 and 2010, was $11.7 million and $6.8 million, respectively, and $19.4 million and $15.6 million for the six months ended June 30, 2009 and 2010, respectively.

The weighted average fair value of stock options issued during the three months ended June 30, 2009 and 2010 was $4.90 and $9.42 respectively, and $3.03 and $10.56 for the six months ended June 30, 2009 and 2010, respectively, using the Black−Scholes option pricing model with the following assumptions:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2009	2010	2009	2010
Expected stock volatility	60%	55%	60% − 61%	55% − 56%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Risk−free interest rate	2.30%	2.40% − 2.66%	2.24% − 2.30%	2.40% − 2.79%
Expected life	6.25 years	6.25 years	6.25 years	6.25 years

As of June 30, 2010, there was $34.0 million of total unrecognized compensation cost related to non−vested stock options that we have granted, which will be amortized using the straight line method over a weighted average period of 1.81 years.

Share−based compensation expense was recognized as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands)	2009	2010	2009	2010
Cost of revenue	$ 675	$ 1,163	$ 1,304	$ 2,132
Sales and marketing	721	1,100	1,419	1,980
General and administrative	3,621	4,113	6,531	8,242
Pre−tax share−based compensation	5,017	6,376	9,254	12,354
Less: Income tax benefit	(1,819)	(2,118)	(3,371)	(4,124)
Total share−based compensation expense, net of tax	$ 3,198	$ 4,258	$ 5,883	$ 8,230

14. Taxes

We are subject to U.S. federal income tax and various state, local, and international income taxes in numerous jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions and the timing of recognizing revenue and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file.

We currently file income tax returns in the U.S., and all foreign jurisdictions in which we have entities, which are periodically under audit by federal, state, and international tax authorities. These audits can involve complex matters that may require an extended period of time for resolution. We remain subject to U.S. federal and state income tax examinations for the tax years 2005 through 2009, U.K. income tax examinations for the years 2002 through 2008, Netherlands income tax examinations for the years 2007 and 2008, and Hong Kong income tax examinations for the year 2008. There are no income tax examinations currently in process. Although the outcome of open tax audits is uncertain, in management's opinion, adequate provisions for income taxes have been made. If actual outcomes differ materially from these estimates, they could have a material impact on our financial condition and results of operations. Differences between actual results and assumptions, or changes in assumptions in future periods are recorded in the period they become known. To the extent additional information becomes available prior to resolution, such accruals are adjusted to reflect probable outcomes. Our effective tax rate is impacted by earnings being realized in countries where we have lower statutory rates.

Rackspace takes certain non−income tax positions in the jurisdictions in which it operates and may be subject to audit from these jurisdictions. Rackspace is also involved in related non−income tax litigation matters. We believe our positions are supportable and we have accrued for known exposure; however, significant judgment is required in determining the ultimate outcome of such matters. In the normal course of business, our position and conclusion related to these non−income taxes may be challenged and assessments may be made. To the extent new information is obtained and changes our views on our positions, probable outcome of assessments, or litigation, changes in estimates to accrued liabilities would be recorded in the period the determination is made.

We currently have a refund claim for sales tax paid on certain licenses that has gone through a judicial hearing. It is our position that these licenses are exempt from sales tax based on resale. Should the court agree with our position, it is our intention to file an additional refund claim for remaining open periods. However, if the court disagrees, we will have the option to appeal in district court. As of June 30, 2010, the court has not yet made a decision.

As of June 30, 2010, we recognized an income tax receivable of $15.5 million due to the anticipated annual benefit related to tax deductions for stock based compensation. Of the $15.5 million income tax receivable, $8.4 million was recorded in the current quarter with an offset to additional paid−in capital. The company expects taxable income for the full year 2010 and therefore has recognized the appropriate tax benefit in accordance with prescribed accounting guidance.

15. Comprehensive Income

Total comprehensive income was as follows:

(In thousands)	Three Months Ended June 30, 2009	Three Months Ended June 30, 2010	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Net income	$ 6,991	$ 11,198	$ 13,579	$ 21,010
Derivative instrument, net of deferred taxes of $(139) and $(176) for the three months ended June 30, 2009 and 2010, and $(175) and $(307) for the six months ended June 30, 2009 and 2010.	260	327	326	570
Foreign currency cumulative translation adjustment, net of taxes of $(1,908) and $465 for the three months ended June 30, 2009 and 2010, and $(1,697) and $512 for the six months ended June 30, 2009 and 2010.	8,254	(2,173)	7,474	(6,589)
Total other comprehensive income (loss)	8,514	(1,846)	7,800	(6,019)
Total comprehensive income	$ 15,505	$ 9,352	$ 21,379	$ 14,991

(In thousands)	Derivative Instrument	Translation Adjustment	Accumulated other comprehensive income (loss)
Balance at December 31, 2009	$ (1,182)	$ (9,075)	$ (10,257)
2010 changes in fair value	570	−	570
2010 translation adjustment	−	(6,589)	(6,589)
Balance at June 30, 2010	$ (612)	$ (15,664)	$ (16,276)

16. Segment Information

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision−maker, or decision−making group, in deciding how to allocate resources and in assessing performance. Our chief operating decision−maker is our chief executive officer. Our chief executive officer reviews financial information presented on a consolidated basis, accompanied by information by reporting unit and geographic region for purposes of evaluating financial performance and allocating resources. We are organized as, and operate three operating segments based on our product and service offerings, which we refer to as our lines of business. The company's service offerings all (i) provide computing power to similar types of customers, (ii) have similar production processes, (iii) deliver their services in a similar manner, and (iv) use the same data centers and similar technologies. As a result of our evaluation of the criteria for aggregation by products and services, we determined we have one reportable segment, which we describe as Hosting.

Revenue is attributed to geographic location based on the location of the operating entity that enters into the contractual relationship with the customer. We break down the locations into either the U.S. or outside the U.S., which primarily consists of our business operations in the U.K. Total net revenue by geographic region was as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands)	2009	2010	2009	2010
United States	$ 113,309	$ 141,214	$ 223,873	$ 273,401
Outside United States	38,686	46,100	73,199	92,718
Total net revenue	$ 151,995	$ 187,314	$ 297,072	$ 366,119

Our long−lived assets are primarily located in the U.S. and U.K., and to a lesser extent Hong Kong. Property and equipment, net by geographic region was as follows:

(In thousands)	December 31, 2009	June 30, 2010
United States	$ 344,353	$ 371,985
Outside United States	88,618	84,665
Total property and equipment, net	$ 432,971	$ 456,650

17. Related Party Transactions

We lease some facilities from a partnership controlled by our chairman of the board of directors. For these leases, we recognized $189 thousand and $92 thousand of rent expense on our consolidated statements of income for the three months ended June 30, 2009 and 2010, respectively, and $366 thousand and $186 thousand for the six months ended June 30, 2009 and 2010, respectively.

ITEM 2 − MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to "we," "our," "our company," "us," "the company," "Rackspace Hosting," or "Rackspace" refer to Rackspace Hosting, Inc. and its consolidated subsidiaries. We have made forward−looking statements in this Quarterly Report on Form 10−Q that are subject to risks and uncertainties. Forward−looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section and Section 21E of the Securities Exchange Act of 1934, as amended, are subject to the "safe harbor" created by those sections. The forward−looking statements in this report are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward−looking statements by terms such as "anticipates," "aspires," "believes," "can," "continue," "could," "estimates," "expects," "intends," "may," "plans," "projects," "seeks," "should," "will" or "would" or the negative of these terms and similar expressions intended to identify forward−looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward−looking statements. We discuss many of these risks, uncertainties and other factors in this document in greater detail under the heading "Risk Factors." We believe it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. The risks described in "Risk Factors" included in this report, as well as any other cautionary language in this report, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward−looking statements. You should be aware that the occurrence of the events described in "Risk Factors" and elsewhere in this report could harm our business.

Given these risks, uncertainties and other factors, you should not place undue reliance on these forward−looking statements. Also, these forward−looking statements represent our estimates and assumptions only as of the date of this filing. You should read this document completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward−looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward−looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward−looking statements, even if new information becomes available in the future.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes contained elsewhere in this document.

Overview of our Business

We are the world's leader in the hosting and cloud computing industry. Our growth is the result of our commitment to serving our customers, known as Fanatical Support®, and our exclusive focus on hosting and cloud computing. We have been successful in attracting and retaining thousands of customers and in growing our business. We are a pioneer in an emerging category, hybrid hosting, which combines the benefits of both traditional dedicated hosting and cloud computing. We are committed to maintaining our service−centric focus and will follow our vision to be considered one of the world's greatest service companies.

We offer a portfolio of hosting services, including managed hosting, cloud hosting and cloud application hosting. The equipment required (servers, routers, switches, firewalls, load balancers, cabinets, software, wiring, etc.) to deliver services is typically purchased and managed by us.

We sell our services to small and medium−sized businesses as well as large enterprises. For the first six months of 2010, 25.3% of our net revenue was generated by our operations outside of the U.S., mainly from the U.K. In addition to our operations in the U.S. and U.K., we operate a data center in Hong Kong and sales offices in Hong Kong and the Netherlands, which generate minimal revenue. Our growth strategy includes, among other strategies, targeting international customers as we plan to expand our activities in continental Europe and Asia. For the first six months of 2010, no individual customer accounted for greater than 2% of our net revenue.

Key Metrics

We carefully track several financial and operational metrics to monitor and manage our growth, financial performance, and capacity. Our key metrics are structured around growth, profitability, capital efficiency, infrastructure capacity, and utilization. The following data should be read in conjunction with the consolidated financial statements, the notes to the financial statements and other financial information included in this Quarterly Report on Form 10−Q.

	Three Months Ended (Unaudited)				
(Dollar amounts in thousands, except annualized net revenue per average technical square foot)	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Growth					
Managed hosting customers at period end	19,363	19,328	19,304	19,366	19,433
Cloud customers at period end**	51,440	61,616	71,621	80,080	88,590
Number of customers at period end	70,803	80,944	90,925	99,446	108,023
Managed hosting, net revenue	$ 138,943	$ 147,065	$ 152,394	$ 159,536	$ 164,094
Cloud, net revenue	$ 13,052	$ 15,334	$ 17,122	$ 19,269	$ 23,220
Net revenue	$ 151,995	$ 162,399	$ 169,516	$ 178,805	$ 187,314
Revenue growth (year over year)	16.2%	17.4%	18.4%	23.2%	23.2%
Net upgrades (monthly average)	1.2%	1.2%	1.3%	1.1%	1.4%
Churn (monthly average)	−1.0%	−1.1%	−0.8%	−0.9%	−0.9%
Growth in installed base (monthly average) *	0.2%	0.1%	0.4%	0.2%	0.5%
Number of employees (Rackers) at period end	2,648	2,730	2,774	2,905	3,002
Number of servers deployed at period end	52,269	54,655	56,671	59,876	61,874
Profitability					
Income from operations	$ 13,403	$ 13,128	$ 15,689	$ 16,728	$ 17,831
Depreciation and amortization	$ 29,711	$ 32,696	$ 35,018	$ 36,698	$ 37,991
Share−based compensation expense					
Cost of revenue	$ 675	$ 778	$ 768	$ 969	$ 1,163
Sales and marketing	$ 721	$ 826	$ 639	$ 880	$ 1,100
General and administrative	$ 3,621	$ 4,008	$ 3,851	$ 4,129	$ 4,113
Total share−based compensation expense	$ 5,017	$ 5,612	$ 5,258	$ 5,978	$ 6,376
Adjusted EBITDA (1)	$ 48,131	$ 51,436	$ 55,965	$ 59,404	$ 62,198
Adjusted EBITDA margin	31.7%	31.7%	33.0%	33.2%	33.2%
Operating income margin	8.8%	8.1%	9.3%	9.4%	9.5%
Income from operations	$ 13,403	$ 13,128	$ 15,689	$ 16,728	$ 17,831
Effective tax rate	36.2%	33.9%	34.0%	33.6%	33.2%
Net operating profit after tax (NOPAT) (1)	$ 8,551	$ 8,678	$ 10,355	$ 11,107	$ 11,911
NOPAT margin	5.6%	5.3%	6.1%	6.2%	6.4%
Capital efficiency and returns					
Interest bearing debt	$ 210,284	$ 167,976	$ 167,386	$ 169,517	$ 169,847
Stockholders' equity	$ 308,823	$ 330,392	$ 349,427	$ 370,425	$ 397,994
Less: Excess cash	$ (129,638)	$ (83,462)	$ (105,083)	$ (109,840)	$ (126,018)
Capital base	$ 389,469	$ 414,906	$ 411,730	$ 430,102	$ 441,823
Average capital base	$ 378,123	$ 402,188	$ 413,318	$ 420,916	$ 435,963
Capital turnover (annualized)	1.61	1.62	1.64	1.70	1.72
Return on capital (annualized) (1)	9.0%	8.6%	10.0%	10.6%	10.9%
Capital expenditures					
Purchases of property and equipment, net	$ 31,027	$ 26,024	$ 34,652	$ 39,622	$ 29,050
Vendor financed equipment purchases	$ 23,637	$ 20,664	$ 12,398	$ 15,766	$ 15,793
Total capital expenditures	$ 54,664	$ 46,688	$ 47,050	$ 55,388	$ 44,843
Customer gear	$ 32,448	$ 28,705	$ 28,421	$ 32,488	$ 29,589
Data center build outs	$ 13,914	$ 4,028	$ 7,880	$ 16,644	$ 5,955
Office build outs	$ 1,651	$ 5,432	$ 5,350	$ 1,220	$ 1,306
Capitalized software and other projects	$ 6,651	$ 8,523	$ 5,399	$ 5,036	$ 7,993
Total capital expenditures	$ 54,664	$ 46,688	$ 47,050	$ 55,388	$ 44,843
Infrastructure capacity and utilization					
Technical square feet of data center space at period end ***	177,371	167,821	162,848	169,998	169,998
Annualized net revenue per average technical square foot	$ 3,631	$ 3,764	$ 4,101	$ 4,298	$ 4,407
Utilization rate at period end	59.8%	62.3%	65.3%	66.5%	69.1%

* Due to rounding, totals may not equal the sum of the line items in the table above.
** Amounts include SaaS customers for Jungle Disk using a Rackspace storage solution. Jungle Disk customers using a third party storage solution are excluded.
*** Technical square footage excludes 30,250 square feet and 4,400 square feet for unused portions of the Chicago and Northern Virginia facilities, respectively.
(1) See discussion and reconciliation of our Non−GAAP financial measures to the most comparable GAAP measures.

Non−GAAP Financial Measures

Return on Capital (ROC) (Non−GAAP financial measure)

We define Return on Capital as follows: ROC = Net operating profit after tax (NOPAT) / Average capital base

NOPAT = Income from operations x (1 – Effective tax rate)

Average capital base = Average of (Interest bearing debt + stockholders' equity – excess cash) = Average of (Total assets – excess cash – accounts payables and accrued expenses – deferred revenue– other non−current liabilities and deferred income taxes)

Year−to−date average balances are based on an average calculated using the quarter end balances at the beginning of the period and all other quarter ending balances included in the period.

We define excess cash as the amount of cash and cash equivalents that exceeds our operating cash requirements, which is calculated as three percent of our annualized net revenue for the three months prior to the period end. We will periodically review the calculation and adjust it to reflect our projected cash requirements for the upcoming year.

We believe that ROC is an important metric for investors in evaluating our company's performance. ROC relates to after−tax operating profits with the capital that is placed into service. It is therefore a performance metric that incorporates both the Statement of Income and the Balance Sheet. ROC measures how successfully capital is deployed within a company.

Note that ROC is not a measure of financial performance under GAAP and should not be considered a substitute for return on assets, which we consider to be the most directly comparable GAAP measure. ROC has limitations as an analytical tool, and when assessing our operating performance, you should not consider ROC in isolation, or as a substitute for other financial data prepared in accordance with GAAP. Other companies may calculate ROC differently than we do, limiting its usefulness as a comparative measure.

ROC increased from 9.0% to 10.9% for the three months ended June 30, 2009 compared to the three months ended June 30, 2010, primarily due to a lower tax rate favorably impacting the ROC calculation for the three months ended June 30, 2010 as well as a reduction of operating costs as a percentage of revenue. Included in the average capital base are capital expenditures of $15.0 million and $48.4 million related to the build out of our new corporate headquarters facility and data centers, respectively, since the beginning of the second quarter of 2009.

Return on assets increased from 4.4% for the three months ended June 30, 2009 to 6.3% for the three months ended June 30, 2010. This increase was primarily due to higher revenue and net income as well as a lower tax rate, partially offset by growth in our asset base due to the purchase of property and equipment to support the growth of our business.

See our reconciliation of the calculation of return on assets to ROC in the following table:

	Three Months Ended (Unaudited)				
(In thousands, except financial metrics)	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Income from operations	$ 13,403	$ 13,128	$ 15,689	$ 16,728	$ 17,831
Effective tax rate	36.2%	33.9%	34.0%	33.6%	33.2%
Net operating profit after tax (NOPAT)	$ 8,551	$ 8,678	$ 10,355	$ 11,107	$ 11,911
Net income	$ 6,991	$ 7,604	$ 9,035	$ 9,812	$ 11,198
Total assets at period end	$ 656,793	$ 625,330	$ 668,645	$ 691,729	$ 720,457
Less: Excess cash	$ (129,638)	$ (83,462)	$ (105,083)	$ (109,840)	$ (126,018)
Less: Accounts payable and accrued expenses	$ (87,316)	$ (77,108)	$ (89,773)	$ (92,828)	$ (97,711)
Less: Deferred revenues (current and non−current)	$ (20,011)	$ (18,222)	$ (19,444)	$ (18,044)	$ (16,640)
Less: Other non−current liabilities and deferred taxes	$ (30,359)	$ (31,632)	$ (42,615)	$ (40,915)	$ (38,265)
Capital base	$ 389,469	$ 414,906	$ 411,730	$ 430,102	$ 441,823
Average total assets	$ 629,114	$ 641,062	$ 646,988	$ 680,187	$ 706,093
Average capital base	$ 378,123	$ 402,188	$ 413,318	$ 420,916	$ 435,963
Return on assets (annualized)	4.4%	4.7%	5.6%	5.8%	6.3%
Return on capital (annualized)	9.0%	8.6%	10.0%	10.6%	10.9%

Adjusted EBITDA (Non−GAAP financial measure)

We use Adjusted EBITDA as a supplemental measure to review and assess our performance. We define Adjusted EBITDA as Net income, plus income taxes, total other income (expense), depreciation and amortization, and non−cash charges for share−based compensation.

Adjusted EBITDA is a metric that is used in our industry by the investment community for comparative and valuation purposes. We disclose this metric in order to support and facilitate the dialogue with research analysts and investors.

Note that Adjusted EBITDA is not a measure of financial performance under GAAP and should not be considered a substitute for operating income, which we consider to be the most directly comparable GAAP measure. Adjusted EBITDA has limitations as an analytical tool, and when assessing our operating performance, you should not consider Adjusted EBITDA in isolation, or as a substitute for net income or other consolidated income statement data prepared in accordance with GAAP. Other companies may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Adjusted EBITDA as a percentage of net revenue has increased from 31.7% for the three months ended June 30, 2009 to 33.2% for the three months ended June 30, 2010 due to revenue increasing at a faster rate than our operating costs.

Income from operations has been favorably impacted by cost containment initiatives particularly in our general and administrative functions, but was partially offset by higher depreciation and amortization expense resulting from capital investments, and increasing share−based compensation expense from grants of stock options and other stock awards to employees. Our operating income margin increased from 8.8% for the three months ended June 30, 2009 to 9.5% for the three months ended June 30, 2010.

See our Adjusted EBITDA reconciliation below.

	Three Months Ended (Unaudited)				
(Dollars in thousands)	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Net revenue	$ 151,995	$ 162,399	$ 169,516	$ 178,805	$ 187,314
Income from operations	$ 13,403	$ 13,128	$ 15,689	$ 16,728	$ 17,831
Net income	$ 6,991	$ 7,604	$ 9,035	$ 9,812	$ 11,198
Plus: Income taxes	$ 3,973	$ 3,900	$ 4,648	$ 4,957	$ 5,572
Plus: Total other (income) expense	$ 2,439	$ 1,624	$ 2,006	$ 1,959	$ 1,061
Plus: Depreciation and amortization	$ 29,711	$ 32,696	$ 35,018	$ 36,698	$ 37,991
Plus: Share−based compensation expense	$ 5,017	$ 5,612	$ 5,258	$ 5,978	$ 6,376
Adjusted EBITDA	$ 48,131	$ 51,436	$ 55,965	$ 59,404	$ 62,198
Operating income margin	8.8%	8.1%	9.3%	9.4%	9.5%
Adjusted EBITDA margin	31.7%	31.7%	33.0%	33.2%	33.2%

Adjusted Free Cash Flow (Non−GAAP financial measure)

We define Adjusted Free Cash Flow as Adjusted EBITDA plus non−cash deferred rent, less total capital expenditures (including vendor financed equipment purchases), cash payments for interest, net, and cash payments for income taxes, net.

We believe that Adjusted Free Cash Flow is an important metric for investors in evaluating how a company is currently using cash generated, and may indicate its ability to generate cash that can potentially be used by the business for capital investments, acquisitions, reduction of debt, payment of dividends, etc. Note that Adjusted Free Cash Flow is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies.

See our Adjusted Free Cash Flow reconciliation to Adjusted EBITDA below, as well as our reconciliation of Net income to Adjusted EBITDA provided above.

(In thousands)	Three Months Ended June 30, 2010	Six Months Ended June 30, 2010
	(Unaudited)	
Adjusted EBITDA	$ 62,198	$ 121,602
Non−cash deferred rent	1,316	3,120
Total capital expenditures	(44,843)	(100,231)
Cash payments for interest, net	(1,831)	(3,928)
Cash payments for income taxes, net	(1,415)	(3,699)
Adjusted free cash flow	$ 15,425	$ 16,864

Net Leverage (Non−GAAP financial measure)

We define Net Leverage as Net Debt divided by Adjusted EBITDA (trailing twelve months). We believe that Net Leverage is an important metric for investors in evaluating a company's liquidity. Note that Net Leverage is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies.

See our Net Leverage calculation below.

(Dollars in thousands)	As of June 30, 2010
	(Unaudited)
Obligations under capital leases	$ 115,508
Debt	54,339
Total debt	$ 169,847
Less: Cash and cash equivalents	(148,496)
Net debt	$ 21,351
Adjusted EBITDA (trailing twelve months)	$ 229,003
Net leverage	0.09x

Results of Operations

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period−to−period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

	Three Months Ended				
(In thousands)	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Net revenue	$ 151,995	$ 162,399	$ 169,516	$ 178,805	$ 187,314
Costs and expenses:					
Cost of revenue	48,235	53,093	53,405	57,007	61,470
Sales and marketing	19,080	19,860	20,016	21,977	23,285
General and administrative	41,566	43,622	45,388	46,395	46,737
Depreciation and amortization	29,711	32,696	35,018	36,698	37,991
Total costs and expenses	138,592	149,271	153,827	162,077	169,483
Income from operations	13,403	13,128	15,689	16,728	17,831
Other income (expense):					
Interest expense	(2,172)	(2,147)	(2,096)	(2,144)	(1,875)
Interest and other income (expense)	(267)	523	90	185	814
Total other income (expense)	(2,439)	(1,624)	(2,006)	(1,959)	(1,061)
Income before income taxes	10,964	11,504	13,683	14,769	16,770
Income taxes	3,973	3,900	4,648	4,957	5,572
Net income	$ 6,991	$ 7,604	$ 9,035	$ 9,812	$ 11,198

Consolidated Statements of Income, as a Percentage of Net Revenue (Unaudited):

	Three Months Ended				
(Percent of net revenue)	June 30, 2009	September 30, 2009	December 31, 2009	March 31, 2010	June 30, 2010
Net revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses					
Cost of revenue	31.7%	32.7%	31.5%	31.9%	32.8%
Sales and marketing	12.6%	12.2%	11.8%	12.3%	12.4%
General and administrative	27.3%	26.9%	26.8%	25.9%	25.0%
Depreciation and amortization	19.5%	20.1%	20.7%	20.5%	20.3%
Total costs and expenses	91.2%	91.9%	90.7%	90.6%	90.5%
Income from operations	8.8%	8.1%	9.3%	9.4%	9.5%
Other income (expense)					
Interest expense	−1.4%	−1.3%	−1.2%	−1.2%	−1.0%
Interest and other income (expense)	−0.2%	0.3%	0.1%	0.1%	0.4%
Total other income (expense)	−1.6%	−1.0%	−1.2%	−1.1%	−0.6%
Income before income taxes	7.2%	7.1%	8.1%	8.3%	9.0%
Income taxes	2.6%	2.4%	2.7%	2.8%	3.0%
Net income	4.6%	4.7%	5.3%	5.5%	6.0%

Due to rounding, totals may not equal the sum of the line items in the table above.

Second Quarter 2010 Overview

To aid in understanding our operating results for the periods covered by this report, we have provided an executive overview and a summary of the significant events that affected the most recent reporting period. These sections should be read in conjunction with the other portions of management's discussion and analysis of our financial condition and results of operations, our "Risk Factors" section, and our consolidated financial statements and notes included in this report.

The highlights and significant events of the three months ended June 30, 2010 and the impact on our operating results compared to the three months ended, March 31, 2010 were as follows:

Net Revenue − Net revenue increased $8.5 million, or 4.8%, from $178.8 million in the three months ended March 31, 2010 to $187.3 million in the three months ended June 30, 2010. The market for hosting services continues to be highly competitive and we face competition from existing competitors as well as new market entrants. However, we continue to grow our Managed Hosting and Cloud service offerings and believe that this full portfolio of hosting services positions us to benefit from increased IT spending in the future. During the second quarter, we experienced a negative revenue impact due to a strengthening U.S. dollar relative to the pound sterling, which resulted in a decrease to revenue of approximately $2.0 million, or 1.1%, for the three months ended June 30, 2010 compared to the three months ended March 31, 2010 with a minimal impact to our margins as the majority of customers are invoiced, and substantially all of our expenses associated with these customers are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. For the three months ended March 31, 2010 and June 30, 2010 we experienced a monthly average churn rate of 0.9%, while net upgrades increased from 1.1% for the three months ended March 31, 2010 to 1.4% for the three months ended June 30, 2010. Overall, our installed base had growth at an average rate of 0.2% for the three months ended March 31, 2010 compared to growth at an average rate of 0.5% for the three months ended June 30, 2010.

Income from Operations − Income from operations increased $1.1 million, or 6.6%, from $16.7 million for the three months ended March 31, 2010 to $17.8 million for the three months ended June 30, 2010. Operating income margin was 9.4% for the three months ended March 31, 2010 compared to 9.5% for the three months ended June 30, 2010.

Adjusted EBITDA − Adjusted EBITDA increased $2.8 million, or 4.7%, from $59.4 million for the three months ended March 31, 2010 to $62.2 million in the three months ended June 30, 2010. Adjusted EBITDA as a percentage of revenue remained at 33.2% for the three months ended March 31, 2010 and June 30, 2010. See the discussion of Adjusted EBITDA, a non−GAAP financial measure for additional information.

Net Income and Net Income per Share − Net income was $9.8 million, or $0.07 per share on a diluted basis for the three months ended March 31, 2010 compared to net income of $11.2 million, or $0.08 per share on a diluted basis for the three months ended June 30, 2010. The increase in net income was mainly due to revenue growth. Lower general and administrative expenses, and depreciation and amortization expenses as a percentage of revenue, as well as a decrease in other expense for the three months ended June 30, 2010 compared to the three months ended March 31, 2010, were offset by an increase in cost of revenue, and sales and marketing expense as a percentage of revenue.

To date, the majority of our services has been offered on a subscription basis however, the advent of virtual and cloud technology services provided on a pay−as−you−go basis are becoming more prevalent. During 2010, our revenue increased across our portfolio of services, but pay−as you go based service revenue grew at a significantly faster rate than our subscription service revenue. We believe that this trend will continue as the market changes the way it consumes computing resources and more companies begin to utilize cloud solutions. As this portion of our revenue continues to increase at a higher rate than our subscription business, our current installed base growth metric may not capture this revenue growth effectively. This is because historically, we have calculated installed base growth on our subscription business only. We are currently reviewing a more suitable basis of calculation to capture growth in all of our service offerings and intend to update this metric. If we had included our pay−as−you−go business in installed base growth under our current methodology, the current growth rate would have been 0.6% compared to the 0.5% currently reported. Historically, the inclusion of our non−subscription business in the calculation of installed base growth did not change the result by more than 0.1%.

In response to the trend for cloud computing, we recently launched OpenStack, an open source cloud platform that powers our Cloud Files and Cloud Servers offerings. We believe that this initiative will help drive industry standards, prevent vendor lock in and foster the development of cloud technology. By creating an environment that supports further cloud development, we will enhance our opportunities to continue and grow our commitment to serving our customers through Fanatical Support®. While it is difficult to predict the impact that OpenStack will have on our business, we believe that this initiative will enable us to maintain our position as a leader within the cloud computing industry.

In addition to OpenStack, we intend to release our Cloud offerings to the UK market in late 2010 and continue to develop and release additional service offerings and enhancements to existing product offerings that further increases our capabilities around Hybrid Hosting that allows our customers to choose and mix our dedicated, public and Cloud technologies. We continue to focus on the service intensive segment of the market.

As our business continues to grow, we will require additional data center capacity. In May 2010, we signed an additional lease to expand the capacity in our Chicago data center to accommodate future growth. We will continue to evaluate opportunities to secure further data center capacity in the future.

Quarterly Results of Operations (June 30, 2009 through June 30, 2010)

Net Revenue

Our net revenue has increased sequentially in each quarter primarily due to an increased volume of services provided, both due to an increasing number of new customers and incremental services rendered to existing customers. During this time period, the growth rate was negatively impacted by the economic conditions and decreased IT spend by our customers. Furthermore, in the fourth quarter of 2009 and the first and second quarters of 2010, the growth rate was negatively impacted by the strengthening U.S. dollar versus the pound sterling. In the second and third quarters of 2009 we experienced a favorable impact from a weakening U.S. dollar versus the pound sterling. In addition to the impact of the economic conditions and foreign exchange rates, net revenue in the second and fourth quarters of 2009 was negatively impacted by service credits issued to certain customers who experienced downtime as a result of service interruptions in a portion of our data center operations in Grapevine, Texas. In the second and fourth quarters of 2009, we extended approximately $2.4 million and $1.3 million, respectively, for these service credits.

Cost of Revenue

Because of the growth of our revenue, our cost of revenue has increased sequentially in each quarter. Beginning in the second and third quarters of 2009, we began incurring rent expense related to our Northern Virginia and Chicago area data centers, even though we did not begin operations in the Chicago area data center until the first quarter of 2010. We recorded non−cash rent expense related to these data centers of $0.2 million, $1.9 million, $2.5 million, $2.2 million and $1.6 million in the second quarter of 2009, third quarter of 2009, fourth quarter of 2009, first quarter of 2010 and second quarter of 2010, respectively. Additionally, in the three months ended December 31, 2009, there was a $2.1 million reduction to cost of revenue related to the reversal of a previously recorded obligation relating to an unresolved contractual issue with a vendor. This reversal was partially offset by an increase in non−equity incentive compensation and other employee related expenses of $1.8 million, which occurred in part from the impact the reversal had on fourth quarter of 2009 results based on targets defined within our non−equity incentive plan.

Employee non−equity incentive compensation through our current non−equity incentive plan, in effect since January 1, 2009, is dependent upon the financial results of the company in relation to a preset target level. Thus, favorable financial performance in comparison to the preset target level is partially offset by increased non−equity incentive compensation expense. If company achievement of the preset target results in a 10% increase in the non−equity incentive compensation percentage payout, this would increase total non−equity incentive compensation by approximately $0.3 million on an after−tax basis and increase net income by $0.1 million. Company achievement resulting in a 10% decrease in the non−equity incentive compensation percentage payout would decrease total non−equity incentive compensation by approximately $0.3 million on an after−tax basis and decrease net income by $0.1 million.

Also, in the first quarter of 2010 consulting costs increased $1.7 million. As a percentage of revenue, cost of revenue remained consistent over the periods presented.

Sales and Marketing Expenses

During 2009, we continued to focus on scaling our expenditures, which is evidenced in the reduction in sales and marketing, expenses as a percentage of revenue in the last three quarters of 2009. Sales and marketing began to increase due to an increase in commissions associated with higher sales and increased discretionary spending in the first two quarters of 2010. As a percentage of revenue, sales and marketing decreased throughout 2009 from 12.6% to 11.8% with a small increase to 12.4% in the second quarter of 2010.

General and Administrative Expenses

Our general and administrative expenses have increased sequentially throughout 2009 and the first two quarters of 2010. Increases have primarily been due to additional headcount in order to support the growth in the business. As a percentage of revenue, general and administrative expenses have decreased sequentially each quarter from 27.3% in the second quarter of 2009 to 25.0% in the second quarter of 2010.

Depreciation and Amortization

Our depreciation and amortization has increased sequentially throughout 2009 and the first two quarters of 2010 as a result of capital expenditures to support the growth of our business. As a percentage of revenue, depreciation and amortization has increased from 19.5% in the second quarter of 2009 to 20.7% in the fourth quarter of 2009 with a decrease in the first half of 2010 to 20.3% in the second quarter of 2010.

Three Months Ended June 30, 2009 and June 30, 2010

Net Revenue

Our net revenue was $152.0 million for the three months ended June 30, 2009 and $187.3 million for the three months ended June 30, 2010, an increase of $35.3 million, or 23.2%. The increase in net revenue was primarily due to an increased volume of services provided, resulting from an increasing number of new customers and incremental services rendered to existing customers. Partially offsetting the revenue increase was the negative impact of a stronger U.S. dollar relative to the pound sterling for the three months ended June 30, 2010 compared to the three months ended June 30, 2009. Net revenue for the three months ended June 30, 2010 would have been approximately $1.7 million higher had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year.

Cost of Revenue

Our cost of revenue was $48.2 million for the three months ended June 30, 2009, and $61.5 million for the three months ended June 30, 2010, an increase of $13.3 million, or 27.6%. Of this increase, $7.1 million was attributable to employee−related expenses due to increases in salaries and benefits of $5.6 million, non−equity incentive compensation of $1.0 million and share−based compensation expense of $0.5 million. These increases are primarily due to the hiring of data center and support personnel to support our growth, higher percentage attainment against the preset target, and equity awards granted in the first quarter of 2010. The cost increase was further attributable to an increase in license costs of $1.3 million, an increase in data center costs of $2.3 million related to power and rent and an increase in consulting fees related to data center assessments and improvements of $2.0 million. The remaining increase was due to small increases in other cost of revenue expenses.

Sales and Marketing Expenses

Our sales and marketing expenses were $19.1 million for the three months ended June 30, 2009 and $23.3 million for the three months ended June 30, 2010, an increase of $4.2 million, or 22.0%. Of this increase, $2.5 million was attributable to an increase in salaries, commissions, benefits, and share−based compensation expense. Total compensation increased as a result salary increases and the hiring of additional sales and marketing personnel and the impact of commissions associated with increased sales. Travel and other employee related expenses increased $0.6 million and advertising and Internet−related marketing expenditures increased $1.1 million.

General and Administrative Expenses

Our general and administrative expenses were $41.6 million for the three months ended June 30, 2009 and $46.7 million for the three months ended June 30, 2010, an increase of $5.1 million, or 12.3%. Of this increase, $3.8 million was attributable to employee−related expenses due to increases in salaries and benefits of $2.0 million, non−equity incentive compensation of $1.3 million and share−based compensation expense of $0.5 million. These increases are primarily due to additional headcount, better higher percentage attainment against the preset target and equity awards granted in the first quarter of 2010. Professional fees increased $0.8 million primarily as a result of increased consulting expenses related to accounting and tax services and corporate strategy. In addition, travel and other employee related expenses such as recruiting fees and relocation increased $1.4 million primarily due to a general increase in hiring during the three months ended June 30, 2010. Finally, expenses for non−income taxes increased $0.6 million. The overall increase was partially offset by a decrease in bad debt expense of $1.3 million due to a positive change in customer payment patterns and increased cash collections.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $29.7 million for the three months ended June 30, 2009 and $38.0 million for the three months ended June 30, 2010, an increase of $8.3 million, or 27.9%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software.

Other Income (Expense)

Our interest expense was $2.2 million for the three months ended June 30, 2009 and $1.9 million for the three months ended June 30, 2010, a decrease of $0.3 million, or 13.6%. The decrease was primarily due to the decreased level of indebtedness (including capital leases), as well as decreased borrowing rates. Interest expense was partially offset by capitalized interest of $0.2 million for the three months ended June 30, 2009 and $0.3 million for the three months ended June 30, 2010.

Interest and other income (expense) was $(0.3) million for the three months ended June 30, 2009 and $0.8 million for the three months ended June 30, 2010. In the three months ended June 30, 2009, we recognized $0.1 million in interest and other income and foreign currency losses of $(0.4) million. In the three months ended June 30, 2010, we recognized minimal interest and other income and foreign currency gains of $0.8 million.

Income Taxes

Our effective tax rate decreased from 36.2% for the three months ended June 30, 2009 to 33.2% for the three months ended June 30, 2010, primarily as a result of increased earnings in 2010 being realized in countries where we have lower statutory rates than in the previous year. Our foreign earnings are generally taxed at lower rates than in the United States. The differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income and permanent differences between the book and tax treatment of certain items.

Six Months Ended June 30, 2009 and June 30, 2010

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period−to−period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

(In thousands)	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Net revenue	$ 297,072	$ 366,119
Costs and expenses:		
Cost of revenue	94,445	118,477
Sales and marketing	39,582	45,262
General and administrative	79,106	93,132
Depreciation and amortization	57,515	74,689
Total costs and expenses	270,648	331,560
Income from operations	26,424	34,559
Other income (expense):		
Interest expense	(4,707)	(4,019)
Interest and other income (expense)	(358)	999
Total other income (expense)	(5,065)	(3,020)
Income before income taxes	21,359	31,539
Income taxes	7,780	10,529
Net income	$ 13,579	$ 21,010

(Percent of net revenue)	Six Months Ended June 30, 2009	Six Months Ended June 30, 2010
Net revenue	100.0%	100.0%
Costs and expenses		
Cost of revenue	31.8%	32.4%
Sales and marketing	13.3%	12.4%
General and administrative	26.6%	25.4%
Depreciation and amortization	19.4%	20.4%
Total costs and expenses	91.1%	90.6%
Income from operations	8.9%	9.4%
Other income (expense)		
Interest expense	−1.6%	−1.1%
Interest and other income (expense)	−0.1%	0.3%
Total other income (expense)	−1.7%	−0.8%
Income before income taxes	7.2%	8.6%
Income taxes	2.6%	2.9%
Net income	4.6%	5.7%

Net Revenue

Our net revenue was $297.1 million for the six months ended June 30, 2009 and $366.1 million for the six months ended June 30, 2010, an increase of $69.0 million, or 23.2%. The increase in net revenue was primarily due to an increased volume of services provided, resulting from an increasing number of new customers and incremental services rendered to existing customers. Partially contributing to the revenue increase was the positive impact of a weaker U.S. dollar relative to the pound sterling for the six months ended June 30, 2010 compared to the six months ended June 30, 2009. Net revenue for the six months ended June 30, 2010 would have been approximately $1.8 million lower had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year.

Cost of Revenue

Our cost of revenue was $94.4 million for the six months ended June 30, 2009, and $118.5 million for the six months ended June 30, 2010, an increase of $24.1 million, or 25.5%. Of this increase, $12.9 million was attributable to employee−related expenses due to increases in salaries and benefits of $9.3 million, non−equity incentive compensation of $1.5 million, share−based compensation expense of $0.8 million and contract labor related to short−term projects of $1.3 million. These increases are primarily due to additional headcount, higher percentage attainment against the preset target and equity awards granted in the first quarter of 2010. Total compensation increased as a result of salary increases and the hiring of data center and support personnel to support our growth. The cost increase was further attributable to an increase in data center costs of $3.8 million related to power and rent, an increase in license costs of $2.6 million and an increase in consulting fees related to data center assessments and improvements of $3.7 million. The remaining increase was due to small increases in other cost of revenue expenses.

Sales and Marketing Expenses

Our sales and marketing expenses were $39.6 million for the six months ended June 30, 2009 and $45.3 million for the six months ended June 30, 2010, an increase of $5.7 million, or 14.4%. Of this increase, $4.2 million was attributable to an increase in salaries, commissions, benefits, and share−based compensation expense. Total compensation increased as a result of salary increases and the hiring of additional sales and marketing personnel and the impact of commissions associated with increased sales. Travel and other employee related expenses increased $1.0 million and advertising and Internet−related marketing expenditures increased $0.4 million.

General and Administrative Expenses

Our general and administrative expenses were $79.1 million for the six months ended June 30, 2009 and $93.1 million for the six months ended June 30, 2010, an increase of $14.0 million, or 17.7%. Of this increase, $10.5 million was attributable to employee−related expenses due to increases in salaries and benefits of $6.5 million, non−equity incentive compensation of $2.3 million, and share−based compensation expense of $1.7 million. These increases are primarily due to additional headcount, higher percentage attainment against the preset target and equity awards granted in the first quarter of 2010. Professional fees increased $1.9 million primarily as a result of increased consulting expenses related to accounting and tax services, corporate strategy and internal system maintenance and improvements. Travel and other employee related expenses such as recruiting fees and relocation increased $2.7 million primarily due to the addition of several executive level positions and a general increase in hiring during the six months ended June 30, 2010. Additionally, property tax increased $0.7 million due to the addition of data center facilities. The overall increase was partially offset by a decrease in bad debt expense of $2.4 million due to a positive change in customer payment patterns and increased cash collections.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $57.5 million for the six months ended June 30, 2009 and $74.7 million for the six months ended June 30, 2010, an increase of $17.2 million, or 29.9%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software.

Other Income (Expense)

Our interest expense was $4.7 million for the six months ended June 30, 2009 and $4.0 million for the six months ended June 30, 2010, a decrease of $0.7 million, or 14.9%. The decrease was primarily due to the decreased level of indebtedness (including capital leases), as well as decreased borrowing rates. Interest expense was partially offset by capitalized interest of $0.5 million for the six months ended June 30, 2009 and $0.3 million for the six months ended June 30, 2010.

Interest and other income (expense) was $(0.4) million for the six months ended June 30, 2009 and $1.0 million for the six months ended June 30, 2010. In the six months ended June 30, 2009, we recognized $0.1 million in interest and other income and foreign currency losses of $(0.5) million. In the six months ended June 30, 2010, we recognized $0.1 million of interest and other income and foreign currency gains of $0.9 million.

Income Taxes

Our effective tax rate decreased from 36.4% for the six months ended June 30, 2009 to 33.4% for the six months ended June 30, 2010, primarily as a result of increased earnings in 2010 being realized in countries where we have lower statutory rates than in the previous year. Our foreign earnings are generally taxed at lower rates than in the United States. The differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income and permanent differences between the book and tax treatment of certain items.

Liquidity and Capital Resources

At June 30, 2010, our cash and cash equivalents balance was $148.5 million. We use our cash and cash equivalents, cash flow from operations, capital leases, and existing amounts available under our revolving credit facility as our primary sources of liquidity. We currently believe that cash generated by operations, current cash and cash equivalents, and available borrowings through vendor financing arrangements and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future.

Our revolving credit facility agreement allows us to borrow in pounds sterling and euros in addition to U.S. dollars; however, we are limited to borrowings of $75 million in these alternate currencies. The option to borrow in other foreign currencies provides some protection against fluctuations in currencies in the countries in which we do business. The credit facility also has financial covenants that include a minimum fixed charge coverage ratio of at least 1.50 to 1.00 each quarter and a maximum funded debt to EBITDA of not greater than 3.00 to 1.00. Also, our foreign cash balance is limited to a balance of $25 million. As of June 30, 2010, we were in compliance with all of the covenants under our facility.

We maintain debt levels that we establish through consideration of a number of factors, including cash flow expectations, cash requirements for operations, investment plans (including acquisitions), and our overall cost of capital. Outstanding debt under our line of credit remained at $50.0 million as of June 30, 2010, with an outstanding letter of credit of $0.6 million. As of June 30, 2010, we had an additional $194.4 million available for future borrowings. Our credit facility expires in August 2012.

We have vendor finance arrangements in the form of leases and notes payable with our major vendors that permit us to finance our purchases of data center equipment. As of December 31, 2009 and June 30, 2010, we had $117.4 million and $119.8 million outstanding with respect to these arrangements. We believe our borrowings from these arrangements will continue to be available, and as long as they are competitive, we expect to continue to finance at least some of our equipment purchases through these arrangements.

Capital Expenditure Requirements

For the full year 2010, we expect to have total capital expenditures between $185 million and $235 million.

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. Our money market mutual funds invest exclusively in high−quality, short−term securities that are issued or guaranteed by the U.S. government or by U.S. government agencies. We actively monitor the third−party depository institutions that hold our cash and cash equivalents. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances may exceed the Federal Deposit Insurance Corporation or "FDIC" insurance limits or are not insured by the FDIC. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted if the underlying depository institutions fail or could be subject to other adverse conditions in the financial markets. To date, we have experienced no loss or lack of access to our invested cash and cash equivalents; however, we can provide no assurances that access to our funds will not be impacted by adverse conditions in the financial markets.

We currently believe that current cash and cash equivalents, cash generated by operations and available borrowings through vendor financing arrangements, data center lease arrangements, and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future. Our long−term future capital requirements will depend on many factors, most importantly our growth of revenue, and our investments in new technologies and services. Our ability to generate cash depends on our financial performance, general economic conditions, technology trends and developments, and other factors. As our business continues to grow, our need for data center capacity will also grow. Most recently we have financed data center growth through leasing activities and we will continue to evaluate all opportunities to secure further data center capacity in the future. We could be required, or could elect, to seek additional funding in the form of debt or equity.

The following table sets forth a summary of our cash flows for the periods indicated:

	Six Months Ended June 30, (Unaudited)	
(In thousands)	2009	2010
Cash provided by operating activities	$ 88,848	$ 102,855
Cash used in investing activities	$ (62,238)	$ (69,237)
Cash provided by (used in) financing activities	$ (119,547)	$ (8,595)
Acquisition of property and equipment by capital leases and equipment notes payable	$ 35,320	$ 31,559

Operating Activities

Net cash provided by operating activities is primarily a function of our profitability, the amount of non−cash charges included in our profitability, and our working capital management. Net cash provided by operating activities was $88.8 million in the first six months of 2009 compared to $102.9 million in the first six months of 2010, an increase of $14.1 million, or 15.9%. Net income increased from $13.6 million in the first six months of 2009 to $21.0 million in the first six months of 2010. A summary of the significant changes in non−cash adjustments affecting net income and changes in assets and liabilities impacting operating cash flows is as follows:

- Depreciation and amortization expense was $57.5 million in the first six months of 2009 compared to $74.7 million in the first six months of 2010. The increase in depreciation and amortization was due to the purchases of servers, networking gear and computer software (internally developed technology), and leasehold improvements, as well as the amortization of intangibles.

- Our provision for bad debts and customer credits decreased from $6.4 million in the first six months of 2009 to $1.4 million in the first six months of 2010 due to positive changes in customer payment patterns and increased cash collections, as well as lower service level agreement credits.

- Share−based compensation expense was $9.3 million in the first six months of 2009 compared to $12.4 million in the first six months of 2010. The increase in expense was due to stock options and restricted stock units granted in 2009 and the first six months of 2010.

- Excess tax benefits from share−based compensation arrangements had no cash impact in the first six months of 2009 and created an operating cash outflow of $15.5 million in the first six months of 2010. Rackspace did not recognize the excess tax benefit from the exercise of options in 2009 because it did not result in a reduction of its current tax payable. However, for the 2010 period, the company does expect to have taxable income for a full year and, as such, has recognized the cumulative excess tax benefit in accordance with the accounting guidance.

- The change in accounts receivable was a cash outflow of $12.9 million in the first six months of 2009 compared to a cash outflow of $6.7 million in the first six months of 2010.

- The change in income taxes receivable was a cash outflow of $1.0 million in the first six months of 2009 compared to a cash inflow of $12.0 million in the first six months of 2010. We received federal income tax refunds totaling $8.1 million in the six months ended June 30, 2010, related to the 2008 and 2009 tax periods. The remainder of the change in income taxes receivable is due to the recognition of excess tax benefits from share−based compensation arrangements.

- The change in accounts payable and accrued expenses created a $12.1 million cash inflow in the first six months of 2009 compared to a $9.9 million cash inflow in the first six months of 2010. The changes resulted from the timing of payments for trade payables.

- The change in deferred rent created a $0.1 million cash inflow in the first six months of 2009 compared to a $3.1 million cash inflow in the first six months of 2010. The change resulted from data center lease arrangements that were entered into in 2009 with terms that included escalating rental payments. As total rent expense for each of these lease arrangements is recorded on a straight−line basis for the term of the lease, there is a difference between rent expense and cash paid for rent during the quarter.

Investing Activities

Net cash used in investing activities was primarily capital expenditures to meet the demands of our growing customer base. Historically our main investing activities have consisted of purchases of IT equipment for our data center infrastructure, furniture, equipment and leasehold improvements to support our operations.

Our net cash used in investing activities was $62.2 million in the first six months of 2009 compared to $69.2 million in the first six months of 2010, an increase of $7.0 million, or 11.3%. The increase was primarily due to an increase in data center build outs and an increase in purchases of customer gear.

We purchase equipment through capital lease arrangements and other types of vendor financing that do not require an initial outlay of cash. Purchases through these arrangements decreased from $35.3 million for the first six months of 2009 to $31.6 million for the first six months of 2010.

Financing Activities

Net cash used in financing activities was $119.5 million in the first six months of 2009 compared to $8.6 million in the first six months of 2010, a change of $110.9 million. This was due primarily to $100.0 million in net payments to our revolving credit facility during the first six months of 2009 compared to no repayments or advances in the first six months of 2010. Principal payments on capital leases and notes payable were $25.4 million in the first six months of 2009 compared to $29.1 million during the first six months of 2010. In addition, proceeds from employee stock plans and the related excess tax benefits increased by $14.3 million in the first six months of 2010. Our net leverage as of June 30, 2010 was 0.09 times. See above for our discussion of Non−GAAP Financial Measures.

Contractual Obligations, Commitments and Contingencies

The following table summarizes our contractual obligations as of June 30, 2010:

(In thousands)	Total	2010	2011−2012	2013−2014	2015 and Beyond
			(Unaudited)		
Capital leases (1)	$ 122,336	$ 31,898	$ 82,063	$ 8,375	$ −
Operating leases	336,572	9,275	46,405	47,207	233,685
Purchase commitments	59,148	21,359	37,789	−	−
Revolving credit facility (2)	50,000	−	50,000	−	−
Software and equipment notes (2)	4,339	1,548	2,791	−	−
Total contractual obligations	$ 572,395	$ 64,080	$ 219,048	$ 55,582	$ 233,685

(1) Represents principal and interest.
(2) Represents principal only.

Leases

Capital leases are primarily related to expenditures for IT equipment. Our operating leases are primarily for data center facilities and office space.

In May 2010, Rackspace entered into an agreement to lease additional space at our Chicago area data center. The operating lease has a term of 15 years from the commencement date with total estimated financial obligation of approximately $100 million to $110 million over the 15 year term, inclusive of base lease payments and Rackspace's pro−rata share of operating expenses. Rackspace has a one−time option to terminate the lease after ten years subject to a penalty, as well as upon expiration of the lease, to renew the lease for two successive five year periods.

Purchase commitments

Our purchase commitments are primarily related to costs associated with our data centers including bandwidth and consulting services as well as commitments to prepay for certain software licenses. In June 2010, we entered into a 3−year software license agreement with a reseller of licenses under which we will make a prepayment of $18.0 million at the beginning of each year for a specified quantity of software licenses. We expect to realize a cost savings as a result of entering into the agreement.

Revolving Credit Facility

We have a credit facility with a committed amount of $245.0 million. As of June 30, 2010, we had $50.0 million of revolving loans outstanding and a $0.6 million letter of credit outstanding under the credit facility, resulting in $194.4 million available for future borrowings. The credit facility has a variable interest rate, which is generally the London Interbank Offered Rate (LIBOR) margin plus a margin spread. The rate was equal to 1.40% at June 30, 2010.

In December 2007, we entered into an interest rate swap agreement converting a portion of our interest rate exposure from a floating rate basis to a fixed rate of 4.135% per annum. The interest rate swap agreement has a notional amount of $50.0 million and matures in December 2010.

Software and Equipment Notes

We finance certain software and equipment from third−party vendors. The terms of these arrangements are generally one to five years. The interest rates on the arrangements range from 0.0% to 6.0%.

Off−Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities.

We have entered into various indemnification arrangements with third parties, including vendors, customers, landlords, our officers and directors, stockholders of acquired companies, and third parties to whom and from whom we license technology. Generally, these indemnification agreements require us to reimburse losses suffered by third parties due to various events, such as lawsuits arising from patent or copyright infringement or our negligence. Certain of these agreements require us to indemnify the other party against certain claims relating to property damage, personal injury or the acts or omissions by us, our employees, agents or representatives. To date, there have been no claims against us or our customers pertaining to such indemnification provisions and no amounts have been recorded.

These indemnification obligations are considered off−balance sheet arrangements. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnification obligations in our financial statements.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with GAAP. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management's judgment in its application, while in other cases, significant judgment is required in making estimates, and selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. These judgments and estimates affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We consider these policies requiring significant management judgment and estimates used in the preparation of our financial statements to be critical accounting policies.

We review our estimates and judgments on an ongoing basis, including those related to revenue recognition, service credits, allowance for doubtful accounts, property and equipment, goodwill and intangibles, contingencies, the fair valuation of stock related to share−based compensation, software development, and income taxes.

We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances to determine the carrying values of assets and liabilities. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period−to−period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

A description of our critical accounting policies that involve significant management judgment appears in our Annual Report filed on Form 10−K filed with the SEC on February 26, 2010, as amended, under "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies."

Recent Accounting Pronouncements

For a full description of new accounting pronouncements, including the respective dates of adoption and impact on results of operation and financial condition, see "Notes to the Unaudited Consolidated Financial Statements – Note 2. Summary of Significant Accounting Policies."

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Power Prices. We are a large consumer of power. During the first six months of 2010, we expensed approximately $8.3 million that was paid to utility companies to power our data centers, representing 2.3% of our net revenue. Because we anticipate further revenue growth for the foreseeable future, we expect to consume more power in the future. Power costs vary by geography, the source of power generation, seasonal fluctuations, and are subject to certain proposed legislation that may increase our exposure to increased power costs. Our largest exposure to energy prices based on consumption currently exists at our Grapevine, Texas data center in the Dallas−Fort Worth area, a deregulated energy market. In August 2008, we entered into a fixed price contract with a provider of electricity for power for our Grapevine data center. The contract allows the company to periodically convert the price to a floating market price during the arrangement. The original term of the contract was 19 months and allowed the provider an option to extend the contract for an additional 19 months. The provider opted to extend the option in January 2010 for an additional 19 months. Also, in June 2009, we entered into a similar fixed price contract for 12 months for our Slough U.K. data center that has since been extended for an additional 12 months to expire in May 2011. These contracts have been designated as meeting the normal purchases and normal sales exception and thus are not accounted for as derivatives.

During April 2010, the U.K.'s carbon emission trading scheme (CRC Carbon Efficiency Trading Scheme) came into operation and based on our data center energy consumption in the U.K., registration would have been mandatory. However, because we did not meet all of the criteria, we are not required to register under the CRC's first phase. Under the scheme's first phase, the period commencing April 2010 to March 2011 is considered a footprint year under which participant companies are required to track and report their carbon dioxide emissions to the regulatory body. Beginning April 2011, participants will be required to purchase allowances to offset their carbon dioxide emissions. The purchase of these allowances will increase the cost of power. If the government decides to keep the scheme under a second phase, it is likely Rackspace UK will need to register and participate in it. The purchase of carbon allowances under a second phase is not expected until 2012; however, the full financial impact of this scheme will be determined as we enter the second phase, which the company is preparing for in 2011. No legislation has been enacted to date that would impact our U.S. or Hong Kong data centers.

Interest Rates. Our main credit facility is a revolving line of credit with a base rate determined by the London Interbank Offered Rate, or LIBOR. This market rate of interest is fluctuating and exposes our interest expense to risk. Our credit agreement obligates us to hedge part of that interest rate risk with appropriate instruments, such as interest rate swaps or interest rate options. On December 10, 2007, we entered into an at−the−market fixed−payer interest rate swap with a notional amount of $50.0 million at an annual rate of 4.135%. This swap essentially fixes the rate we pay on the first $50.0 million outstanding on our revolving credit facility. As we borrow more, we may enter into additional swaps to continuously control our interest rate risk. Generally, we do not hedge our complete exposure. As a result, we may be exposed to interest rate risk on the un−hedged portion of our borrowings. For example, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of June 30, 2010 we did not have exposure to interest rate risk as we only had $50.0 million outstanding on our revolving credit facility.

Leases. The majority of our purchases of customer gear are vendor financed through capital leases with fixed payment terms generally over three to five years, coinciding with the depreciation period of the equipment. As of June 30, 2010, we have a principal liability for these leases of $115.5 million on our consolidated balance sheet, of which $51.5 million is classified as current. Although we believe our borrowings from these arrangements will continue to be available, we have exposure that vendor financing may no longer be available or the borrowing rates, which are fixed rates, may increase.

Foreign Currencies. The majority of our customers are invoiced, and substantially all of our expenses are paid, in the functional currency of our associated operating entity. As such, there is a minimal impact to our margins. A relatively insignificant amount of customers are invoiced in currencies other than the applicable functional currency, such as the euro. Therefore, our results of operations and cash flows are subject to fluctuations in foreign currency exchange rates. We also have exposure to foreign currency transaction gains and losses as the result of certain receivables due from our foreign subsidiaries, which are denominated in both the U.S. dollar and the pound sterling. During the first six months of 2010, we recognized foreign currency gains of $0.9 million within other income (expense). We have not entered into any currency hedging contracts, although we may do so in the future. Our revolving credit facility agreement provides us with the ability to borrow from our credit facility in pounds sterling and euros, rather than restricting borrowings to U.S. dollars. We currently do not have borrowings in any alternative currencies from our credit facility. As we grow our international operations, our exposure to foreign currency risk could become more significant.

ITEM 4. − CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a−15(e) and 15d−15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"), as amended, as of the end of the period covered by this quarterly report (the "Evaluation Date"). Based on this evaluation, our chief executive officer and chief financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to the Company, including our consolidated subsidiaries, required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting

There were no changes in our internal controls over financial reporting during our most recent fiscal quarter reporting period identified in connection with management's evaluation as required and defined by paragraph (d) of Rules 13a−15 and 15d−15 under the Exchange Act, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations of Internal Controls

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision−making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost−effective control system, misstatements due to error or fraud may occur and not be detected.

PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. In addition, on October 22, 2008, Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston, was filed in the 37 th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us. We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

On March 26, 2010 Bedrock Computer Technologies LLC's filed its First Amended Answer and Counterclaim to Red Hat, Inc.'s Complaint for Declaratory Judgment (Red Hat, Inc., v Bedrock Computer Technologies, LLC Cause No. 6:09−CV−00549 –LED, United States District Court for the Eastern District of Texas). In its answer and counterclaim, Bedrock has named Rackspace as a third party defendant in a civil action by asserting cross claims against Rackspace and several other companies alleging direct and indirect infringement of United States Patent No. 5,893,120 based on the use of computer equipment configured with or utilizing software based on various versions of the Linux operating system. Bedrock is seeking a finding that the third party defendants, including Rackspace, be enjoined from selling any infringing product, and that Bedrock be awarded actual damages, pre and post judgment interest and attorney's fees. We believe that we have meritorious defenses to the claims and intend to defend ourselves vigorously against these infringement claims. At this time, we do not anticipate that the claims will have a material adverse effect on our business, financial position or results of operations. There can be no assurance, however, that we will be successful in our defense.

ITEM IA – RISK FACTORS

Risks Related to Our Business and Industry

Our physical infrastructure is concentrated in a few facilities and any failure in our physical infrastructure or services could lead to significant costs and disruptions and could reduce our revenue, harm our business reputation and have a material adverse effect on our financial results.

Our network, power supplies and data centers are subject to various points of failure. Problems with our cooling equipment, generators, uninterruptible power supply, or UPS, routers, switches, or other equipment, whether or not within our control, could result in service interruptions for our customers as well as equipment damage. Because our hosting services do not require geographic proximity of our data centers to our customers, our hosting infrastructure is consolidated into a few large facilities. While data backup services and disaster recovery services are available as a part of our hosting services offerings, the majority of our customers do not elect to pay the additional fees required to have disaster recovery services store their backup data offsite in a separate facility, which could substantially mitigate the adverse effect to a customer from a single data center failure. Accordingly, any failure or downtime in one of our data center facilities could affect a significant percentage of our customers. The total destruction or severe impairment of any of our data center facilities could result in significant downtime of our services and the loss of customer data. Since our ability to attract and retain customers depends on our ability to provide customers with highly reliable service, even minor interruptions in our service could harm our reputation. The services we provide are subject to failure resulting from numerous factors, including:

- Power loss;
- Equipment failure;
- Human error or accidents;
- Sabotage and vandalism;
- Failure by us or our vendors to provide adequate service or maintenance to our equipment;
- Network connectivity downtime;
- Improper building maintenance by the landlords of the buildings in which our facilities are located;
- Physical or electronic security breaches;
- Fire, earthquake, hurricane, tornado, flood, and other natural disasters;
- Water damage; and
- Terrorism.

Additionally, in connection with the expansion or consolidation of our existing data center facilities from time to time, there is an increased risk that service interruptions may occur as a result of server relocation or other unforeseen construction−related issues.

We have experienced interruptions in service in the past, due to such things as power outages, power equipment failures, cooling equipment failures, routing problems, hard drive failures, database corruption, system failures, software failures, and other computer failures. While we have not experienced a material increase in customer attrition following these events, the extent to which our reputation suffers is difficult to assess. We have taken and continue to take steps to improve our infrastructure to prevent service interruptions, including upgrading our electrical and mechanical infrastructure. However, service interruptions continue to be a significant risk for us and could materially impact our business.

Any future service interruptions could:

- Cause our customers to seek damages for losses incurred;
- Require us to replace existing equipment or add redundant facilities;
- Affect our reputation as a reliable provider of hosting services;
- Cause existing customers to cancel or elect to not renew their contracts; or
- Make it more difficult for us to attract new customers.

Any of these events could materially increase our expenses or reduce our revenue, which would have a material adverse effect on our operating results.

Customers with mission−critical applications could potentially expose us to lawsuits for their lost profits or damages, which could impair our financial condition.

Because our hosting services are critical to many of our customers' businesses, any significant disruption in our services could result in lost profits or other indirect or consequential damages to our customers. Although we require our customers to sign agreements that contain provisions attempting to limit our liability for service outages, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a service interruption or other Internet site or application problems that they may ascribe to us. The outcome of any such lawsuit would depend on the specific facts of the case and any legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may exceed our liability insurance coverage by unknown but significant amounts, which could materially impair our financial condition.

We provide service level commitments to our customers, which could require us to issue credits for future services if the stated service levels are not met for a given period and could significantly decrease our revenue and harm our reputation.

Our customer agreements provide that we maintain certain service level commitments to our customers relating primarily to network uptime, critical infrastructure availability, and hardware replacement. If we are unable to meet the stated service level commitments, we may be contractually obligated to provide these customers with credits for future services. As a result, a failure to deliver services for a relatively short duration could cause us to issue these credits to a large number of affected customers. In addition, we cannot be assured that our customers will accept these credits in lieu of other legal remedies that may be available to them. Our failure to meet our commitments could also result in substantial customer dissatisfaction or loss. Because of the loss of future revenue through these credits, potential customer loss and other potential liabilities, our revenue could be significantly impacted if we cannot meet our service level commitments to our customers.

If we do not prevent security breaches, we may be exposed to lawsuits, lose customers, suffer harm to our reputation, and incur additional costs.

The services we offer involve the transmission of large amounts of sensitive and proprietary information over public communications networks, as well as the processing and storage of confidential customer information. Unauthorized access, computer viruses, accidents, employee error or malfeasance, fraudulent service plan orders, intentional misconduct by computer "hackers", and other disruptions can occur that could compromise the security of our infrastructure, thereby exposing such information to unauthorized access by third parties and leading to interruptions, delays or cessation of service to our customers. Techniques used to obtain unauthorized access to, or to sabotage systems, change frequently and generally are not recognized until launched against a target. We may be unable to implement security measures in a timely manner or, if and when implemented, these measures could be circumvented as a result of accidental or intentional actions by parties within or outside of our organization. Any breaches that occur could expose us to increased risk of lawsuits, loss of existing or potential customers, harm to our reputation and increases in our security costs. Although we typically require our customers to sign agreements that contain provisions attempting to limit our liability for security breaches, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a security breach that they may ascribe to us. The outcome of any such lawsuit would depend on the specific facts of the case and legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may significantly exceed our liability insurance coverage by unknown but significant amounts, which could seriously impair our financial condition.

If we fail to hire and retain qualified employees and management personnel, our growth strategy and our operating results could be harmed.

Our growth strategy depends on our ability to identify, hire, train, and retain executives, IT professionals, technical engineers, operations employees, and sales and senior management personnel who maintain relationships with our customers and who can provide the technical, strategic, and marketing skills required for our company to grow. There is a shortage of qualified personnel in these fields, specifically in the San Antonio, Texas area, where we are headquartered and a majority of our employees are located. We compete with other companies for this limited pool of potential employees. There is no assurance that we will be able to recruit or retain qualified personnel, and this failure could cause our operations and financial results to be negatively impacted.

Our success and future growth also depends to a significant degree on the skills and continued services of our management team, especially Graham Weston, our Chairman, and A. Lanham Napier, our Chief Executive Officer and President. We do not have long−term employment agreements with any members of our management team, including Messrs. Weston and Napier. Mr. Napier is the only member of our management team on whom we maintain key man insurance.

If we are unable to maintain a high level of customer service, customer satisfaction and demand for our services could suffer.

We believe that our success depends on our ability to provide customers with quality service that not only meets our stated commitments, but meets and then exceeds customer service expectations. If we are unable to provide customers with quality customer support in a variety of areas, we could face customer dissatisfaction, decreased overall demand for our services, and loss of revenue. In addition, our inability to meet customer service expectations may damage our reputation and could consequently limit our ability to retain existing customers and attract new customers, which would adversely affect our ability to generate revenue and negatively impact our operating results.

Our existing customers could elect to reduce or terminate the services they purchase from us because we do not have long−term contracts with our customers, which could adversely affect our operating results.

Customer contracts for our managed hosting services typically have initial terms of one to two years which, unless terminated, may be renewed or automatically extended on a month−to−month basis. Our customers have no obligation to renew their services after their initial contract periods expire. Moreover, our customers could cancel their managed hosting service agreements before they expire. In addition, most of our other services, such as our cloud computing services, are generally provided on a month−to−month basis and do not have an extended initial term at all. Our costs associated with maintaining revenue from existing customers are generally much lower than costs associated with generating revenue from new customers. Therefore, a reduction in revenue from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue to retain our existing customers could have a material adverse effect on our operating results.

Our corporate culture has contributed to our success, and if we cannot maintain this culture, we could lose the innovation, creativity, and teamwork fostered by our culture, and our operating results may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity, and teamwork. If we implement more complex organizational management structures because of growth or other structural changes, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. This could negatively impact our future operating results. In addition, being a publicly traded company may create disparities in personal wealth among our employees, which may adversely impact our corporate culture and employee relations.

If we are unable to manage our growth effectively, our financial results could suffer.

The growth of our business and our service offerings has strained our operating and financial resources. Further, we intend to continue expanding our overall business, customer base, headcount, and operations. Creating a global organization and managing a geographically dispersed workforce requires substantial management effort and significant additional investment in our operating and financial system capabilities and controls. If our information systems are unable to support the demands placed on them by our growth, we may be forced to implement new systems which would be disruptive to our business. We may be unable to manage our expenses effectively in the future due to the expenses associated with these expansions, which may negatively impact our gross margins or operating expenses. If we fail to improve our operational systems or to expand our customer service capabilities to keep pace with the growth of our business, we could experience customer dissatisfaction, cost inefficiencies, and lost revenue opportunities, which may materially and adversely affect our operating results.

If we are unable to adapt to evolving technologies and customer demands in a timely and cost−effective manner, our ability to sustain and grow our business may suffer.

Our market is characterized by rapidly changing technology, evolving industry standards, and frequent new product announcements, all of which impact the way hosting services are marketed and delivered. The adoption of new technologies, a change in industry standards or introduction of more attractive products or services could make some or all of our offerings less desirable or even obsolete. These potential changes are magnified by the continued rapid growth of the Internet and the intense competition in our industry. To be successful, we must adapt to our rapidly changing market by continually improving the performance, features, and reliability of our services and modifying our business strategies accordingly. We cannot guarantee that we will be able to identify the emergence of all of these new service alternatives successfully, modify our services accordingly, or develop and bring new products and services to market in a timely and cost−effective manner to address these changes. Our failure to provide products and services to compete with new technologies or the obsolescence of our services would likely lead us to lose current and potential customers or cause us to incur substantial costs by attempting to catch our offerings up to the changed environment.

We could also incur substantial costs if we need to modify our services or infrastructure in order to adapt to these changes. For example, our data center infrastructure could require improvements due to (i) the development of new systems to deliver power to or eliminate heat from the servers we house, (ii) the development of new server technologies that require levels of critical load and heat removal that our facilities are not designed to provide, or (iii) a fundamental change in the way in which we deliver services. We may not be able to timely adapt to changing technologies, if at all. Our ability to sustain and grow our business would suffer if we fail to respond to these changes in a timely and cost−effective manner.

The acceptance and growth of cloud computing is an example of a rapidly changing technology that has impacted our business and our market. Because of the technological advances and the market adoption and utilization of cloud computing, we have adapted to the changing market and implemented the new technology in our hosting service delivery. This change has already required us to make a substantial financial investment to develop and implement cloud computing into our hosting solution model and has required significant attention from management to refine our business strategies to include the delivery of cloud computing and hybrid solutions. As the market continues to adopt this new technology, we expect to continue to make substantial investments in our service solutions and system integrations.

Even if we have developed an attractive solution to the changing technology or standards, our introduction of the new solution could have lower price points than other offerings and may result in our existing customers switching to the lower cost products and services, which could reduce our revenue and have a material, adverse effect of our operating results. For example, the introduction of our cloud computing solutions provides a reasonable alternative to some of our dedicated hosting solutions at a lower price point and some of our dedicated hosting customers have switched to cloud computing solutions. We expect that other customers in this situation will switch to cloud computing in the future.

Finally, even if we succeed in adapting to a new technology or the changing industry standard by developing attractive products and services and successfully bringing them to market, there is no assurance that the new product or service would have a positive impact on our financial performance and could even result in lower revenue, lower margins and/or higher costs and therefore could negatively impact our financial performance.

We may not be able to continue to add new customers and increase sales to our existing customers, which could adversely affect our operating results.

Our growth is dependent on our ability to continue to attract new customers while retaining and expanding our service offerings to existing customers. Growth in the demand for our services may be inhibited and we may be unable to sustain growth in our customer base for a number of reasons, such as:

- A reduction in the demand for our services due to the economic recession;
- Our inability to market our services in a cost−effective manner to new customers;
- The inability of our customers to differentiate our services from those of our competitors or our inability to effectively communicate such distinctions;
- Our inability to successfully communicate the benefits of hosting to businesses;
- The decision of businesses to host their Internet sites and web infrastructure internally or in colocation facilities as an alternative to the use of our hosting services;
- Our inability to penetrate international markets;
- Our inability to expand our sales to existing customers;
- Our inability to strengthen awareness of our brand; and
- Reliability, quality or compatibility problems with our services.

A substantial amount of our past revenue growth was derived from purchases of service upgrades by existing customers. Our costs associated with increasing revenue from existing customers are generally lower than costs associated with generating revenue from new customers. Therefore, a reduction in the rate of revenue increase or a rate of revenue decrease from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue attracting new customers or grow our revenue from existing customers for a prolonged period of time could have a material adverse effect on our operating results.

We may not be able to compete successfully against current and future competitors.

The market for hosting and cloud computing services is highly competitive. We expect to face additional competition from our existing competitors as well as new market entrants in the future.

Our current and potential competitors vary by size, service offerings and geographic region. These competitors may elect to partner with each other or with focused companies like us to grow their businesses. They include:

- Do−it−yourself solutions with a colocation partner such as AT&T, Equinix, SAVVIS, and other telecommunications companies;
- IT outsourcing providers such as CSC, HP, and IBM;
- Hosting providers such as AT&T, British Telecom, SAVVIS, Terremark, The Planet, and Verio; and
- Large technology companies such as Amazon, Microsoft, Google, IBM and Salesforce.com, who are making investments in cloud computing.

The primary competitive factors in our market are: customer service and technical expertise; security reliability and functionality; reputation and brand recognition; financial strength; breadth of services offered; and price.

Many of our current and potential competitors have substantially greater financial, technical and marketing resources, larger customer bases, longer operating histories, greater brand recognition, and more established relationships in the industry than we do. As a result, some of these competitors may be able to:

- Develop superior products or services, gain greater market acceptance, and expand their service offerings more efficiently or more rapidly;
- Adapt to new or emerging technologies and changes in customer requirements more quickly;
- Bundle hosting services with other services they provide at reduced prices;
- Take advantage of acquisition and other opportunities more readily;
- Adopt more aggressive pricing policies and devote greater resources to the promotion, marketing, and sales of their services; and
- Devote greater resources to the research and development of their products and services.

Our operating results may be further adversely impacted by unfavorable economic conditions, worldwide political and economic uncertainties and specific conditions in the markets we address.

Recently, general worldwide economic conditions have experienced a deterioration due to among other things, credit conditions resulting from the financial crisis affecting the banking system and financial markets including: slower economic activity, concerns about inflation and deflation, volatility in energy costs, decreased consumer confidence, reduced corporate profits and capital spending, the ongoing effects of the war in Iraq and Afghanistan, recent international conflicts, terrorist and military activity, and the impact of natural disasters and public health emergencies. These conditions can make it extremely difficult for both us and our customers to accurately forecast and plan future business activities. Additionally, they could cause U.S. and foreign businesses to slow spending on our services, which could delay and lengthen our new customer sales cycle and cause existing customers to do one or more of the following:

- Cancel or reduce planned expenditures for our services;
- Seek to lower their costs by renegotiating their contracts with us;
- Move their hosting services in−house; or
- Switch to lower−priced solutions provided by us or our competitors.

Customer collections are our primary source of cash. We have historically grown through a combination of an increase in new customers and revenue growth from our existing customers. Over some recent quarters, we have experienced a decrease in our installed base growth. If the economic conditions were to deteriorate, we may experience additional reductions in our installed base growth, increases in churn and/or longer new customer sales cycles. We could also experience a decrease in revenue and a reduction in operating margins. Further, during challenging economic times, our customers may have difficulty gaining timely access to sufficient credit, which could result in an impairment of their ability to make timely payments to us. We cannot predict the timing, strength or duration of any economic slowdown or subsequent economic recovery. If the economy or markets in which we operate were to deteriorate, we may have to record additional charges related to the impairment of goodwill and other long−lived assets, and our business, financial condition and results of operations could be materially and adversely affected.

Finally, like many other companies, our stock price decreased during the onset of the recent economic downturn. Although our stock price has since recovered, if investors have concerns that our business, financial condition and results of operations will be negatively impacted by an economic downturn, our stock price could decrease again.

If we overestimate or underestimate our data center capacity requirements, our operating margins and profitability could be adversely affected.

The costs of construction, leasing, and maintenance of our data centers constitute a significant portion of our capital and operating expenses. In order to manage growth and ensure adequate capacity for new and existing customers while minimizing unnecessary excess capacity costs, we continuously evaluate our short and long−term data center capacity requirements. Due to the lead time in expanding existing data centers or building new data centers, we are required to estimate demand for our services as far as two years into the future. We currently plan to increase our infrastructure as required through the addition and expansion of data centers in the U.S. and internationally. In contrast to most of our data centers that we have established to date, several of which were acquired relatively inexpensively as distressed assets of third parties, our current expansion plans may require us to pay full market rates for new data center facilities. If we overestimate the demand for our services and therefore overbuild our data center capacity or commit to long term facility leases, our operating margins could be materially reduced, which would materially impair our profitability.

If we underestimate our data center capacity requirements, we may not be able to service the expanding needs of our existing customers. Additionally, we may be required to limit new customer acquisition while we work to increase data center capacity to satisfy demand, either of which may materially impair our revenue growth.

We rely on a number of third−party providers for data center space, equipment, maintenance and other services, and the loss of, or problems with, one or more of these providers may impede our growth or cause us to lose customers.

We rely on third−party providers to supply data center space, equipment and maintenance. For example, we lease data center space from third party landlords, lease or purchase equipment from equipment providers, and source equipment maintenance through third parties. While we have entered into various agreements for these products and services, any failure to obtain additional capacity or space, equipment, or maintenance, if required, would impede the growth of our business and cause our financial results to suffer. For example, if a data center landlord does not adequately maintain its facilities, or provide services for which it is responsible, we may not be able to deliver services to our customers according to our standards or at all. Further, the equipment that we purchase could be deficient in some way, thereby affecting our products and services. If, for any reason, these providers fail to provide the required services, fail to deliver their equipment, or suffer other failures, we may incur financial losses and our customers may lose confidence in our company, and we may not be able to retain these customers.

We may not be able to renew the leases on our existing facilities on terms acceptable to us, if at all, which could adversely affect our operating results.

We do not own the facilities occupied by our current data centers, but occupy them pursuant to commercial leasing arrangements. The initial terms of our main existing data center leases expire over a period ranging from 2012 to 2027, with each having at least one renewal period of no less than three years. Upon the expiration or termination of our data center facility leases, we may not be able to renew these leases on terms acceptable to us, if at all. If we fail to renew any data center lease and are required to move the data center to a new facility, we would face significant challenges due to the technical complexity, risk, and high costs of relocating the equipment. For example, if we are required to migrate customer servers to a new facility, such migration could result in significant downtime for our affected customers. This could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Even if we are able to renew the leases on our existing data centers, we expect that rental rates, which will be determined based on then−prevailing market rates with respect to the renewal option periods and which will be determined by negotiation with the landlord after the renewal option periods, will be higher than rates we currently pay under our existing lease agreements. If we fail to increase revenue in our existing data centers by amounts sufficient to offset any increases in rental rates for these facilities, our operating results may be materially and adversely affected.

We rely on third−party hardware that may be difficult to replace or could cause errors or failures of our service, which could adversely affect our operating results or harm our reputation.

We rely on hardware acquired from third parties in order to offer our services. This hardware may not continue to be available on commercially reasonable terms in quantities sufficient to meet our business needs, which could adversely affect our ability to generate revenue. Any errors or defects in third−party hardware could result in errors or a failure of our service, which could harm our reputation and operating results. Indemnification from hardware providers, if any, would likely be insufficient to cover any damage to our business or our customers resulting from such hardware failure.

We rely on third−party software that may be difficult to replace or which could cause errors or failures of our service that could lead to lost customers or harm to our reputation.

We rely on software licensed from third parties to offer our services. This software may not continue to be available to us on commercially reasonable terms, or at all. Any loss of the right to use any of this software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained, and integrated, which could harm our business. Any errors or defects in third−party software or inadequate or delayed support by the third party could result in errors or a failure of our service which could harm our operating results by adversely affecting our revenue or operating costs.

We engage and rely on third−party consultants who may fail to provide effective guidance or solutions which could result in increased costs and loss of business opportunity.

We engage third−party consultants who provide us with guidance and solutions relating to everything from overall corporate strategy to data center design to employee engagement. We engage these parties based on our perception of their expertise and ability to provide valuable insight or solutions in the areas that we believe need to be addressed in our business. However, these consultants may provide us with ineffective or even harmful guidance or solutions, which, if followed or implemented, could result in a loss of resources, operational failures or a loss of critical business opportunities.

Increased energy costs, power outages, and limited availability of electrical resources may adversely affect our operating results.

Our data centers are susceptible to increased regional, national or international costs of power and to electrical power outages. Our customer contracts do not allow us to pass on any increased costs of energy to our customers, which could affect our operating margins. Further, power requirements at our data centers are increasing as a result of the increasing power demands of today’s servers. Increases in our power costs could impact our operating results and financial condition. Since we rely on third parties to provide our data centers with power sufficient to meet our needs, our data centers could have a limited or inadequate amount of electrical resources necessary to meet our customer requirements. We attempt to limit exposure to system downtime due to power outages by using backup generators and power supplies. However, these protections may not limit our exposure to power shortages or outages entirely. Any system downtime resulting from insufficient power resources or power outages could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Increased Internet bandwidth costs and network failures may adversely affect our operating results.

Our success depends in part upon the capacity, reliability, and performance of our network infrastructure, including the capacity leased from our Internet bandwidth suppliers. We depend on these companies to provide uninterrupted and error−free service through their telecommunications networks. Some of these providers are also our competitors. We exercise little control over these providers, which increases our vulnerability to problems with the services they provide. We have experienced and expect to continue to experience interruptions or delays in network service. Any failure on our part or the part of our third−party suppliers to achieve or maintain high data transmission capacity, reliability or performance could significantly reduce customer demand for our services and damage our business.

As our customer base grows and their usage of telecommunications capacity increases, we will be required to make additional investments in our capacity to maintain adequate data transmission speeds, the availability of which may be limited or the cost of which may be on terms unacceptable to us. If adequate capacity is not available to us as our customers' usage increases, our network may be unable to achieve or maintain sufficiently high data transmission capacity, reliability or performance. In addition, our business would suffer if our network suppliers increased the prices for their services and we were unable to pass along the increased costs to our customers.

Our operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.

Our operating results may fluctuate due to a variety of factors, including many of the risks described in this section, which are outside of our control. As a result, comparing our operating results on a period−to−period basis may not be meaningful. You should not rely on our operating results for any prior periods as an indication of our future operating performance. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of long−term future revenue. Given relatively fixed operating costs related to our personnel and facilities, any substantial adjustment to our expenses to account for lower than expected levels of revenue will be difficult and time consuming. Consequently, if our revenue does not meet projected levels, our operating expenses would be high relative to our revenue, which would negatively affect our operating performance.

If our revenue or operating results do not meet or exceed the expectations of investors or securities analysts, the price of our common stock may decline.

We could be required to repay substantial amounts of money to certain state and local governments if we lose tax exemptions or grants previously awarded to us, which could adversely affect our operating results.

In August 2007, we entered into an agreement with the State of Texas (Texas Enterprise Fund Grant) under which we may receive up to $22.0 million in state enterprise fund grants on the condition that we meet certain employment levels in the State of Texas paying an average compensation of at least $56,000 per year (subject to increases). To the extent we fail to meet these requirements, we may be required to repay all or a portion of the grants plus interest. In September 2007, we received the initial installment of $5.0 million from the State of Texas, which was recorded as a non−current liability.

On July 27, 2009, the Texas Enterprise Fund Grant agreement was amended to modify the job creation requirements. Under the amendment, the grant has been divided into four separate tranches. The first tranche, called "Basic Fund" in the amendment, is $8.5 million with a Job Target of 1,225 new jobs by December 2012 (in addition to the 1,436 jobs in place as of August 1, 2007 for a total of 2,661 jobs in Texas). We already have drawn $5.0 million of this grant. We can draw an additional $3.5 million when we reach 1,225 new jobs. If we do not create 1,225 new jobs in Texas by 2012, we will be required to repay the grant at a rate of $1,263 per job missed per year (clawback). As of December 31, 2009, we had created 617 new jobs. The maximum clawback would be the amounts we draw plus 3.4% interest on such amounts per year. The remaining three tranches are at our option. We can draw an additional $13.5 million, based on the following amounts and milestones: $5.5 million if we create a total of 2,100 new jobs in Texas; another $5.25 million if we create a total of 3,000 new jobs in Texas; and $2.75 million more if we create a total of 4,000 new jobs in Texas. We are responsible for maintaining the jobs through January 2022. If we eliminate jobs for which we have drawn funds, the clawback is triggered.

In October 2008, we received a grant in partnership with the State of Texas and Alamo Community College District, which will provide us the opportunity to be reimbursed for up to $4.7 million for certain training expenses conducted through Alamo Community College over the next three years. In order to fulfill our requirements, we must meet the employment requirements defined in the original Texas Enterprise Fund Grant agreement, which is unlikely. Although we have not received any reimbursements, we are in the process of evaluating this grant and the need to renegotiate its terms.

On August 3, 2007, we entered into a lease for approximately 67 acres of land and a 1.2 million square foot facility in Windcrest, Texas, which is in the San Antonio, Texas area, to house our corporate headquarters and potentially a future data center operation. In connection with this lease, we also entered into a Master Economic Incentives Agreement ("MEIA") with the Cities of Windcrest and San Antonio, Texas, Bexar County, and certain other parties, pursuant to which we agreed to locate existing and future employees at the new facility location. The agreement requires that we meet certain employment levels each year, with an ultimate job requirement of 4,500 jobs by December 31, 2012, provided that if the job requirement in any grant agreement with the State of Texas is lower, then the job requirement under the MEIA is automatically adjusted downward. Consequently, because the Texas Enterprise Fund Grant agreement has been amended to reduce the state job requirement, we believe the job requirement under the MEIA has been reduced to 1,774. In addition, the MEIA requires that the median compensation of those employees be no less than $51,000 per year. In exchange for meeting these employment obligations, the parties agreed to enter into the lease structure, pursuant to which, as a lessee of the Windcrest Economic Development Corporation, we will not be subject to most of the property taxes associated with the property for a 14 year period. If we fail to meet these job creation requirements, we could lose a portion or all of the tax benefit being provided during the 14 year period by having to make payments in lieu of taxes (PILOT) to the City of Windcrest. The amount of the PILOT payment would be calculated based on the amount of taxes that would have been owed for that period if the property were not exempt, and then such amount would be adjusted pursuant to certain factors, such as the percentage of employment achieved compared to the stated requirements.

We have significant debt obligations that include restrictive covenants limiting our flexibility to manage our business; failure to comply with these covenants could trigger an acceleration of our outstanding indebtedness and adversely affect our financial position and operating results.

As of June 30, 2010, outstanding indebtedness under our credit facility totaled $50.0 million, with an outstanding letter of credit of $0.6 million. Our credit facility requires that we maintain specific financial ratios and comply with covenants, including financial covenants, which contain numerous restrictions on our ability to incur additional debt, pay dividends or make other restricted payments, sell assets, enter into affiliate transactions and take other actions. Our existing credit facility is, and any future financing arrangements may be, secured by all of our assets. If we are unable to meet the terms of the financial covenants or if we breach any of these covenants, a default could result under one or more of these agreements, which may require us to repay all amounts owed under our credit facility.

If we are unable to generate sufficient cash to repay our debt obligations when they become due and payable, either when they mature or in the event of a default, we may not be able to obtain additional debt or equity financing on favorable terms, if at all, which may negatively impact our ability to continue as a going concern.

We also have substantial equipment lease obligations, the principal balance of which totaled approximately $115.5 million as of June 30, 2010. The payment obligations under these equipment leases are secured by a significant portion of the hardware used in our data centers. If we are unable to generate sufficient cash flow from our operations or cash from other sources in order to meet the payment obligations under these equipment leases, we may lose the right to possess and operate the equipment used in our data centers, which would substantially impair our ability to provide our services, which could have a material adverse effect on our liquidity or results of operations.

We may require additional capital and may not be able to secure additional financing on favorable terms to meet our future capital needs, which could adversely affect our financial position and result in stockholder dilution.

In order to fund future growth, we will be dependent on significant capital expenditures. We may need to raise additional funds through equity or debt financings in the future in order to meet our operating and capital needs. We may not be able to secure additional debt or equity financing on favorable terms, or at all, at the time when we need such funding. If we are unable to raise additional funds, we may not be able to pursue our growth strategy and our business could suffer. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new equity securities we issue could have rights, preferences, and privileges senior to those of holders of our common stock. In addition, any debt financing that we may obtain in the future could have restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions.

We are exposed to commodity and market price risks that have the potential to substantially influence our profitability and liquidity.

We are a large consumer of power. During the first six months of 2010, we expensed approximately $4.4--- million to utility companies to power our data centers. We anticipate an increase in our consumption of power in the future as our sales grow. Power costs vary by locality and are subject to substantial seasonal fluctuations and changes in energy prices. Our largest exposure to energy prices currently exists at our Grapevine, Texas facility in the Dallas−Fort Worth area, where the energy market is deregulated. Power costs have historically tracked the general costs of energy, and continued increases in electricity costs may negatively impact our gross margins or operating expenses. We periodically evaluate the advisability of entering into fixed price utilities contracts. If we choose not to enter into a fixed price contract, we expose our cost structure to this commodity price risk.

Our main credit facility is a revolving line of credit with a base rate determined by the London Interbank Offered Rate, or LIBOR. This market rate of interest is fluctuating and exposes our interest expense to risk. Our credit agreement obligates us to hedge part of that interest rate risk with appropriate instruments, such as interest rate swaps or interest rate options. On December 10, 2007, we entered into an at−the−market fixed−payer interest rate swap with a notional amount of $50.0 million at an annual rate of 4.135%. This swap essentially fixes the rate we pay on the first $50.0 million outstanding on our revolving credit facility. As we borrow more, we may enter into additional swaps to continuously control our interest rate risk. Generally, we do not hedge our complete exposure. As a result, we may be exposed to interest rate risk on the un−hedged portion of our borrowings. For example, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of June 30, 2010 we did not have exposure to interest rate risk as we only had $50.0 million outstanding on our revolving credit facility.

The majority of our customers are invoiced, and substantially all of our expenses are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. However, some of our customers are currently invoiced in currencies other than the applicable functional currency. As a result, we may incur foreign currency losses based on changes in exchange rates between the date of the invoice and the date of collection. In addition, large changes in foreign exchange rates relative to our functional currencies could increase the costs of our services to non−U.S. customers relative to local competitors, thereby causing us to lose existing or potential customers to these local competitors. Thus, our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. Further, as we grow our international operations, our exposure to foreign currency risk could become more significant. To date, we have not entered into any foreign currency hedging contracts, although we may do so in the future.

We may be accused of infringing the proprietary rights of others, which could subject us to costly and time−consuming litigation and require us to discontinue services that infringe the rights of others.

There may be intellectual property rights held by others, including issued or pending patents, trademarks, and service marks that cover significant aspects of our technologies, branding or business methods, including technologies and intellectual property we have licensed from third parties. Companies in the technology industry, and other patent and trademark holders seeking to profit from royalties in connection with grants of licenses, own large numbers of patents, copyrights, trademarks, service marks, and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. These or other parties could claim that we have misappropriated or misused intellectual property rights and any such intellectual property claim against us, regardless of merit, could be time consuming and expensive to settle or litigate and could divert the attention of our technical and management personnel. An adverse determination also could prevent us from offering our services to our customers and may require that we procure or develop substitute services that do not infringe. For any intellectual property rights claim against us or our customers, we may have to pay damages, indemnify our customers against damages or stop using technology or intellectual property found to be in violation of a third party’s rights. We may be unable to replace those technologies with technologies that have the same features or functionality and that are of equal quality and performance standards on commercially reasonable terms or at all. Licensing replacement technologies and intellectual property may significantly increase our operating expenses or may require us to restrict our business activities in one or more respects. We may also be required to develop alternative non−infringing technology and intellectual property, which could require significant effort, time, and expense.

Our use of open source software could impose limitations on our ability to provide our services and expose us to litigation, which could adversely affect our financial condition and operating results.

We utilize open source software, including Linux−based software, in providing a substantial portion of our services. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to offer our services. Additionally, the use and distribution of open source software can lead to greater risks than the use of third−party commercial software, as open source software does not come with warranties or other contractual protections regarding infringement claims or the quality of the code. From time to time parties have asserted claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes their intellectual property rights. We could be subject to suits by parties claiming infringement of intellectual property rights with respect to what we believe to be open source software. In such event, we could be required to seek licenses from third parties in order to continue using such software or offering certain of our services or to discontinue the use of such software or the sale of our affected services in the event we could not obtain such licenses, any of which could adversely affect our business, operating results and financial condition. In addition, if we combine our proprietary software with open source software in a certain manner, we could, under some of the open source licenses, be required to release the source code of our proprietary software.

We have also sponsored an open source project designed to foster the emergence of cloud computing technology standards and cloud interoperability. Our participation in the project includes the release of our previously proprietary core cloud storage code and we expect to release additional core cloud code in the future. Our sponsorship activities could subject us to additional risks of litigation including indirect infringement claims based on third party contributors because of our sponsorship of this project.

We may not be successful in protecting and enforcing our intellectual property rights, which could adversely affect our financial condition and operating results.

We rely primarily on copyright, trademark, service mark, and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. We rely on copyright laws to protect software and certain other elements of our proprietary technologies, although to date we have not registered for copyright protection. We cannot assure you that any future copyright, trademark or service mark registrations will be issued for pending or future applications or that any registered or unregistered copyrights, trademarks or service marks will be enforceable or provide adequate protection of our proprietary rights. We currently have one patent in the U.S. Our patent may be contested, circumvented, found unenforceable or invalidated.

We endeavor to enter into agreements with our employees and contractors and agreements with parties with whom we do business to limit access to and disclosure of our proprietary information. The steps we have taken, however, may not prevent unauthorized use or the reverse engineering of our technology. Moreover, others may independently develop technologies that are substantially equivalent, superior to, or otherwise competitive to the technologies we employ in our services or that infringe our intellectual property. We may be unable to prevent competitors from acquiring trademarks or service marks and other proprietary rights that are similar to, infringe upon, or diminish the value of our trademarks and service marks and our other proprietary rights. Enforcement of our intellectual property rights also depends on successful legal actions against infringers and parties who misappropriate our proprietary information and trade secrets, but these actions may not be successful, even when our rights have been infringed.

In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the U.S. Despite the measures taken by us, it may be possible for a third party to copy or otherwise obtain and use our technology and information without authorization. Policing unauthorized use of our proprietary technologies and other intellectual property and our services is difficult, and litigation could become necessary in the future to enforce our intellectual property rights. Any litigation could be time consuming and expensive to prosecute or resolve, result in substantial diversion of management attention and resources, and harm our business, financial condition, and results of operations.

We may be liable for the material that content providers distribute over our network and we may have to terminate customers that provide content that is determined to be illegal, which could adversely affect our operating results.

The law relating to the liability of private network operators for information carried on, stored on, or disseminated through their networks is still unsettled in many jurisdictions. We have been and expect to continue to be subject to legal claims relating to the content disseminated on our network, including claims under the Digital Millennium Copyright Act, other similar legislation and common law. In addition, there are other potential customer activities, such as online gambling and pornography, where we, in our role as a hosting provider, may be held liable as an aider or abettor of our customers. If we need to take costly measures to reduce our exposure to these risks, terminate customer relationships and the associated revenue or defend ourselves against such claims, our financial results could be negatively affected.

Government regulation of data networks is largely unsettled, and depending on its evolution, may adversely affect our operating results.

We are subject to varying degrees of regulation in each of the jurisdictions in which we provide services. Local laws and regulations, and their interpretation and enforcement, differ significantly among those jurisdictions. These laws can be costly to comply with, can be a significant diversion to management's time and effort, and can subject us to claims or other remedies, as well as negative publicity. Many of these laws were adopted prior to the advent of the internet and related technologies and, as a result, do not contemplate or address the unique issues that the internet and related technologies produce. Some of the laws that do reference the internet and related technologies have been and continue to be interpreted by the courts, but their applicability and scope remain largely uncertain.

In addition, future regulatory, judicial, and legislative changes may have a material adverse effect on our ability to deliver services within various jurisdictions. National regulatory frameworks that are consistent with the policies and requirements of the World Trade Organization have only recently been, or are still being, put in place in many countries. Accordingly, many countries are still in the early stages of providing for and adapting to a liberalized telecommunications market. As a result, in these markets we may encounter more protracted and difficult procedures to obtain any necessary licenses or negotiate interconnection agreements, which could negatively impact our ability to expand in these markets or increase our operating costs in these markets.

Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our products and services.

Since our products and services are web based, we store substantial amounts of data for our customers on our servers (including personal information). Any systems failure or compromise of our security that results in the release of our customers' data could (i) subject us to substantial damage claims from our customers, (ii) expose us to costly regulatory remediation and (iii) harm our reputation and brand. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand our hosting footprint.

Regulatory authorities around the world are considering a number of legislative proposals concerning data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have an adverse effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

Our ability to operate and expand our business is susceptible to risks associated with international sales and operations.

We anticipate that, for the foreseeable future, a significant portion of our revenue will continue to be derived from sources outside of the U.S. A key element of our growth strategy is to further expand our customer base internationally and successfully operate data centers in foreign markets. We have limited experience operating in foreign jurisdictions other than the U.K. and expect to continue to grow our international operations. Managing a global organization is difficult, time consuming, and expensive. Our inexperience in operating our business globally increases the risk that international expansion efforts that we may undertake will not be successful. In addition, conducting international operations subjects us to new risks that we have not generally faced. These risks include:

- Localization of our services, including translation into foreign languages and adaptation for local practices and regulatory requirements;
- Lack of familiarity with and unexpected changes in foreign regulatory requirements;
- Longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- Difficulties in managing and staffing international operations;
- Fluctuations in currency exchange rates;
- Potentially adverse tax consequences, including the complexities of transfer pricing, foreign value added tax systems, and restrictions on the repatriation of earnings;
- Dependence on certain third parties, including channel partners with whom we do not have extensive experience;
- The burdens of complying with a wide variety of foreign laws and legal standards;
- Increased financial accounting and reporting burdens and complexities;
- Political, social, and economic instability abroad, terrorist attacks and security concerns in general; and
- Reduced or varied protection for intellectual property rights in some countries.

Operating in international markets also requires significant management attention and financial resources. The investment and additional resources required to establish operations and manage growth in other countries may not produce desired levels of revenue or profitability.

We rely on our Partner Network Program members for a significant portion of our revenues, and we benefit from our association with them. The loss of these members could adversely affect our business.

Our Partner Network Program drives a significant amount of revenue to our hosting services business. Most of our member partners offer services that are complementary to our hosting services. Some of the participants in our network, however, may actually compete with us in one or more of our product or service offerings. These network partners may decide in the future to terminate their agreements with us and to use a competitor’s or their own services, which could cause our revenue to decline.

Also, we derive tangible and intangible benefits from our association with some of our network partners, particularly high profile partners that reach a large number of companies through the internet. If a substantial number of these partners terminate their relationship with us, our business could be adversely affected.

Our acquisitions may divert our management's attention, result in dilution to our stockholders and consume resources that are necessary to sustain our business.

We have made acquisitions and, if appropriate opportunities present themselves, we may make additional acquisitions or investments or enter into joint ventures or strategic alliances with other companies. Risks commonly encountered in such transactions include:

- The difficulty of assimilating the operations and personnel of the combined companies;
- The risk that we may not be able to integrate the acquired services or technologies with our current services, products, and technologies;
- The potential disruption of our ongoing business;
- The diversion of management attention from our existing business;
- The inability of management to maximize our financial and strategic position through the successful integration of the acquired businesses;
- Difficulty in maintaining controls, procedures, and policies;
- The impairment of relationships with employees, suppliers, and customers as a result of any integration;
- The loss of an acquired base of customers and accompanying revenue; and
- The assumption of leased facilities, other long−term commitments or liabilities that could have a material adverse impact on our profitability and cash flow.

As a result of these potential problems and risks, businesses that we may acquire or invest in may not produce the revenue, earnings, or business synergies that we anticipated. In addition, there can be no assurance that any potential transaction will be successfully identified and completed or that, if completed, the acquired business or investment will generate sufficient revenue to offset the associated costs or other potential harmful effects on our business.

Concerns about greenhouse gas emissions and the global climate change may result in environmental taxes, charges, assessments or penalties.

The effects of human activity on the global climate change have attracted considerable public and scientific attention, as well as the attention of the United States government. Efforts are being made to reduce greenhouse emissions, particularly those from coal combustion by power plants, some of which we may rely upon for power. The added cost of any environmental taxes, charges, assessments or penalties levied on these power plants could be passed on to us, increasing the cost to run our data centers. Additionally, environmental taxes, charges, assessments or penalties could be levied directly on us in proportion to our carbon footprint. Any enactment of laws or passage of regulations regarding greenhouse gas emissions by the United States, or any domestic or foreign jurisdiction we perform business in, could adversely affect our operations and financial results.

Terrorist activity throughout the world and military action to counter terrorism could adversely impact our operating results.

Terrorist attacks and other acts of violence, as well as governments' responses to such activities, may have an adverse effect on business, financial, and general economic conditions internationally. Terrorist activities may disrupt our ability to provide our services or may increase our costs due to the need to provide enhanced security, which would have a material adverse effect on our business and results of operations. These circumstances may also adversely affect our ability to attract and retain customers, our ability to raise capital, and the operation and maintenance of our facilities. We may not have adequate property and liability insurance to cover catastrophic events or attacks brought on by terrorist attacks and other acts of violence. In addition, we depend heavily on the physical infrastructure, particularly as it relates to power, that exists in the markets in which we operate. Any damage to such infrastructure in these markets where we operate may materially and adversely affect our operating results.

Risks Related to the Ownership of Our Common Stock

The trading price of our common stock may be volatile.

The market price of our common stock has been highly volatile and could be subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, and other factors beyond our control, such as stock market volatility and fluctuations in the valuation of companies perceived by investors to be comparable to us.

Further, the stock markets have experienced price and volume fluctuations that have affected our stock price and the market prices of equity securities of many other companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political, and market conditions, such as recessions, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock. We may experience additional volatility as a result of the limited number of our shares available for trading in the market.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008 and the price of our common stock has fluctuated substantially since then and may fluctuate substantially in the future.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008. The trading price of our common stock has fluctuated significantly since then. For example, between December 31, 2009 and June 30, 2010, the closing trading price of our common stock was very volatile, ranging between $15.51 and $23.09 per share, including single−day increases of up to 10.7% and declines up to 9.2%. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this quarterly report on Form 10−Q.

Contractual lock−up restrictions on the sale of approximately 99 million shares held by certain stockholders expired on February 3, 2009 and to the extent a stockholder is not an affiliate, its shares are now eligible for sale without restriction. Affiliate sales are subject to the volume, manner of sale and other restrictions of Rule 144 of the Securities Exchange Act of 1933 which allow the holder to sell up to the greater of 1% of our outstanding common stock or our average weekly trading volume during any three−month period. Shares beneficially held by Graham Weston, Wells Fargo and Company and certain other parties will be subject to such requirements to the extent they are deemed to be our "affiliates" as that term is defined in Rule 144. Additionally, Weston, and certain other holders possess registration rights with respect to some of the shares of our common stock that they hold. If they choose to exercise such rights, their sale of the shares that are registered would not be subject to the Rule 144 limitations. If a significant amount of the shares that become eligible for resale enter the public trading markets in a short period of time, the market price of our common stock may decline.

Additionally, certain of our large stockholders are entities that may from time to time distribute the shares of our stock held by them to their beneficial owners in order to provide them with liquidity with respect to their investment in our stock. The distributed shares may be eligible for immediate resale, in which case all or a significant portion of these shares may be sold by these beneficial owners in the public markets during a short period of time following their receipt of these shares, which may cause the market price for our stock to decline.

The issuance of additional stock in connection with acquisitions, our stock option plans, or otherwise will dilute all other stockholdings.

We have a large number of shares of common stock authorized but unissued and not reserved for issuance under our stock option plans or otherwise. We may issue all of these shares without any action or approval by our stockholders. We intend to continue to actively pursue strategic acquisitions. We may pay for such acquisitions, partly or in full, through the issuance of additional equity. In addition, our Amended and Restated 2007 Long−Term Incentive Plan contains an evergreen provision, which annually increases the number of shares issuable under the plan. Any issuance of shares in connection with our acquisitions, the exercise of stock options or otherwise would dilute the percentage ownership held by our then existing stockholders.

Your ability to influence corporate matters may be limited because a small number of stockholders beneficially own a substantial amount of our common stock.

Our directors and executive officers and their affiliates beneficially own a significant portion of our outstanding common stock. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. Although our directors and executive officers are not currently party to any agreements or understandings to act together on matters submitted for stockholder approval, this concentration of ownership could limit your ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

Anti−takeover provisions in our organizational documents and Delaware law may discourage or prevent a change of control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our restated certificate of incorporation and amended and restated bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors deemed undesirable by our board of directors that our stockholders might consider favorable. Some of these provisions:

- Authorize the issuance of blank check preferred stock which can be created and issued by our board of directors without prior stockholder approval, with voting, liquidation, dividend, and other rights senior to those of our common stock;
- Provide for a classified board of directors, with each director serving a staggered three−year term;
- Prohibit our stockholders from filling board vacancies or increasing the size of our board, calling special stockholder meetings or taking action by written consent;
- Provide for the removal of a director only with cause and by the affirmative vote of the holders of a majority of the shares then entitled to vote at an election of our directors; and
- Require advance written notice of stockholder proposals and director nominations.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our restated certificate of incorporation, amended and restated bylaws and Delaware law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by our then current board of directors, including a merger, tender offer or proxy contest involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could cause the market price of our common stock to decline.

ITEM 2 – UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Sales of Unregistered Securities

On April 15, 2010, we issued 27,080 shares of our common stock to the former owner of Jungle Disk, Inc. as partial consideration for reaching an earn−out target related to our acquisition of the Jungle Disk business on October 22, 2008. The issuance of these shares of common stock was made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933.

ITEM 3 – DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4 – RESERVED

ITEM 5 – OTHER INFORMATION

None

ITEM 6 – EXHIBITS

Exhibit Number	Description
10.1 *†	First Amendment to Lease, dated May 4, 2010, by and between Trantula Ventures LLC and Rackspace US, Inc.
10.2 *	Non−Employee Director Compensation Schedule, effective September 1, 2010
31.1 *	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a−14(a) and 15d−14(a), as adopted pursuant to Section 302 of the Sarbanes−Oxley Act of 2002
31.2 *	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a−14(a) and 15d−14(a), as adopted pursuant to Section 302 of the Sarbanes−Oxley Act of 2002
32.1 **	Certifications of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002
32.2 **	Certifications of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002

*	Filed herewith
**	Furnished herewith
†	Confidential treatment has been requested for portions of this exhibit. These portions have been omitted from this Quarterly Report on Form 10−Q and submitted separately to the Securities and Exchange Commission.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10−Q to be signed on its behalf by the undersigned, thereunto duly authorized, on May 4, 2010.
Rackspace Hosting, Inc.

Date: August 9, 2010	By: /s/ Bruce R. Knooihuizen
	Bruce R. Knooihuizen Chief Financial Officer, Senior Vice President and Treasurer (Principal Financial Officer)

CONFIDENTIAL MATERIAL HAS BEEN OMMITTED AND
FILED SEPARATELY WITH THE SECURITIES AND
EXCHANGE COMMISION. BOXES AND
ASTERISKS DENOTE SUCH OMISSION

FIRST AMENDMENT TO LEASE

THIS FIRST AMENDMENT TO LEASE (“First Amendment”) is dated as of May 4, 2010 (the “Effective Date”), by and between Tarantula Ventures LLC, a Delaware limited liability company (“Landlord”), and RackSpace US, Inc., a Delaware corporation (“Tenant”).

W I T N E S S E T H:

R−1. Landlord has constructed a data center facility known as “CH1 Phase I”, located at 2200 Busse Road, Elk Grove Village, Illinois (the “Building”). CH1 Phase I contains approximately two hundred fifty−three thousand (253,000) gross square feet, comprised in part of approximately one hundred twenty−one thousand (121,000) square feet of raised floor area, and has 18.2 megawatts of Critical Load Power. Adjoining the Building is an office building (the “Office Building”).

R−2. By that certain Lease dated July 31, 2009, by and between Landlord and Tenant (the “Original Lease”), Tenant leases five (5) computer rooms referred to as Pods 1, 5, 6, 7 and 8 in CH1 Phase I (the “Existing Pods”), as well as the Office Space (the “Existing Office Space”) and Storage Space (the “Existing Storage Space”) (all such area being hereinafter referred to as the “Premises”).

R−3. Landlord and Tenant desire to add three (3) large computer rooms, one (1) small computer room and additional storage space, with the possible addition of a fourth large computer room, in CH1 Phase I, as well as additional office space in the Office Building, to the Premises, subject to and in accordance with the terms and conditions set forth in this First Amendment; and

R−4. Landlord and Tenant desire formally to reflect their understandings and agreements whereby the aforesaid rentable area will be added to the Premises, and therefore to revise and modify the Original Lease accordingly.

NOW, THEREFORE, in consideration of the mutual covenants and agreements contained herein, and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as follows:

1. RECITALS; DEFINED TERMS. The foregoing recitals are hereby incorporated into this First Amendment by reference, as if fully set forth in this first paragraph. Capitalized terms not otherwise defined herein shall have the same meaning as set forth in the Original Lease, as amended hereby. As of the Effective Date, the term “Lease” shall mean the Original Lease, as amended by this First Amendment.

2. EXPANSION PODS.

A. Expansion Pods. Landlord hereby leases and demises to Tenant and Tenant hereby leases and accepts from Landlord, for the term and upon the conditions hereinafter provided, the space in CH1 Phase 1 designated as computer rooms 3, 11, 12 and 13 on the floor plan attached as Exhibit A hereto and made a part hereof (collectively, the "Expansion Pods" and singularly, an "Expansion Pod" or, respectively, "Pod 3," "Pod 11," "Pod 12" and "Pod 13"). The Expansion Pods, together with the Additional Office Space (as defined in Section 3 below) and the Additional Storage Space (as defined in Section 3 below), may be hereinafter referred to as the "Expansion Space." Pod 3 contains approximately two thousand seven hundred (2,700) rentable square feet of raised floor space with 433 kilowatts of available Critical Load Power and Pods 11, 12 and 13 each contain approximately eight thousand five hundred (8,500) rentable square feet of raised floor space with 1.3 megawatts of available Critical Load Power. Landlord hereby acknowledges that Pod 1 has 433 kilowatts of available Critical Load Power and Pods 5, 6, 7 and 8 each has 1.3 megawatts of available Critical Load Power. As used herein, the term "Pod Maximum Load Limit" shall mean and refer to the maximum available Critical Load Power available to an Expansion Pod or an Existing Pod, as applicable. Effective as of Expansion Pods Lease Commencement Date, the Expansion Pods shall be added to and become a part of the Premises under the Lease and may be referred to thereinafter as "Pods." The Pods comprising a portion of the original Premises [i.e., Pods 1, 5, 6, 7 and 8], together with the Expansion Pods, are hereby agreed to contain a total area of approximately sixty−four thousand nine hundred sixty−nine (64,969) rentable square feet of raised floor space and 9.966 megawatts of available Critical Load Power. Except as otherwise set forth in this First Amendment, all terms and conditions of the Original Lease applicable to the Pods shall apply with respect to the Expansion Pods and, effective as of the Expansion Pods Lease Commencement Date, all references to the Premises shall be deemed to include and refer to the Expansion Pods.

B. Expansion Pods Term.

(1) Except as otherwise set forth in this First Amendment, all of the provisions of this First Amendment shall be in full force and effect from and after the Effective Date. The "Expansion Pods Lease Commencement Date" shall be June 1, 2010. The term of the Lease with respect to the Expansion Pods (hereinafter referred to as the "Expansion Pods Lease Term") shall commence on the Expansion Pods Rent Commencement Date, as determined pursuant to Section 2.B.(2) below, and continue for a period of fifteen (15) years thereafter, unless such Expansion Pods Lease Term shall be extended, renewed or terminated earlier in accordance with the provisions hereof. Notwithstanding the foregoing, if the Expansion Pods Rent Commencement Date shall occur on a day other than the first day of a month, the Expansion Pods Lease Term shall commence on such date and continue for the balance of such month and for a period of fifteen (15) years thereafter. The term "Expansion Pods Lease Term" shall include any and all renewals and extensions thereof pursuant to and in accordance with Section 2.F. below. Notwithstanding anything to the contrary contained herein or in the Original Lease, Tenant may elect to substitute the Lease Term expiration date of any Existing Pod for the Expansion Pods Lease Term expiration date of any Expansion Pod (with an equal Pod Maximum Load Limit), provided that the aggregate Lease Term shall remain unchanged, and provided further that Tenant provides Landlord written notice of such election at least twelve (12) months prior to the expiration date of the affected Pod(s) which is soonest to occur. Tenant's notice shall identify which Pods are affected. Subject to the terms and provisions of the two (2) immediately preceding sentences, all references in the Original Lease to the Lease Term or Term shall, unless the context otherwise indicates, mean and refer to the "Lease Term" with respect to the Existing Pods, the Existing Office Space and the Existing Storage Space and to the "Expansion Pods Lease Term" with respect to the Expansion Space.

(2) The “Expansion Pods Rent Commencement Date” shall be the earlier of (i) February 1, 2011 or (ii) the date on which Tenant commences the conduct of its business upon any portion of an Expansion Pod pursuant to Section 2.C. below. Landlord warrants and covenants that, as of the Expansion Pods Lease Commencement Date, the following items shall have been completed, obtained and/or be true, as applicable, and Landlord warrants and covenants that the same will be completed, in effect and/or true, as applicable, as of the Expansion Pods Rent Commencement Date: (I) Landlord’s Work (except for the Tenant Deployment Work, which shall be completed in phases, at such times as have been agreed to between Landlord and Tenant) has been substantially completed in accordance with Section 9.1 of the Lease; [*****], more particularly described and defined in Section 2.K. below, has been substantially completed in accordance with the terms and provisions of Section 2.K. below; (III) all mechanical and electrical systems for each Expansion Pod, and all components thereof, including, without limitation, PDUs, power distribution boards, CRACs and other components of the HVAC system, UPSs, EPO kiosks, and Engine Generators, and the Security Systems and Building Management System, are in good working order; (IV) data center level 4 testing and level 5 commissioning have been completed with respect to all mechanical and electrical systems for each Expansion Pod, as certified by EYP Mission Critical Facilities, the Building engineer (“EYP”), and further supported by a final report from Hood, Patterson and Dewer, the Building commissioning agent (“HPD”); and (V) a certificate of occupancy (or local equivalent) and any other required occupancy and/or use permits have been issued by Cook County and/or any other applicable governmental authority(ies) with jurisdiction, for the Building, including the Expansion Pods. For avoidance of doubt, except as otherwise expressly provided in Section 2.C. below, the Expansion Pods Access (as hereinafter defined), any Electrical and Mechanical Systems Testing with respect to the Expansion Pods and Tenant’s performance of any Expansion Pods Installations (as hereinafter defined), shall not constitute the conduct of Tenant’s business upon any portion of any Expansion Pod. [*****].

(3) [*****]

Further, notwithstanding anything to the contrary contained herein, 4.333 megawatts of Critical Load Power will be available to the Expansion Pods as of the Expansion Pods Rent Commencement Date, and Tenant may use more than the applicable Expansion Pod Phase Load Limit, up to 4.333 megawatts, at any time during the Expansion Pods Phasing Period, subject to and in accordance with the terms and provisions of this Section 2.B.(3).

(4) Promptly after the Expansion Pods Rent Commencement Date and the commencement of each subsequent Phase are ascertained, Landlord and Tenant shall execute a written declaration setting forth, as applicable, the Expansion Pods Rent Commencement Date, the commencement date of each subsequent Phase for each Expansion Pod (subject to the provisions of Section 2.B.(3) above), and the date upon which the Expansion Pods Lease Term and the applicable Phase will expire for each Expansion Pod. The form of such declaration is attached as Exhibit C to the Original Lease. Landlord and Tenant acknowledge that the Expansion Pods Lease Term expiration date for any Expansion Pod may be changed by Tenant pursuant to and in accordance with the terms and provisions of the final two (2) sentences of Section 2.B.(1) above.

C. Expansion Pods Access. Tenant shall not enter the Expansion Pods for any reason until after November 1, 2010. From and after November 1, 2010 (the “Expansion Pods Access Date”), Landlord shall permit Tenant to enter the Expansion Pods (the “Expansion Pods Access”) in order to commence Tenant Installations in the Expansion Pods (“Expansion Pods Installations”), provided that, prior to commencing any such work in any Expansion Pod, Tenant shall comply in all respects with the requirements of Article IX of the Lease. In performing Tenant’s Expansion Pods Installations from and after Expansion Pods Access Date, up until the Expansion Pods Rent Commencement Date (the “Expansion Pods Access Period”), Tenant shall be permitted to use [*****] normal, non−Critical Load Power in any Expansion Pod, at its expense, for installation and testing. Except as otherwise expressly provided herein below, [*****], Tenant will be deemed to have commenced the conduct of its business for purposes of subpart (ii) of the first sentence of Section 2.B.(2) hereof, provided, that Landlord shall not be required to give Tenant more than one (1) such notice and opportunity to cure during the Expansion Pods Access Period. All terms and conditions of the Original Lease, as amended by this First Amendment, shall apply to Tenant’s Expansions Pod Access during the Expansion Pods Access Period, except for the payment of Base Rent, Operating Expenses and Management Fee, which will be payable in accordance with the terms of Sections 2.D. and 2.E. below. [*****]

D. Expansion Pods Base Rent.

(1) Commencing on the Expansion Pods Rent Commencement Date, Tenant shall pay to Landlord as monthly Base Rent, net of all Operating Expenses, without set off, deduction (unless otherwise expressly agreed to herein) or demand, with respect to each Expansion Pod an amount equal to [*****] on the date that such monthly Base Rent is due and payable, subject to annual adjustment pursuant to Section 2.D.(2) below. The monthly Base Rent payable hereunder shall be due and payable in advance on the first day of each month. Payment of monthly Base Rent for any fractional calendar month shall be prorated.

(2) The Expansion Pods Base Rent Rate shall be escalated on November 1, 2010 and each anniversary of such date thereafter during the Expansion Pods Lease Term by [*****].

E. Expansion Pods Additional Rent. Effective on the Expansion Pods Lease Commencement Date, Tenant’s “Pro Rata Share” shall mean fifty−four and seventy−six one hundredths percent (54.76%). Commencing on the Expansion Pods Lease Commencement Date, subject to the next sentence of this paragraph, Tenant shall pay the Management Fee and Tenant’s Pro Rata Share of all Operating Expenses for CH1 Phase I with respect to the entire Premises, including the Expansion Pods [*****]. [*****]. Notwithstanding anything to the contrary contained herein, upon the expiration or earlier termination of the Lease as to one or more but less than all of the Pods, Tenant’s Pro Rata Share shall be reduced to the ratio of Critical Load Power available to the Premises, as then constituted, compared to the Critical Load Power available to CH1 Phase I.

F. Expansion Pods Renewal. Landlord hereby grants to Tenant the rights, exercisable at Tenant's option and subject to the conditions described below, to renew the Expansion Pods Lease Term for two (2) additional, successive terms of five (5) years each (each such five−year term, if exercised, being referred to herein as an "Expansion Pods Renewal Term"). If such rights are exercised, and if the conditions applicable thereto have been satisfied, the first Expansion Pods Renewal Term shall commence immediately following the end of the Expansion Pods Lease Term and the second Expansion Pods Renewal Term shall commence immediately following the end of the first Expansion Pods Renewal Term. The rights of renewal (collectively, the "Expansion Space Renewal Rights") herein granted to Tenant shall be subject to, and shall be exercised in accordance with, the terms and conditions of Article XXV of the Lease; provided, however, that (i) references therein to Lease Term shall mean Expansion Pods Lease Term; (ii) references therein to the Premises shall mean the Expansion Space; and (iii) references therein to Renewal Term shall mean Expansion Pods Renewal Term. Moreover, the Expansion Space Renewal Rights may be exercised with respect to any or all of the Expansion Pods. In the event Tenant exercises its Expansion Space Renewal Rights with respect to less than all of the Expansion Pods, Tenant shall, as part of its Renewal Notice, designate those portions of Additional Office Space and/or Additional Storage Space that shall also be subject to Tenant's Expansion Space Renewal Rights. Notwithstanding anything contained in the Lease to the contrary, Tenant's Expansion Space Renewal Rights are in addition to Tenant's rights to renew the Lease Term with respect to the initial Premises granted pursuant to Article XXV of the Lease.

G. Tenant's Expansion Pod Work. Subject to the terms and provisions of this Section 2.G. herein below, Tenant, or an agent of Tenant, will manage the construction of, and improvements to, the Expansion Pods ("Tenant's Expansion Pods Work"). This includes the selection of contractors, architects and/or engineers, as applicable. Landlord will have reasonable approval rights of any proposed general contractor and will be allowed to review and reasonably approve all plans and specifications relative to Tenant's Expansion Pods Work. In connection with the foregoing, Tenant shall consult with, and reasonably consider suggestions by, Landlord regarding the design of the electrical distribution, perforated floor tile placement and equipment layout of the Expansion Pods in connection with Tenant's Expansion Pods Work, to optimize the performance of the Expansion Pods. [*****] At Tenant's election, Tenant may engage Landlord to perform Tenant's Expansion Pods Work, on the same terms as are provided in Section 9.1(a) of the Original Lease regarding the Tenant Deployment Work for the initial Pods (as such terms are defined in the Original Lease); provided, however, that Section 2.2(c) of the Original Lease will not be applicable to any such Tenant's Expansion Pods Work performed with respect to the Expansion Pods.

H. [*****].

I. [*****].

J. Pod 16. Another tenant ("Tenant X") in CH1 Phase I has an unexercised option ("Pod 16 Option") to lease the space in CH1 Phase I designated as computer room 16 on the floor plan attached hereto as Exhibit B and made a part hereof ("Pod 16"). Pod 16 contains approximately nine thousand nine hundred fifty−two (9,952) square feet of raised floor space with a Pod Maximum Load Limit of 1.3 megawatts of available Critical Load Power. The Pod 16 Option expires on June 1, 2010. Unless Tenant X exercises the Pod 16 Option, Pod 16 shall become a part of the Expansion Pods under this First Amendment immediately and without further action on the part of either Landlord or Tenant, on the earlier to occur of (i) the date that Landlord notifies Tenant in writing that Tenant X has elected to forego the Pod 16 Option, or (ii) June 15, 2010. In such event, all terms and conditions of this First Amendment applicable to the Expansion Pods shall apply with respect to Pod 16 and all references to the Expansion Pods shall be deemed to include Pod 16; [*****].

K. [*****]

3. ADDITIONAL STORAGE AND OFFICE SPACE. Landlord acknowledges and agrees that, in addition to the Expansion Pods, Tenant requires additional storage space in CH1 Phase I and additional office space in the Office Building. Landlord agrees (i) to work with Tenant reasonably and in good faith to determine the location and amount of additional storage space (“Additional Storage Space”) and additional office space (“Additional Office Space”) Tenant will require to support its operations in the Expansion Pods and (ii) to lease such Additional Storage Space and Additional Office Space to Tenant as hereinafter provided. Tenant will pay gross rent for the Additional Storage Space and Additional Office Space, at the rates per square foot, as escalated, that apply with respect to the Existing Storage Space and the Existing Office Space which form a part of the initial Premises. Once the location and amount of the Additional Storage Space and Additional Office Space are determined, Landlord and Tenant shall enter into an amendment to the Lease adding such Additional Storage Space and Additional Office Space to the Premises, on terms substantially similar to the terms and provisions of the Original Lease applicable to the Existing Office Space and the Existing Storage Space, including, without limitation, Sections 1.3, 1.4, 3.3 and 9.1 of the Original Lease. From and after the date on which the Lease commences with respect to the Additional Office Space and Additional Storage Space, (A) the Additional Office Space shall be added to and become part of the Office Space and the Premises under the Lease, and (B) the Additional Storage Space shall be added to and become part of the Storage Space and the Premises under the Lease.

4. [*****]

5. MODIFICATIONS TO ORIGINAL LEASE. The Original Lease shall be modified as set forth herein below.

A. The first sentence of Section 4.6 of the Original Lease is hereby amended such that the brackets surrounding the words “Washington, D.C.” are hereby deleted and the bracketed words “[Chicago Illinois]” (including the brackets), are hereby deleted.

B. The following provision is added to Section 5.6 of the Original Lease:

“[*****]”

Furthermore, the penultimate sentence of Section 5.6 of the Original Lease is hereby amended to delete the word “personal” and replace it with the word “personnel.”

C. The references in Sections 13.2(i) and 13.2(iii) and in the penultimate sentence of Section 13.2 of the Original Lease to “5.633 megawatts” shall be deleted and replaced with “9.966 megawatts,” provided, that, in the event Pod 16 is added to the Expansion Pods pursuant to and in accordance with Section 2.J above, such references shall be replaced with “11.266 megawatts.”

D. Section 13.5 of the Original Lease is hereby amended as follows:

(i) The penultimate grammatical sentence of Section 13.5 of the Original Lease is hereby deleted in its entirety.

(ii) The following provision is added to the end of Section 13.5 of the Original Lease:

“[*****]”

E. The second sentence of Section 13.9 of the Original Lease is hereby deleted in its entirety and replaced with the following:

"[*****]"

F. Section 13.10 of the Original Lease is hereby deleted in its entirety and replaced with the following:

"13.10 Landlord is developing, and will install and implement, on or before February 1, 2011, a "dashboard" type web−based monitoring system for the tenants' use (the "Dashboard Monitoring System") that is integrated with the Building Monitoring System (or BMS) and permits Tenant to monitor and observe (i) the environmental conditions [i.e., temperature, humidity and underfloor pressure] (the "Environmental Conditions") within each Pod [Existing and Expansion Pods] and (ii) the parameters and status of the CRAC units within each Pod [Existing and Expansion Pods] and (iii) the load parameters (current, KVA & kW) for those portions of the Building electrical distribution systems (PDUs and UPS output distribution boards) directly supporting each Pod [Existing Pods and Expansion Pods], ((i) – (iii) collectively, the "Pod Mechanical and Electrical Systems"). Once developed and installed, Landlord and Tenant will enter into a license agreement reasonably acceptable to each party, under the terms of which license agreement, and pursuant to the terms and provisions of this Lease, Tenant will have non−exclusive access to, and use of, at no additional charge to Tenant, the Dashboard Monitoring System in order to monitor and observe the Environmental Conditions and the Pod Mechanical and Electrical Systems. [*****]"

G. Section 18.6 of the Original Lease is hereby amended such that the late charge is changed from two percent (2%) of the amount of the payment of Base Rent to a flat fee of $10,000.

H. The fifth (5th) sentence of Section 26.1(c) of the Original Lease is hereby deleted and replaced with the following:

"If the operation of the antenna shall require electrical power, Landlord will install, at Tenant's reasonable cost (payable as Additional Rent upon receipt of an invoice from Landlord), a twenty (20) amp, one hundred twenty (120) volt circuit with an unprotected (non−UPS) utility outlet (the "Antennae Power Source"), to power the antenna. Tenant shall pay Landlord, as Additional Rent hereunder, [*****] for the use of power from the Antennae Power Source."

I. The reference in Section 23.1 of the Original Lease to "[*****]" shall be deleted and replaced with "[*****]."

J. The references in Article XXIX to the "Premises" shall be deleted and replaced with the "Existing Pods, Existing Office Space and Existing Storage Space."

K. The following provisions are added as subsections (c), (d) and (e) to Section B.iii. of the Services Exhibit attached as Exhibit F to the Original Lease:

"(c) Preventative Maintenance Program

[*****]. In connection with the foregoing, promptly after establishment thereof, Landlord shall provide Tenant with access to documentation reasonably acceptable to Tenant setting forth the parameters and specifications of the Preventative Maintenance Program, in order for Tenant to review such documentation.

(d) Building Maintenance and Testing Information

As part of Landlord's Maintenance and Repair Obligations, Landlord shall maintain such records, documentation and other information regarding Landlord's maintenance, repairs and testing of the Building Structure and Systems [including, by way of example and not limitation, records regarding Landlord's preventative and routine maintenance on the Building mechanical and electrical systems] as is consistent with industry standards for first class data centers (the "Building Maintenance and Testing Information"). [*****].

(3) Training Programs

[*****].

L. The following shall be added as Section F of Exhibit F to the Original Lease:

"[*****]"

M. The following is added as Section C.iv. of the Services Exhibit attached as Exhibit F to the Original Lease:

"[*****]"

6. BROKER AND AGENT.

Landlord and Tenant each represents and warrants to the other that neither of them has employed or dealt with any broker, agent or finder in carrying on the negotiations relating to this First Amendment. Each party shall indemnify and hold the other harmless from and against any claim or claims for brokerage or other commissions asserted by any broker, agent or finder engaged by the indemnifying party or with whom the indemnifying party has dealt in connection with this First Amendment.

7. OTHER TERMS AND PROVISIONS.

A. Landlord Representation. As of the Effective Date, Landlord represents that there is no mortgage or deed of trust encumbering the Property.

B. Ratification. Except as otherwise expressly modified by the terms of this First Amendment, the Original Lease shall remain unchanged and continue in full force and effect. All terms, covenants and conditions of the Original Lease not expressly modified herein are hereby confirmed and ratified and remain in full force and effect, and, as further amended hereby, constitute valid and binding obligations of Landlord and Tenant enforceable according to the terms thereof. If any provision of this First Amendment conflicts with the Original Lease, the provisions of this First Amendment shall control.

C. Binding Effect. All of the covenants contained in this First Amendment, including, but not limited to, all covenants of the Original Lease as modified hereby, shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, legal representatives and permitted successors and assigns.

D. Effectiveness. The submission of this First Amendment shall not constitute an offer, and this First Amendment shall not be effective and binding unless and until fully executed and delivered by each of the parties hereto.

E. Counterparts. This First Amendment may be executed in multiple counterparts, each of which shall be an original, but all of which shall constitute one and the same First Amendment. Additionally, the parties hereto hereby covenant and agree that, for purposes of facilitating the execution of this First Amendment, (i) a facsimile signature shall be deemed to be an original signature and (ii) a telecopy delivery or electronic delivery (i.e., the transmission by any part of his, her or its signature on an original or any copy of this First Amendment via telecopy, fax machine or e−mail) shall be deemed to be the delivery by such party of his, her or its original signature hereon.

F. Entire Agreement. The terms and provisions set forth in this First Amendment constitute the entire agreement and understanding between Landlord and Tenant with respect to the specific subject matter addressed herein, and are hereby deemed to supersede all prior agreements and understandings (including, without limitation, those expressed originally in the Original Lease, to the extent inconsistent with the terms and provisions of this First Amendment, and any prior oral or written communications between Landlord and Tenant, or their respective agents or representatives) concerning the specific subject matter hereof. No subsequent modification or amendment of the terms and provisions of this First Amendment shall be effective unless in writing and signed by Landlord and Tenant.

G. Authority. By its execution and delivery hereof, Landlord does hereby certify and confirm to Tenant that the undersigned party executing this First Amendment as Landlord is, in fact, presently the "Landlord" under the Lease, that the person(s) or party(ies) executing this First Amendment on behalf of Landlord has/have done so with all requisite due authority, with the effect that this First Amendment, as so executed, constitutes the valid and binding agreement of Landlord, enforceable against Landlord in accordance with the terms and provisions hereof, and that this First Amendment has been duly executed and delivered by Landlord without the necessity of the joinder of any third party. By its execution and delivery hereof, Tenant does hereby certify and confirm to Landlord that the person(s) or party(ies) executing this First Amendment on behalf of Tenant has/have done so with all requisite due authority, with the effect that this First Amendment, as so executed, constitutes the valid and binding agreement of Tenant, enforceable against Tenant in accordance with the terms and provisions hereof, and that this First Amendment has been duly executed and delivered by Tenant without the necessity of the joinder or consent of any third party.

H. Construction. Descriptive headings used herein are for convenience of reference only and shall not control or affect the meaning or construction of any provision set forth in this First Amendment. Where required for proper interpretation, words used herein in the singular tense shall include the plural, and vice versa; the masculine gender shall include the neuter and the feminine, and vice versa. As used in this First Amendment, the words "hereof," "herein," "hereunder" and words of similar import shall mean and refer to this entire First Amendment and not to any particular section or paragraph of this First Amendment, unless the context clearly indicates otherwise. If any provision hereof is for any reason unenforceable or inapplicable, the other provisions hereof will remain in full force and effect in the same manner as if such unenforceable or inapplicable provision had never been contained herein. This First Amendment shall be construed without presumption of any rule requiring construction to be made against the party causing same to be drafted. This First Amendment shall be construed and interpreted pursuant to the laws of the State of Illinois.

I. Guarantor. The Guarantor has joined in this First Amendment for purposes of consenting to the terms and conditions of this First Amendment and confirming that the Guaranty dated July 31, 2009 is in full force and effect and is fully enforceable with respect to the Original Lease, as amended by this First Amendment.

[Signature Page Below]

IN WITNESS WHEREOF, Landlord and Tenant have executed this First Amendment on or as of the day and year first above written.

LANDLORD:

TARANTULA VENTURES LLC,
a Delaware limited liability company

By: Tarantula Interests LLC,
a Delaware limited liability company
its Managing Member

By: DuPont Fabros Technology, L.P.,
a Maryland limited partnership,
its Managing Member

By: DuPont Fabros Technology, Inc.,
a Maryland corporation,
its General Partner

By: /s/ Hossein Fateh
Name: Hossein Fateh
Title: President & CEO

TENANT:

RACKSPACE US, INC.,
a Delaware corporation

By: /s/ Alan Schoenbaum
Name: Alan Schoenbaum
Title: Sr. Vice President & General Counsel

GUARANTOR:

RACKSPACE HOSTING, INC.,
a Delaware corporation

By: /s/ Alan Schoenbaum
Name: Alan Schoenbaum
Title: Sr. Vice President & General Counsel

EXHIBIT A

Floor Plan (Pods 3, 11, 12 and 13)

****

EXHIBIT B

Floor Plan (Pod 16)

****

RACKSPACE HOSTING, INC.
NON−EMPLOYEE DIRECTOR COMPENSATION SCHEDULE
(EFFECTIVE SEPTEMBER 1, 2010 AND APPROVED AUGUST 3, 2010)

1. Compensation for Non−Employee Directors. Each Rackspace Hosting, Inc. (the "Company") Non−Employee Director shall be entitled to receive the following compensation for service on the Board:

   Annual Common Stock Compensation to all Non−Employee Directors:

   (a) $100,000 to be paid in shares of restricted Common Stock annually for standing Non−Employee Directors; plus

   Annual Compensation to all Non−Employee Directors:

   (b) $50,000 annually; plus

   Annual Compensation to Lead Director:

   (c) $25,000 annually to the lead director (as may be designated by the Company Non−Employee Directors); plus

   Annual Compensation to Committee Chairpersons:

   (d) $20,000 annually if such Company Non−Employee Director serves as chairperson of the audit committee, compensation committee or service and strategy committee; plus

   (e) $10,000 annually for each standing Board committee, other than the audit committee, compensation committee or service and strategy committee, for which such Company Non−Employee Director serves as chairperson; plus

   Annual Compensation to Committee Members (Non−Chairpersons):

   (f) $10,000 annually for each standing Board committee for which such Company Non−Employee Director serves as a member of the audit committee, compensation committee or the service and strategy committee (other than the chairperson of such committee); plus

   (g) $5,000 annually for each standing Board committee for which such Company Non−Employee Director serves other than the audit committee, compensation committee or service and strategy committee (other than the chairperson of such committee).

   In addition, the Board may issue additional discretionary restricted common stock compensation to Company Non−Employee Directors in an amount not to exceed $200,000 per Non−Employee Director per year.

2. Subsidiary Directors. If the Board designates by resolution that directors of any Subsidiary are to participate in the Plan, then each such Subsidiary Non−Employee Director shall receive such amount of shares of Common Stock and/or cash as shall be specified by resolution of the Compensation Committee.

3. Chairman's Right to Reduce or Withhold Compensation. Notwithstanding anything contained herein to the contrary, the amount of cash or shares of Common Stock payable to any Non−Employee Director may be reduced or withheld by the Chairperson of the Board for failure to attend meetings of the Board, or the Boards of Directors of any Subsidiary upon which such Non−Employee Director serves, or for failure to otherwise perform the duties of such Non−Employee Director's office.

4. Compensation Committee's Right to Revise Compensation Terms. Notwithstanding anything contained herein to the contrary, the Compensation Committee may, in its discretion, cause the number of shares and/or amount of cash determined pursuant to Section 1 above, to be issued and paid at such time or times as it shall determine in its discretion.

5. Effective Date. This Compensation Schedule shall be effective as of September 1, 2010.

6. Common Stock Compensation.

    (a) Annual Common Stock Compensation Pursuant to Section 1(a). Common Stock paid pursuant to Section 1(a) shall be paid in the form of Common Stock only, payable as of the last day of each calendar quarter for services relating to that quarter and shall be delivered to the Non−Employee Director promptly thereafter. The shares of Common Stock to be issued pursuant to Section 1(a) shall be valued at the fair market value of the Common Stock as of the date the Common Stock becomes payable. For example, on December 31, 2010, each Non−Employee Director shall be entitled to receive shares of Common Stock valued at $25,000.00 (one−fourth of the annual compensation amount under Section 1(a)) and the number of shares of Common Stock payable would be derived by dividing the $25,000.00 by the fair market value of a share of Common Stock as of December 31, 2010. Therefore, if the fair market value of the Common Stock on December 31, 2010 was $25.00 per share, then 1,000 shares would be payable to each Non−Employee Director.

    (b) Right to Designate Certain Compensation Under Sections 1(b) – (g). All compensation paid under Section 1(b) – 1(g) shall be paid in cash, unless the Non−Employee Director has previously provided (under the Non−Employee Director Compensation Schedule in effect prior to this Schedule) the Company (through written notice to the General Counsel's office) with a one−time irrevocable election to receive Common Stock in lieu of the Non−Employee Director's cash compensation to be paid under Section 1(b) – 1(g). The one−time election shall be effective through the end of the director's term on the Board, cannot be changed during the term and must be made again for any subsequent terms (as described below). If a Non−Employee Director failed to make such election to receive Common Stock, the compensation paid under Section 1(b) – 1(g) shall be paid in cash.

    (c) Right to Designate Certain Compensation as a New Non−Employee Director. In the event that an individual becomes a Non−Employee Director and becomes entitled to compensation hereunder after the Effective Date, then the new Non−Employee Director may make a one−time irrevocable election to receive Common Stock in lieu of the Non−Employee Director's cash compensation to be paid under Section 1(b) – 1(g) on or before the fifteenth (15^{th}) day after he or she becomes a Non−Employee Director or is re−elected to the Board (the "Initial Election Period"), which shall be effective through the end of the director's term on the Board; provided, however, that an election to receive Common Stock may not be made (1) when the Company's directors are subject to a "blackout period" or (2) the electing director has possession of material, non−public information about the Company. In the event that a blackout period falls within the Initial Election Period or the electing director has possession of material, non−public information about the Company, then the Non−Employee Director shall be entitled to make the election to receive compensation paid under Sections 1(b) – (g) in the form of Common Stock pursuant to Sections 1(b) – (g) on or before the fifteenth (15^{th}) day after any applicable blackout ends and/or the director is not in possession of material, non−public information (the "Additional Election Period"). However, in the event that the Additional Election Period is required, all compensation earned up to the first day of the month following the election shall be payable in cash.

    (d) Right to Designate Certain Compensation Upon Re−Election to the Board. An election to receive Common Stock for compensation paid under Sections 1(b) – (g) is only effective through the end of the term in which the election is made by the Non−Employee Director. If a Non−Employee Director is re−elected to the Board for an additional term, then the election to receive the compensation in the form of Common Stock must be made again for the new term. The process for making the election shall be the same as if the re−elected Non−Employee Director were a new Non−Employee Director under Section 6(c) of this Schedule.

    (e) Common Stock Designation. In the event the Non−Employee Director elects to receive the compensation paid under Sections 1(b) – (g) to be in the form of Common Stock, such Common Stock compensation shall be earned by the Non−Employee Director on a monthly basis on the last day of each calendar month, but shall be issued to the Non−Employee Director on a quarterly basis promptly after the applicable quarter in which the Common Stock was earned. Shares of Common Stock will be valued at the fair market value of the Common Stock on the last day of the quarter in which the shares were earned.

    (f) Fractional Shares. To the extent that the payments made pursuant to Section 1 to a Non−Employee Director result in fractional shares of Common Stock being issuable to such Non−Employee Director, the number of shares will be rounded to the nearest whole share.

    (g) Full Value Award. Common Stock issued hereunder shall be issued as a Full Value Award under the Company's 2007 Long Term Incentive Plan.

7. Cash Compensation. In the event the Non−Employee Director is to receive compensation under Sections 1(b) – (g) to be in the form of cash, the cash compensation shall be earned on a monthly basis on the last day of each calendar month and shall be paid promptly after the applicable calendar month in which such compensation was earned.

Exhibit 31.1

CERTIFICATION PURSUANT TO RULE 13a−14(a) OR 15d−14(a) OF THE SECURITIES EXCHANGE
ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF
THE SARBANES−OXLEY ACT OF 2002

I, A. Lanham Napier, certify that:

1. I have reviewed this quarterly report on Form 10−Q of Rackspace Hosting, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a−15(e) and 15d−15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a−15(f) and 15d−15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2010

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer, President and Director
(Principal Executive Officer)

Exhibit 31.2

CERTIFICATION PURSUANT TO RULE 13a−14(a) OR 15d−14(a) OF THE SECURITIES EXCHANGE
ACT OF 1934, AS ADOPTED PURSUANT TO SECTION 302 OF
THE SARBANES−OXLEY ACT OF 2002

I, Bruce R. Knooihuizen, certify that:

1. I have reviewed this quarterly report on Form 10−Q of Rackspace Hosting, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a−15(e) and 15d−15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a−15(f) and 15d−15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 9, 2010

By: /s/ Bruce R. Knooihuizen
Bruce R. Knooihuizen
Chief Financial Officer, Senior Vice President and Treasurer
(Principal Financial Officer)

Exhibit 32.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES−OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10−Q of Rackspace Hosting, Inc. for the quarterly period ended June 30, 2010 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), A. Lanham Napier, as Principal Executive Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: August 9, 2010

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer, President and Director
(Principal Executive Officer)

Exhibit 32.2

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES−OXLEY ACT OF 2002

In connection with the Quarterly Report on Form 10−Q of Rackspace Hosting, Inc. for the quarterly period ended June 30, 2010 as filed with the Securities and Exchange Commission on the date hereof (the “Report”), Bruce R. Knooihuizen , as Principal Financial Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes−Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: August 9, 2010

By: /s/ Bruce R. Knooihuizen
Bruce R. Knooihuizen
Chief Financial Officer, Senior Vice President and Treasurer
(Principal Financial Officer)