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RAX - Q2 2015 Rackspace Hosting Inc Earnings Call

EVENT DATE/TIME: AUGUST 10, 2015 / 8:30PM GMT

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcomes to Rackspace Hosting Q2 2015 earnings call. As a reminder, this call is being recorded.

At this time, all lines are in a listen-only mode to prevent background noise. After the prepared remarks, there will be a question-and-answer session.

(Operator Instructions)

Is now my pleasure to introduce Bryan McGrath, Vice President of Finance for Rackspace. You may begin.

Bryan McGrath - *Rackspace Hosting - VP of Finance*

Hello, everyone. Welcome to Rackspace's second-quarter 2015 earnings conference call.

We hope that you've had a chance to read our press release, which we issued earlier today. If you do not have a copy of the press release, please visit our Investor Relations page at our website at www.ir.rackspace.com. This call is also being webcast online and can be accessed through our Investor Relations site.

For Rackspace, on the call today will be Taylor Rhodes, our President and Chief Executive Officer; and Karl Pichler, our Chief Financial Officer. I need to remind you that some of the comments we make today are forward-looking statements, including statements regarding expected operations and business results, our growth plans and expectations, the impact of new products and services, and our expected level of capital expenditures. These statements involve a number of risks and uncertainties that could cause actual results to differ materially.

Please note that these forward-looking statements reflect our opinions only as of the date of this call, and we undertake opinions only as of the date of this call, and we undertake no obligation to revise or publicly release the results of any revisions to these forward-looking statements in light of new information or future events. Please also note that certain financial measures we will use during this call, such as adjusted EBITDA, are expressed on a non-GAAP basis, and that our GAAP results and GAAP to non-GAAP reconciliation can be found in our earnings release, which is currently posted on the investor page of our website.

After our prepared remarks this afternoon, we will be happy to take your questions. I will now turn the call over to Taylor. Taylor?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you, Bryan. Good afternoon and thank you for joining us.

Today, we are going to update you on our managed cloud strategy and the progress we are making to expand into exciting multi-billion dollar high growth markets that we are uniquely well-equipped to dominate. I will also share the validation points that give us confidence that we are gaining traction in the focus areas we identified in 2014, as well as in the new businesses we are building for 2016 and beyond. First, though, I want to address some of the challenges in our business that are resulting in slower near-term growth than we had planned.

When we last spoke with you three months ago, we warned of slower growth in Q2. But we maintained our full-year guidance based on two expectations: one was that the impact of certain large deals, where revenue materialization was slipping beyond Q2, would be felt in Q3. That has held true and we are booking revenue from significant enterprise deals that will benefit us in Q3 and beyond.

The other expectation was that we would experience a rebound in public cloud growth and overall sales momentum after a slow Q1, consistent with the seasonal patterns that we've long observed. That expectation has not been fulfilled. While our overall sales momentum did pick up in the latter part of Q2, our public cloud growth remained slow throughout the quarter.

The root causes of the softness in our first-half execution can be separated into marketing and sales issues, and product challenges in our public cloud. We are laser-focused on both areas and have corrected or are in the process of correcting them. After digging in, we see that these issues were exasperated by a talent gap that lingered into the first half of this year, following a period of elevated turnover connected to the publicly announced strategic evaluation that we went through in 2014. Our sales, marketing, product and engineering teams experienced the brunt of the turnover.

Despite these issues, it is important to note that customer churn and net promoter scores in our cloud business and, in fact, across our entire portfolio remain very stable and industry-leading. Our customers value our expertise and fanatical support.

Where we suffered in Q2 was in incremental demand generation. We have seen that incremental demand rebound starting in June, when our sales team had a very strong month. We have also seen improvement in our cloud growth in July and early August, but we have not improved enough to achieve our original guidance range of 14% to 18% constant-currency revenue growth for the full year. Today we are lowering that guidance to a range of 12% to 14%.

We are moving aggressively to address each of the key issues that have affected our performance. Let's start with talent.

We hired 151 net new rackers in Q2 after adding just 28 in Q1. These Q2 hires reflect the vitality that RackSpace has regained as a great place to work, and it brought us many critical rackers in leadership and front-line roles. They include accomplished leaders, such as our new Senior Vice President of Strategy, Product, and Engineering, Scott Crenshaw. Scott played an instrumental role in red-hat success with Linux and OpenStack.

We have recently hired senior sales leaders in the northeastern and central US, as well as in Latin America and Australia and New Zealand. We have added a new America CMO, Carla Sublett from Dell, who has an extensive experience in demand generation. We have also welcomed our new Senior Vice President of HR, Amy Hoyt, who has held leading roles at ITT, HP, and Cisco. Amy will lead the charge for us as we work on talent acquisition and retention.

Now let's turn to our strategy and the large new markets we are expanding into. The cloud market continues to segment into two distinct categories, unmanaged cloud and managed cloud. Both are growing rapidly.

We couldn't be more pleased that our leadership of the managed cloud category was reaffirmed two weeks ago in Gartner's annual Magic Quadrant reports for both North America and Europe, where we are placed high and to the right. We see the market opening up for us, as large traditional players struggle to adopt cloud business models and as mainstream businesses demand multiple options for cloud infrastructure, along with high-value managed services.

Our strategy and differentiation have two key elements. First, we deliver the deepest expertise and best customer service in our industry, which we call fanatical support. As mainstream businesses move to the cloud, many lack the requisite skills to manage complex cloud infrastructure, tools, and application. Our ability to fill that gap in expertise is becoming more and more valuable.

Second, we create additional value by providing customers with a choice of the world's leading technology, including soon, multiple public and private clouds, e-commerce platforms, data services and productivity suites. We serve customers on the technologies that are best for their needs. This approach differentiates us, because we are the only at-scale specialists in cloud support and expertise.

Product companies focus on developing their technology stacks. Technology conglomerates and telcos offer some services but it is not their specialty. Other peer-support companies are relatively small and narrowly focused. None can match what Rackspace has to offer. That is why Gartner has affirmed our leadership in the managed cloud market category.

At the top of my remarks, I mentioned that we are seeing strong progress in key areas of our business. First, we are winning more and bigger enterprise customers and workloads, away from the major legacy players. In Q2, we set a new record for bookings from deals worth $100,000 or more per month.

One major deal was with TD Bank, which was recently featured in a Fortune magazine story that described how it chose the OpenStack private cloud for its flexibility and freedom from vendor lock-in. That story also told why TD Bank turned to Rackspace: for our fanatical support and unrivaled expertise in OpenStack.

Over the last four quarters ending in Q2, we landed twice as many six-figure a month deals as we did in the eight quarters before that period. We are expanding our enterprise sales and support capabilities, including by adding more sales reps in more cities around the world, and we're winning both new customers and additional workloads. Our 50 largest customers are increasing their spending with us at a rate more than twice as fast as our overall growth.

Our second big area of progress is in the expansion of our managed cloud strategy to provide expertise and support for multiple public cloud platforms. Last month, we announced fanatical support for Microsoft Azure, which is growing rapidly in adoption and revenue. That announcement was made at Microsoft's annual worldwide partner conference, where we were named hosting partner of the year for a record fifth time.

Azure is a powerful platform, but like most cloud technologies, it is complex to operate. More than 3,000 large enterprise customers have added Azure to their contracts, but many use only a fraction of its capabilities. We and Microsoft are confident that Rackspace expertise and support will help more customers deploy Azure and leverage it to its full potential. As a reflection of this confidence, Microsoft has placed Rackspace in its elite tier-two cloud service provider program.

We also see strong demand for managed services from customers who prefer the AWS cloud platform. We have deployed a team that is building the market-leading offering for customers who want specialized expertise and fanatical support on the AWS cloud. We expect to launch this offering later this year, and we look forward to sharing the details with you at that time.

As I've advised you on earlier calls, we don't expect significant revenue from managed services on other cloud providers in 2015, but we are excited about the prospects for this business. We estimate that the addressable market is in the multiple billions of dollars annually and is growing in the high double digits. Because of our scale and reputation for fanatical support, we are positioned to become the dominant service provider for these cloud platforms.

The third highlight that I want to call out is our new partnership with Intel. Together we are creating an OpenStack innovation center at Rackspace headquarters in San Antonio. It will include the world's largest OpenStack developer cloud, with two server clusters containing 1,000 nodes each. Rackspace and Intel will dedicate to this project hundreds of engineers with specialized expertise in OpenStack.

Starting this month, the Intel engineers will be working side-by-side with our rackers. This initiative will Rackspace expand our leadership in providing enterprise, private, and hybrid clouds, which we believe can grow into a $1-billion business within the next several years. Working with the OpenStack foundation, Intel and Rackspace will accelerate development of features that will make OpenStack simpler to deploy, more scalable, and more secure.

These improvements will make our OpenStack public cloud even more attractive to customer who value OpenSource technologies for their flexibility and freedom from vendor lock-in. OpenStack also appeals to the growing number of hybrid cloud customers who want a single provider to host their public cloud, private cloud, and dedicated servers and to make all of those platforms work together.

The improvements that Rackspace and Intel make to OpenStack will be available to the entire OpenStack community. This has been our approach ever since we founded OpenStack along with NASA five years ago last month. We are proud of that milestone and of the growing popularity of OpenStack, which just last month attracted Google as a major sponsor. Intel's choice to partner with us is a reflection of our expertise and leadership in this rapidly growing business.

Our partnerships and the recent deals we announced reinforce our core strategy, which is to provide the world's best expertise and support for the world's leading technologies. We are uniquely positioned to provide that expertise and support on infrastructure owned not only by Rackspace, but also by a customer or by a third party like Microsoft, VMware, or AWS.

These key differentiators have enabled us to profitably grow our revenue by double digits for 15 years. We serve more than 300,000 business customers who regularly recommend us to their friends. Our churn is consistently low, our margins are strong and stable, and our expansion to support customers on multiple public clouds positions us to profitably serve a vast and growing market.

To underscore our confidence in our strategy and the value it will re-create for our racker, our customers, and our shareholders, our Board has approved a significant increase to our current share buyback authority, which we intend to start acting on immediately in volume. The larger buyback authorization is part of a new, ongoing financial policy and capital structure that will better support our business opportunity, optimize our cost of capital, and provide our shareholders with sizeable cash returns. Karl will discuss the details with you in a few moments.

In closing, let me say that I am very confident in our strategy, our products, and our people. In the first half of this year, we have been moving aggressively to position Rackspace for the leadership position in managed clouds for many years to come. In a short time, we have added significant new talent to our team, launched fanatical support for Azure, and struck an innovative and powerful partnership with Intel to propel open-stack forward. We are also working on an exciting and substantive new offer that will take us into even larger cloud markets.

A lot of what we are accomplishing this year at Rackspace in partnerships, training, hiring, and technology investments won't show up in this year's growth numbers. But rest assured that I and my fellow rackers are laser-focused on our key initiatives and positioning the business to grow strongly and profitably for the years to come.

Finally, I want to take this opportunity to thank the more than 6,000 rackers around the world who deliver fanatical support to our customers every day. Rackers, you are special people on a special mission. You joined Rackspace because you stand for delivering amazing outcomes in a world of complex technical challenges and mediocre service. Thank you for volunteering your best to each other and to our customers.

With that, I will turn the call over to Karl.

Karl Pichler - *Rackspace Hosting - CFO*

Thank you, Taylor.

My three key topics to discuss on this call are the second-quarter financial results, the outlook for the remainder of the year, and the decisions we have made around our capital structure and financing policies. Let me start with the financial results for the second quarter.

Reported revenue on a GAAP basis for the second quarter grew 1.9% sequentially to $489.4 million. Currency changes affected this result positively by $700,000. On a constant currency basis, sequential growth was 1.8%.

Comparing Q2 of 2015 to the second quarter of 2014, we grew 11 % on a reported basis and 13.7% on a constant currency basis. Adjusted EBITDA for the second quarter was at $162 million for a margin of 33.1%. Net income was $29 million for a margin of 6%, EPS on a fully diluted basis was $0.20, and return on capital was 12.1%. On a net basis, we had a negligible impact from non-recurring items.

Operating cash flow was $123 million, and capital expenditures came in at $152 million. Our adjusted free cash flow was essentially $0 for the quarter, and our cash balance increased by $41 million. We ended the quarter was $317 million in cash.

Our adjusted EBITDA margin declined by 50 basis points, driven by an increase in personnel-related costs, and in marketing program spend as we came out of the seasonally low first quarter. The increase was partially offset by lower expenses for licenses and other corporate costs. Furthermore, the decrease in our EBITDA margin was completely offset by a reduction in expenses further down the income statement, so that our net income margin essentially remained flat at 6%.

The other comment to make is on our CapEx number. As mentioned above, our CapEx for the quarter was $152 million. This is obviously much higher than usual. The higher number was driven by a $30 million pre-purchase of storage-related licenses that covered three years of future usage. Even including this large purchase, our capital expenditures through the first half of the year are at 25% of revenues, consistent with our guidance.

Looking ahead at revenue growth and margin for the remainder of the year. For the third quarter, we expect quarter-over-quarter revenue growth to be in the range of 2% to 3.5%. This range yields total revenue of approximately $503 million at the midpoint for the third quarter.

For the fourth quarter, we expect quarter-over-quarter revenue growth to be in the range of 2% to 3.5%, or approximately $517 million in total revenue at the midpoint. Using the midpoint of our revenue guidance range for the third and fourth quarter, results in total revenue for 2015 of just below $1.99 billion, representing constant currency growth of approximately 13% for the year.

One of the key considerations going into our revenue growth guidance for the remainder of 2015 is a new multi-year agreement that we entered into during the third quarter that will be accretive to our revenue growth rate in the second half of the year. We are unable to disclose any specific details about the agreement because of confidentiality obligation.

From a profitability standpoint, we anticipate that adjusted EBITDA margins will range between 33% and 34% for both the third quarter and the fourth quarter. And for the full year, we also anticipate adjusted EBITDA margins to be in the range of 33% to 34%.

Let's talk now back capital structure. As you know, we have already executed a $200-million accelerated share repurchase that concluded during the second quarter. Like most high-growth technology companies, we have operated to-date without the need to fund our business with any significant amount of financial leverage. We have, however, carefully considered shareholder feedback on our capital structure, and we have performed our own analysis.

We have decided to adopt a new capital structure policy, which will include a prudent level of debt supported by strong cash flow and the assets we have in place. While our strong growth prospects will continue to drive our shareholder returns, we believe that adding a prudent level of leverage to our business will enhance shareholder return.

We have concluded that a targeted debt level, inclusive of our off-balance-sheet obligations of approximately 1.5 times EBITDA strikes an appropriate balance between value-enhancing financial leverage and the need to maintain strategic flexibility. We will use our cash on hand, proceeds from near-term debt issuances, and future free cash flow to fund share repurchases of as much as $1 billion over a period not to exceed 24 months, as authorized by our Board. We expect to complete at least $500 million of this new buyback within the next six to nine months, subject to market conditions and the arrangement of the appropriate financing.

We are very excited about our growth opportunities, and we continue to regard our profitable organic growth as our primary drivers for shareholder value. This new capital structure policy allows us to continue to invest for growth, while optimizing our cost of capital and returning capital to shareholders in an efficient manner.

Before we end the call, I would like to announce the addition of Winston Len to our Investor Relations team. He was one of the analysts who worked on our IPO back in 2008. Subsequently, he covered our stock as the lead data center analyst for Goldman Sachs. He has had a long relationship with the Company and we are happy to have him on board.

This concludes our prepared remarks. Operator, please open the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Gray Powell, Wells Fargo.

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

Hi guys. Thank you for taking the questions. Maybe two separate questions from my side. To start, can you talk about the potential to support additional third-party cloud environments? And just what gives you the confidence that this is the right strategy? And then just to get it done all at once, on the numbers, Q3 and Q4 guidance implies that growth increases meaningfully from the pace of Q2. What is your conviction level there and what are the main drivers? Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Hey, Gray. Thank you. This is Taylor. Let me take that second question first. I think that very simply, in the first part of the year, on the last call, we talked about a large customer churn that hit us on April 1st, so therefore, it had a full effect for Q2. We just talked about the other factors that were driving slowness, both seasonal factors as well as some of the impact that we've talked about with sales and marketing and effects that are hangover from the strategic process we went through last year. When we think about the second half, in order to have high confidence in the acceleration, we said that we had to have the enterprise deals that we are pushing out past Q1, on the last call, to land and materialize into revenue in the second half. We have clear revenue visibility into those. We also said that we needed to see a pickup in our public cloud growth coming out of what is normally a slow Q1 seasonal period. In the early days of Q3, we are seeing the early signs of improved growth trajectory on the public cloud as well. So between the combination of visibility into large enterprise deals and an understanding of what the issues were in are cloud and fixing those, we have good confidence in the second half of the year.

The third-party cloud model you mentioned, why are we confident that it is the right strategy? Look, I think we are -- we usually go where we feel strong demand from our customers. Historically, if you think about our expansion of business, whether it was initially going from Linux to Windows with our intensive offering or going into public cloud, moving into new geographies, we normally go where we feel strong pull first form our install base. And then secondly, where we can map that on to the broader market. And I would just say that we see and can measure significant demand for customers who are adopting cloud models and could manage them themselves but choose not to. Or customers who really frankly don't have the skills on their own payroll who adopt and manage a multi-cloud world. And as we see mainstream adoption pick up, we see this demand being validated more than ever. But also frankly, you can go read any analyst out there who is validating the fact that the market for infrastructure plus services is starting to grow as fast, if not faster than (inaudible) market. So we feel like there's plenty of evidence points out there. Our heritage of being able to deliver services at scale and operate complex things for customers just positions to do it better than anybody else. So that's why we feel confident in that strategy.

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

Thank you very much.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you, Gray.

Operator

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Thank you. Just a couple of questions. One more general and then a little more specific. Just generally speaking, obviously, the guidance came down from 14% to 18% down to 12% to 14%. Just trying to figure out what happened there in terms of that adjustment, and if you can give any more color on that? And then with respect to capital expenditures, I noticed that customer [gear] was up a lot in the quarter, relative to the previous four or five quarters. Is this foreshadowing of the revenue growth you're seeing and the contracts you're winning? Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you, James. This is Taylor. I'll take the first part and then Karl can talk to the CapEx. In terms of the May call, when we spoke to you last, we told you that the Q2 forecast was going to be low and lower than it was last year, lower than the market expected. And we said again, that the drivers of that would be primarily at large enterprise deals that were slipping out, as well as generally what we see is a slow start to the year in a seasonal period. At the time, what needed to happen, and pardon me, and also with the addition of the large customer churn, those are the three things primary drivers. At the time when we gave the guidance, what needed to happen for us to stay in the low end of the original guidance range was for us to get those large enterprise deals closed and online, and that is done. Those are in the bag and those are materializing into revenue that we can now measure with certainty.

The other piece was that we needed the public cloud growth to pick up, and as mentioned, that didn't happen in Q2. We are starting to see signs of it picking up. We understand from our customers some of the challenges that drove it. The pace of change in the cloud market from an engineering workload perspective is very high. When you start to fall a bit behind on key talent in your engineering teams and your support teams, then you will miss a couple of cycles on feature and functionality that allows you to win incremental workload. So what we saw was that our base of customers is very stable. We have remarkably stable MPS and churn within our cloud base. Where we missed due to some of the attrition in our sales and marketing team, as well as some of the feature functionality that we needed to close was incremental demand, both from net new customers, as well as from some workloads, from some of our larger cloud customers that got delayed because we needed to close some gaps from them. The public cloud piece is the new news.

I think importantly for us, we feel very confident that we understand the root causes. We are aggressively fixing or have fixed them. We talked about the talent added and the measurable significant increase in talent added in Q2. We are seeing good traction from our enterprise customers and those workloads materializing, and we are seeing continued validation from Gartner and other market sources on both the managed cost strategy as well as our leadership position in it. So that is where we are, that is what drove the re-guide, and that is why we feel confident that we can hit it. Karl, do you want to talk about the customer-geared CapEx?

Karl Pichler - *Rackspace Hosting - CFO*

Absolutely. There are a couple of things that are worth mentioning here. First of all, if you look at the Q1 number, you see a low number, and Q2 was a little bit on the high side. And so one thing that is definitely worthwhile is to look at this on a year-to-date basis. If you look at the entire year-to-date spend relative to revenue, it is exactly 25 %. That includes the buildup of our [alongside] facility, which is obviously requiring the build out and then the necessary inventory levels to support the operation. I have mentioned in the prepared remarks the pre-purchase of a fairly large amount of storage-related licenses that is for future revenue support. But it's the full number to date. You are right, large deals have chunkier capital requirements that are more so front-loaded than the traditional smaller scale business, that has a small impact as well. And then there are some timing fluctuations, as mentioned, between Q1 and Q2 that I've mentioned on the last call that we would expect a high level going forward. I think overall, the expectation is still that 25% is a good number. We will most likely come in slightly above that number, but we have significant build up in inventory in [alongside] and these licenses that a little bit out of the ordinary in terms of our run-rate business. And that is what explains the numbers.

James Breen - *William Blair & Company - Analyst*

Great, thank you.

Operator

Frank Louthan, Raymond James.

Frank Louthan - *Raymond James & Associates, Inc. - Analyst*

Great, thank you. First, on the buyback, what led to the decision regarding this and make the capital change at this point? You went through this last year. What is different now? Is this the sign of the business being more mature or a just direct commentary on the valuation? And then, can you give us just a little more color on what is changing in the marketplace? Is it just more difficult to get some of the smaller size customers, see how we can move up market? Or is it just a matter of how you reshuffled the sales and marketing on that end, and we'll see that start to pick back up again? Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Sure, Frank. Thank you. This is Taylor. I'll comment first on the buyback. I think bottom line is because we see more and more clouded option happening, because we see the trends that I've mentioned, where mainstream customers are going to want and need a trusted innovator who can underwrite great LSAs for them and help them manage multiple clouds. We feel that we have a very bright future, and we are really uniquely positioned in these very largest TAMs to go and lead. And so we have high confidence in our managed cloud strategy. And this unprecedented capital program and the buyback that goes with it is a good way for us to express our confidence in our future. Karl, did you want to comment further on the capital structure decision?

Karl Pichler - *Rackspace Hosting - CFO*

Yes, absolutely. Look, I think you mentioned the term mature business; I think that we have had a business that has generated a significant amount of operating cash flow that we have been able to fund our entire build-up of capital base, and we all know we are somewhat asset-intensive here with our own money. So we actually have never really had to fund our growth CapEx with sources of debt or anything like that, which has --serves us extremely well. But it is somewhat of a sub-optimal capital structure. And we have had conversations about this over the years, especially over the last 12 months where our cash balance just started to increase. It's just the right thing to do from a corporate finance policy, to actually apply some leverage to this business, and still, at the same time, provide a high degree of financial flexibility. Because at the end of the day, part of our value proposition is to finance the operation of data centers and the equipment purchases on behalf of our customers. So a strong balance sheet is always going to be important. We have the asset base to lever up. We have the strong cash flow to lever up, and so it is just the right thing to do. Now with this, there are obviously coming a large amount of funds towards us. We are intending to repurchase our stock quite significantly. We will start right away and come into at least through half of it or $500 million over the very near term, six to nine months, and then continue to maintain that leverage rating over time. That's really the policy is to target the debt rating, which is -- the debt rating and the associated capital structure, and then continue to provide shareholder returns way beyond this initial buyback.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Great. Thank you, Karl. So Frank, you asked a question about what's changing in the marketplace. Is it harder to compete for the smaller customers? I think frankly that we've always had a very healthy SMB business. A lot of the market out there made up of SMB customers are exactly the types who want and need to buy managed services. They can much more economically buy slices of our resources on a variable cost monthly fee, versus staffing those on their own payroll. We actually see good, strong traction, as we always have, in the SMB market. We do think that the move up market, as we talked about on the last call, is the right move. Because if you just look at the Gartner Magic Quadrant as one measure, you see big, traditional players who are struggling. And quite frankly, their business models are really being disrupted by cloud. You can look at their growth rates, you can look at transfer of market capitalizations, etc. And so we feel like the right, prudent place for us to go in the market is to go to mid-market and enterprise customers and compete to win larger deals that are profitable for us that provide scale on our business, where we can add a lot of value, rather than arguing over the price of bits and bytes. And we're excited about that. But as we talked about on the last call, sometimes those deals can be chunky; they can be lumpy, both in terms of when they close and when they materialize. And so we talked last time about less visibility into the actual smoothness of our revenue stream. And that over time, you will see more lumpiness in it. But we feel competitive there. We have a base of business in the SMB there that is strong and consistent. And opportunity to keep moving comes from enterprise, as well as expanding fanatical support onto other leading cloud platforms and managing these multi-cloud worlds for our customers.

Frank Louthan - *Raymond James & Associates, Inc. - Analyst*

That's helpful and thank you for the color on maintaining that leverage over time. That's good color. Thank you.

Operator

Simon Flannery, for Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you. Good evening. Taylor, I think that you talked at the outset about some product issue with the public cloud. Can you just give us a little bit more color on that. And when do you think with some of the talent hiring here, when do you think the product will be to where you want it to be, and maybe some of the developments with Scott Crenshaw and with Intel, et cetera? Obviously, we see Amazon producing some pretty strong results. Do you think you're going to be able to keep your product relevant? And then Karl, the margin guidance, I think you were initially 33% to 36%, now 33% to 34%. It implies a step down in margins in the second half. Is that really some of the hiring that you're doing or are there other items here that are pushing you toward the low end of the [margin]? Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you, Simon. This is Taylor. I will go first. As you all know, in 2014, when we went through this strategic process, as that process wore on, frankly, we lost some good people who weren't sure whether or not we were going to remain an independent Company. Because that process wore on into late in the year, people who had taken phone calls maybe in the fall or early winter, it took them time to make the decision to accept an offer. And so we lost some talent, not only in our engineering group, but also in our sales and marketing teams and our product teams. That is in the fast pace change of the public cloud; those things cost you in terms of creating advancements. With Scott here, we have dived in deep, and the teams are actually making very strong progress. They're moving quickly, spending a lot of time with our customers, understanding the issues and challenges. And also, the upside, what do they want us to add to continue to specialize OpenStack and make it a different platform than AWS that is good for customers who value open source, customers who value the ability to have portable workloads, the ability to operate hybrid clouds. And so I actually feel that not only are we closing gaps, we're also discovering and now being able to deploy against value-adding features, which is a good segue into the Intel partnership.

The real strategy behind the Intel partnership is to propel OpenStack forward at a much greater pace in a focused monetization strategy for us, targeted toward enterprise private and hybrid cloud. There's a very large class of applications and workloads out there that don't want to be in a peer public cloud, and there are new and exciting things coming down the road in terms of containerized applications that will run differently in OpenStack than they're run anywhere else. And so the ability to work with Intel to differentiate and focus OpenStack is actually a brilliant monetization strategy for us. We are receiving feedback in the market that our OpenStack private cloud product is one to two years ahead of competing products in the market. We are seeing good wins there, like TD Bank and others, at-scale sized private cloud wins. And the partnership with Intel will help us speed down the path of really putting the features and capabilities around OpenStack private and hybrid cloud that enterprise want and need. Again, I think that is a $1-billion plus market opportunity. Analysts in the market estimate us growing at 40% plus, and at OpenStack is hitting a good tipping point. So partnering up with Intel, by seeing players like Google come into OpenStack, we actually really feel that on its fifth birthday, OpenStack is now really starting to hit an inflection point that's very important for us. So let me turn it over to Karl and answer your second question.

Karl Pichler - *Rackspace Hosting - CFO*

You heard us talk about this in the past, that in the short term over one or two quarters, revenue growth and margin is really positively correlated, which is largely really effect of revenue growth and fixed cost leverage. We can time the hiring and obviously the timing of the hiring creates some margin variability. But in the long term, that has a high degree of correlation. In the short term, if we don't grow as we originally expected, then we don't have the same fixed-cost leverage, and that's what creates the -- the margin (inaudible) come in at the bottom end of the range as well.

Simon Flannery - *Morgan Stanley - Analyst*

So no change really to the long-term margin expectations?

Karl Pichler - *Rackspace Hosting - CFO*

No.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

(Operator Instructions)

Patrick Walravens, JMP Securities.

Patrick Walravens - *JMP Securities - Analyst*

Okay, great. Thank you. Taylor, could you talk a little bit about what steps you still need to take to launch managed AWS? And in particular, is one of those steps to sign some kind of agreement with Amazon itself? Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Hey Pat. Thank you for the question. I am going to be frustratingly silent for you on this today. We are working on it and we have big plans. But by our strategy, we would like to reserve further comment. I will just say that we are very satisfied with our progress. We have a dedicated team working on it, and we have really, really covered a lot of yards. But for marketing and offering strategy reasons, we are going wait until we make our launch announcement to share more detail. But we're excited about it.

Patrick Walravens - *JMP Securities - Analyst*

Can you address whether it's important to have an agreement with Amazon to do it?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

I am not going to comment on it. Thank you.

Patrick Walravens - *JMP Securities - Analyst*

Okay. Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

We'll share more soon, Pat.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for taking the question. Taking a step back and looking at the overall arc for the growth dynamic of the industry, obviously, we've spoken about some of the rising demand trends with respect to cloud and how you folks believe that you're positioned to capitalize on that. If I take a look at the growth dynamics in the near term, how should we think about the longer-term growth opportunity in terms of trajectory of the business. Clearly, we're looking at a little bit more tempered projection for the time being. Would love to hear your thought process and how we should think about the mid to longer-term outlook here.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you Amir. First, I want to make sure that we're clear: we're not here to provide 2016 guidance or anything beyond that. But I will talk about the TAMs that we're moving into and maybe just aggregate our business a little bit from how we see the different parts and the growth rates. We think that the dedicated managed hosting business is still large and very viable. There are a lot of classes of applications out there that are never going to be re-platformed for the public cloud, either by lack of resource or intent to cloudify those apps or frankly, just inertia within a resource constrained IT shops. And so we think by our best data that the dedicated hosting market is still very large. Probably growing somewhere between 8% and 10%, because we're the market leaders there, we feel like we can do well in that space.

We think about the private cloud market, which includes virtualized servers as very large and actually more rapidly growing. Really, some estimates think that it's a north 30% growth market over the coming three to five years. And we agree, because we feel very strongly that while public cloud will be the high-volume platform choice for the high volume of applications, what we're also seeing is that enterprise and mid-market customers have a desire to operate with a service provider, their own cloud architectures, where they can do cloudlike things but in a secure way that they can control. We all know security is becoming more and more of an issue. But also because there's a class of applications that either don't behave well in a public cloud or get very, very expensive to run in a public cloud, because their workloads are more stable and predictable. So we see that the market for private cloud and virtualized servers is quite large, probably growing at least to 25% and maybe higher than that. And we see pickup and demand for enterprise private clouds growing significantly.

And then I think you get into the pure public cloud market. I think, quite frankly, the market probably thought that public cloud was growing at 50%, and now it seems like it's growing at 81% because AWS's numbers were 81. And they're taking the share of volume in that market space. And we feel like that is logical because they have the head start. They also have the most mature product platform. They have a sticky ecosystem of developers who like their platform. And we feel like our public cloud play is two fold. One, I mentioned continue to hone and specialize OpenStack for customers who actually prefer the value of open-source platforms, avoiding vendor lock-in, and wanting fanatical support to run OpenStack private and public together. But also, frankly, to participate in the high-growth TAM of AWS's market by being the leading managed services provider. We don't know how big that market is.

The estimates market vary, but let's just take a look little journey of fantasy here and say that if AWS soon becomes a $10-billion market, and 20% of that market are what we call support seekers, which really is a low estimate when you think about historical IT that's split between do-it-yourself and managed services, usually you think about more 30% to 50% of the market likes to buy managed services. So let's just conservatively say $10 billion, 20% is support seekers who want managed services. And now you're at a $2 billion addressable market in the very near term. And if we take a small share of that, it can become a very large business for us when you think about 2017 and beyond. These are big opportunities. They are going to take time for us to build the new businesses into big businesses. But we feel good about the fact that these become accretive to our overall growth rate over time.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much. That's very helpful. And then if I may, one follow-up question. It seems as though one of the folks, Taylor, since you have taken the helm at the Company, has certainly been a focus on the margin improvement and cash-generation capability of the business. If I sit back and I look at the new capital structure in terms of the expectation around debt and expectations around investing in the business, how should we think about your prospects for cash generation here, and how should we think about that in relation to investing to drive some of the growth opportunities here that you mentioned?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Amir, I'm going to let Karl answer that, but I will start it out by saying we have deliberately chosen a target leverage level that does not constrain us from growing the business. This was a thoughtful part of our analysis. We believe that we will have exciting opportunities to continue to deploy growth capital, and the level we've chosen we don't believe constrains us from doing that. Karl, do you want to talk a bit more?

Karl Pichler - *Rackspace Hosting - CFO*

Yes, look, this is certainly true. We have focused more so than maybe in the near past on creating higher degrees of productivity across our business. We also mature as a business, and we have a fairly stable asset base and fairly stable cash flows that just lend themselves to be levered against. That is certainly the case. We also have business opportunities ahead of us that have a very different capital requirement. Those businesses that rely on third-party infrastructure are capital light, which creates different cash flow profiles and different margin profiles than our existing business has. So overall, it is just worthwhile more so than ever in the past to utilize a prudent level of debt, as Taylor said. So we continue to see ourselves as an organic growth machine that creates value through debt, and we would never increase leverage to an extent that would sacrifice or limit our growth abilities or growth opportunities. But is just the right thing to do for the business, and to basically utilize the benefits of debt a little more so than we'd done in the past.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the incremental color, gentlemen.

Operator

Siti Panigrahi, Credit Suisse.

Siti Panigrahi - *Credit Suisse - Analyst*

Hi guys. Going back to your (inaudible) cloud strategy. One question I keep getting that the new strategy, like people started comparing you with professional service of like Accenture and (inaudible). How do you compare/contrast your new strategy with those companies? And looking at the margin in the third-party cloud services margin, how is that going to compare to your existing margin profile?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Siti, thank you. I'll take the first part. Karl can talk about the second part. The -- look, I think Accentures and the global SIs have a very different business model, obviously. What they want to do is come in and focus on business transformation and application level transformation, where they are managing -- re-platforming or building a new applications and the migration of those applications. Very, very different business for us. We have never really focused on getting into the PS business, because we value sticky, recurring revenue models. And our experience so far in the market in understanding where customers need help and express value is very much not in -- we are not going to pull up the bus and unload it with 40 people and come staff for nine months to do a body shop type model to help replatform [mats], right? We don't want to get into that business, it's not what we do well, and we don't think the margins are great there. What we want to do is we want to bring expertise to the table to companies who are wanting to leverage the right cloud stack for what they're trying to do. We can add value first by helping them understand what to do there; second, by helping them understand what types of applications they should move and providing some guidance and assistance along the way.

But third, we are very much developing customer use cases that are about ongoing value-add and operating those applications, optimizing them as the product stacks change, and really help them solve very sticky, thorny problems like making no-SQL databases work in cloud models, which is hard. These are all scarce skill-set areas where we can really monetize our economies of expertise, and where we can be sticky to these customers over time. We are finding promising returns from our work in the market, so far early stage. What customers are not looking for, primarily, is just a quick hit. I think you can look at companies in the market for examples of that. For instance, in OpenStack, [morantas] initially focused on being the front-end PS shop that would come in and help you build and deploy a custom OpenStack cloud, and then hey, you're on your own. They have had to pivot their strategy to try to get further into longer-term sticky services, because they found that's just not a great business model. And so we are always going to be about ongoing, sticky value-added recurring revenue-type services on top of these.

I think the other thing to keep in mind is that every analyst you read who covers the IT space declares us to be a multi-cloud or a hybrid-cloud world. That means that customers will use more than one thing, and that creates even more complexity and opportunity for us to add value by being really the only one in the market who can these things on an ongoing basis across multiple clouds for customers. And we think that is a value-differentiating zone as well.

Karl Pichler - *Rackspace Hosting - CFO*

Let me take the margin piece, then to add on on this. When you think about this in a very conceptual unit economics point of view, where you really look at the marginal cost and the marginal revenue component to it. Then the third-party cloud support business, if you want to call it that, really differs from a margin perspective along the following lines. From an EBITDA margin perspective, you would have a lower EBITDA margin contribution, but you would have roughly the same pretax or after-tax contribution. The main difference, of course, coming from the fact there is no {D&A] associated. And then also on the flip side, no capital requirements associated with this. So overall, the short summary, again from a unit economics perspective is lower EBITDA, roughly similar pre-tax, and then no capital requirements leading to higher ROIC. The reason why I'm saying cloud (inaudible) economic space is of course the way that this will end up actually showing on our corporate PNL will depend on a very many things. Most notably, of course, how quickly those revenue streams build up relative to our existing business, what other investment activities are going on in the Company, and so it would be wrong to conclude that margin profile will quickly materialize as such. But those are the different inherent characteristics of the business model.

Siti Panigrahi - *Credit Suisse - Analyst*

Just a follow-up. Taylor, you talked about the large opportunity with (inaudible). But also, fanatical support is one of the key differentiation for -- to attract customers -- or access infrastructure. As you see this business grow, how do you compare the opportunity versus cannibalation to your exit theme (inaudible)?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Siti, thank you. Good question. I think that as you heard me say, hopefully, what we view is that there's a large, ongoing market for dedicated hosting, which obviously is differentiated for us. Single tenancy in a cloudlike way will continue to be something you can do at Rackspace that you can't do in one of the public cloud leaders and not do well at a telco or other service provider. And also, you've heard us talk about the specialization of OpenStack to really become the true stack for enterprise private and hybrid clouds, which clearly runs on our infrastructure. So our guiding thesis going forward is that when we spend a dollar on infrastructure it's because we can create specialized high-return outcomes in market spaces that we can dominate. We don't view that going away.

But we also view that the future of the world is that our customers for the most part, especially the medium and large size ones, will want to operate across multiple cloud stacks. We see it today, and I think that the analyst literature out there also verifies that. So I would view that a future customer will be consuming some open-stack-based private cloud product with us and public cloud, potentially, for certain workloads. They may have big databases hammering away in a bare-metal dedicated server environment with us. And we may be managing a significant amount of workload for them, either on Azure or AWS. And that is a rich mix of value add for that customer, and we like the profile of that business going forward.

Siti Panigrahi - *Credit Suisse - Analyst*

Thank you for the color.

Operator

Steve Milunovich, UBS.

Steve Milunovich - *UBS - Analyst*

Thank you. Hey, Karl. A couple of questions. One, accounts payable jumped like 20 days sequentially. What was the reason for that? And then you guys mentioned some sort of accretive deal that you didn't want to elaborate on. What's the nature of that, and is that separate from the vendor financing that we see in the cash flow, which is mostly the storage licenses?

Karl Pichler - *Rackspace Hosting - CFO*

The AP is related to that purchase specifically. So that is why we had this big jump, and that is also why cash flow from investment on the balance sheet is only 110 and our cash balance actually increased. That was all due to this [$80 million].

Steve Milunovich - *UBS - Analyst*

What about the agreement that you said might be accretive in the second half?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Hey, Steve. This is Taylor. I'll take that. Just like last year, if you remember, if you look back to our Q2 transcript from last year, we talked about significant enterprise deals that we were booking that would be accretive to our growth rate in the second half of the year. We have been successful out with a couple of big deals. They are of size that they will help us accelerate the results in the second half of the year. And again, that is one of the reasons that we have the confidence in the visibility to doing better in the second half of the year. So I would just say it's a statement of the fact we have some big things that will move the number. And just like last year, we can't comment specifically on who they are, but they give us confidence in the second-half guidance.

Steve Milunovich - *UBS - Analyst*

I got you. Can you characterize the enterprise business? Is it like 15% to maybe 20% of your revenue today?

Taylor Rhodes - *Rackspace Hosting - President and CEO*

We don't break that out Steve, so I'm not going to comment on the percent today.

Steve Milunovich - *UBS - Analyst*

Okay. Thank you.

Operator

Jonathan Atkin, RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you for the color, Karl on the margin profile and capital intensity issue shift toward third-party platforms. My question, two questions real quick. On Azure, and then prospectively on (inaudible) I'm interested in what exactly is needed in terms of personnel investment and training and other factors to be able to provide support on those platforms. Is it a matter of cross-training OpenStack experts into Azure and AWS? Are you hiring new people? I would be interested in that, hearing some thoughts on that. From an asset point of view, are you open to any kind of a sale lease-back type arrangement for the data center assets that you own, as well as maybe subleasing data center capacity that you've contracted for that perhaps you may not grow into based on the shift in your model toward capital light. Thank you.

THOMSON REUTERS

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Thank you, Jonathan. I think good questions. Let me, this is Taylor. I'll start first with your question about personnel investment. I think the good news is that we have a very large cadre of technical rackers who have grown up in the Linux world and the Windows world who are really, really easily re-trainable to learn Azure and to learn AWS. And as we grow the business, will we be making incremental hires? You bet yak, because these are attractive business models. Really what we are able to do is we're able to redeploying resources. We have got a very unique asset here called Rackspace University, that has actually been one of our best discoveries when we did it a long time ago. Because we have one of the capabilities in the world where we can train and retrain technical rackers at scale, and we have been doing that to move rackers into these new areas. Remember, we are, if not the largest then one of the largest Microsoft service providers, and we have a very large amount of our revenue over time on Microsoft applications and operating systems. And so we have got lots of rackers who have been training on Azure for some period of time, because our customers have wanted somebody to consult with them, even before we got into the business. So that's a relatively easy move for us. On AWS, we have lots and lots of rackers who are very, very fungible and can move quickly into the training of that. And so we are seeing good pick up there. In terms of what's the mix between existing resource and new, by far today it's existing resource. But as these businesses pick up and we see the growth traction, we will want to invest new talent as well that can really create even more of a competitive advantage for us.

Karl Pichler - *Rackspace Hosting - CFO*

Let me take the DC question then. Good question. So on the sale and lease-back piece of your question, we have really changed our data center strategy over the last couple of years and are completely in a wholesale collocation lease model today. If there is anything for sale in the lease-back consideration, it would really be our legacy facilities or our oldest facilities, so to speak. Even there, we are leasing the sell and the significant build out from the outset and have improved those with leasehold improvements. All of these facilities are actually leased. And certainly, our go-forward path is to continue doing that. So I think we've already -- 90% there and having the right ownership and financing structure for facilities, anything we could do there would be secondary optimization.

Then the second piece you were asking about subleasing existing space. There is obviously a big question as to how much revenue will require data center space, and whether it's running in our facilities or on third-party clouds and all of that. But as Taylor mentioned before, we see continued demand for dedicated hosting, we see continued demand for private cloud deployments. We see many customers that actually don't want to be in the data center business anymore, or even in dedicated large private clouds. We certainly anticipate to provide the data center space as well. Furthermore, our leasing contract do have flexibility built in. They are largely in terms of delaying phases, or the build out phases, so that will allow us to time infrastructure capacity to as much -- to as close as possible to the revenue being generated. Subleasing would be a possibility, but I think it is a remote possibility. It's not --we have growth capacity in our production facilities, and the other facilities are pretty much full. So we feel fairly confident that is not going to create some sort of requirement to actually start leasing out part of our data centers.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you.

Taylor Rhodes - *Rackspace Hosting - President and CEO*

Operator, I think that concludes the call. Thank you all for joining us today.

Operator

That concludes today's conference. We thank you for your participation.
