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RAX - Q3 2015 Rackspace Hosting Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting third-quarter 2015 earnings call. As a reminder, this call is being recorded, November 9, 2015.

(Operator Instructions)

It is now my pleasure to introduce Winston Len, Vice President of Finance for Rackspace. Mr. Len, you may begin please.

Winston Len - *Rackspace Hosting, Inc. - VP of Finance*

Hello, everyone. Welcome to Rackspace's third-quarter 2015 earnings conference call. We hope that you have had a chance to read our press release, which we issued earlier today. If you don't have a copy of the press release, please visit our investor relations page on our website at 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 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 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 will be used 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, Inc. - President & CEO*

Thanks Winston. Good afternoon, and thank you all for joining us for today's discussion of our Q3 financial results. We'll also talked with our Q4 expectations, the state of our core business, and our strategy for the future. For Q3, we reported revenue of $509 million, which represents sequential growth of 3.8% on a constant currency basis and 4% as reported on a GAAP basis. Our adjusted EBITDA margin was 34.9%. This was a strong quarter driven by two major factors. The first one involves several large enterprise deals that we discussed with you earlier in the year. Delays in closing those deals adversely affected our Q2 results, but I'm pleased to report that we began recognizing revenue from them in Q3 which boosted our results for the quarter. The second factor driving our Q3 results was slightly higher growth in our public cloud. Our customer base there remains stable and loyal with low churn.

We saw an increase in incremental demand in part because of progress we have made on our product roadmap. We also experienced increased usage due to normal seasonality as our eCommerce customers ramped up for their busiest season. In Q3, we continued to demonstrate traction with our enterprise customers. Among our 300,000 plus customers, the top 50 continue to grow their spending with us at a rate significantly faster than our overall growth. This is a part of our business we will continue to expand. Finally, we continued to make progress in hiring high priority talent in the quarter adding 62 additional Rackers to critical areas of our business.

Now, let me provide you with our perspective on Q4. On our last earnings call, we provided guidance for the full second half of the year. Q3 came in above the high end of that guidance, and we are now narrowing the guidance range for Q4. We expect sequential revenue growth in Q4 to be in the range of 2% to 3% on a constant currency basis. That range is below the sequential growth rate that we posted in Q3 for two main reasons. One is the higher-than-expected revenue base that we achieved in Q3. The other is that as in past years, we expect customers will ramp down their IT projects in December resulting in a reduction in cloud usage. Amid these normal fluctuations, the state of our core business is healthy. We continue to grow and to create high customer loyalty, which keeps churn consistently low. Our business has also been and continues to be consistently profitable, and we are producing cash.

If you look at our revenue growth across the quarters this year, you will see that our sequential constant currency growth rate is averaging between 2% and 3% a quarter. That is the current rate in which our business is growing with some variance driven by familiar seasonal factors and by the lumpy nature of large enterprise deals. As we continue to nurture our stable and attractive core business, we have focused this year on expanding our portfolio with offerings that make us more competitive. These new offers position us to lead in large high-growth markets, and they will drive our growth in 2017 and beyond. First, we worked with Microsoft, our longtime partner, to offer our expertise and Fanatical Support to customers using Microsoft Azure, the Microsoft private cloud, and Office 365. We have already landed several new large accounts for each of these products.

Second, we've partnered with Intel to create the OpenStack Innovation Center at our headquarters in San Antonio. This center is staffed by engineers from both Rackspace and Intel, and we expect their work to accelerate the adoption of OpenStack by enterprise users of private and hybrid clouds. Third, we've launched Rackspace managed security services. For years, we have built deep expertise and experience in cyber security. Now we're productizing all the investments that we have made in securing our own infrastructure and are offering our expertise and toolsets to help customers secure their companies with managed security as a service.

Finally, we launched Fanatical Support for AWS at the re:Invent conference. Right out of the gate, we met the criteria to become an advanced consulting partner and an audited AWS managed service provider, a feat rarely achieved in tandem or at launch. We rank in the top tier of service providers in terms of the number of AWS technical certifications that our Rackers have earned and in our ability to support customers at scale. When compared to others in the AWS managed services ecosystem, Rackspace brings a global scale and heritage in cloud operations that none can match. We are well positioned to be the leader in this fast-growing market. We have been pleased by our progress in the first month since our launch of Fanatical Support on AWS. A large majority of the customers are new customers to Rackspace. Many others are established Rackspace customers who are bringing incremental AWS workloads to us.

We couldn't support those workloads in the past and now we can. The majority of the customers have also chosen our highest service level, which we call Aviator, and they are awarding us high net promoter scores. These trends indicate to us that we are adding significant value in the services and technology innovations that we provide on top of the AWS platform. Since the founding of Rackspace, our strategy and differentiation has been built upon two simple but key elements. First, we provide the best customer service and expertise in our industry; we call that Fanatical Support. Second,, we offer customers a choice of leading technologies and platforms. Simply put, we help customers leverage the power of a multi-cloud world without the pain of managing it all themselves. That is why industry experts like the ones at Gartner have affirmed our leadership in the managed cloud market.

With our recent product launches and strategic partnerships, we believe that Rackspace offers the industry's most comprehensive and differentiated portfolio of managed cloud services. No other cloud provider is as well positioned as we are to guide and serve business customers as the shift accelerates from traditional IT to multi-cloud service models. As with all new businesses, we expect that the ones we have launched in recent months will take some time to scale. But we believe that these new offerings will become significant contributors to our revenue in 2017 and beyond. We intend to fund these new offerings in a disciplined manner based on the pace at which customers adopt them. To date, we have funded them by reallocating existing resources and spending. If demand ramps faster than expected, we will invest appropriately to accelerate growth and ensure success. We see each of these platform and technology choices as an and rather than an or. More and more customers are using multiple clouds.

For example, we see customers running some of their workloads on Rackspace dedicated servers while running others on Fanatical Support on AWS and still others on Microsoft Azure. Our customers have broad application portfolios and most want to leverage multiple infrastructure option. Let me comment specifically on OpenStack and how we see it evolving. We see that the OpenStack public cloud appeals to customers who value open technologies and who are concerned about long-term vendor lock-in. OpenStack is also the best fit for those who want their public cloud to work well with their dedicated hosting environment via our RackConnect product. As you know, the growth rate for our OpenStack public cloud has slowed over the past year. We expect it to continue to grow albeit at a slower rate than in the past because of the appeal of other public clouds.

Many customers prefer AWS or Azure as their public cloud platform, which presents us with the opportunity to add value by managing those clouds for them as part of a comprehensive multi-cloud strategy. To be crystal clear, we expect OpenStack to be an increasingly important part of our future growth as the market for OpenStack shifts towards large private and hybrid cloud environments. The demand signal here is encouraging and is accelerating. No other vendor is as focused as we are here, and no one else has the experience in OpenStack engineering and operations that we have. The demand for OpenStack private and hybrid clouds is heating up and we will lead this market. In closing, I want to emphasize that this year at Rackspace has been all about sharpening our competitiveness by expanding our differentiated product portfolio.

It's been about developing the expertise and tools to deliver the best customer service on the industry's leading public and private cloud platforms. I would like to thank our Rackers around the world for their hard work toward that accomplishment. They have rapidly mastered and created new technologies while continuing to serve our existing customers and have learned to serve new customers in new ways. They have done so eagerly because they are special people who thrive on challenges and learning. Thank you Rackers. I am humbled and proud to be on your team. With that, I'll turn the call over to Karl to update you on the details of our financial results. Karl?

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Thank you, Taylor, and good afternoon, everyone. For the third quarter, revenue grew to $509 million; this equates to a reported sequential growth rate of 4%. Foreign exchange rate changes have had a positive impact on our growth this quarter. On a constant currency basis, our growth rate was 3.8%. On a year-over-year basis, our reported revenue grew by 11% and by 13% on a constant currency basis. Our adjusted EBITDA margin for the quarter was 34.9%, up from 33.1% during the second quarter. Our net income for the quarter was $36.5 million for a margin of 7.2%, up from 6% here in Q2. Our earnings per share for the quarter was $0.26, up from $0.20 during the second quarter, and return on capital for the third quarter was 15%. Our CapEx for the quarter was $128 million, in line with our 25% guidance for the quarter and the year.

Our adjusted free cash flow was $45 million for Q3 and $112 million for the first nine months of 2015. Given our current growth rate, we expect to continue to generate positive adjusted free cash flow on a fairly consistent basis. Our cash position was mainly affected by our stock buyback activities. In accordance with the program we announced in our previous call, in the third quarter we bought back 8.2 million shares for a total cost of $250 million. We funded that buyback with cash on the balance sheet and the temporary drawdown of our credit facility. As we reported last quarter, we have adopted a targeted growth debt level inclusive of our off balance sheet obligations of approximately 1.5 times EBITDA. We believe that level of debt strikes an appropriate balance between value enhancing financial leverage and the need to maintain strategic flexibility.

We have made good progress towards a more optimized capital structure. In addition to the stock buyback activities, we have obtained credit ratings from Moody's and Standard & Poor's which confirmed our expectations with Ba1 and BB+ ratings respectively. We are also engaged in ongoing discussions to renew our revolving line of credit. We are aiming to close the new credit facility in the next couple of weeks. The agreement will provide for $200 million in revolver capacity with a maturity of 2020. We are also actively pursuing other long-term debt financing. We reaffirm our commitment to complete $500 million of our stock repurchases within the next three to six months subject to market conditions.

Let me now move on to guidance for the fourth quarter. From a revenue perspective, are expecting to grow between 2% and 3% on a sequential basis. As Taylor mentioned, we have benefited in the third quarter from the timing of enterprise deals and stronger seasonal cloud growth, which made Q3 a higher growth quarter than what we expect for Q4. Given the strong third quarter revenue performance, the midpoint of our growth fourth quarter guidance implies total revenue of $521 million, which is $4 million higher than the guidance we issued three months ago. On to profit, during the third quarter, we benefited from operating leverage due to strong revenue growth and we furthermore had some nonrecurring items such as professional fees, corporate cost, and personnel related items, that on a net basis positively contributed to our profit margin.

On a normalized basis, our adjusted EBITDA margin ranges between 33% and 34%, and we expect Q4 to be in that range as well. Let me conclude by congratulating Rackers around the world for achieving yet another milestone in our Company's history. In the third quarter, we surpassed $500 million in quarterly revenue or $2 billion in annualized run rate. This is a great accomplishment. This concludes our prepared remarks. Operator, please open the call up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Taylor, can you just talk about what you're seeing in the early stages now with AWS and how you think that can develop over the next several quarters? Thanks.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Thanks, James. Happy to. As I said in my prepared remarks, we are encouraged by the early results, particularly because of the mix of the type of customers we are winning. Whenever you launch a new product, you go into product market fifth stage you have to learn about what is the most likely buying behavior, where do they see value, et cetera. We are encouraged because the majority of the new customers are choosing the higher service-level Aviator and that has been frankly to the positive from our expectations. We thought that would take a bit longer to educate customers on that, but we think it's a good validation point that says that we have developed significant value through technology as well as service capability around the AWS platform; so that's one encouraging sign.

The second is the mix of business coming from our global teams. So this has been a good mix of business from our teams in the UK and EMEA as well as our teams in Asia PAC and the Americas. I'm encouraged by that mix. Finally, I think that overall, the most encouraging thing is that the majority of the customers are net new to Rackspace. So this is allowing us to expand our TAM and go out and find customers who we may not have been able to serve before. So we believe that these are positive early signs. I do want to be careful, cautious, and prudent and say that as with anything these will take time to turn into meaningful revenue dollars.

I think there was an article in the Wall Street Journal today that quoted Evercore saying that some of the leaders in this space have built $100 million of revenue and that it would take time for this to move the needle for Rackspace. I agree on the take time but I also believe that that $100 million is somewhat of a myopic view since you have an AWS ecosystem growing at 80% at $8 billion, and a fraction of those customers want managed services over time. We think we can do much better than other players in the market. We think it's a big opportunity. We're going for it, but it will take time to move the needle on our corporate numbers.

James Breen - *William Blair & Company - Analyst*

Great.

Operator

Gray Powell, Wells Fargo.

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

Just a couple, if I may. Can you give us a sense as to the linearity of bookings in Q3? On last quarter's call, you talked to improve to manage [light] August. I'm just curious if that held into October. And then along those lines, it looks like sales execution has improved. How should we think about that impacting your growth rate going forward?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Let me take that apart in a couple of pieces. As you know, we talked about in Q2 that the two things that hurt us on growth were a slowdown in our public cloud as well as in our timing of enterprise deals. Ultimately, I think that what we benefited from primarily in Q3 was closing those enterprise deals, getting them online, and seeing materialization from the revenue of those, so we were able to do a good job on execution there. That points back to sales execution in Q2 and early Q3 and then operational execution getting these customers online and billing here in the quarter. We benefited from that compare. We continue to see a healthy deal pipeline. None of the overall trends in the market that we have talked about have changed our perspective. We still see companies coming out of the corporate data center into multi-cloud service models. We continue to feel good when we compete against tech conglomerates and telcos who are being disrupted in their own right in that space, so I would say that overall we continue to see a healthy pipeline and no major changes to report there.

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

Got it. Thank you very much.

Operator

Frank Louthan, Raymond James.

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

Just wanted to discuss sort of the pace of the new customers. You say some of them are new to AWS. What is the common denominator there that you are seeing for why customers are attracted to this? And then if you could comment a little bit on the announcement of Equinix putting in some space with their cloud hubs. If this is really a type of -- the type of products that are going to be more 2016/2017 for the more meaningful, why the rush to get there now? Is it possibly tracking a little bit ahead of that schedule? Thank you.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Sure. I think the first part of your question on the AWS customers or Fanatical Support on AWS customers. My comment was not that they're necessarily all new to AWS. My comment was they are net new customers to Rackspace. Some of them are new to AWS, and what we heard at re:Invent, which is fitting the pattern we are seeing in the market, is you heard some of the AWS leadership talk about the importance of partners to their continued growth because much of the mainstream market is limited in its capability and access to skills, talent, and resources to be able to migrate to the public cloud, but they can't wait any longer because they are seeing their competitors get the benefit of moving in the cloud model.

We think that our entry into the market actually helps increase the size of the pie because many of these customers need a managed services partner to help them understand how to migrate, which applications to migrate, how to architect, how to secure them, how to operate them in an ongoing basis. Some of the customers we're seeing are those types who have been developing a cloud strategy but have been lacking the right partner to help them actually go execute on it. I would call those new to Rackspace, new to AWS. Others are existing AWS customers who have been running cloud operations at AWS and are trying to reclaim precious skills back toward things that are more strategic to them. So for instance, if you have been growing on the AWS cloud, chances are you've got a good part of your engineering talent that is running ops on AWS and that's taking cycles away from developing product and doing things that are more differentiating for that company.

The other motion we see is companies who are there but are getting out of the managed cloud business themselves so they can redeploy resources toward more strategic things. We see customers who follow both. On the Equinix question, yes, we launched a product called RackConnect Global, which is really a secure private network connectivity between Rackspace and select Equinix data centers. Customers can connect any infrastructure they have with us to hardware they have inside the Equinix facilities. They can also connect via this product to Microsoft Azure. We just see again in this movement to a multi-cloud world, customers have multiple types of infrastructure, sometimes they are in certain facilities due to geographic proximity.

Sometimes they are in certain providers due to fit for that application, but they want a way to make these applications work well together as a portfolio. This is our effort to go again, take that next step in letting customers use multiple types of infrastructure in multiple locations and connect them well. In terms of growth, yes, this would be one of those products that we see as promising and ramping but accretive to us further down the road.

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

Okay, great. Thank you.

Operator

Simon Flannery, Morgan Stanley.

Lisa Lam - *Morgan Stanley - Analyst*

Hi. This is Lisa for Simon. Maybe just heading over to the margins. You had pretty good margins this quarter. You mentioned hiring the 62 Rackers. Are you pretty much done with the hiring that you have indicated that you would go through last quarter? And when you talk about reallocating resources currently to fund these newer products, do you see that margin basically benefiting from that real application?

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Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Lisa, hi. This is Taylor. I'll comment first and then I would like Karl to talk about a couple things. The first is, are we finished hiring. The answer is no. We are always hiring. If you look at any quarter because we are a growth business, we'll always be hiring but we have made significant progress with the 151 Rackers that we added in Q2 and the 62 this time. We have made significant progress in those critical areas that slowed us down frankly at the tail end of 2014 and going into this year. Good progress. I am happy that we are able to attract good talent from leading companies, but we still have more work to do there and we'll continue hiring as appropriate. In terms of the question around margins and reallocation of resources, Karl, I'll turn that over to you.

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Actually, this is pretty much a follow-on of a question that Simon asked last call. So really the way we think about the initial funding at least is really in a margin neutral way. As we mentioned previously, we have leverage in our core business that adds growth, becomes more profitable, and then as we as a general business philosophy, we take the majority of those earnings and reinvest it into what we believe are attractive growth opportunities so no different this time. We have certainly funded the initial resources that go with the product development in the launch of the AWS and Azure offering with existing Rackers that are passionate about these new technologies and that want to extend our expertise into those areas. Then, from then on really, everything becomes really success based and if we have the traction that we hope to generate on these offerings, then we will apply more resources on it and then just continue our deliberate funding and diligent funding, but we also require as always quick feedback in terms of monetization and returns on investment as we expand our resources.

Lisa Lam - *Morgan Stanley - Analyst*

Great. Thank you.

Operator

Pat Walravens, JMP Securities.

Pat Walravens - *JMP Securities - Analyst*

Great. Thank you. Congratulations on the quarter. Just to be clear on AWS though, we should expect the margins to be lower, right?

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Yes, look we have also talked about that before. On an EBITDA basis, we have certainly a lower margin profile but on an EBIT basis, it's very comparable to our existing business. You basically replace the DNA factor with the costs that you incur by reselling those services and on the service piece that sits on top of that, it's a very similar profile. The way that we usually summarize this is lower EBITDA, similar EBIT, and equal to higher free cash flow depending on the CapEx dynamics.

Pat Walravens - *JMP Securities - Analyst*

Okay. Great. Taylor, for you. CenturyLink, Verizon, AT&T, all reportedly looking to sell posting assets. How do you see the industry changing and is that good or bad for Rackspace?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Pat, I think it's good. The more people who give up the ghost because they are not specialists, who don't have the scale, who aren't good at these things, then the more market opportunity there is for us. I've heard the same rumors and frankly, I think it's very difficult for non-specialists to compete in this space and in this era because one, they're not known for great service particularly in this space, and two, they have struggled to make their cloud strategies work. They really haven't developed clouds. They've developed virtualization platforms which don't have the same attributes. I think I like it, and it opens up more space for us. This has been very consistent as you have heard me talk about the two magic quadrants that we compete in. The one is for managed cloud and on that, you compete with those telcos and tech conglomerates who are all getting really disrupted in feeling the full force of the Amazon and Azure world on their businesses. We view it as opportunity.

Pat Walravens - *JMP Securities - Analyst*

Thank you.

Operator

Siti Panigrahi, Credit Suisse.

Siti Panigrahi - *Credit Suisse - Analyst*

In terms of large deals, you mentioned on your last call that you landed twice as many large deals in the last four quarters than eight quarters before that. Are all of those deals live and contributing to revenue now? Also, could you comment on or maybe give us some color in terms of large deal environment in Q3 and the [live deals] in Q4?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Siti, you faded out a little bit there but I think I made out most of your question. We continue on a good pace with large deals. Large enterprise or complex deals remain a sweet spot for us. I think you asked if all of those that we closed earlier this year are online. You can assume that the ones we talked about to you earlier this year are online and in fact are creating the lift -- a significant part of the lift in Q3. Clearly, we would have closed some others in Q4 that will come online in Q4. That's just a constant process for us but the large needle movers that we talked about in Q2 are now online and again providing the revenue lift here in Q3.

Then I think you asked a look forward question, how is the pipeline which I commented on earlier. Again, per Pat's question there, we continue to feel like there's market opportunity out there as companies choose their partners, as the traditional telcos and others become less competitive. They're looking for companies who can credibly help them innovate with good SLAs and good track records and adopt multi-cloud platforms. And we think that, that is a continuing demand signal and the market for us will go -- continue to build out capabilities to win those deals.

Siti Panigrahi - *Credit Suisse - Analyst*

Great. Thank you.

Operator

Steve Milunovich, UBS.

Steve Milunovich - *UBS - Analyst*

Where do you see your expense ratio going? Both R&D and SG&A were down sequentially and R&D was down year over year. Just curious if you can give us a little guidance in terms of what to expect on expenses.

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Yes, hi Steve. This is Karl. G&A is certainly an area that we want to continue to leverage. There are certain time periods when we have capability adds and then a lot of what we do as a business is reflected in G&A, general support for expansion, and even customer support to a certain extent. On the R&D side, that is also an area that we have built over the last three to four years to a level where we probably expect it to hold flat and start to leverage. Obviously, we have the relationship with Intel that is focused squarely on further developing OpenStack related product offerings and solutions, mainly around private clouds. So it's not that we're going to de-fund any of those activities at all, but we will certainly think about this as a leverage opportunity going forward.

Steve Milunovich - *UBS - Analyst*

Thanks.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - *Barclays Capital - Analyst*

Dovetailing on that prior question on expenditures, I was wondering if you can give us some color in terms of how we should think about CapEx trajectory in the near term as well, particularly as you look to allocate resources to what seem to be more CapEx like type businesses with the AWS partnerships and so forth. Then, on the second question, thank you for the color in terms of your capital allocation strategy. If I'm not mistaken based on the numbers, there still seems to be a bit more room in terms of levering up. Can you give us a little bit more color in terms of the potential trajectory there and how to think about things? Thank you.

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

I will take that. This Karl. CapEx trajectory near term, I think we have extensively elaborated on how CapEx works in our business. We have a maintenance component to our capital requirements, which are mostly really reflected as customer care because that's the largest proportion of it. That is about 10% of revenue. That's a good proxy for that maintenance component. And then the second component is growth, which is about $0.50 on a marginal dollar of revenue. That is an incredibly consistent relationship that we have had over the years where we certainly had some outliers when we had big deployments around the world but we have fairly consistently averaged 50% on the marginal dollar of revenue for growth CapEx.

Very simply, that means as a result that the faster we grow, the more growth CapEx we have and the slower we grow, the smaller amount of growth CapEx we have. 25% just happened to be the number that was relevant for this year. For next year, it will obviously depend on the growth rate and the success-based nature of that growth CapEx. And secondarily, it will depend on what amount of growth contribution we see from those, let's call it third-party cloud initiatives. Every dollar of incremental revenue now traditional hosting business has 50% of CapEx dollars associated with it. Those are attractive returns that we generate on those dollars, so we're happy to continue to do that but every dollar of incremental revenue added we generate on AWS has zero capital requirements.

Really it's hard to predict what the contribution will be and how long it will take to fundamentally change the uptakes of our corporate financial statement, but it will certainly have a lightening impact on our total capital requirements. On the leverage target, look, we are a Company that implicitly is part of our business model provides financing on behalf of our customers. We make commitments to data center providers. We take up space. We buy equipment. We rent it out so to speak to our customers, which is a fundamental part of our business. Rock solid financial statements is an important consideration in our customers' long-term choices that they make in terms of partnership. Having very moderate levels of debt is a strategic almost requirement.

Secondarily, we think that we are going to have long-term growth opportunities and we certainly don't want to lever ourselves up to a point where we lose or reduce our strategic flexibility and financial flexibility. So we want to certainly err on the moderate side of leverage, and we acknowledge that there is value to it and by optimizing our capital structure. This is an important step for us to make that -- to establish a permanent level of debt as targeted in our policy.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Amir, just to amplify on that from the Board's perspective, we believe that where we are today takes us toward a step of accretively helpful leverage in the model in terms of optimizing our capital structure but leaves us with the strategic flexibility we need as a growth company and that's where the Board is and we believe this is a good first step. I think that rounds out our comments on that.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the additional color.

Operator

Colby Synesael, Cowen and Company.

Colby Synesael - *Cowen and Company - Analyst*

Congrats on what great numbers. First off on the AWS model, and I guess even Azure for that matter, can you just walk us through the actual revenue recognition process? So if a customer for example spends X amount of money on Amazon, are you also recognizing that, and that's essentially a pass through? And then as part of that question, if Amazon is to reduce its own pricing, how does that potentially impact what you recognize in revenue and ultimately margins?

My second question is on free cash flow. As I'm sure you are aware, some of those who are more negative on the Company keep on pointing to the Company's free cash flow margin and profile as one of their bigger reasons for being negative. How do you think that free cash flow will evolve over time in terms of growth and margin? And ultimately, how are you making your investment decisions to warrant that this is obviously a good business? Thanks.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

That's a lot of questions, Colby. You squeezed about five in there.

Colby Synesael - *Cowen and Company - Analyst*

Technically two.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Let me talk about the pricing real quick on the AWS and Azure models because I think it's important to clarify. And also what we said last time is that as these businesses become bigger and more material, we'll share more with you about them. I think Karl has done a good job walking you through the margin profile on them. But ultimately our pricing strategy is very clear and transparent. It's on the website. We have chosen value-added pricing. It is not susceptible to automatically being cut if Amazon does an infrastructure price cut. We have tried hard to strategically make our pricing understandable for somebody who is making the decision -- should I do this myself or is there value in buying this as a variable cost service from Rackspace.

We have particularly paid attention to essentially drawing out the value of our services versus being just a percentage of AWS infrastructure spend. We don't think that's a wise pricing model so I invite you to check it out on the site. In terms of the revenue recognition and how we do that, I think we will hold on that question until we get further into the business model and provide more update on how the business economics work. Karl, do you want to talk about the free cash flow margin and profile and how we see that evolving over time?

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Yes. Sure. Look, we have always been a company that has deployed capital as part of providing value to customers. We have always had a very strong discipline in terms of ensuring that those capital dollars that we deploy are monetized quickly and generate adequate rate of return on it. We have control metrics that are voluntary disclosure metrics along those lines with capital turnover being the metric that shows that we consistently and quickly monetize our capital investment dollars. And we have ROC that shows that we're not only turning them into revenue but we also generate adequate rates of return on it. We feel very comfortable as a business about deploying dollars of capital with respect to infrastructure because that was what we were originally doing.

We also feel comfortable in that context that free cash flow margins are reduced in periods of high growth as a general relationship. We really don't have any concern about that concern that you are raising because we have a very good handle on the fact that this capital that is being deployed is actually a good thing from a value generation perspective. Then on the margin profile, there are all these trends that we are talking about which is obviously as margins changes in the P&L materialize themselves, they flow through OCS. Growth CapEx is a very consistent relationship to incremental growth and as we grow into third-party cloud solutions and revenue, this marginal relationship will be more favorable in terms of free cash flow profile.

Colby Synesael - *Cowen and Company - Analyst*

Great. Thank You.

Operator

Gray Powell, Wells Fargo.

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

I just want to make sure that I understood the comments around the growth rate correctly. Can I talk to that 2% to 3% constant currency sequential growth. Obviously it ticked up here in Q3. Just how should we think about that fluctuating going forward? What are some of the factors we should think about and just normal seasonality, that kind of thing? Thank you.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Thanks, Gray. This is Taylor. I'll take that one and Karl, you can add any color as we go through this. Gray, I think the comment on 2% to 3% sequential growth, if you look at not only this quarter but also average our performance in the quarters of this year and clearly our guidance for Q4, that is the growth rate that we are currently performing at in the business and what we expect to exit this year with. There is variance to that. Obviously, you can see that in our Q2 results, in our Q3, so a couple of things that drive the variance to that 2% to 3% normalized range. One is going to be timing of these large enterprise deals. Sometimes those are needle movers and when they land and we materialize them, we can expect seasonal, or pardon me, lumpiness that could carry that up.

Then the other big part of our business where we see seasonality is obviously in the public cloud and that, like in a quarter like Q1 where we would see cloud usage being seasonally and normally lower and then in Q3 where cloud usage is seasonally and normal higher, that will affect slight variances within that range. We feel like that is a good concept to have in mind. We don't expect significant revenue contribution from these new businesses. Again, I just want to reiterate that until 2017, but we believe that that 2% to 3% is a good base and then these businesses will add to and grow on top of that rate with those normal fluctuations in mind.

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

I think I get it. So 2% to 3% sort of a base range and then a large deal can drive it higher. If like Amazon kicks in, that could drive it higher, something like that. Is that a good way to categorize it?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Yes, that, and you could say potentially a quarter where some of these larger deals are in the pipe and waiting to be closed, you might see a pop in the following quarter and a little bit of lightness in the preceding quarter and then public cloud seasonality. That's the way to think about it.

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

Perfect. Cool. Thank you very much.

Operator

Phil Cusick, JPMorgan.

Phil Cusick - *JPMorgan - Analyst*

This may be a little strange given your different businesses, but it seems like a number of big companies are getting out of this space. Do you have any interest in adding scale or would you rather stick with your core and do the occasional bolt-on?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Phil, good question. The first thing I would say is that we are looking for the greatest returns, and so if an opportunity came along to make an acquisition that would bolster our scale and our core business and if we could get a good return out of it, we would certainly be open minded to that. We look at those as they come. We try to be a good judge between investing organically in our new businesses, using excess cash to do share buybacks, and then looking at M&A, and we really try to understand where the best returns and lowest risks are.

I would say that if you think about how the business is consolidating, and you could look at a landscape that says that telcos and other smaller dedicated or managed hosting providers are exiting because of the pressure from AWS primarily and Azure, et cetera, there could be some plays out there that allow to go take our market leadership as the largest pure-play managed hosting provider and buy up some of those assets, get them into our more efficient and profitable model, and make a good run at that. There is nothing imminent on that, but certainly if we could get a good return there we would examine those opportunities.

Phil Cusick - *JPMorgan - Analyst*

That's helpful. If I can squeak in one more. As you pointed out earlier, the business has become sequentially I would say much more stable over the last year. Any reason we should look for that to decelerate in 2016 or maybe more likely accelerate given the potential of AWS?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

I think again, I think the AWS business will -- and Azure and managed security and our OpenStack private cloud, those are good businesses with very large TAMs but they're going to take some time. Don't look for acceleration in 2016 necessarily from those. Think about the comments I just made to Gray about the normal rate right now, 2% to 3% with some variability around that as a good way to think about things.

Phil Cusick - *JPMorgan - Analyst*

That helps. Thank you.

Operator

Tim Horan, Oppenheimer.

Tim Horan - *Oppenheimer & Co. - Analyst*

Taylor, do you see any other competitors with your strategy? And it seems to be unique, kind of cloud-to-cloud strategy. Do you think anyone else can catch up to you? And I guess related to that, do you have the software tools and skill set to execute? I was at re:Invent also and the main thing I got away was people don't have the headcount or the expertise to execute what you guys are executing on. I am just curious how much more investment it's going to take or are you there now? Do you have all the tools and the expertise to implement? Thanks.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Thank you for that question. That's a really good one to understand the market landscape. I'll start first with competitors. One of the things we have watched very carefully this year as we were preparing to launch our Azure and our AWS strategies was who was already doing it and how are they doing. We watched relatively small companies with probably Datapipe being the largest and that ecosystem really starting to grow well, get high multiples, and perform well because frankly of the very factor or phenomenon you just highlighted which is there is a big skills gap in the market. Companies who are trying to get the clouds do not have the knowledge and they oftentimes because they're not in Silicon Valley, they can't go hire people who understand the fast-changing technologies of the clouds.

What we are seeing is small players who lack scale and who don't have anything particularly special doing well in the space because of that demand for companies to get to the cloud. When we watched some of those companies, we thought they're doing well. We bring scale that is much larger. We bring a heritage of cloud operations. We've got Fanatical Support. Those are good leading indicators of our opportunity there. In terms of others who are going to market with similar strategies, I think again, you could potentially point to a Datapipe that has a similar strategy. They are offering hosting as well as services on AWS and Azure.

They are much smaller than we are and don't have the global scale, but they're doing reasonably well growth-wise in that space so we think that's actually positive for us. On the higher end, you can see companies like HP Enterprise, HPE that just split out. They're exiting OpenStack public cloud and talking about providing services to their customers across AWS, Azure, and private cloud. So it sounds very similar, and I think that's a natural move for them and they are Fortune 500, Fortune 1,000 install base because that is where their customers will push them, but I think it remains to be seen how they will do there and there's a lot of change going on in that company.

Tim Horan - *Oppenheimer & Co. - Analyst*

But do you have the expertise to implement at this point, or do you have to do a lot more training and software development?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

To date what we have been able to do, remember we have one of the largest pools of technical talent in the industry and frankly, a lot of that technical talent has grown up on Linux and cloud-based technology so they are not far away from being able to be retrained and repurposed to support AWS and these other clouds. In fact, when we launched in our press release, we were careful to name a number of cloud certifications that we have already obtained. If people are following the industry closely, that number of triple digits is a very fast number of certifications we have been able to obtain largely because we have a large technical base.

We have a capability internally called Rackspace University that is one of our core competencies of training technical talent. We can make these shifts well. I will say though that if these businesses start to scale rapidly, then we will have to hire. We will have to invest in more of those skills and capabilities because if we don't, we wouldn't be able to get talent in front of that fast enough. We'll be watching the scale and take on these businesses carefully, and we will hire and invest appropriately.

Tim Horan - *Oppenheimer & Co. - Analyst*

Thank you.

Operator

Jonathan Atkin, Royal Bank of Canada.

Jonathan Atkin - *RBC Capital Markets - Analyst*

I was interested in the 63.6 megawatts under contract and that's flat sequentially, and is that going to increase in the foreseeable future? I'm trying to get a sense of your commitments with landlords and cost of margin implications in the near term. The second question was just around the compliance assisted offering that was mentioned in the press release, and I wondered if there is particular compliance verticals where you are seeing or expecting demand and are these going to be more likelihood on Azure, AWS, OpenStack? Maybe a little bit of color around that. Thank you.

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

Jonathan, this is Karl. The commitments that we have entered that have a ramp implication are really with respect to our London facility, so we have taken the initial 2 megawatts and an additional megawatt to facilitate the migrations out of power data centers that we are ramping down in London, which are two, and migrate that into the new facility. Ultimately, we're going to end up with a double data center footprint in London versus three that we have right now. That combination or that consolidation if you want requires us to deploy little bit of upfront capacity. The general ramp on the London facility is 2 megawatts a year, which is probably a little bit ahead of actual consumption need. So we would have a little bit of built up of excess capacity over that and then ramps four and five for the 8 and 10 megawatts have optionality attached to it that we will evaluate in due time.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you. And then the compliance assisted offer?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Jonathan, can you just help me understand, are you referring to the compliance offer we announced as part of the AWS launch or to the managed security services offering that we just launched as well?

Jonathan Atkin - *RBC Capital Markets - Analyst*

I guess you could cover both but the compliance assisted offer that it sounds like by definition part of that is Amazon, but is there more broadly -- are you seeing demand from -- or compliance driven demand whether it's financials or healthcare or whatnot, and what types of cloud destination to see these coming on to? Is it fair to say that Azure or AWS or OpenStack is more suitable for certain types of applications or is it too soon to be making those sorts of generalities?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

The choice of which cloud for which app can be driven by many factors. Some it's by the customer's preference. On the Microsoft shop, so I'm choosing Azure. Others, on greenfield apps, I'm choosing AWS. I think it is too early to call the shot on particularly which cloud will be best for compliance and security related stuff. Clearly, all cloud leaders are investing in those spaces because it's simply priced to play. I don't see a tremendously differentiated position on either Azure or AWS. I think both are investing heavily in security and compliance, which is good in terms of the overall market adoption. For us, our focus is you don't have to read too far into any periodical today to find an article about cyber security or compliance. It is top of mind for all boards of public and private companies.

I'm sure you see the same thing we do which is boards forming cyber security committees, budgets being created because this is simply a no longer an optional path. We have built our own capabilities over time to secure our homeland and to secure our customer environments, but what we haven't done is taken the next step to really turn those into a product-sized set of managed security and compliance services. We think it's a big opportunity that we'll grow into over time but everybody who comes to us today is certainly top of mind, how do I maintain compliance standards, which ones do I need, what can you do for me as a cloud hosting provider versus what do I have to do myself, and that's on the compliance side. So lots of questions there and need for help. I think on the security side, you don't have to call more than one time and say, do want to have a conversation about cyber security.

If you are an end-user company today trying to manage cyber security, you have to navigate not only across your infrastructure provider but a whole constellation of software and tools providers and try to pick which is the right bundle and then how to manage that, and our approach will be to not only secure the infrastructure but it will be to have a selection of applications, tools, and services that are bundled and managed as a service for our customers for a reasonable add-on to their current spend with us. That was the launch that we made. We recently opened our customer security operation center live here in San Antonio, and we think this is a big future potential market for us.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you. I just wondered if you can just go down the FX exposures by currency. Is it changed from last quarter?

Karl Pichler - *Rackspace Hosting, Inc. - CFO*

On the top line, we had a 20-basis point tailwind. Reported numbers were 4%. Constant currency was 3.8%, so we benefited. The main exposure is to the pound sterling. All the other currencies are fairly insignificant, and then if you go down the P&L, the exposure pretty much goes away because the sterling revenues are mainly served out of our UK office where we have the majority of our international cost structure, which we also incur in sterling so you have pretty much almost no dollar exposure on the profit side and completely immaterial exposure on the cash side either.

Operator

Louis Miscioscia, CLSA.

Louis Miscioscia - *CLSA Limited - Analyst*

Thank you. Could you give us some thoughts on the big picture strategy shift? I guess if you're looking to grow let's say 8% to 12% without adding in the enterprise customers or getting to material revenue on the services side. I guess on the managed hosting and the cloud business, are you looking to moderate the growth there in the sense of obviously when we started the year, we were hoping to do 18% or higher growth rate and now obviously it seems an awful lot less.

Let me just tie that back into the OpEx question we had before. OpEx levels were very -- were down quarter to quarter, which was very unexpected. 11% operating margins are very nice, but I'm just wondering if you are starting to pull back on the hopeful long-term growth rate and then also monitoring back the OpEx which will marry that but then also limit possible growth in comparison to some of the other leaders out there.

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Louis, thanks for the question. We're going through a transition as a business. We talked about it in Q2 that the reason we lowered our guidance range for the year on revenue is because of primarily a slowdown in our public cloud growth rate. As I commented in my prepared remarks, we still see public cloud growth but we see it slowing compared to previous years. Look, that's a transition that the Company has to go through. We think as I said, OpenStack is changing shape to enterprise, private, and hybrid clouds, which see large deployments. We see that demand signal heating up and being a good source of growth in the future.

Ultimately, our strategy around managed cloud has not changed since I took the President role in 2014. We see managed cloud as being the path that most enterprises and mainstream companies will take as they come out of their corporate data centers. They will look for multiple types of infrastructure to include AWS and Azure. They will look for private clouds in addition to public clouds and they will want someone with credibility around SLAs in service to manage them. The reflection of the 2% to 3% core growth rate is a reflection of slowing in our public cloud and the need for us to go get new offers into market and drive future growth. That's the combination.

In terms of the OpEx, I wouldn't read the OpEx being anything other than us managing the cost structure of our business. It doesn't mean we are giving up the ghost on growth or anything else. It means that we are usually a disciplined Company, and we manage our expense base in line with our growth. That's what we have done this quarter. I've talked extensively about reallocation of resources to get these new offers into the market and frankly, we have done a lot of work this year around our product portfolio. We've just been reallocating costs to do that rather than taking on new costs. We think that's the right thing right now and as these businesses gain traction, then we will invest OpEx accordingly to go make sure we're not the growth bottleneck. If the market wants them likely is the way we hope they will. We want to be the service provider of choice in the multi-cloud world, and we're going through a transition to get there.

Louis Miscioscia - *CLSA Limited - Analyst*

You think you can hold 10% or 11% operating margins going forward?

Taylor Rhodes - *Rackspace Hosting, Inc. - President & CEO*

Well, we're not providing 2016 guidance today, so why don't we cap it there and we will give you more update on 2016 when we get there. Thank you.

Operator

This does conclude today's conference. We thank you for your participation.