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Rackspace Hosting Inc

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PHIL CUSICK: Hi, my name is Phil Cusick, I cover Telecom and Cable here at J. P. Morgan. I want to welcome Karl Pichler, the CFO of Rackspace. Karl joined Rackspace in 05 and became the CFO in 2011. Thanks, Karl for coming.

KARL PICHLER: Thank you.

PHIL: I wonder if you can start, if you can share your long term vision of Rackspace as a provider of services versus public cloud hosting and how does that mix change over time.

KARL: For those of you who may not know our history, let me briefly go back to the beginning. We've started a business around the provisioning of physical infrastructure in our own data center.

Really fulfill the need that was unserved in the late '90s, where a lot of web businesses started to develop, but there was really a hard time for most of these companies to find a service provider that will allow them to effectively utilize that technology.

So really, the first iteration of the business model was a lot of provisioning-related stuff. And then very quickly the company realized that what people really need post-provisioning and post-deployment is also help on actually utilizing that technology most effectively.

The very first situation was a workaround system administration, mainly around the Linux stack, and then evolved into Windows. Up until 2006 or so, the x86 architecture with the LAMP or the .Net stack were the predominant basis on which websites were hosted.

We built that business. We were about at a half-billion dollars in revenue when we went public in 2008. After that we had the little blip of the recession, as we all had.

After that was really the advent of the cloud, cloud infrastructure. We started that with an acquisition of a company called Slicehost that really kicked off our cloud business that later evolved into OpenStack. Amazon, obviously, was a very dominant company and continues to be and will be.

But we felt very strongly that we and the world need an alternative that can be deployed independently from a proprietary stack, so either in-house as a private cloud solution or by other public cloud providers. That was our motivation to take the OpenStack source code and put it in a foundation to foster innovation, to drive innovation on that.

Our whole heritage was really around two things. One is the effective deployment of infrastructure. The second one was expertise around the operations of that. When we think about the future, we will see that evolve with a couple of tweaks or changes that are possibly quite substantial in terms of our opportunity set.

One, we have been talking about accepting third party clouds as alternative infrastructure elements in our portfolio as a compliment and providing service on AWS. It's the headline on that. The way that we are thinking about this is that we have a lot of people that are geeks.

Our technical people are geeks. They want to serve customers. They want to surround themselves with other geeks that know technology. In the old days, we had more RedHat certified engineers in RedHat that were managing the LAMP stack for our customers.

Very similarly, we see an opportunity to serve a market where we become the premiere provider of services to run a deployment effectively on third party clouds, Amazon or others.

That's a natural evolution in terms of what we do. We call this, "Infrastructure Op." Where we basically provide services to deploy applications and run them effectively on infrastructure solutions. The big change obviously is that, that we're changing the unconditional approach we had towards capital allocation of the past where we said, "Everything that you run with Rackspace has to be on our capital."

We now relax and constraint and allow other form factors to co-exist.

This is early stage. Taylor Rhodes our CEO, very explicitly called out, this is a horizon three initiative. It's very easy for expectations to get very big because obviously the Amazon momentum is very big. But we're really in the phase of developing the business model, the offer set, the SLAs that we want to create, the pricing schemes, that's where we are on that stage.

PHIL: Let's dig into that since you brought it up. What would have to happen for you to start to work with Amazon or [inaudible 04:49] , or something like that? Is there a relationship you have to build with them? Could you do this just with customers and going on, what's otherwise is open platform?

KARL: The deeper the relationship, the better. There are many ways of a partnership to create value in this collaborative effort. When you think about the three parties, the infrastructure provider, us, and Amazon. In the past, when we deliberately decided to not do this in the past, we've always stayed away from the fact that there's lower degree of controlability for the stock if we don't deploy it ourselves.

There's also much less influence on the road map that you have obviously, if you're on somebody else's stack.

Those are couple of concerns that need to be addressed in terms of escalation and involvement with our partnerships we have. Traditionally, we had a very good relationship with Microsoft over the years. We were hosting partners for them many, many times.

We know how to collaborate them without a formal arrangement, whether it's a re-seller arrangement that provides economic benefit or more of a partnership that remains to be seen. Those are helpful but not necessary ingredients, contractually. The second thing we need is expertise. That's in our real house.

We pride ourselves of having a culture of technical experts that like to provide service. Their mission is to create a good customer outcome. We have already, in the company, many people that are already AWS certified, just by nature of what they did for other customers, for our customers already.

We're going to pull them together and start creating the, call it the, "business unit" or small, [inaudible 06:42] starts to develop the offer in the product-market fit.

The third one is tooling. To effectively manage any sort of deployment, whether it's just simple system administration or capacity management, tooling into monitoring will become relevant. We're investing in that, either organically or inorganically.

PHIL: How would you see this going for? Would you name a significant new customer? Do you think you'd go and build a new offer and open it up? How would you build up the capabilities?

KARL: Traditionally, what we do is we create some initial offers. We traditionally have been pulled into new areas like this, similar to this, by our customers. It's no different this time. Customers would love us to help them with their applications that run on other clouds as well.

Most customers do have deployments at AWS even if they have stuff with us. There's certainly a pull from the customers there. We will certainly work with customers to develop that product market fit quickly, and to find valuable solutions for them.

PHIL: How do you think about your pricing model, as you say, "You know what, we're working together on our gear. You want us to start managing your stuff and AWS." How do you price that to make sure that your own margins, both in your term and long term, as maybe this evolves to be a bigger business down the road?

KARL: The service fee should probably be most thought of as very similar to subscription-type fees rather than share utility fees. While the infrastructure can be consumed on utility basis and may have some discontinuities because pricing changes. The service fee are not going to be tied back to the bill, which is what a lot of current service providers do.

That creates a lot of instability on the topline, on margin, and on anything else.

PHIL: You disaggregated the service fee from the hardware fee over the last few years, is that fair way to think about it?

KARL: We charge it independently but we sell it as a bundle.

PHIL: Right. This is explicitly stating that, "OK, this is your hardware and this is your service fee." Do you think that service fee can just migrate over without the hardware or does having them together should have create a lot of economies of scale?

KARL: It can migrate over. There's a similar approach we have. We have base fees, and then we have volume consumption base fees as well. It's not a flat fee regardless of what you consume. It's not directly tied to the bill. Those pricing models should be transferable.

PHIL: If I thought about you making an announcement that you were working with a partner, and they were drawing you over to that side. Because that's something that can happen in this year or is that a little bit longer term?

KARL: We're certainly working on that this year. It's probably fair to assume that there's not going to be a big announcement. It's going to just change everything from one day to the next. There are multiple fronts that we're working on and with multiple parties as well.

PHIL: Good. Let's take it up a little bit and just talk about the [inaudible 09:46] instead of business. We started and it got a little quicker that I would've planned. You came through with [?inaudible 09:53] in through the full year. The first quarter was a little bit strong, but the second quarter was a little bit slower than we've been looking for.

You called out one particular piece of [inaudible 10:02] . It doesn't seem like that's a big driver of slower business in the second quarter. What is happening now? What has to happen to see you accelerate this business and hit that [inaudible 10:14] range?

KARL: What happened as expected is that we had a fairly slow activity in December and January and early February, which is fairly consistent with what we've seen in prior years. We've successfully denied the sales reps, the excuse that our business is seasonal, but it is. It has certainly become more seasonal.

The more revenue contribution we get from larger enterprise-type customers because they go and did vacation.

The budget cycle are not entirely done by that time the year starts. The activity is considerably slower in the December-January timeframe. We've seen that in the past. It has been more pronounced this year. We've seen improvement in March relative to February, we've seen improvement in April relative to March. So we're on a positive trajectory but we're still a little bit behind where we need to be.

That's factor number one for the Q2 guidance. Factor number two was really timing-related. We wanted to get a little bit more color in terms of how the intra-quarter months are materializing. Once the deal is brokered there's materialization that happens afterwards. We had kind of the perfect storm in terms of a large opportunity was pushed back to a late Q2 start and the return situation was effective April 1.

When you look at the months within the quarter we have a fairly weak April, an average May, and a strong June. In a sequential revenue growth model that creates a lot of headwind.

Our trajectory has to improve. When you think about the guidance range and the low end of the guidance range, assuming the midpoint in Q2, we would have to grow 3.8 percent per quarter in Q3 and Q4. That is a significant step up relative to where we are, but it's also not as high as we were just Q2, 3, 4 last year, where we grew over 4 percent on a constant currency basis.

We feel there is momentum building. We have data points from backlog and pipeline that give us confidence that we don't really have a lead flow problem or a demand breakoff or anything like that. But the sales execution has to increase momentum.

PHIL: As you think about the accelerator, that 3.8 percent, are you looking at a variety of small deals coming through, or do you feel like there's a couple big hero wins that could come through and drive up business?

KARL: We have broken out our sales efforts into really three types of businesses. One is very transactional, which doesn't have a lot of visibility, forward visibility, but it has a high degree of consistency. Those are deals that come in and are closed within the current month and usually deployed very quickly.

There are mid-market activities, which are larger deployments, but not very large deals, and then there is a growing contribution from larger deals that are more lumpy in nature that take longer, both from the negotiation cycle and then from the deployment cycle as well.

And last year, where we had a significant contribution from larger deals, they were coming in fairly consistently over those nine months. That drove a lot of contribution.

PHIL: It seems like that's a bit of a growing pains issue as you go into the enterprise space. These are going to take longer. Do you feel like you just need to build a backlog of relationships and then they'll start coming through fairly steadily?

KARL: Yeah. We started the enterprise efforts in earnest a couple of years ago. That was always a little bit of growing pain. Last year we really felt that we had good momentum in terms of a fairly high degree of consistency, even though the sales cycles are longer. Now we just need to re-prime that pipe again.

PHIL: Again, that's more of a seasonal priming of the pipe rather than any real momentum loss that you saw in the business?

KARL: That's what we believe, yes.

PHIL: Over time, how big does enterprise get as a portion of the overall business?

KARL: We don't really think about enterprise as a customer segment. We use it on the sales side in terms of addressing the potential a customer or prospect, just because the procurement process is different, the way that you negotiate with these customers is different, so the quality of the people is different.

It takes longer. There's more legals involved, there's more pricing involved, there's more customization involved. That's why the cycles are longer. We have no high customer concentration in terms of there's no customer that's bigger than two percent.

We don't really segment them that way in terms of "These are enterprise customers" but we do have dozens of deployments that are over a hundred thousand dollars. That's not a huge segment, but it's meaningful revenue. But it's more meaningful on the margin in terms of revenue contribution as we grow than it is on the entire base. Because we're still very traditionally S&P-oriented.

PHIL: Help me think about, and this goes a little bit to the legacy business as well, the traditional discovery and onboarding process. If I'm an SMB, how do I find out about Rackspace and how do I know that I need it, and then how does that transition as you start attacking bigger deals?

Are you going more outreach as you look at bigger customers or is it coming in still through the same channel?

KARL: They are different. We've certainly started to drive more of a solution focus going forward than we've done in the past. When we went from infrastructure hosting plus services on the infrastructure into the managed cloud umbrella that we've basically opened up last year in terms of that is our strategic overarching business purpose, to manage cloud deployments all over the world.

The next step of that was, "OK, how do you differentiate yourself away from a pure infrastructure provider," because this is where the biggest competition is, the undifferentiated deployment of computing storage. What we've already done in terms of website launch and redesign and lead generation is to have a solution focus that includes more of the application layer than traditionally.

Rather than selling general-purpose infrastructure that you, customer, can do whatever you want to do with it, we're selling database solutions. We're managing everything from the physical aspect to the software stack to the database itself to the administration of the database to the scaling of the database to the backing up of the database, so that you can just choose what database you want to use.

Modern web applications use multiple databases, they have to communicate between each other. We facilitate that. So we're offering database solutions so that customers can basically drop the data and analyze it rather than thinking about how they're going to shard it and how they're going to scale it and how they're going to back it up.

That is one example that came out of the object [inaudible 17:40] acquisition that was solely focused on one database type, which is MongoDB that's now being extended to other database flavors, including relational databases. There's a lot of traction for that.

Another big group or solution area, as we call it, is what we refer to as digital, for lack of a better term, which is really content management systems in e-commerce, which traditionally has been a large customer set. So we're working on creating highly integrated solutions, again from hardware, software, and services that provide the best-possible platform to run an e-commerce site.

The customer can, again, focus on the e-commerce site only and not deal with Magento or Sitecore or any of the packages that are underneath. So moving up the stack for us and differentiating away from the infrastructure-only provider is that we're packaging more of the application stack into it and then providing it as a solution.

We still have general-purpose computing solutions which are, we believe, very attractive solutions or alternatives to the public cloud, which is basically OpenStack private clouds or VMware based private clouds, which is still very much in demand.

PHIL: OK, but in terms of, again, if I want to go and attack that base, how am I finding these guys and sort of selling those bigger deals? I would think these were more competitive than what you've seen in the past.

KARL: Yeah, I mean, there is multiple channels. We have the partner channel, where we have a big set of partners ourselves, an ecosystem, so to speak, of partners that refer deals to us.

Typical agencies, our typical very successful channel that we have, we have the traditional lead generation that is more geared towards SMB, that is more banner oriented for people that actually are technically savvy, do their own research. If you do your own research in terms of, OK, I need to host something, where, you're going to eventually run into us in terms of traditional banner advertising.

The solution areas are geared more towards creating awareness on the higher end of the funnel, so with thought pieces and customer events like Solve. We have a series of customer events where we invite our customers to speak to prospects as to what we do for them, so we use that kind of referral process in more generic sense to demonstrate what we do for our customers.

PHIL: Is the margin profile of those bigger deals different? Is it, and what I said earlier that it's more competitive. Is that fair that it is a more competitive space as you get into bigger deals?

KARL: That's what we have thought it would be and we have not seen that yet extensively. Our expectation was a little bit that large deals are very unprofitable, because they get heavily negotiated and you get another party in that kind of competes aggressively. We have not seen that to be the case.

It's not, the factors there are that large deals are much more attractive from a cost space to serve, so you can give them very aggressive or very good pricing that makes it ideal for both parties.

PHIL: How is it more attractive? Is it sort of the same effort in terms of design work with just a lot more revenue behind it and size?

KARL: Yes.

PHIL: Yeah.

KARL: Big legal stack versus small legal stack, we just have economies of scale.

PHIL: Another thing we maybe erroneously thought in the past is that with larger deals you'd require more customization and sort of more effort. But that sounds like that's not the case at all.

KARL: Well, the reality is that both customers and your sales force is always pulling you to do stuff that you don't want to do as a business, and so that's just the reality of the beast. Customers ideally want us to do everything for them, or some customers do. Some of the things we do and some of the things we don't do.

Then, as we evolve the business, we say yes to certain things and we generate practices and standardization around it so we can serve it effectively, then it becomes part of our evolution.

But it's not like that we're staying away from data center consolidation or your mess for less or anything like that, that the traditional outsourcing business would have done in the past.

PHIL: OK, and I think Taylor said recently that there's sort of more outbound versus inbound sales effort these days.

KARL: Yeah.

PHIL: I mean, again, is the inbound getting tougher and so you have to build that outbound? Or is it sort of an accelerating growth effort?

KARL: Well, it's both, it's an actual evolution and it's also a necessity. If you want to build a business that continuously grows, you need to develop muscles on all fronts.

Five years ago we didn't really have any significant outbound efforts, or no outbound efforts. Now we have a sales office in New York, we have a sales office in San Francisco. We have a much more active engagement on an outbound basis through the Solve events that we're organizing, so there are way more activities around it.

The numbers just get bigger and they need to deploy against that.

PHIL: Right, and do you need to ramp up your spending in terms of SG&A on a percentage basis, anyway? Or is it, do you actually get efficiencies as the business grows?

KARL: It's both. I mean, certain, we try to not make those huge lump sum investments that are coming in front of revenue, so it's basically building the machine as we run it and building out the machine as we run it. That explains why our margin structure, in the grand scheme of things, is fairly consistent.

But there are investments, of course, that need to be made and some of them are more marketing nature. We had some in 2013 where we did a big branding campaign. We built a sales force in the field offices that is, the cost impact of that is not even visible on the P&L.

But it's continuous application of resources to get additional revenue opportunities.

PHIL: OK. I do want to open it up for the audience. If anybody has a question, please just either raise your hand or walk up and I'll keep going until then.

About a third of the business comes from international?

KARL: Yeah.

PHIL: Can you help us with what the country by country or currency mix looks like and how you're treating that business, given the currency volatility overall?

KARL: Of course. We have about 25 to 30 percent of our business is served out of the UK. Really, the way to think about this, domicile is a very strange concept in our world. We have customers in 130 countries. But that revenue is really generated out of the US and the UK to probably 95 percent.

There's a high degree of concentration in terms of domicile there, but then there's also very wide distribution on the long tail.

We really only bill in US dollars, in GBP, in Euro, in Hong Kong dollars and in Australian dollars. Those are the billing currencies that we accept. We have a Latin American effort, but we don't actually bill in pesos. We remit in pesos, but it's at a changing rate, so there's no currency implication there.

With respect to the non-American business, the vast majority of the non-American business is invoiced in pounds sterling. That basically explains the top line volatility that we see and the need for us to differentiate between what a report on gap basis and what we derive from a pure traction perspective, which is the constant currency growth rate.

Over the years, over the last 10 years, the pound was our friend and then it was our enemy, and now it's kind of doesn't know what it wants to do. Or the dollar, depending on how you think about the world.

There is volatility on that. The topline volatility is quite visible, as we know and as we talked about. But even if you go down to P&L, that exposure goes away very quickly. Just numerically, in Q1, our top line impact of the pound variation, or the FX variation was 5 million dollars. If you go down to P&L, go down to net income, it's less than 1 million dollars.

Basically, because we have about a thousand people in the UK, because we have now two data centers in the UK and the vast majority of costs associated with the pound sterling revenue is in currently pound sterling, there is no economic exposure whatsoever.

PHIL: You're not, you're investing in those businesses anyways, you're not repatriating any of that money back.

KARL: That's correct, that's correct.

PHIL: What's the level of sort of net overseas investment? Is that going faster or slower than the US?

KARL: We've always had this desire, I spent three years in the UK and we've always had this internal rallying cry that we're going to outgrow the US. It's really hard. Outgrowing the US is really, really hard, just because the market is way more fragmented there.

In men's addressable market in the US, insatiable. If you want to do Europe, just Europe itself is very fragmented very quickly. We have a big service element in our business. Generally, the language of IT is certainly English, but there is localization requirements if you want to address markets properly.

We have efforts in the German speaking continent, the European part, that's why we did Australia, because it's more homogeneous to what we already have, where we see a lot of traction. Hong Kong is a difficult market. We have some traction there, but it's not really significant in any grand scheme of things.

They basically grow at the same rate as the US grows. The international business for the longest period has been sometimes a little bit faster, sometimes a little bit slower. Generally speaking, the non-US markets are behind in terms of technology adoption, but they have been growing about the same.

The reinvestment rate is very similar, they are, we are producing cash both in US and in UK at the rates are currently growing. There is not significant amounts of cash there, but there is some.

PHIL: OK, and you said the technology in international is behind. Is that because customers are acting differently? Or it's just fewer have adopted sort of the cloud so far?

KARL: Yeah, that, the second one. The general notion of basically letting go of your infrastructure and have somebody else deploy it is very much behind. It's coming and it's there and it's going to provide growth opportunities going forward. But generally speaking, people talk about a two to three year lag and you can pretty much confirm that all over the place.

PHIL: No reason they wouldn't, so far, anyway, follow that same trend.

KARL: Well, Germans don't like Amazon, so I don't know what's going to happen there. But they're going to find a way, so.

PHIL: You can provide an alternative?

KARL: Yeah, we can provide an alternative. Exactly.

PHIL: OK. You stopped breaking out the managed hosting and public cloud, but help us understand the underlying trends in each of those businesses. Do most customers sort of buy both from you? Or is it very distinct?

KARL: Yeah, so the reason why we really started to collapse these two lines is there are very, there are technical reasons and there are practical reasons.

The technical reasons are really that customers do use both, that it's application dependent, that we have a lot of customers that may be starting in the public cloud platform because they like the fact that they don't have to commit and they can spin up and they can test and they can develop an application.

Then often times, which is kind of the same thing as we've seen years ago, when it comes to production workloads, a lot of customers prefer single tenancy and high degrees of customization. We have to move from public cloud to private cloud or to dedicated solutions, if you want.

They're more on a subscription basis where variability of resources that are being consumed is not as important as the stages of the app development world.

We have certain cloudy products, like single tenant instances that are being provisioned behind the open stack API. But they are being sold as a single tenant subscription. We have basically different pricing models applied to different product stacks, and so the lines are completely blurring.

Then it becomes a practical issue, because if the lines are blurring constantly, if a customer's going back and forth, then it becomes, the reporting quality is really starting to suffer. Then you have the SEC calling, "Why is this this?"

PHIL: You've got a sign this at the end [inaudible 30:53] .

KARL: Exactly. It just becomes impractical and also not very relevant.

PHIL: OK, that makes sense.

Let's just dig into margins a little bit. There was a decent amount of volatility over the last couple of years. It seems like the last two or three quarters have started to stabilize and go in the direction that investors are looking for. How do you think about cost controls? This is a growth company, my impression is that you don't want to sort of tighten things down. How do you manage that balance?

KARL: Every day. OK, so basically, the way that we generally think about our business model is that we have a fairly high degree of analytics applied to our understanding of unit costs and unit pricing to insure that every marginal unit of growth is profitable.

That's task number one is to make sure that we can unconditionally say, in every customer situation, even if it's a large customer, that every marginal unit of growth is contributing. Right? That's kind of step one.

We've had this discipline in place forever and we continue to have this in place and that serves us really well. That's step one. Step two, then, is OK, if you can do that, what you've got to do is you've got to maximize your revenue opportunity because maximizing revenue is maximizing value.

So we apply resources to continuously evolve the sales engine to continuously deliver more and more revenue dollars to the topline. That's the value-maximizing strategy. Then the second question then becomes, "How do you manage the investment areas?"

What you've seen over the years, the volatility that you're referring to, I think is related to the 2012-'13-'14 kind of margin [inaudible 32:43] is that the existing book of business generates a healthy amount of profit. Then that profit is being reinvested into the different areas of the business that require evolution, investment, development, whatever you want to call it.

In 2012 we've basically allowed to reinvest as much profit into the development of our product development group, which was a capability that we haven't had previously with the constraint that our margins overall are not degrading. And in 2013 we relaxed that constraint and said "We have to invest faster and more and that will have an impact on margins."

The takeaway from the world out there or the fear was that we have a problem in the unit economics where the pricing is eroding or you're basically not able to compete. We've always said that that's not the case, that our corporate margins are a reflection of our investment areas and our investment behavior and the pace at which we build new capabilities and fund new investments.

In '14 we felt compelled to demonstrate that we have margin stability and that we can pace our investments, that we can pace them more, which creates more margin stability. But your general comment is correct, there is a constant opportunity to fund additional business opportunities and we have to do both. We have to manage margins today and fund the areas that provide huge growth.

PHIL: I'm trying to think of the word. It's not "discipline," but it seems like there's a recognition that you have to serve Wall Street what they expect. Do you now look at it in terms of, "OK, we've got a budget"? "Margins aren't going to go down, but there's huge opportunity here and do you want to invest everything you can against that?" Otherwise...

KARL: We certainly consider margin a constraint or a strong consideration when we set the budgets and what we invest in. That's definitely the case. The ideology where you basically say you're just going to tank the margins and invest as much as you can doesn't really apply to us.

I think we are careful investors. We have built this business very carefully and some people say not aggressively enough. There's always this balance between what do you do in the short term versus the long term.

PHIL: Thank you for your time.

KARL: Sure. Thank you.