Rackspace

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Siti Panigrahi: Alright. Good morning and welcome to the Credit Suisse TMT conference. I'm Siti Panigrahi, an analyst at software research team, and we're fortunate to have Taylor Rhodes, CEO of Rackspace. Taylor, welcome to the conference.

Taylor Rhodes: Thank you, Siti. Appreciate it.

Siti Panigrahi: It's been a year since you took over as CEO of Rackspace and last year we talked about your managed cloud strategy at this conference. Maybe to kick off, where did you start it? Give us an update on that. And also, this year you announced some new products and services. Maybe how do those services complement your strategy?

Taylor Rhodes: Sure, thanks. So when we talked about the managed cloud strategy in 2014, it kind of -- underpinned by two key assumptions. The first was that we're very early in the move to cloud outside of the corporate data center. The real target opportunity is the 80% of IT that still runs in the corporate data center and that mainstream and option would be picking up. We're moving past early adoption in the mainstream and that mainstream buyers generally also consume managed services in addition to various cloud infrastructure form factors.

And the second premise was that we would see what we call a multi-cloud or a hybrid-cloud role, meaning that as CIOs think about their broad portfolio of applications they will want infrastructure choices; some going to public cloud, some going to private cloud, some going to dedicated hosting, and that simply fits the parameters that not all applications are created equal.

So our managed cloud strategy was built upon the assumption that we would be the service leaders, helping people move out of their corporate data center who generally need the skills that Rackspace has to help them migrate, operate, secure and run their infrastructure and apps. And the second is that we would be able to provide choice.

And so we started thinking about choice, meaning providing optionality on the world's leading cloud infrastructures. So when you think about that, we already have a portfolio that includes dedicated hosting. It includes private clouds built on OpenStack. And what we've added in this year is the ability for customers to consume the world's two leading public clouds, AWS and Azure. And our value add there is to make those clouds work better by running the operations and securing the applications for our customers there, but also to make those clouds work as part of that multi-cloud portfolio that most of our customers tell us they'll need.

And so what you've seen us add this year is those major product launches around managed security as a service, Fanatical Support for AWS, Fanatical Support for Azure. And really, that has built out our portfolio of offers to a place where we feel differentiated in the market.

Siti Panigrahi: Right. And digging more into that announcement on supporting AWS and Azure, what triggered this change? You guys really used to compete against AWS and Google and now partnering with them. What really triggered that change and what sort of key trends that you have seen in the market that drove your strategy to support (inaudible) cloud service?

Taylor Rhodes: Sure. If you think back, again, part of the legacy of Rackspace has always been offering our customers choice of leading technology types. So in the early days that was a Windows operating system or a Linux operating system. And in today's world it simply means that there will be more than one cloud out there. And our customers, our installed-base customers, have workloads that they feel better about putting into the Amazon cloud or into Azure because they prefer that technology stack, but they still want help running them and governing them. So for us, the addition of AWS and Azure is really a logical extension of our strategy, which has been always not to be the OEM that invents all the technology. It's been to take the world's leading technology choices and run them better, add more value to them for our customers. So that's what led us to make the addition of these into our portfolio.

And clearly, we feel very strong about the fact that the addition of Azure and AWS has brought us into new TAMs that are high growing. Again, early days where the mainstream market is just really starting to get moving and that's the market that generally wants and needs help, right? And that's what Rackspace has always existed to do, is to add value and infrastructure by managing the operations for our customers and so it's really just a logical extension of our ongoing strategy.

Siti Panigrahi: It's been a few months since you have launched Fanatical Support on Azure and AWS. Just wondering what sort of feedback you have got from customers--.

Taylor Rhodes: Sure.

Siti Panigrahi: And what your expectation may be. I think you talked about 2016.

Taylor Rhodes: Yes. We just closed our second month of having the Fanatical Support for AWS in the market. As I mentioned on our call a couple of weeks ago, it's early days, right? We don't expect that these will move the needle on us substantially on our $2 billion revenue base until 2017 and beyond, but I characterized some of the early returns as encouraging.

So one of the things that we know now is that the majority of the customers who are coming to Rackspace are net new to Rackspace, meaning we weren't serving them before. And that's very important for us to think about expanding our TAM, right, by being able to attract new customers.

The second thing is that the vast majority of the customers are buying the higher service level that we call Aviator, and at substantially higher cost than our lower service level Navigator, and that's a good indication that customers are also seeing value. They are perceiving value in Rackspace's capability to make the AWS Cloud more secure, run with higher up time and performance, help customers govern the way they're using the AWS Cloud. So, those are a couple of leading indicators that we feel very positive about.

Our business with Azure and the Microsoft private cloud, which are also offers we added this year, are also building pipeline nicely. We're seeing good traction. So again, early days. We will see in

2017 and beyond when these things really start to move revenue growth-wise, but good early indicators for us.

Siti Panigrahi: Alright. And you also talked about that it expands your TAM. And we know that AWS [has like] $8 billion run rate and it's growing much faster, but also they're in the hundreds of consulting partners offering services on AWS. And how do you think-- what's your plan to effectively compete in that, to become a premier consulting partner for AWS?

Taylor Rhodes: Yes.

Siti Panigrahi: Where do you think--?

Taylor Rhodes: Absolutely. So Amazon's following a very traditional path. We often get asked the question do you think AWS will ever offer sort of the Fanatical Support model around their cloud and what we're seeing is no. What they say they're going to do and what they're doing are two-- are actually the same. What they're doing is following a very traditional enterprise tech path where they're bringing a channel ecosystem that can add value to their technology for customers who prefer managed services with it. So you do see quite a few names in their ecosystem. I think it's important, though, to sort of parse those. You see lots of professional services firms who do one-time work on the front end, really focusing on migrating applications to the AWS Cloud. That's a very different business model from ours where we perform the ongoing management operations and security services.

Also, you see others in the ecosystem that are much smaller than Rackspace and don't have our either heritage in cloud operations or our portfolio. Again, think about the value proposition for a CIO, meaning I view AWS as a tool in my portfolio, a great fit for certain applications, but I'll also want dedicated hosting. I'll also want private cloud for other application environments. So the combination of our size and scale and heritage around running cloud operations, as well as the ability to manage that multi-cloud portfolio are the two ways we'll differentiate.

One of the things we shared at launch was that we had immediately gained audited managed service partner status and also that we have certified in the triple digits of technical Rackers on the AWS Cloud. Those are signs that we can bring scale to this that we think others will be challenged to bring.

Siti Panigrahi: Right. So now your sales guys are selling Rackspace Cloud are also selling AWS Cloud and Azure Cloud. So how is your go-to-market strategy different for selling top-rated cloud versus your Rackspace Cloud? Do you (inaudible) divide differently your sales guys?

Taylor Rhodes: Yes, a good question. So in the SMB space a lot of customers come to us knowing what they want. They come and say, hey, I'm an AWS customer or I'm a Microsoft shop, but I'm looking for dedicated hosting and in that space you're less consultative. You're simply helping the customer solution the right platform for what they already know they want.

However, in then midmarket and enterprise, customers value our ability to be consultative and to be objective. Remember, one of the things that we always talk about is we don't invent all the technology so we can be objective to our customers and help them say which applications are right for the right infrastructure. So in that space we get the chance to understand what problem they're trying to solve. Remember, many of those companies also are not homogenous. They'll have parts of their app environments that are Microsoft ecosystem apps, others that are greenfield that might be going on AWS, and others that are VMware virtualized workloads that will stay on dedicated hosting. So the breadth of that portfolio and the ability to help guide a customer into the right fit is actually a differentiator for us versus the technology OEMs.

Siti Panigrahi: I mean does this give you an opportunity to upsell or cross-sell some of your Rackspace services on AWS and Azure like selling your Managed Security services or something like that?

Taylor Rhodes: Sure. Yes. You can think about a starting point for us-- we are what we call targeted workload hunters, right? We'll go out and focus on the e-commerce platform or a big data and analytics or a payment transaction gateway, something that matters to what I call the revenue side of IT. We'll win that initial workload and then what we do is, through Fanatical Support, which means we're going to take great care of it and add value to it. Generally our customers are very happy with us and loyal and sticky over time. We'll then be able to come in and follow and cross-sell and upsell the rest of the portfolio to those customers.

Siti Panigrahi: You talked about this market cloud environment. Could you share some of the customer use cases where they're using this market cloud environment? And how do you think Rackspace is a strategic fit for a customer to support such a hybrid environment?

Taylor Rhodes: Sure. I think the multi-cloud evidence is everywhere out there. You can read IVC, Forrester, Gartner, whoever you want, and most of the feedback from CIOs is am I going to be using more cloud in the future? Yes. Am I going to have private clouds and public clouds? Yes. But when you break that down to an individual customer case, here's a perfect example. We'll have a customer who runs an e-commerce environment with us and dedicated hosting. They'll connect by our RackConnect product into our OpenStack public cloud and burst into the cloud, but they'll keep customer data and the high-performance databases in the dedicated environment and they'll value the ability to have dedicated alongside public cloud.

Also, though, now with our ability to support AWS there would be other workloads in that customer environment that we weren't serving before and now we've got the ability to serve more of their wallet and bring that in. And we see in the early days customers who are saying, okay, I am a managed services buyer. That's my chosen philosophy of IT. I have other workloads that I would prefer to put on these clouds and now that you can provide Fanatical Support on them now I can do more business with you.

Siti Panigrahi: One (inaudible) we keep getting from investors that now customers will turn from Rackspace Cloud to AWS and Azure. Just wondering, like now AWS has started increasing their focus on enterprise. So are you seeing any kind of trends within your installed base or any kind of discussion you're having with customer?

Taylor Rhodes: Yes. First of all I think it's important to know overall the pie, the size of the cloud market is getting bigger. Remember, the real opportunity here is the 80% of data-- of IT that still runs in the data center. So as Amazon accelerates, as Microsoft accelerates, as Google accelerates, the size of the market is actually getting bigger.

In our installed base we have a very long heritage of very low customer churn; in fact, negative churn. On a monthly basis our installed base grows and we get good growth on an annualized basis from that. And we'll give you an example that might help people understand the propensity for churn or lack thereof.

When we launched our public cloud business in 2008 there was a lot of concern that our dedicated hosting business would be cannibalized by our public cloud. The customers would say, oh, here's a clouded solution, it's cheaper, let's move quickly. What we didn't see is that happen and for a couple of reasons. One, applications are sticky. Usually customers try to avoid a migration because a migration requires risk, cost and deviation from running the business, right? Normally a customer migrates an application when there's a burning platform. That can be a problem or it can be such a substantial value proposition in moving it. So normally what we see is that existing applications have a lot of inertia. Instead of seeing the big churn to the public cloud, we actually have seen our dedicated business continue to grow over time for those workloads that actually prefer an isolated dedicated environment.

So, we don't have the ability to predict 100% what cannibalization rates will be, but we do know that the early results show that this is a market opportunity expander for us, both with net new customers as well as net new workloads from our existing installed base customers.

Siti Panigrahi: Right. And one thing, there has been a slowdown in the growth in your public cloud, Rackspace public cloud over time. So what has caused this slowdown? And also, given that now you support both AWS and Azure, why would a customer pick your public cloud versus-- over other-- AWS or Azure?

Taylor Rhodes: Yes. We talked about on the call that the top contributor to our revenue growth slowdown has been decelerating growth rate in our public cloud and that's simply due to competitive factors, right? The AWS Cloud is doing extremely well, as you know. Azure is also starting to catch up and close the gap. So our cloud is growing slower due to a competitive dynamic. And we continue to expect it to grow. It is a positive grower, but it do expect that incrementally we'll gain more public cloud customers supporting them on top of AWS and Azure in the future.

We have customers, though, on our cloud who have chosen it historically for one simple reason. They're managed services buyers. They care less about the bits and bytes underneath. And they wanted a cloud and they want it managed. And we have seen very, very long-term stickiness from our customers on our public cloud. Again, think about that inertia in migrating. So we view our public cloud going forward as a great solution for customers who are primarily trying to buy managed support and who frankly have a fear of vendor lock in. There's a significant part of the market that thinks about that Hotel California problem and we've talked about that before.

Siti Panigrahi: Yes.

Taylor Rhodes: So we expect our public cloud to continue to be a grower at a lower rate. When we talked about on the call that our core business is now growing on average somewhere between 2% and 3% a quarter, we talked about it being a useful way to think about the business. But also we said that there'll be some variability around that average driven partially by cloud seasonality and by lumpiness of enterprise deals. So when you think about our future business going forward, you can think about some quarters being below that average, Q1 is normally a quarter that is seasonality slow for us, and some quarters like Q3, normally our strongest quarter, being above that. But that's a good average to think about for the business driven with some of that seasonal lumps in it.

Siti Panigrahi: Yes. So before we switch to the managed cloud, I just want to ask a question. In Q2 you talked about employee turnover as one of the [issues] in the Company. But since then you have already hired more than 200 Rackers in (inaudible). This morning, like do you think you have the right team in place now to go after all the opportunity you talked about?

Taylor Rhodes: Yes. As you know, part of what we discussed on the Q2 call was the fact that in 2014 we went through a publicly visible strategic evaluation and that created some turnover in our employee ranks, particularly in our sales and marketing and our product and engineering teams, and that was part of why we lost some of them in Q2 of this year. We've made good progress hiring back. As you mentioned, over 200 Rackers in the last four or five months. We feel like we've made good progress. Now it's time to digest. As you know, when you hire a lot of people it's time to onboard them, time to get them effective in the business. So you'll see us take a little time and digest these new hires and you can expect us to sort of plateau for a little while in terms of the hiring. But we're always looking for key talent. There are parts of our business, like sales and marketing, where we continue to need strong leadership to go take us to market and increase our ability to reach new markets. So you'll see us continue to add selective talent in areas like sales and marketing and product and engineering.

Siti Panigrahi: Right. Okay. Now switching to the managed cloud business, could you discuss your pipeline for managed cloud and how should we think about the potential for growth in that business?

Taylor Rhodes: I think you mean our managed dedicated--.

Siti Panigrahi: Yes, yes.

Taylor Rhodes: Business, right? Yes. So remember, managed cloud for us is an umbrella term that we use to cover our dedicated hosting business, our private cloud business and our public cloud business. The dedicated hosting business, we are the largest pure-play dedicated hoster in the market. We continue to see growth in that for a couple of simple reasons. First is that there are a lot of workloads running in the corporate data center today that will never go to the public cloud. They just won't be re-factored and re-architected. But those applications, lots of them running VMware as their hypervisor, need to be moved out of the corporate data center so the CIO actually has space in his or her budget to staff to go do the work the company really wants them to do. So those are types of workloads that come in to dedicated hosting on a regular basis so we continue to see good growth opportunities there.

The second reason that dedicated hosting and private clouds will actually have a place in IT for a very long time is that as companies get smarter and smarter about the good things that public clouds can do for you, they also get smarter about things that aren't a fit. And there are many applications that don't perform well or get actually more expensive in a public cloud. And customers want the isolation, predictability of resource availability and predictability of cost that dedicated or private clouds give them and so that's also a growth driver for the future.

Siti Panigrahi: Okay. Now switch to the-- or switching to the OpenStack, Rackspace was one of the founder, along with NASA. We have seen now a lot of new companies, technology vendors coming in and contributing to the ecosystem. Could you give us a high level, like what you are seeing in terms of OpenStack (inaudible)? Where is OpenStack at this point in terms of private cloud and public cloud adoption? And then how is Rackspace positioned to monetize that (inaudible).

Taylor Rhodes: Yes. So OpenStack for us, as you know, used to be a pure public cloud story. And as I mentioned earlier, we've seen a slowdown in the growth of our OpenStack public cloud, primarily because, frankly, the AWS and the Azure clouds are at greater scale and have more feature breadth than the OpenStack public cloud does. What we're seeing in the market is that OpenStack is changing shape. The major demand signal in the market is for enterprise private clouds. If you think about all of the workloads that VMware has virtualized over time and gained almost a 90% share at one point in time of virtualization, that virtualization drove productivity in IT for the last 10 years. It was all about the server rationalization. Now a lot of that productivity is done and so those CIOs who have data centers and who have staff and want to run a private cloud architecture are looking for the alternative to that. OpenStack is the most mature, and really the only viable private cloud architecture out there for large enterprises wanting to run enterprise private clouds. So we see that being a large market. We see us being absolutely the best positioned for it and we are going to go lead that market going forward.

So think about that being, again, a new business. It will take time to make a difference in the numbers. And that's one of the reasons as OpenStack shifts that we've talked about that growth range that the business is in today. It'll take time for that growth range to accelerate on top. But things like OpenStack private clouds will be the things that will help us with growth optionality in the future.

Siti Panigrahi: Okay. Rackspace historically [was very] SMB heavy, but then we started seeing a lot of large deals coming in the last one year or so. Could you talk about your growth market in terms of moving up market, grabbing these large deals and how is that (inaudible)?

Taylor Rhodes: Yes, it does. It creates lumpiness and you've seen that in our results this year with Q1 being here, Q2 being here, Q3 being here. So the lumpiness of enterprise deals is just a factor as we make the shift. But we actually launched our enterprise business in 2008 on the heels of the global financial crisis. We had an opportunity to start to serve companies who were trying to shed cost, looking for new options. And moving into the midmarket and enterprise has actually been one of our big growth drivers over the last six or seven years. We are now more intentionally focused on it because if you look at the Gartner Magic Quadrant that we play in, we play against tech conglomerates and telcos who are going through their own set of disruption, as we can see in their results. So we feel like we have more of an opportunity going forward to move and continue to be an enterprise provider of choice. Those deals are big when they land. We get good scale on them. They're healthy profitability-wise for us. But again, they will drive some of that variability in our results as we continue to shift into that market space.

Siti Panigrahi: Let me pause here and see if there are any questions in the audience. I have a few more questions, but raise your hand if you have any questions.

Maybe-- one thing we have seen in the last one year is that your change in capital allocation strategy. Now you're maybe more shareholder friendly and are (inaudible) to buy back and all that. So how do you look at the balance between that versus M&A?

Taylor Rhodes: Sure. Yes, we always look for three areas of return. The first is organic growth, the second is M&A and the third is doing things like returning cash to our shareholders through share buybacks. And one of the things that-- as our growth has modulated or slowed over the last couple of years, we've historically been a debt-free company, but we've been accused of having a lazy balance sheet. We are capital intensive. And I think one of the things that we've committed to-- I know one of the things we've committed to is bringing on a moderate level of leverage. As you know, we committed to getting into a leverage structure about 1.5x gross. Or if you exclude the off balance sheet data center leases, that's about 0.8x of EBITDA. And so that's a very moderate level of leverage. And we view right now a good return opportunity is for us to do a share buyback and so we have committed to $1 billion of incremental share buyback. As we disclosed on the call, we've completed $250 million in the last quarter and we're moving ahead with that plan because we believe it's a good move for our shareholders at this point in time.

Siti Panigrahi: Right. And maybe a last question. You talked about last time about vertical IT solutions. Now we're trying to build some-- kind of the e-commerce solution or the big data. How is that solution and has that strategy going lately? Talk about the (inaudible).

Taylor Rhodes: Absolutely. So we talked about a few of them over time and I'll just use our digital solutions as an example. That's where we talk about e-commerce solutions and big data solutions, web content management. That's predictably-- or primarily aimed at CMOs who have a lot of budget, who are doing more and more to digitize their businesses. And that's often a great lead-in for us. We now host more of the top 1,000 internet e-commerce sites than anyone else in the industry. That's a very self-referencing way for us to get in and win that first workload and then use the portfolio to cross-sell and upsell. So we think that's a good opportunity for us to continue to invest there in the future.

Siti Panigrahi: Great. With that, the time is over. Thank you, Taylor.

Taylor Rhodes: Absolutely. I appreciate it.

Siti Panigrahi: Thanks.

Taylor Rhodes: I appreciate it very much.

Siti Panigrahi: And I think we have a breakout after this.

Taylor Rhodes: Okay, wonderful. Thanks.

Siti Panigrahi: Thank you.