FINAL TRANSCRIPT

Thomson StreetEvents℠

RAX - Q2 2010 Rackspace Hosting, Inc. Earnings Conference Call

Event Date/Time: Aug. 09. 2010 / 8:30PM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Bryan McGrath
Rackspace Hosting, Inc. - Director of Finance

Lanham Napier
Rackspace Hosting, Inc. - President & CEO

Bruce Knooihuizen
Rackspace Hosting, Inc. - SVP, CFO, Treasurer

CONFERENCE CALL PARTICIPANTS

Sri Anantha
Oppenheimer - Analyst

James Breen
William Blair & Co. - Analyst

Simon Flannery
Morgan Stanley - Analyst

Chris Larsen
Piper Jaffray - Analyst

Gray Powell
Wells Fargo Securities - Analyst

Jonathan Atkin
RBC Capital Markets - Analyst

Jason Armstrong
Goldman Sachs - Analyst

Jonathan Schildkraut
Jefferies & Company - Analyst

Brian Thackray
Deutsche Bank - Analyst

Alex Kurtz
Merriman & Company - Analyst

Colby Synesael
Cowen and Company - Analyst

Mitesh Dhruv
Banc of America - Analyst

Frank Louthan
Raymond James - Analyst

Erik Suppiger
Signal Hill Group LLC - Analyst

PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to Rackspace Hosting's second-quarter earnings conference call. As a reminder, this call is being recorded. At this time all lines are in a listen-only mode to prevent background noise. After the prepared remarks, there will question-and-answer session. (Operator instructions). It is now my pleasure to introduce Bryan McGrath, Director of Finance for Rackspace. Please go ahead, sir.

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

Good afternoon; thank you for joining Rackspace's second quarter 2010 earnings conference call. I'm here today with Lanham Napier, our CEO; and Bruce Knooihuizen, our CFO. We issued a press release after close of market today with our unaudited financial results for the second quarter of 2010. If you do not have a copy, please visit the investor section of our website at Rackspace.com, where this call is also being webcast.

The primary purpose of today's call is to discuss the second quarter 2010 results. However, some of our comments today are forward-looking statements that involve risks, uncertainties and assumptions. If the risks and uncertainties materialize or assumptions prove incorrect, our results could differ materially from the expressed or implied by the forward-looking statements and assumptions. All statements other than historical facts are statements that could be deemed forward-looking statements. These risks, uncertainties and assumptions are described in our Form 10-K for the year ended December 31, 2009, which was filed with the SEC on February 26, 2010, and our second-quarter Form 10-Q that will be filed today. These forward-looking statements speak as of today. Except as required by law, we assume no obligation to update these forward-looking statements publicly, even if new information becomes available in the future.

During today's discussion we will be using GAAP as well as non-GAAP financial measures, such as adjusted EBITDA. Our GAAP results and GAAP to non-GAAP reconciliations can be found in the earnings release we issued earlier today, which is posted on our website, as mentioned previously. Following our prepared remarks today we will open the call up for your questions. And now, with the Safe Harbor completed, let's get started. Lanham?

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

Good afternoon and thank you for joining us today to review our second-quarter results. We have a lot of exciting news to share with you, so let's get started by highlighting three key points to take away from our call today.

One, we're delivering on the roadmap that we shared with you at the beginning of the year to achieve our financial goals for 2010. Two, cloud computing represents a massive opportunity for us, and we are more confident in our competitive position in the market today than we ever have been in the history of our Company. Three, our business as a whole is becoming more capital efficient, and we expect this trend to continue, resulting in an improved free cash flow profile for the Company.

At the beginning of the year we shared with you our 2010 roadmap with specific financial goals. First, we said that we wanted to grow faster in 2010 compared to 2009 and that we expected that most of the acceleration would be back-end loaded. Second, we said that we expected margins to be higher in 2010 and that we are committed to maintaining our current margin profile while we continue investing in new projects that promote revenue growth or improve the efficiency of the business. Third, we said that we expect to be free cash flow positive unless growth rates exceed 35% for the full year.

Looking at our performance in the first two quarters of the year, it is clear that we're delivering on our financial plan. Our subscription revenue model gives us lots of stability, and we are optimistic that we will continue to delivering on our goals in the back half of the year. While we are pleased with our financial performance in Q2, we are not satisfied with our current annualized growth rate and we are making a concentrated effort to accelerate our growth rate in the back half of the year.

Looking across the industry as a whole, we believe there is very little debate that cloud computing represents a multi-year, multi-billion dollar market opportunity. However, sorting out the differences between all the companies can be difficult. The sheer volume of advertising and media coverage of cloud computing can make the markets seem confusing, but we see it very clearly. We view the marketplace as one where the competitors can be sorted along the continuum. At one extreme is a do-it-yourself approach where businesses undertake almost all IT operations themselves. At the other extreme, businesses completely outsource their IT operations.

In our view, colocation companies such as Equinix are an example of a do-it-yourself approach. These companies are in the business of providing data center space and interconnectivity, but other aspects of running IT operations are primarily the responsibility of the customer. Amazon Web Services is primarily in the do-it-yourself camp. Amazon provides access to compute cycles and storage resources, but the customer is responsible for the other tasks necessary to deploy and maintain the systems that use those resources. Microsoft is also in the do-it-yourself segment. While it provides development and deployment platforms, Microsoft is not in the business of providing support for the applications running on these platforms.

On the opposite end of the continuum would be traditional large outsourcers like IBM, CSC or EDS. These companies will take IT systems and charge customers to run it for them. However, this lack of specialization can prevent them from deriving most of the economic benefits of scale, which would then prevent them from being able to pass on savings to customers. This also can limit their ability to provide the same level of speed, flexibility and expertise that a specialist provider like Rackspace can deliver.

All of these companies provide valuable solutions for their customers, but they are focused on different segments of the market than the one Rackspace serves. Rackspace competes in the area that is not addressed by vendors in these two extremes. We are a specialized service provider that is purpose built to run hosted applications. We bring a portfolio approach to tailor the right service level for our customers' applications. Our specialization and portfolio approach is compelling because it enables us to, number one, run IT systems for our customers at high levels of uptime; number two, rapidly deploy new system; and, number three, provide a great total cost of ownership for our customers.

From the perspective of an investor, specialization enables us to provide superior, cost-effective services. Superior service produces engaged, loyal customers. Loyal customers stay with us, grow with us and ultimately help us deliver higher returns for shareholders. This is a self-reinforcing cycle that is very difficult to create and cannot be easily replicated. The best way to gauge how we are executing on this strategy is to look at our customers. During the second quarter we added more than 8500 new customers, bringing our installed base to 108,000 and counting. We are very proud of achieving this 100,000 customer milestone, and we believe our potential market contains millions of customers on a global basis.

Not only is the size of our installed base growing, the quality of our customer base continues to improve as well. During Q2 we were pleased to be selected by one of the most innovative technology companies to emerge in the last decade, SaaS pioneer salesforce.com. Salesforce.com chose Rackspace to host two different applications because of our ability to deploy quickly and our reputation of providing exceptional service. In addition to salesforce.com, Vodafone in the UK renewed with Rackspace for an additional five-year contractor host its industry-leading mobile phone financial services application, M-PESA. M-PESA is now the most popular money transfer and payment system in Kenya, revolutionizing the way its users can send and receive money. Stability of the hosted system is critical, as loss of data or delays in financial transactions are massively disruptive to the users who have come to rely on the system. Rackspace's ability to deliver Fanatical Support, security, massive scalability and true disaster recovery were key factors in winning the partnership with Vodafone.

The Ivy League institution Columbia University also chose Rackspace to be its hosting partner because of our ability to deploy service quickly and also for the commitment we exhibit to our customers. Beyond customer examples, our operating results contain proof points that our strategy is working. While Bruce will go into more detail during his section, let me just say now that we are proud to report that churn stayed at very low levels in Q2, and our revenue per server increased for the fourth quarter in a row. These metrics demonstrate that customers value their relationship with us and that we are delivering higher levels of service to them. From a product development standpoint we have made significant progress in expanding our services portfolio during the quarter, which further differentiates us from competitors and enables us to capture more of the market share.

During the quarter we made an exciting and bold strategic move for Rackspace. In collaboration with NASA we announced that we will transform the technology behind our Cloud Servers and Cloud Files products into an open source project called OpenStack.

The project will merge some of our core cloud code with the technology that powers the NASA Nebula Cloud Platform. In addition to NASA, supporters and collaborators in OpenStack include Citrix, Dell, Intel, AMD and more than 20 other industry leaders.

The strategic rationale behind our decision to open source our cloud technology is straightforward. Number one, accelerate adoption of cloud computing by providing an open, standardized cloud technology platform; number two, minimize our competitors' ability to compete on technology; and number three, maximize our ability to compete on service. CIOs want to be free to adopt cloud computing without the vendor lock-in associated with proprietary software on cloud offerings. OpenStack provides standardized cloud technology that will allow businesses to choose freely among service providers to run the same basic software. If the cloud platform becomes standardized and Rackspace is one of the companies that leads the development and excels at deploying and supporting the technology, then we have an advantage in winning a disproportionate share of new deployments.

OpenStack also creates new opportunities for us. If we create technological parity we can extend our fanatical support service experience, pushing it further up into the stack and out into more locations. We can offer support packages wherever OpenStack is running and at any level the customer chooses. From the perspective of an investor, this means new revenue opportunities, capital efficiency gains and enhanced competitive differentiation. We are very excited about OpenStack. Expect to hear a lot more from us on this initiative.

Earlier this year we launched a beta version of Cloud Servers for Windows. After a successful program involving over 2200 customers, we are pleased to announce that Cloud Servers for Windows will be generally available starting tomorrow. We are nearing completion of many new service offerings in addition to OpenStack and Cloud Servers for Windows, including a higher managed service level in our public cloud, extending our public cloud to the UK, the next generation of private cloud and, of course, hybrid hosting.

We expect all these new offerings to be made generally available before the end of the year, which should help us accelerate revenue growth and enter 2011 with strong momentum.

The final Q2 theme that I would like to discuss is the overall capital efficiency of the business. We are striving to be less asset-intensive by dis-aggregating the infrastructure and platform layers of our business from the value-added service-intensive layer that we specialize in. Service is where we differentiate and it's where we make our margins. While we have always endeavor to become more efficient, we seem to have hit an inflection point in Q2. The best indicator of this improvement was our record free cash flow. Bruce will go into more detail about the different drivers of this improvement and the implications to our finances. But in short, we believe our model will continue to improve.

Before turning the floor over to Bruce, I would like to thank our customers for trusting us to run their most critical IT systems. Rackers are a special group of people who give 110% for their customers, and they deserve recognition. Thanks to all of our Rackers for their commitment and tireless work.

With that, I'll turn it over to Bruce to review our detailed financial results. After Bruce finishes, we will take your questions. Bruce?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Thank you, Lanham. During the previous two earnings calls, we communicated our belief that we will grow faster in 2010 than we did in 2009. Our goal of faster growth is subject to the economy staying on track. But regardless of the economic conditions, we think we will generate market-leading growth compared to the industry and our competitors.

The first two quarters of the year completed, we feel optimistic that we will deliver on these goals. We also said that we expected the growth to be weighted more toward the back half of the year, in part because of our release schedule for new products. As we look out toward the last two quarters of the year, we continue to believe that our goals are achievable.

Beginning with revenue and growth, our total net revenue for the second quarter was $187 million, up 4.8% sequentially from the first quarter and 23.2% year-over-year from the second quarter of 2009. Shifts in currency exchange rates quarter over quarter had a negative impact on net revenue of $2 million. Adjusting for this and a $1.3 million one-time service credit issued in the fourth quarter of 2009, sequential revenue growth was once again 5.9% for the second quarter in a row. The last time we saw this level of growth was in the fourth quarter of 2008.

Shifts in currency exchange rates year-over-year had a positive impact on net revenue of $1.7 million. On a constant currency basis year-over-year revenue growth was 22.1% in the second quarter of 2010.

Cloud revenue for the second quarter was $23.2 million, representing 20.5% sequential growth and a 77.9% growth on a year-over-year basis. We are continuing to work on our managed Cloud Service and in making our public cloud available in the UK. We expect these offerings to be released before the end of the year.

Revenue growth for both our managed and cloud products was driven by a number of factors, including continued progress of our Enterprise group, improved traction from our channel program and increased activity within our installed base. Our Enterprise group, which was launched in April of 2009, continues to deliver positive results. Enterprise generated a record amount of new sales in June and had significant new customer wins, including salesforce.com and a large sale to one of the world's largest consumer packaged goods companies. The Enterprise group continues to be the fastest-growing segment within managed hosting, and we are optimistic that Enterprise sales will accelerate even further when we introduce the next generation of our Enterprise cloud and hybrid offerings later in the year.

Our Channel business is becoming a larger source of revenue growth. Since reinvigorating our channel partner program at the end of 2009, channel sales have grown to represent a significant portion of new customer wins. This was accomplished by attracting a greater number and higher caliber of channel partners. With our proven track record of supporting enterprises, Rackspace is proud to announce two new channel relationships that were secured in the second quarter, Ingram Micro and XO Communications. The Ingram Micro partnership will bring Rackspace's managed hosting and cloud computing offerings to Ingram Micro's growing base of North American channel partners. XO Communications replaced all of its internal hosted IT offerings with Rackspace products and services, making Rackspace the primary provider of cloud computing and other hosted services for XO's midmarket and Enterprise customers. We will jointly go to market through XO Communications' 400-person sales force.

We are pleased to report that both Ingram Micro and XO Communications have already generated new business for Rackspace since the partnerships were announced.

Installed base growth for Q2 was 0.5%, better than the 0.2% we reported in the first quarter and the highest since the third quarter of 2008. Churn in the second quarter was 0.9%, which was in line with Q1 and well within that healthy range. As a reminder, our monthly churn averaged 0.9% for 2006 and 2007, when the economy was strong. As the economic environment weakened in the back half of 2008, churn increased, averaging 1.2% for the year. As the economy began to recover in 2009, churn leveled out at 1.0% for the year.

Although the current economic environment is still much weaker than 2006 and 2007 and our competitors now include very large companies such as Amazon, IBM and Microsoft, we are very pleased that churn has remained at 0.9% for the first two quarters of 2010. Our customers stay with us only if we continue to provide superior service and deliver value. We believe that churn is one of the best measures of the value we deliver to our customers relative to the alternatives in the market. We view our low levels of churn as proof that our competitive advantage is real and that our strategy is working.

Net upgrades for the second quarter were 1.4%, up from 1.1% in the first quarter, rising to the highest level since the fourth quarter of 2008. As we have said in the past, net upgrades are a key part of our installed base growth, and we are encouraged to see this metric improve in the quarter.

As Lanham mentioned earlier, revenue from our cloud products is becoming a larger mix of our business. One of the side effects of this evolution is that our installed base growth metric tends to lose accuracy as a measurement of the different drivers of revenue growth. This occurs because the way we currently calculate installed base growth does not capture the upgrades, downgrades and churn activity associated with Cloud Files, Cloud Servers and a portion of our private cloud products.

With cloud sales above 10% of revenue and growing, we have decided that, beginning in Q3, we will amend the way we calculate installed base growth to include the upgrades, downgrades and churn from customers of our Cloud Files, Cloud Servers and private cloud products. Using the amended methodology for Q2, the net installed base growth would have been 0.6%, which compares to the 0.5% figure that we reported. In the past, this new methodology would not have produced a difference in our installed base figure of more than 0.1% because cloud is just now becoming large enough to materially impact this metric. Nonetheless, we will provide a historic reconciliation of the two different methods when we report our Q3 results.

Shifting to profitability and the cost side of the business, adjusted EBITDA for the second quarter grew to $62 million, a sequential increase of approximately 5% and year-over-year increase of 29%. Adjusting only for non-cash stock-based compensation, adjusted EBITDA margin was once again 33.2%, consistent with our margins in Q1 and the profitability goals we mentioned during last quarter's earnings call. Our adjusted EBITDA margin was negatively impacted by GAAP accounting rules. As you may recall from prior periods, lease accounting rules under GAAP require us to straight-line the full amount of rent expense for data centers even though we structure the cash payments to match our expected demand. Because of GAAP requirements we recognized $1.3 million of non-cash rent expense in the second quarter.

Excluding the non-cash rent expense, adjusted EBITDA margins would have been 33.9% in Q2. We continue to expect approximately $6 million to $8 million of non-cash rent expense for all of 2010.

Other than the non-cash rent expense, on a net basis one-time items did not materially help or hurt adjusted EBITDA margins in the quarter. Return on capital for the second quarter was 10.9% annualized, up from 10.6% in the first quarter. Net income for the quarter was $11.2 million, up 60% from Q2 2009 and 14% from the first quarter. Both return on capital and net income would have been higher in the quarter, excluding the non-cash rent expense that we are required to record under GAAP accounting rules.

In addition you will notice that other income for the quarter was positively impacted by a foreign currency remeasurement gain of approximately $800,000. However, on an after-tax basis and offsetting for higher variable compensation due to the gain, net income was only positively impacted by $130,000 for the quarter.

As we stated last quarter, for the remainder of the year we remain focused on growing revenue while maintaining our current margin profile. We remain committed to future profitability increases, and any investments that we make will continue to be closely scrutinized based on the impact they will have on our overall profitability profile and shareholder returns.

Let's move onto capital expenditures. We spent $45 million in capital expenditures during the second quarter. Of this amount, we spent $30 million on customer gear, $6 million on data center build-outs, $1 million of office space and $8 million on capitalized software development and other projects. For the first two quarters of 2010 capital expenditures totaled $100 million.

At the beginning of the year our forecast was for total capital expenditures to be between $185 million and $235 million. With half the year completed we expect total capital expenditures will fall close to the middle of that initial range. Adjusted free cash flow increased to $15.4 million in the quarter from $1.4 million in Q1. As Lanham mentioned, this was a record cash flow quarter for Rackspace, and it is indicative of our business model becoming less asset intensive and more capital efficient. The improved efficiency is driven by a number of factors, including cloud revenues increasing to more than 12% of revenue compared to roughly 10% in the past two quarters; secondly, higher margins; third, past investments in automating many back-end functions of our business; fourth, higher service-level offerings that do not require incremental capital requirements; and, fifth, leasing of data center capacity.

As cloud continues to represent a larger mix of revenue and our business continues to scale, we expect to continue to become more capital efficient, which should result in an improvement in our free cash flow generation profile. During the IPO in 2008, our business began to burn cash at revenue growth rates above 25% year-over-year. At the beginning of 2010 we had improved that threshold rate to 35%. Based on the results we were able to generate in Q2, we believe we can continue to improve the free cash flow capability of our business.

Finally, I will move on to the balance sheet. Our cash balance increased to $148.5 million, and we continue to have access to an additional $194 million under our revolving credit facility. Our total debt outstanding including capital leases was $170 million, and net debt was $21 million. Net leverage at the end of the quarter was essentially zero.

With that, we are ready to take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator instructions) Sri Anantha, Oppenheimer.

Sri Anantha - *Oppenheimer - Analyst*

I know you talked about the growth in the Enterprise segment. Is it possible to quantify that? What percentage growth are you seeing in that particular segment? And today, what percentage of your total managed hosting revenue comes from the Enterprise segment?

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

Could you repeat that one more time? You broke up a little bit halfway through, and I missed a couple words.

Sri Anantha - *Oppenheimer - Analyst*

At the Enterprise segment, what percentage of your managed hosting to date is contributed by your Enterprise division? And secondarily, like the growth in the managed hosting business on a sequential basis has slowed down from 1Q. Is this a function of some of your contracts not ramping up, or what is driving that?

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

Okay, great, thank you. Our Enterprise segment and initiatives within managed hosting is our fastest-growing piece of managed hosting. In our prepared remarks we gave a little bit of the context around launching that group the spring of 2009. So far we have been thrilled with the results. Today Enterprise activity produces almost half of our new bookings within managed. We believe that we're just scratching the surface in terms of the growth opportunity there.

This business -- because these contracts come in larger forms, the business tends to be lumpier with respect to revenue growth than what we experienced in our traditional SMB offering. So part of what we see within Enterprise is a timing difference of when we will secure the contract versus when the infrastructure goes online and we start billing for it. So, with Enterprise being a meaningful chunk and portion of our managed hosting growth today, that will create some tiny differences. So far, we are really thrilled with the performance we've gotten out of Enterprise. This quarter again we had another record sales month in the quarter. That is entirely due to some extent to what our Enterprise group is providing. We are happy about the selection by salesforce.com to run [some max] for them. We are happy about the renewal with Vodafone over in the UK. So we continue to feel very bullish on our Enterprise opportunity.

Operator

James Breen, William Blair.

James Breen - *William Blair & Co. - Analyst*

Just one general and one specific question. Generally speaking, Lanham, can you just comment on where you feel you guys stand right now competitively, relative to some of the guys out there like the Amazons and Microsofts?

And then secondly, more specifically, last quarter you talked about having record bookings during the quarter. Can you give us an update on how that trend has continued this quarter?

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

Yes, okay. So the first one, competitive position and then the second one, bookings -- from a competitive position with our traditional competitors as well as the emerging cloud competitors, I would say our Company has never been in a stronger spot. As we sit here today, we have a leadership position. We believe we are differentiated around service leadership that we call Fanatical Support. So if we go through some of the proof points here, from a growth perspective we are growing faster than last year. Now, we are not where we want to be on growth. We are doing everything we can that's practical to accelerate that growth. And, assuming the economy cooperates with us, we believe our growth will accelerate in the back half of the year.

From a profits point of view, we are hitting the highest EBITDA margins in our history. Return on capital continues to grow. Our asset turns are growing, and net income has improved. So from a financial performance with growth in profits, we are happy.

From a cash flow perspective we just turned in a record free cash flow quarter for our Company. Our customers are voting positively as our churn hangs in there at 0.9%. This churn level is close to the churn levels we experienced in an expansion environment in the economy. We are turning in the same types of churn in what is currently a recession trending toward recovery, so we're pleased about that. We believe we are serving our customers well there. We are also holding up against big competitors like Amazon and IBM and Microsoft and EDS. We are pleased with the installed base growth ticking up this quarter. If we look over the past year or so, the installed base growth has been trending up. It's sort of a one step forward, half step back type scenario, so we have watched that very closely here.

And then one of the other metrics that we follow closely is revenue per server. As we think about revenue per server, we believe that provides a great proxy for the value that we deliver, and that's another metric that continues to increase. So we feel like, around the board, our competitiveness is strong. We are also very excited about the new services that we have coming out the back half of this year. So tomorrow we released our Windows Server out of beta for the cloud.

We talked about increasing our service levels on the cloud to provide a managed service level on the cloud which will roll before the end of the year. We've got our cloud rolling out. In the UK we also have higher service-level offerings that we are launching in our Enterprise group before the end of the year. So, across our Company, we feel like we are focused, we are going to do things that generate additional advantage around our Fanatical Support difference, and we like our spot in the market.

Your next question was about bookings and what's going on there. Our Enterprise group, because of its lumpiness has the capability to give us an acceleration on our base case bookings so that, if we looked at our quarterly results here in the second quarter, we have a couple months in Q2 that were record bookings. So this provides you a glimpse of what our Company can do when everything is clicking. So when everything is clicking in our model, we are getting good traction with our Enterprise growth. We are having good growth with our cloud business. We are rolling out new servers, and then the financial benefits accrue to the stockholders here in the form of higher profits, better returns and free cash flow. So we feel like this quarter gives us a glimpse of our Company is going to be able to do going forward.

James Breen - *William Blair & Co. - Analyst*

Just as a follow-up, the bookings improved throughout the quarter, so setting up for good growth in the second half?

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

We have never commented on trends specifically within the quarter. It's one of those things where I think, in terms of your analytics with the model, ours is a recurring revenue business. It's a stable model. It's a game of a lot of little steps. And so having two out of three that are really good certainly bode well going forward.

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

First, Lanham, on the channel partners, couple of important deals there -- can you just expand on how the economics of those may vary from your direct customer acquisition? And is this the start of other deals that you're looking to secure over the next several quarters?

And then on the utilization, it ticked up a bit. How are you thinking about your datacenter footprint as you go into the rest of this year and into next year? Are you pretty comfortable with where you stand today? Might you be looking for more space over that time frame?

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

Let's start with channel and comparing the channel economics to our direct sales economics. Without getting into too much detail, our channel economics are superior. So what happens conceptually with the channel -- we are able to create a force multiplier with our channel partners. We spend a long time thinking through the proper incentive and alignment of interests to make the channel a real partnership. We brought in new leadership in our channel program with Robert Fuller last year, and then Robert has built out his team around him. Our channel is having great success right now. We are optimistic about the channel because the economics are better in our channel environment versus our direct environment because of acquisition costs and the leverage that we are able to create. If we look at the productivity around a channel opportunity versus a direct opportunity, most of the metrics there are better.

So we are bullish on channel. We want to do more of it, and we will continue to invest in Robert Fuller's team. And I will just say, on a side note, Robert has done a great job with it.

THOMSON REUTERS

Simon Flannery - *Morgan Stanley - Analyst*

Is it a different kind of customer than what you are getting directly?

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

No. It's really a matter of reach, and it's the economic trade-off between reach in these relationships that our channel partners have versus us investing to replicate that reach on our own.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Okay, and Simon, you asked about our data center capacity and utilization picking up a little bit in the current quarter. There's a couple of things on that. First of all, last year we had signed our first agreement in Chicago with DuPont Fabros to expand our footprint. And so we have still the second phase that will be going online shortly that's not included in our totals.

Likewise, if you remember earlier this year, we signed an additional expansion of that data center, again with DuPont. That will probably be online closer to the first quarter, sometime in the first quarter of next year. So, from the short run, we have plenty of capacity in our data centers or the potential with the footprint.

I would add that with the growth in our business that we've seen year to date, we always keep our eyes open for other opportunities. And with the lead time, you can expect us to keep looking at opportunities that are strategic and timely for us. But certainly, we've got sufficient capacity in the short term available to us.

Operator

Chris Larsen, Piper Jaffray.

Chris Larsen - *Piper Jaffray - Analyst*

I wonder if you could talk a little bit about the rate of growth in the installed base and whether this 0.5% is something we should expect to keep moving up. It's moved up, it's moved down. Is there any sort of trend that we should start to factor in there? And then secondly, maybe, Bruce, you could talk a little bit about the cloud being a lower-margin business. I think a lot of folks that I hear fear that the cloud is a lower-margin business. Is there anything you can give us, whether it's flow-through or an incremental margin, that can help us think about how the cloud business eventually will ultimately shake out in terms of EBITDA and margin contribution?

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

I'll start with the installed base growth question. If we plot the numbers over the past few quarters, we will see that the trend in the installed base growth is up, but it's not linear. So we'll take a step forward, take a half-step back kind of thing here as the economy recovers. We believe that the installed base growth is highly correlated and levered to economic activity, specifically IT budgets. So as IT budgets are growing and we are serving customers well, our expectation is we will get increased workloads and opportunity to serve them. When our customers and the economy are going through shrinking IT budgets, this puts pressure on how much customers want to spend with us and how many workloads and what type of work we can do with them.

So generally speaking today, turning in a 0.5 -- that's the best we've done in a while. So we are encouraged by that. We think this is a continuation of the trend toward a higher number, but at this point we don't expect it to wildly deviate from what it has done here historically. We continue to believe that, as the economy recovers, we are highly levered to an increase in the installed base growth rate. We believe that having our business grow 15% a year based on installed base traction in an expansionary economic time is absolutely a reasonable thing for our Company to achieve. Right now, we feel like we are seeing some glimpses of things getting better. We are proud of the quarter we just turned in. I think it's a continuation of the current trend of a step in the right direction. And as the economy ebbs and flows, we will see what future quarters look like.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

And then, talking about the cloud margins, in some of the past quarters we have mentioned how the margins in the cloud business are not yet at the level of the managed hosting business because it's still in the early stages of the growth of cloud as well as the rate of growth. A couple of things, though, that we have also suggested, and that is that we believe that margins in that business over time will be equal to what we are seeing in the managed hosting business, higher returns because of the efficiency of the capital, though. And some of the things that give us that expectation is, as we look at cloud today, on an incremental basis they have some of the highest margins in the business. So we continue to see improvement in the margins every quarter and we expect that as we continue growing that product or various products in the cloud, we will achieve similar margins to what we're seeing on the managed hosting side.

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

Chris, this is Lanham. I would just add to that, if when we parse the financial results of the Company here over the past few quarters, cloud is providing a disproportionate share of the growth. With this growth we are having margin, cash flow and return increases. So I think it speaks to the perspective that cloud is going to create a lot of value inside of our portfolio approach to serve our customers.

Chris Larsen - *Piper Jaffray - Analyst*

Thanks, that's very helpful.

Operator

Gray Powell, Wells Fargo Securities.

Gray Powell - *Wells Fargo Securities - Analyst*

Good afternoon, guys, thanks for taking the questions, just had a couple. What would you say is the biggest driver of revenue growth over the next year? Is it selling customers on your existing product set or the introduction of new products?

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

I thought you were going to give us three or four questions there.

Gray Powell - *Wells Fargo Securities - Analyst*

I can do it all at once, if you want.

THOMSON REUTERS

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

No, let's just go one at a time; it makes it easier for me. When we think about our growth -- let's just take one step back here. We take a portfolio approach so that basically we have multiple sources of growth here. Number one is our installed base growth. Number two is the rollout of cloud and the additional implementation of higher levels of service in the cloud. Number three is enterprise, and number four is our SMB business. When we look at the most attractive growth drivers today in this in terms of the aggregate number of wins, customers and potential revenue impact, the top two are Cloud and Enterprise.

As the economy recovers we'll get an incremental lift that's very meaningful out of installed base growth. But right now the driver for us with revenue growth is really Enterprise and Cloud. This is what makes us excited about the services we have coming in the second half of the year as we extend our cloud into Europe, as we roll out managed service levels on the cloud, as we get our Windows cloud out of beta. All this stuff gives us reason to be excited about our ability to differentiate in the market around Fanatical Support.

So within our portfolio it's about focusing on these two big levers, rolling out new services to new customers as well as taking some of these existing services into the current enterprises that we serve.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay, that makes sense. And then you actually touched on my next question. If I look at your Q, it looked like US revenue grew just under 7% sequentially, whereas international, excluding the FX, it was closer to 3%. With Cloud and the Enterprise expansion into the UK, should we see an acceleration there? And then how do you expect adoption of the cloud in the UK to trend just relative to the US?

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

Okay, so one way I would rephrase the question is, what's going on in Europe? Right? What's going on internationally here? So let's just parse international first.

Our business in Asia is doing great. Jim Fagan is our leader over there, and he's doing a great job. When we look at Europe, specifically the UK, coming into this year, we planned on having choppiness at a macro level in the UK, anyway. So far, through the first half of the year we have executed along our plan. We believe that the new services we have planned, for example, bringing cloud to Europe, the Enterprise efforts that we have in Europe as well -- they are part of the plan and aimed to help offset some of this macro choppiness that we're seeing today. So yes, the environment is choppy in Europe. We planned on that coming into the year. So far, through the first half of the year we've executed real well against our plan. We are happy with what we've done so far. We think the additional services that we have coming over there give us a higher opportunity to grow faster or offset any additional choppiness that may show up.

Gray Powell - *Wells Fargo Securities - Analyst*

Okay, well that's it, that's all I have, thank you very much.

Operator

Jonathan Atkin, RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

I was wondering how we could think about trends in your R&D budget going forward, with your open sourcing, for instance, with [open] (inaudible) and you are able to leverage other parties' efforts to develop technology. So could one expect that type of activity to lower your R&D spend going forward?

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

Yes. I think the -- let's talk for a second about OpenStack, and I'll tie it back to the ROI for us on the initiative.

The first thing that we think about with OpenStack is Rackspace providing thought leadership around the evolution of cloud technology frameworks. So being able to collaborate with the likes of NASA to get a great start and having an open sourced, standards-based technology framework in the cloud, we believe, is a compelling thing for our Company. What we are trying to achieve here is we want to compete and win on service. We want to build a service leader inside of our industry and category. So what OpenStack is going to do is help us keep the technology field on an open standards-based plane. In that environment, we believe we can out serve the other folks that show up.

So the first part of OpenStack is let's reduce vendor lock-in, let's get rid of proprietary environments. Let's open the standards and make it a service-based decision. So from an R&D point of view what we are trying to do here is basically get more out of the same investments we make. So the notion here is, we need to energize the open source community with the rollout of OpenStack. With that energy we need to attract developers and active participants that are [going to] contribute code to the project. As they do that, we believe the framework will advance faster than if Rackspace did it all by ourselves. So basically here, when we think about success with OpenStack, we think about traction with communities and developers. We think about people making commits to improve the code. And we look at the number of OpenStack environments deployed.

Jonathan Atkin - *RBC Capital Markets - Analyst*

So, no noticeable downward trend in terms of R&D dollars? Presumably, any savings there would be reallocated elsewhere.

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

No, sir. Our belief is we will continue to invest in the framework just like we're doing it today. And our expectation is we're going to be able to get more out of those investments.

Operator

Jason Armstrong, Goldman Sachs.

Jason Armstrong - *Goldman Sachs - Analyst*

A couple questions, maybe first, just to follow up, there was an earlier question on managed services growth decelerating a little bit in the quarter that I don't think was answered, just some color there. And then the second question, just the income in customers you have for cloud services, I'm wondering where they are coming from. Are they brand-new to cloud, or to what extent are they coming from industry peers that maybe aren't layering on the service layer to the extent you are, and then you get people coming in at that layer and moving up to you for a services component?

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

Let's start with the cloud growth question, and then Bruce will do the revenue question around managed services. With cloud, the cloud category itself is going through hyper-growth. If you look at our growth rates here, year-over-year we are growing 8%. So with a category growing at that speed, most of the customers we are winning are early customers into the category. We have not yet hit a level of development in the category where there's a ton of switching going on between different types of providers out there. The people that we are winning in the cloud in terms of a customer profile are everything from early startups and developers into Enterprise customers. So what's happening in the cloud business is it is transitioning from that early first app into more production-persistent type apps for customers that are doing more things.

Some of the early-use cases for our cloud were marketing campaigns and apps that required dynamic bursting based on the nature of the app itself or the work, the business work that was trying to be done or early frameworks for people to do to test and dev in their environments. Now, people are figuring out architecturally how to apply cloud thinking and capability into their more mainstream production apps. So, today, it's people that are new to the category. It's our existing customers that are trying to figure out how to use this tool, and we are helping our customers understand how to use cloud and incorporate it into their environments. Going forward, we believe cloud will continue to experience hyper-growth and that there will be lots of companies coming into the category. And then, at some point, there will be more switching.

So, while the category is going through this rapid growth, we are going to make sure we double down and focus on our point of difference for the long run, which is going to be building service leadership.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

In terms of the managed hosting business and its growth, first of all, I'd like to say that on a trend basis we are seeing the trends going in the right direction for us. It won't always be linear; there's going to be some choppiness. And some of the things that affect it is, as Lanham mentioned before, the UK has some choppiness in, and we've got some things that will offset that. Likewise, as Lanham talked about the Enterprise group, because of the lead times and the size of those, that tends to make it choppier as well. But overall, we are really pleased in the direction that it's going, and it's showing improvement on a trend basis.

Operator

Jonathan Schildkraut, (inaudible).

Jonathan Schildkraut - *Jefferies & Company - Analyst*

Two questions, please. First, in terms of CapEx, Bruce, during your prepared remarks you talked about improving capital efficiency. Today, you pointed to the same kind of range on CapEx, maybe to the midpoint of the range. But, given the increasing capital efficiency over the course of the year, does that maintenance of the range imply a little bit more positive outlook in terms of growth?

Driving further along the CapEx line, I've also noticed that the amounts of vendor financing that you've used as a percent off your customer gear CapEx has fallen off in the first half of this year relative to historical ranges and even what we talked about in the past. Is that a conscious decision to use less vendor financing, given your liquidity position, or is there something else driving it?

My second question has to do with public cloud competition in Open Source. When we look at the public cloud landscape, most of the real players are you and Amazon today. Even some up-and-coming players tend to have their own technology driving the cloud. In terms of some of the other players, smaller players trying to get into public cloud, there's a lot out on VMware. Based on our research, a VMware license costs a lot relative to maybe your open source for building a cloud. Have you seen any interest in terms of the open source from some of the smaller providers? And maybe you can update us in terms of those conversations?

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

Why don't I start with the cloud competitive landscape, and then Bruce can follow up with CapEx. So I agree with a lot of the implications of the statements you made about the cloud competitive environment. Let's talk about that. I think that, first of all, with cloud, it's obviously a massive opportunity, billions of dollars playing out over time, depending on which analyst we read it's $40 billion or $50 billion, just massive numbers. So any opportunity like that is going to attract attention from entrepreneurs as well as established tech companies.

Our approach here is that we will try to continue to differentiate based on service and the portfolio of capabilities that we bring to it. So this is where we think about increasing our current service levels on cloud. It's where we think about hybrid hosting being able to attach or dedicate environments to our cloud, and OpenStack falls directly into this differentiation.

We have a basic belief that any proprietary closed stack can generate a competitive advantage for a period of time, but that period of time is fleeting. Any time a proprietary stack gets rolled out, yes, it may have a head start for a little while, but the market catches up to it and another competitor passes it.

We also believe that these proprietary stacks can be an economic drain on customers. So, what we want to do is have an open standards-based cloud to where providers compete on service instead of on closed technology. So OpenStack falls right in line with this. When we think about the traction we've already captured with OpenStack, whether it's the number of tweets or the hits to the website or the people, developers talking to us about contributing to the project or the number of companies that have already signed up to help, the traction has literally been amazing. At this point in time I would say it exceeds our expectations.

So we believe that, from a landscape point of view, what OpenStack ought to do is create standards that level the proprietary technology landscape. Then what we will do is, on top of OpenStack, invest in amazing service levels that provide great value to customers so we can differentiate on those service levels.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Okay, customer gear -- you had a couple questions about customer gear. First of all, in terms of the implication of growth rates, I think we talked a little bit in our prepared comments about what we've seen in the first half of the year and what we expect from a full-year standpoint, particularly as compared to last year. And we still believe that all those targets are achievable. Some of the things we are seeing in the marketplace and with the products that we are introducing make us feel very confident about some of those targets as well.

Generally, though, in terms of the customer gear CapEx, we have not changed our position on financing some of the equipment purchases through vendors. But there are a lot of factors that will influence that. For instance, depending on how much gear we buy from a manufacturer that has a -- if we have a leasing agreement with versus other vendors that are more commodity like, will impact that percentage. So that's a big impact. In terms of the total amount of customer gear CapEx we purchase, if you remember our model, part of that customer gear is for new incremental revenue, and part of it is obviously the maintenance CapEx. But when you think about the incremental revenue, remember at one time we said that for every dollar of incremental revenue that we produced it costs us, on average, roughly $0.50 of customer gear CapEx. Because we are being much more efficient this year, and we've talked about a number of those reasons why we are more efficient, the dollars or the cents per dollar of incremental revenue is much smaller. This year, on average, we're spending about $0.47 per every incremental revenue dollar, whereas last year it was closer to $0.59. So we've made a lot of improvements. And again, some of those reasons are we are just being more efficient with the capital and how we are spending it

The cloud, as it continues to grow, is having a real positive impact as we are more efficient from a capital standpoint. And even on the managed hosting side with virtualization makes our customer gear much more efficient as well.

So all those are allowing us to be more efficient, and our expectation is that if we can continue on those trends, that this is an area where we are hoping to continually improve on.

Jonathan Schildkraut - *Jefferies & Company - Analyst*

Great. Thanks for answering those questions. If I could sneak one more in here, do you guys have any view on SoftLayer and [The Planet] getting together in terms of potential competitive impacts?

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

Well, I don't have a whole lot to say about that. They have been competitors in the low end of our business for quite a while. They are not the folks we worry about everyday. They are also not the place -- the segment that we aspire to have service leadership in, either. So when we look at the landscape today, I would say competitor number one is Amazon. Competitor number two is somebody like IBM or incumbent outsourcer in the enterprise ranks. So that's where we are putting our focus today and where will continue to invest.

Jonathan Schildkraut - *Jefferies & Company - Analyst*

Okay, thanks again for taking the questions.

Operator

Brian Thackray, Deutsche Bank.

Brian Thackray - *Deutsche Bank - Analyst*

A question on Cloud Servers for Windows that rolls out tomorrow. What should we expect the sequential impact be here in Q3, as you have some higher service levels? Is pricing moving higher? Does that impact the existing 2200 customers? Will we see something here in Q3-Q4 around Cloud Server for Windows? Can you give some better insight into that?

Secondly, on OpenStack, can you give maybe a little bit more insight in terms of how that impacts the financial model longer-term as you shift to an open source, service-based business model compared to the existing cloud business you have today?

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

Those are great questions. With respect to the Windows Cloud Server, let's talk about what we are trying to achieve without commenting on the timing of Q3 or Q4. I don't want to get hung up on the timing of it. Strategically, since we have rolled out our beta for Windows, Windows' traction in the cloud is almost as high as our Linux traction if you look at just a base OS level. Now, we offer different versions of Linux. Okay? But if you look in aggregate, Linux versus Microsoft at the core of the cloud environment, Windows has gone from zero to in some months providing 40% or 50% in terms of the traction that we are having in terms of customer wins. So what we are trying to achieve here is, first, create traction in the Windows segment of the marketplace and then, secondly, as we add additional service levels to the cloud on top of that environment, increase our price point over time.

THOMSON REUTERS

So that what we believe today in our cloud offering is we offer a level of service that is better than what the rest of the market provides. We believe that the level of service we provide today is something that's a starting point, that we will continue to invest and add a whole lot more to it. So Windows increases our addressable market, and then the new services in Windows increases that addressable market again so that, over time, what we should be able to achieve is a higher price point and, therefore, higher-margin with the higher service-level products on Windows.

When we talk about OpenStack in the long-term impact on our financials, in the short term there's really no impact. We will continue to invest in it. It will be awhile before OpenStack gets deployed meaningfully. So in the short term, no impact. In the long-term, one of the potential outcomes for Rackspace with OpenStack is that OpenStack should accelerate cloud adoption. As the community gets energized around it, as developers donate code to it and the framework evolves, it ought to accelerate cloud adoption around standards and open-based technology.

That gives Rackspace opportunity to sell services, and to create services around that framework, whether that OpenStack is deployed inside of our facility or anywhere else in the world. So there is an opportunity here that, as we roll out service levels for OpenStack, we could be providing professional services to OpenStack deployments inside of our customers' facilities. We could be providing managed services on OpenStack deployments inside of our facilities. So there is an opportunity here for us to create additional services businesses out of OpenStack. But right now that is absolutely in the long-term.

Brian Thackray - *Deutsche Bank - Analyst*

Okay, that's helpful, thanks. If I could have one follow-up for Bruce. Bruce, if you strip out the installed base growth within the enterprise and just focus on SMB, can you give us a sense for what that was this quarter, installed base growth just within SMB?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

We really don't break that out, those pieces, just that, as Lanham said earlier, that enterprise in the managed hosting combined, both installed base plus new sales, is the fastest-growing area of the managed hosting business.

Brian Thackray - *Deutsche Bank - Analyst*

Is it fair to say that you did see sequential improvement in the SMB core market that you saw, Q2 versus Q1?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

We are seeing high growth rates in -- did you say SMB or enterprise?

Brian Thackray - *Deutsche Bank - Analyst*

SMB.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

SMB?

Brian Thackray - *Deutsche Bank - Analyst*

The question is --

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Yes, yes (multiple speakers) --

Brian Thackray - *Deutsche Bank - Analyst*

-- sequential increases in (multiple speakers) enterprise.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Absolutely, I'm sorry, yes.

Operator

Alex Kurtz, Merriman & Company.

Alex Kurtz - *Merriman & Company - Analyst*

Bruce, with all these new initiatives taking place in the second half here, can you just talk about OpEx load around programs or around on launching these? How should we be thinking about that in Q3 and Q4?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Well, again, we've got a number of initiatives. We are always rolling out new products, and obviously we are real excited about some of these new products. But between these new products, between other initiatives, if you strip out these programs, we are still scaling in our core business, from a margin standpoint. And what we are doing is we are using that additional scaling to reinvest in some of these projects so that, on the whole, we're expecting our margins to stay relatively flat here.

Alex Kurtz - *Merriman & Company - Analyst*

Okay, and Lanham, at the outset you obviously outlined some new products and new services that are going to drive the back half and give you that confidence in the back-half growth that you're talking about. If you had to strip out just one or two or highlight one or two that are really critical to hitting your internal projections, what would you say those are, and what are the risks around deploying those, as far as execution?

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

I guess another way to say that is, what part of our portfolio do we think has the most upside, and what are the risks to achieving that? When we look at the new services we are rolling, certainly the work we are doing in our cloud is very exciting for us. The risks -- sorry, let me take a step back.

So we talk about cloud having growth opportunity here. This is about as we increase our service levels in the cloud, as we take more of a portfolio approach to the cloud and introduce it more capably to our installed base here. Some of the risk here is literally we are now operating on a company and a web-scale basis. And so the technology challenges here in getting the services to roll exactly right, provide a service-level experience worthy of being called Fanatical Support -- there's risks there to making all that happen. These are complicated services and capabilities to roll out to customers. We have been working on it for months already, so we like our position and we are confident in what we are doing. But they are difficult things to execute. We take a very disciplined approach to it and measure and monitor each step we take, particularly on potential risks to delays or not making it work properly.

So the stuff we're most excited about right now is in our cloud first and then, I think, secondly in our enterprise work, just the channel traction that we've had bringing new customers to us. That has really been a force multiplier. And when we think about the opportunity to dislocate some of the incumbents out there like IBM and EDS and Fortune 100 accounts, we get pretty fired up about that too. That -- the risk there around winning more of those customers, that risk really comes down to our ability to execute and run that sales process and how we talk to those customers about understanding the value that a specialist on purpose-built provider like us brings.

Alex Kurtz - *Merriman & Company - Analyst*

Just one more point on the enterprise -- growth opportunity -- do you still think channel is the best demand pull for that business instead of really accelerating Taylor's organization as far as body count?

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

Well, what we want to do is create a model that builds advantage. So when we think about that, we do not want to replicate what IBM or EDS has. The opportunity for us to provide account coverage that's superior to an IBM for people on the ground is probably pretty remote. So we have to figure out another way to do things.

The way we want to do is we want to leverage our central team here, which is Taylor's organization. And those guys are doing great. Those Rackers are doing really well. We want to leverage that central organization. We want to supplement that and augment it with channel relationships that produce at-bats, because we get an at-bat, we have a great win rate. We are saving enterprise customers 30% to 40% versus what they are paying the incumbents. So when we get the at-bat, we love our chance. The issue is, how do we get more at-bats, how do we learn how to manage the sales process? These are the things we're trying to solve, and we believe the best path of success is a model where we leverage what we have centrally, we supplement it with a channel program and we stay disciplined around those areas where we can really add value for customers.

Operator

Colby Synesael, Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

I just have one question. Your server net adds was about, I think, 2000 this quarter versus about [3200] last quarter. Just curious if there's any dynamics at play there that could explain that, or would you just equate it to the ebb and flow of typical business?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

We are going to see some of those fluctuations because of a number of reasons. One is, as you said, when you have some large enterprises that bring on servers, that will increase the number. Likewise, when we start some data centers with cloud computing, for instance -- in cloud, you don't set up just one server at a time. You set it up more in huddles, and so, depending on the timing of the huddle, that could cause that number to be higher in one quarter. And then you start filling it up, so you scale it much quicker from that standpoint.

So every quarter we are going to have some of those impacts. But generally, again, we are really happy with the growth that we are seeing. The fact that it goes down from first quarter to second quarter is not indicative of the growth opportunity in the near-term, it's just indicative of things like cloud having a huddle built. And so that helps us.

Likewise, we are seeing a lot of opportunities -- we talked a little bit about this earlier -- the opportunity to increase some of our revenue from a server basis through virtualization. And that increases our ability to, obviously, make our returns higher and get more efficient on our capital. And so those are the reasons. In terms of just general growth, the numbers are right in line with what we had hoped. And as I said earlier, the fact that it fluctuates from quarter to quarter -- those last two quarters is not indicative of near-term growth in the business. It's just timing.

Operator

Mitesh Dhruv, Banc of America.

Mitesh Dhruv - *Banc of America - Analyst*

Just a couple of quick ones. The first thing, Lanham, when you let out the initiatives for the second half of the year which could have incremental growth impact, obviously you laid out like three or four initiatives. Just one clarification first, on the managed -- the service layers of the managed services in the cloud, what was the time line for the availability there?

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

Well, what we said in the prepared remarks is it will be ready before the end of the year.

Mitesh Dhruv - *Banc of America - Analyst*

Okay. So then, if you are saying that the second half of the year should see some incremental impact versus the first half, what would be the top two things which you are hanging your hat on?

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

Well, it's a little bit what we described earlier. Generally, our cloud offer is becoming more competitive as we roll out services. The managed service layer is one example. The Windows Cloud beta release is another example. And so we think that these are services that have a great upside for us and a good opportunity for us. I think the other thing is enterprise. We continue to believe that we have a great opportunity to increase our traction with enterprise customers as well.

Mitesh Dhruv - *Banc of America - Analyst*

So, if I might just clarify, on the Windows part of it, first, are you seeing any reaction from customers, given that Azure is out for about six, seven months now?

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

Remarkably, very little chatter about Azure in our world. So we've had Windows beta out for -- since the beginning of the year, basically. During that time there has been a lot of discussion about Azure. We just haven't felt a material impact in our business. The one difference between our offering and Azure, is Azure is really a framework in which the customer still does most of the work, where we are trying to take these technologies and provide it as a service experience for customers. So in some ways I think part of the reason we haven't heard more discussion about Azure inside of our customer universe is that we are serving a different segment of the marketplace relative to the target that Azure has.

Mitesh Dhruv - *Banc of America - Analyst*

And also just one follow-on. For the Windows segment again, if you were to quantify the broad financial parameters qualitatively, quantitatively, what kind of market opportunity are you going after with this Windows cloud? Can you just elaborate on that?

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

Yes. In terms of having a Windows cloud, what we have experienced so far is that it is now, depending on which period you want to look at, now up to half of the traction we have in our cloud. So one way to look at it is, if we only had a Linux cloud, we would be giving away half of what we are getting and not competing for that market. Okay?

So I think that the Windows cloud is a meaningful increase in the addressable market for us to go pursue. The next part that's exciting for our cloud growth over the second half of the year is being able to launch it in the UK. We feel like the UK is another significant expansion in our addressable market.

Mitesh Dhruv - *Banc of America - Analyst*

Got it. So when you say half of the cloud traction, but that has not manifested itself into revenues thus far. Correct?

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

Well, basically we've had customers in beta on cloud. So we've had customers in beta on Windows cloud. So we haven't fully released it yet. That full release will happen tomorrow.

Mitesh Dhruv - *Banc of America - Analyst*

Got it. And one last question -- can you tell us how many customers you migrated to the cloud this quarter versus I think he was 135 last quarter?

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

Yes. There was a little over 120.

Mitesh Dhruv - *Banc of America - Analyst*

Perfect. That's it for me. Thank you.

Operator

Frank Louthan, Raymond James.

Frank Louthan - *Raymond James - Analyst*

On the channel partners, what is your long-term mix of sales coming from partners? And can you give us a little better idea of how you sort of vet those partners and make that decision? What are some of the things you're looking for when you try and make those arrangements?

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

Well, I think in terms of understanding the long-term customer mix that comes out of the channel program it's a little early to speculate on it. We've invested in the program with the hiring of Robert Fuller and his team. We are having great success. And basically, the way we want to set expectations and characterize the channel program today is the channel program, from an economic point of view, delivers great value relative to our direct sales approach. It creates opportunities that tend to have a higher value coming in, so that translates into a higher price point. Okay? How this trends over time -- we believe we've got a glimpse of it today. We are very excited about our channel and the potential it has, and that we believe it's a force multiplier that could help us penetrate additional enterprise accounts. We also think it helps penetrate SMB accounts that have a bigger budget as well.

So the way we vet these partners is our channel team spends time with these partners, understanding where the right fit and match is relative to what Rackspace can provide, our value system, the services we want to roll out, plus the partners customers, the prospects the partner will be talking to, as well as how the partner operates. Because ultimately, for a successful channel program to work, we've got to have great synergy between how we see the world and how our partner sees the world and how our partner's prospects see the world.

So any customer that we win through our channel partner program -- all the same EVA-based discipline apply in that we are trying to create, win customers here that are going to be promoters of our company and stick around for years. So understanding what type of channel partner we have and how they vet their own prospects is really important to us. So we want to get all those variables to align. We've had it already aligned with the partners we mentioned in our prepared remarks, XO, and so what we have here is, when we get it lined up properly, we have almost immediate results in sales. So we have already got results out of the partners we've talked about today.

Frank Louthan - *Raymond James - Analyst*

And with the larger increase in enterprise, is it taking longer for the bookings to turn into revenue? And how should we think about that transition going forward?

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

Yes, it does, sometimes. The answer is, unfortunately, it depends. But I think we're on pretty safe ground to say that timing gaps tend to be larger with customer deployments that are larger from enterprises so that they will have a pretty thorough selection process, the selection process through an RFP or whatever mechanism they want to utilize will take a few months. And then, because the environment itself is fairly complicated, our implementation process takes a while. And so therefore all this translates into lumpiness.

So we may win a contract this month, and it may be 90 days or 120 days before the customer is actually online and we are billing them.

Operator

Erik Suppiger, Signal Hill.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Most of my questions have been asked, but in terms of the cloud services, your revenue per customer improved this quarter. Are you seeing the service component with your cloud customers go up at this point, or what are the trends that's behind that?

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

Yes, well, a lot of the revenue per cloud customer that we believe will increase in the future will be driven by the new service levels that we will provide, but we haven't had all of that hit the market yet. What we have had hit the market is a base level service offering which we still believe is differentiated within the cloud market today. So this is translating into increased levels of revenue per cloud server and revenue per cloud customer as that mix moves around. But we believe the inflection point, the step function will occur when we get some of these other services rolled out, when we talk about a truly bolstered managed service-level on a cloud. But we're not going to have that until the back half of this year. So, so far, what we see is we see a preference for the support levels we provide today in the cloud. We believe that that preference will grow as people run production applications in the cloud, so we want to be there with a higher service-level to take care of those customer apps.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO, Treasurer*

Yes, in addition to that, what we are seeing is just a lot of existing customers may start with a smaller application and they just add more to it. And so, your average revenue per customer starts growing as they grow their applications on our cloud.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

One other quick question -- your customer growth for your hosting, your traditional hosting business, it has kind of been leveling off in the tens of customers -- 60, 70 customers. Do you see that going back to historical levels, or do you think that it stays -- historical levels where it was several hundred per quarter? Or, do you think that that incremental customer growth is going to continue to go into the cloud and you're not going to see the number of new customers for hosting get back to historical levels?

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

Well, part of this has been deliberate in that, in our hosting group we have targeted enterprise customers that -- basically, what this does is it's a higher ARPU per customer; fewer customer wins, but each customer brings a bigger value to the table. We also took a look at our customers that are on single servers and wanted to figure out how best to serve them. Are they going to stay in managed? Are we going to migrate their apps and workloads to cloud?

And so, over time, we've provided data -- this quarter I think it was 120 customers or so that migrated from managed hosting over to cloud. Our belief actually is that the managed hosting customer win numbers -- so the this quarter, 67 wins -- actually, we think that number is being constrained by the economic conditions that we're facing right now. We think, as IT budgets start to expand more broadly, that number is going to come up again. We also think that over time the same customer will be consuming dedicated physical gear, which is in our managed group, and virtual services that are shared across a multi-tenant platform, which is in our cloud group. So our customer account is going to blur here pretty quickly.

Operator

Ladies and gentlemen, this does conclude our question-and-answer session. I would now like to turn the call back to Lanham Napier for closing remarks at this time.

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

First off, thank you for tuning in for our results. We are proud of the quarter we've put together. We believe it provides a glimpse into what our Company is capable of doing, and we are seeing our model transform here with the adoption of cloud services. We also want to thank our customers, who place their trust in us to run their mission-critical apps every day, and our Rackers that continue to volunteer their best to make Fanatical Support real. Take care.

Operator

And this now concludes our conference call for today. Thank you for your participation. Have a nice evening.