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EDITED TRANSCRIPT

RAX - Q4 2015 Rackspace Hosting Inc Earnings Call

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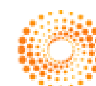

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting Q4 2015 earnings call.

As a reminder this call is being recorded.

(Operator Instructions)

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

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

Thank you. Good afternoon, everyone.

Welcome to Rackspace's fourth-quarter and FY15 earnings conference call. We hope that you have had the chance to read our press release and slide deck which were issued earlier today.

If you don't have a copy of the press release and slide deck, please visit the investor relations page of our website at ir.rackspace.com. This call is also being webcast online and can be accessed through our investor relations site.

For the Rackspace call today, we have Taylor Rhodes, our President and Chief Executive Officer, and Karl Pichler, our Chief Financial Officer.

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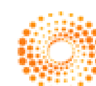

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I need to remind you that some of the comments we may make today are forward-looking statements including statements regarding expected operations and business results, our growth plans and expectations, the impact of new products and services and 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 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 and non-GAAP EPS, 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'll be happy to take your questions. I will now turn the call over to Taylor. Taylor?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Thanks Winston. Good afternoon and thank you for joining us for today's discussion of our financial results for Q4 and the full year of 2015. We'll also talk about our strategy and expectations for 2016.

For Q4 we reported revenue of $523 million, which represents sequential growth of 3.2% on a constant currency basis and 2.8%, as reported on a GAAP basis. Our adjusted EBITDA margin was 35.1%. This was a strong quarter across all our metrics and builds on the good results we posted in Q3. For the full year of 2015 we're pleased to announce that our revenue passed the milestone of $2 billion.

Our annual revenue grew by 13.7% on a constant currency basis and 11.5% on a GAAP basis. Our adjusted EBITDA margin was 34.2% for the year. During 2015 we achieved four bold objectives that position us well for the future.

First we launched Fanatical Support for Amazon Web Services and for Microsoft's private cloud, Azure and Office 365. These moves open up huge and fast-growing new markets for us and strongly differentiate us as the only company with the tools and expertise to provide Fanatical Support for the world's leading clouds.

Second capital efficiency initiatives helped us reduce capital expenditures to 23% of revenue and our adjusted free cash flow rose to $196 million. We expect that our capital efficiency will continue to improve as we provide more of our services on our partners' infrastructure.

Third we shared our increased free cash flow with our stockholders through a major share buyback that is still underway. Finally we hired key leadership talent. Our new sales and marketing leader, Alex Pinchev, brings deep experience and proven success in our industry, including as a senior executive at Red Hat. We're confident that Alex will boost our sales and marketing execution.

Brian Stein, our new head of global engineering who joined us in January, commands great respect in our industry for his innovative work at Red Hat and Puppet Labs. Our results for Q4 and for 2015 demonstrate that our core products set has a stable customer base and generates consistent revenue growth, profit and free cash flow. Our customers are loyal and sticky. Their spending with us recurs and grows and we expect that growth to continue.

A recent study by Gartner estimates that spending on managed hosting will grow almost 9% a year through 2019. We're number one in the world in managed hosting and we're proud to report that customer churn for that product hit a three-year low during Q4.

Alongside our core product set we've launched several new offers that help us expand into large fast-growing adjacent markets, where we are already gaining good traction. We expect these new offers to be the future growth-drivers for Rackspace. What binds our core product set and our new offers is our strategy to provide Fanatical Support for the world's leading clouds.

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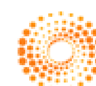

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As more mainstream companies move out of their own data centers and on to cloud models we believe they share two key traits that favor Rackspace as their cloud provider. First they are using multiple clouds. They operate multiple workloads and want to run each one where it will achieve the highest performance and cost efficiency, whether on dedicated servers, public cloud or Private Cloud.

A new survey by RightScale of more than 1,000 technology professionals found that the average company today is using six clouds across public and private cloud and dedicated servers from multiple vendors. That survey mirrors what we're seeing among our customers, who want a choice of leading call technology. More and more customers are consuming services from our core product set, as well as our new offers of Fanatical Support on AWS and the Microsoft cloud.

The second key point is that these are managed services buyers. They seek help to architect, migrate, secure and operate their applications. They do not employ in-house all the specialized cloud engineers that they would need for this work.

In the recent RightScale survey, the number one challenge cited by cloud adopters is no longer security, which now ranks number two. The biggest challenge is finding the expertise and other resources required to operate multiple clouds. We find that many of these businesses favor a manage cloud model, which combines the choice of multiple cloud platforms with high-value expertise, tools and customer service.

The two leading public clouds, AWS and Azure, are seeing a new wave of these mainstream customers who want to use their infrastructure along with managed services. AWS and Microsoft don't want to disrupt their products' focus, so they are cultivating networks of managed service providers. We intend to become the biggest and the best of these and we're seeing strong direction toward that goal. Our top priority is to lead the AWS managed service provider ecosystem, letting AWS provide the economies of scale on its infrastructure, while we provide valuable economies of expertise.

Let me share with you some of the characteristics of our AWS service from its launch on October 6 through the end of January. During its first four months our AWS team signed 100 customers, including what we expect to be our first six-figure a month enterprise customer.

The majority of these customers are new to Rackspace. We believe that this is an encouraging indicator of our ability to win new market share. Most of these new customers are ones we could not have won without providing AWS support. Now that we've got them in the door, we believe that we can cross-sell to them our other offers, such as managed security, private clouds and data services.

We are also actively selling Fanatical Support on AWS to existing Rackspace customers. Of these the large majority are bringing us new workloads. Through most of our history our installed base growth was driven by winning the first workload from a new customer, delighting it with Fanatical Support and then winning additional workloads.

In recent years more of these incremental workloads have gone to AWS, contributing to our slowdown in growth. Now we're seeing encouraging signs that our multi-cloud portfolio can reignite that essential part of our growth engine.

More than 1/3 of our AWS customers are international. We are actively leveraging AWS data centers and sales partnerships around the world and believe that we can now grow in a capital-light in regions where he previously had no physical presence.

More than 70% of our AWS customers are choosing our highest service level, which we call Aviator. This trend indicates we are adding significant value on top of the AWS infrastructure. We add that value into ways: through the proprietary software tools that we have created to make the platform easier to use, and through the specialized expertise that we have built among our cloud engineers.

We have now achieved more than 230 AWS technical certifications and more than 1,100 business and technical accreditations on AWS. We are also proud to report that we've recently achieved AWS certification as a dev-ops competency partner. These accomplishments place us among the top few AWS service providers in terms of expertise. They also demonstrate a long-standing strength of Rackspace, which is to rapidly create technical expertise at scale.

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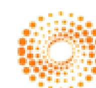

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The customers of our AWS service include market-leading companies such as Razorfish, one of the world's largest digital agencies. These customers also include one of the world's largest management consulting companies. Our sales pipeline is building nicely and we believe it's a good leading indicator of the growing demand for the expertise required to make the AWS Cloud run better.

As we've discussed in earlier calls we expect this new offer to drive our growth in 2017 and beyond. We're pleased with our early traction and are determined to be the leader in the space. So where does that leave us for 2016? Even as we nurture our fast-growing new offers we are working to optimize our more established ones. By doing so we intend to achieve significant savings, which we are investing in our new hypergrowth products.

As we demonstrated in the second half of 2015 we can launch and fund new businesses, while also keeping margins in line with historical levels. One of our established products, our OpenStack public cloud, has a customer base that is sticky and continues to grow its spending with us; however, more and more new cloud workloads are heading towards AWS and Azure. Without those incremental workloads we expect the growth rate for our OpenStack public cloud to slow in 2016.

At the same time now that we support AWS and Azure customers, we are in a good position to benefit from the growth in those clouds and this is where we will see rapid growth in our business. For that reason we're shifting engineering and marketing resources from our OpenStack public cloud to our new offers, including our OpenStack private cloud, which is growing in the high double digits.

Several recent surveys of IT decision-makers show rapid growth in private cloud adoption, and particularly in the hosted Private Cloud model. For example RightScale's survey showed that 77% of companies are now adopting private clouds, up from 63% last year.

Even as we shift resources toward our higher growth products we intend to continue to improve the reliability and performance of our OpenStack public cloud for the many customers who continue to use it. Many of those are hybrid customers who connect their public cloud environments to our dedicated servers.

These hybrid users are among our stickiest and fastest-growing customers. With regards to guidance, Karl will provide the specifics, but let me give you a brief overview. For the full year of 2016 we expect revenue growth in the range of 6% to 10% on a constant currency basis after normalization to account for a small asset divestiture, which Karl will discuss. We believe this range is prudently conservative, and takes into account our expected Q1 softness, our lower expectations for growth in our OpenStack public cloud and the uncertain economic environment.

As you know Q1 is seasonally a slow quarter for us. We expect it to be slower than usual this year in part because of shifts that we are making in our marketing and sales efforts towards our multi-cloud offers. We are optimistic however that our focus on providing Fanatical Support for the world's leading clouds will enable us to accelerate over time.

We expect 2016 adjusted EBITDA margins to be consistent with historical trends despite significant investments in growth initiatives. We have done a lot of hard work in 2015 revitalizing our product portfolio and our talent. In 2016 we intend to build on that foundation to aggressively expand our leadership of the market for managed cloud services.

In the meantime we will continue to advance the interest of our shareholders. In 2016 and beyond we expect that our capital intensity will decrease and our free cash flow will increase. We will continue to share that cash flow with stockholders through the share buyback program already underway.

In closing, I want to thank our Rackers around the world for their indomitable spirit, and for their hard work to develop the expertise and tools to deliver Fanatical Support for the world's leading clouds. They have rapidly mastered and created new technologies and learn to serve customers in new ways. They are special people make is the world leader in rapidly creating technical expertise at scale.

With that I'll turn the call over to Karl to update you on the details of our financial results. Karl?

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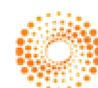

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Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Thank you, Taylor, and good afternoon to everyone on the call.

Q4 was a very good quarter for us and we ended the year on a strong note. In Q4 we had solid growth, our highest operating income margin since Q1 of 2013, and record adjusted free cash flow. In 2015 we increased our revenue margins, capital efficiency, and return on capital, even as we began investing in the new growth areas.

Furthermore we started to optimize our capital structure and returned $367 million to our shareholders through share repurchases. From the press release and slide deck supporting this call you can get all the details of our financial results. Let me discuss the most important ones.

First our revenue grew to $523 million in the fourth quarter and to $2 billion for the full year of 2015. Currency fluctuations had a negative impact on our topline results. On a constant currency basis we grew 3.2% for the quarter and 13.7% for the year.

For the fourth quarter we reported adjusted EBITDA margins of 35.1%. Margins improved over the course of the year and on a year-over-year basis. Our full-year 2015 adjusted EBITDA margin was 34.2%, up 50 basis points from 2014.

As a profit contributions from our US business ended up higher than originally anticipated, we saw an increase in our overall effective tax rate for the year. Our previous estimate for the year was 32.4%, and our final rate for the year is 34.8%. This true-up makes our Q4 rate look unusually high at 42.5%.

For Q4, our diluted earnings per share came in at $0.24, our full-year diluted EPS was $0.90, an increase of 17% year-over-year. For the purpose of comparability to other companies, we will start providing a non-GAAP EPS metric in our earnings release. This metric excludes stock-based compensation expense net of taxes.

For 2015 non-GAAP diluted EPS was $1.26, an increase of 15% relative to 2014. Adjusted free cash flow for 2015 was $196 million, a 21% increase year-over-year, where the full-year CapEx was 23.3% of revenue. For 2015, our capital turnover was 2-times versus 1.94-times in 2014, improving our annual Return on Capital to 13.2% in 2015, versus 12.3% in 2014.

During the fourth quarter we issued $500 million worth of senior notes as part of our new capital structure policy, which will target a permanent level of debt and use excess cash for share repurchases. We have in the past expressed a target leverage that included gross debt, capital leases and off-balance-sheet operating leases. To simplify the conversation we will use a more conventional definition of leverage that excludes off-balance-sheet leases going forward.

From now on our leverage will be expressed as the sum of gross debt and capital leases divided by LTM adjusted EBITDA. Based on this definition our target ratio is approximately 0.75-times. As of December 31, 2015 our gross debt and capital leases added up to $502 million, and our adjusted EBITDA was $684 million. This equates to a leveraged ratio of 0.73-times, which means we're currently on target with respect to our indebtedness.

During our Q2 2015 earnings call back in August, we committed to buy back $500 million in shares within 6 to 9 months. Since then we have completed a total of $367 million in share buybacks through a combination of open market and 10b5-1 plan purchases. We intend to fulfill our commitment by May of 2016. In addition, as we have previously discussed, our board has approved an overall buyback program that runs through May 2017 and leaves us with $500 million of additional program capacity following completion of our current commitment.

With regard to our operating metrics in Q4 our server count and megawatts utilized decreased quarter over quarter. There are two main reasons for this. First we are actively migrating customers from our pre-OpenStack public cloud to our OpenStack offering. We expect this migration to continue into early 2017. Second the data center that we opened in London in 2015 allowed us to consolidate and decommission smaller facilities and redundants here.

As a result of these initiatives, we expect improving capital and operating efficiencies, as well as higher average revenue per server. As Taylor referenced in the first quarter of 2016, we divested an online file storage product called Jungle Disk, which is no longer a good fit with our strategy.

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During the first quarter we will recognize a gain from that sale, which will be excluded from our adjusted EBITDA and non-GAAP EPS calculations. We will provide further details on the next call.

Let me conclude with some remarks around our expectations for Q1 in 2016. With respect to the first quarter, we expect revenue to range between $517 million and $521 million. Excluding the impact of the Jungle Disk divestiture and currency movements, which add up to approximately 170 basis points, we expect our normalized sequential revenue growth rate to range between 0.5% and 1.4%.

Starting today in order to better account for the seasonal nature of our business and align ourselves with industry practice, we will express our revenue growth rates in year-over-year terms, comparing each quarter to the same quarter for the previous year. We expect our normalized year-over-year growth rate for Q1 to range between 9.2% and 10.2%. This excludes the impact of the Jungle Disk divestiture and currency movements, which add up to approximately 170 basis points.

For the year we expect GAAP revenue to range between $2.08 billion and $2.16 billion. Excluding the impact of the Jungle Disk divestiture and currency movements, which add up to approximately 190 basis points for the year, we expect our normalized annual revenue growth rates to range between 6% and 10%. As for adjusted EBITDA we expect margins to range between 33% and 35% for Q1, as well as for the full year 2016.

We expect margins to remain in line with historical trends even though we are increasing investments in our new offerings. We expect our CapEx requirement to come down as a result of increasing efficiencies, lower customer year CapEx, and increasing customer adoption of the offers that we provide on AWS and Microsoft infrastructure, which requires minimal CapEx on our side.

In 2016 we expect CapEx as a percentage of revenue to be in the range of 20% to 22%. Finally we expect our full-year effective tax rate for 2016 to be approximately 35%.

With that we will open the call for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Frank Louthan, Raymond James.

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

Great, thank you. Just maybe give us a little bit more color on what's changed. Seems like a little bit of our rapid change from last quarter you got in 2% to 3% sequential growth, now guiding below that a few months later. What kind of shifted so much in the base business there of the demand that's causing that change in the guidance?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Hello, Frank, thanks for the question, this is Taylor.

I think that's one a lot of people want to understand so let me run through what's driving our guidance.

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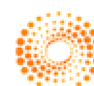

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So on the last call we talked about the fact a good rule of thumb is that our business has been growing in 2015 2% to 3% a quarter. We talked about the fact that the seasonal patterns in our business mean that we'll likely be below that range in Q1s and likely ahead of that range as you saw in Q3 and Q4.

So we took a few things into account for the 2016 guidance. The first is the soft Q1, and the soft Q1 has a couple of things hitting it. The first is the normal seasonality and timing of kind of enterprise deals that we saw last year. We don't have any reason to expect that we'll see anything different there from last year.

But the second factor is, as Alex Pinchev joins us, he is exercising the latitude to go make some changes to our sales and marketing teams and their focus areas. Alex has a lot of experience but he's not a magician so some of that will take some time as we move resources in front of these new opportunities. And we expect potentially a little gap there as Alex gets the engine revving. So that's the first thing that's driving Q1 softness, as you know in a recurring revenue model you start Q1 slower and it has penalty for the rest of the year.

But the second thing that we baked into the guidance ranges, the trends we're seeing in our public cloud. I mentioned in the prepared remarks that we're not worried about the base on our public cloud, that's a sticky and loyal base they have been around a long time. For example we still have thousands of customers on our public cloud who were on our pre-OpenStack first-generation cloud products.

Our cloud customers our support seekers and unless there's a real burning platform driving the migration they don't tend to move very easily. But I think it's fair to say more and more incremental or new workloads are heading to AWS and Azure. Winning those new workloads used to be a key part of our growth driver, and without them we expect our OpenStack public cloud growth to slow in 2016 and that's a factor baked into the guidance as well.

And finally I think we're all living in very uncertain times and so while we are not seeing any specific macroeconomic indicators yet, we all realize that if the current uncertainty gets elongated and lasts for an extended period of time we will see potentially impact on customers' buying psyche and sales cycles et cetera, budget sensitivity. So with an abundance of caution we've baked in a bit of the challenging economic cycle into our estimate as well.

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

How much on the economic side could there potentially be from upside that doesn't materialize? How much does that hard slow growth?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

I think overall what we know today as we feel good on the 6% to 10%, we think it's a fair guide. I can't handicap how much is macro versus other but in the mix of those three things that's where we ended up.

Certainly throughout the year we are confident that Alex will have an impact and that we can get these new offers growing as well. So if we have an opportunity to update you on guidance later in the year we will do that, and right now what we want to do is give you the best information we have.

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

Great, thank you, that's very helpful.

Operator

Amir Rozwadowski, Barclays.

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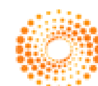

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Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much. I was wondering if we could talk a bit more about your investment initiatives.

If we take a look at the guidance you folks have for 2016, it seems as though you're keeping your margin targets really flattish with historical trends. But there seems to be a lot of discussion around some of the investments that you folks are going to be making to support some of these new initiatives. I was wondering if you could provide us with some color on how we should think about the shifting allocation of capital as you look to target some of these new opportunities?

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Yes, this is Karl, we've made a couple statements along those lines in the past. First as we started the initiatives the investments were really minimal, which is targeting starting with initial offer development and customer research et cetera, coming up with the right set of offerings. And then as we go after this and go into beta and then GA launches we apply more and more resources towards it, so that is our established approach of developing and launching new offers.

And then very quickly we get into success-based mode of resourcing and staffing really against the opportunity and the traction we see in the marketplace. And that has allowed us to really in the past developing new offers while the core business, and really core meaning the sense of the traditional managed hosting business, has provided more and more leverage over the years and has provided economies of scale.

So that has really helped us over the years and this year it's not really different. We have significant investment dollars that go to those new businesses.

We can fund those with the efficiencies and savings that we generate on the bigger part of the more established part of the business. And we expect that to basically result in equivalent margin profiles as we've seen in 2015. Of course there will be quarter-to-quarter variability as we expect, but overall all of these investments can be funded with our existing business.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the color, and if I may one follow up.

If we think about some of the opportunity set out there, it seems as though as you mentioned there is this transition occurring from your current business opportunities to as workflows moved to some of these cloud service providers. What gives you the confidence that as that transition happens the ultimate -- how do I put it -- addressable market for you folks expands within this time frame? Because it does seem like there's a bit of a transition phase as we should think about for 2016 as you look to those new opportunities.

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Amir, this is Taylor, I'll take that one. And I can tell you unequivocally every single data point we see points to the fact that the rates out of the corporate data center is on. I think at the latest IDC or Forrester estimate that estimates between 200 and 300 billion conservatively, that's in corporate data centers that's in play that come out in the cloud SAAS models.

When we interact with partners and prospects in the market, we see, the feedback we hear is the bottleneck right now is clearly that CIOs are moving but they are now figuring out how to get there. We don't have any trepidation at all about the market opportunity.

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However, as we move into this new space we've got to build our capabilities, we've got to build our sales acumen on the front and. We've got to build our support model, we've got to train Rackers, we've got to change the way we work with partners, so that's really our ramp. It's ramping into this market.

And remember these are adjacent markets for Rackspace. Cloud is big we all know that it's getting bigger, but we have a long heritage and history of supporting clouds and running technology for customers, so these are really adjacent markets. The market is here, we are just building our capabilities to really lead the very nascent and fragmented managed service provider ecosystem on top of them.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much for the incremental color.

Operator

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Just around some of the new initiatives with Azure and Amazon, I think Taylor talked about having 100 customers and one in particular six figures. As I think about that one six-figure customer on a monthly basis adds probably half a percent of growth to total.

So it would imply that you're starting to see some help on the growth line from that. I'm just wondering how that balances out between your core business and the support business, I know the estimate, and how you strategize around the marketing side of that? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Sure, I'll go marketing first. I think our very clear positioning statement in the market is Fanatical Support for the world's leading clouds. We've had a managed cloud strategy in the market since mid-2014 and under that umbrella we want to make it very clear that if you are choosing one of the world's leading clouds, which in our mind is AWS, Azure an OpenStack for private clouds, then if you are a support seeker, then you should call Rackspace to run those and add value to those clouds.

So you'll see our marketing content already in our first salt of the year in New York last week, on the website, other places start to rollout with that positioning around Fanatical Support for the world's leading clouds. We think that's a clear message, we want to be able to answer the question when should I call Rackspace, if you're trying to add value to the AWS, Azure or OpenStack private clouds you're getting out of your data center, you should call Rackspace.

In terms of the revenue growth, looks it's early innings, right? We wanted to share lots of transparency with you all on the first 3-plus months of this offer. But that is 3-plus months, and I still I would echo the comment that says while we are encouraged on the traction we expect for these things to take some time to get to revenue levels that are big enough to move the $2 billion base.

We'll update you along the way but I would say we're certainly encouraged by the early traction, by the sales pipeline build and we're seeing good demand. I mentioned AWS specifically because in listening to our shareholders that's where the main focus was, but I think it's also fair to comment that our Microsoft cloud business is off to a good start.

Our sales initiatives around the cloud are seeing pipeline build led by Microsoft's private cloud, their Hyper V stack, and then followed up with Azure starting to build in the pipeline as well, and that sort of follows Microsoft's product roadmap in the market. You've seen them launch Azure

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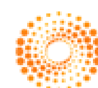

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stack which is their combination of Private Cloud and public working together. So we're seeing good traction on the Microsoft cloud will business as well.

James Breen - *William Blair & Company - Analyst*

Thanks for that. Can you give us a little bit of color on the press release you put out in the last week or so about the agreement with the Red Hat on the OpenStack side and strategically where you are going there?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Think of the Red Hat version of OpenStack running in a hosted cloud model is very analogous to us having been the leading service provider channel for Red Hat Enterprise Linux and our dedicated hosting business for years and years. So this is simply following strategy of not inventing all the technology but offering our customers' choice of leading cloud technologies. The common thread is we want to be in will be the predominant hosted services provider for private clouds.

We're seeing more datapoints show up not only on intent to have Private Cloud as an element of multi-cloud architecture but also as companies are considering what is happening in the post VMware world, OpenStack is gaining traction as the leading Private Cloud stack. So we want to be able to offer customers a choice of Red Hat if they choose that flavor or Rackspace if they choose that flavor. The commonalities they should buy from us as a managed service.

James Breen - *William Blair & Company - Analyst*

Great, thank you, and I just have one follow up for Karl.

When you look at the guidance, 9% to 10% year-over-year for the first quarter but 6% to 10% for the full-year, how should we think about that as the year progresses? It would imply that there's potential for that growth rate to slowdown as the year goes on? Thanks.

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

That's correct. That's mainly an artifact of the mix between 2015 and 2016 growth.

When you look at it from a sequential rates basis the low rates in Q1 that we've guided to, that Taylor alluded to and myself as well, is really what creates the headwind getting out of the box so to speak. And so the sequential rate of roughly 1% for Q1 at the mid-point is really what has an impact on the full-year as well.

James Breen - *William Blair & Company - Analyst*

Great, thank you very much.

Operator

Siti Panigrahi, Credit Suisse.

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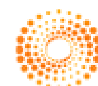

Siti Panigrahi - *Credit Suisse - Analyst*

Hello, thanks for taking my question. Just wanted to dig into the managed hosting, you talked about the industry growing around 9%. Just wondering what is your expectation whether your managed hosting part of the business grow, above, below or in line with that industry?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Yes, Siti, this is Taylor, thanks. I think it's fair to say we expect our managed hosting business to grow at market rates.

And again that base of business has two important things to remember. The first is that very low churn, I mentioned we saw a multi-year low churn rate in Q4 so those customers are proving to be sticky and have long lives.

The second thing to remember though is that base of business is actually a strong business for us to go into a cross-sell/upsell our new offers. If you'll remember in past years our install base growth was really fueled by incremental workload. And so as Amazon has really become the predominant home for new apps over the last several years, more of those incremental workload have gone to AWS. And in our initial results that I shared with you on the AWS business, we are seeing existing Rackspace customers running in our managed hosting business bring us net new workloads to run in AWS.

So we're excited about having that base to go in and sell things like AWS, Azure managed security to et cetera. So it has not only its own inherent value is a growing business but it has that platform value of being able to expand and bring new workloads in.

Siti Panigrahi - *Credit Suisse - Analyst*

Got it. As I look at your public cloud business and then the guidance, you talked about a new workloads moving to AWS and Azure. But what have you factored in, in terms of churn from your public cloud business existing business when you guided 6% to 10%?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

It's all in there, Siti. Were giving a 6% to 10%, we're saying our public cloud rate is slowing, so we don't break it out anymore, but the churn as well as the seasonality and the install base growth are all and there.

I think I would reemphasize the fact that we don't see any blinking red lights on churn in that base. Again these are long life customers who historically have been around for multiple generations of the cloud product, and primarily again these customers come to Rackspace for support.

Historically they're customers who value three things. They value support, they don't want to run their own cloud. Second they like to connect public cloud to our dedicated servers, and right now our OpenStack public cloud is the best platform to allow the connection to happen. And third there are a good healthy number of them who are open-source minded people who choose OpenStack for the open-source value, so for those three reasons we don't see them as being huge candidates for churn risk.

Again where the growth slowdown is predominately coming from is not winning as many net new customers as net new workloads on that cloud. But that's again the reason we are very excited about the progress we are making in AWS and Azure because we can go compete for those incremental workloads.

Operator

Colby Synesael, Cowen and Company.

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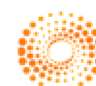

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Colby Synesael - *Cowen and Company - Analyst*

Great, thank you. I guess just to follow up on that last question, you'd previously I think or year or so ago broken out public cloud versus managed hosting, obviously you've moved away from that. But can you give us a sense how big the public cloud business is today?

Because I think what we are trying to get at as an investment community is where is that business today in terms of revenue and growth rate? And ultimately where does it need to go and over what period of time so we can start to see more of what we refer to as the normalized growth rate for the managed hosting business. And then obviously these new support models that you're building out today? Any help I think on that would be extremely helpful for I think all of us.

The second question I have then is on that new support model whether it's for Microsoft Azure, for AWS or anybody else, do you intend to break out that business separately whether it's revenue margin, capital intensity,? And the reason I ask that is obviously the growth rate, the margin and the capital intensity of that business are very different than your current business. And I guess my concern is if you start to muddle those two, what might make your overall growth rate look better, it could be detrimental to margins and ultimately send the wrong message. Thank you.

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Let me take the first stab at that. Hello, Colby, this is Karl.

Let's just go back to the point in time where we did disclose this, so the public clouds business was back in the day about a year ago about a quarter of our total revenue. And since then from a product prospective it has still been growing, it has still been growing double digit rates, it has been growing faster than our dedicated hosting business which is high single-digit rates when you look at it from a product perspective.

I don't want to repeat all the reasons why they made us collapse the two revenue lines, but the products are merging together. The lines are blurry, the customers consume them together, so there's just many reasons why this is really our managed hosting business combined utility type of products with subscription type of products. And we continue to see that merging together.

Now from a going forward perspective there will be -- we're looking actively into a couple of issues around segment versus product versus consolidated reporting. We have every intention, which I think you've seen on the call to share with you very explicitly traction metrics that we observe and monitor and manage on our new service offerings to give you insight into how they are going to take off.

From a revenue perspective they are immaterial from a corporate standpoint so they don't trigger really any SEC did closure requirements. But we look forward to a possibility where certain products, business lines or maybe certain revenue types for example -- resell revenue would be broken out separately to provide the substantiation of that comments we're making.

This is certainly variable over time. We're both bound by regulatory requirements and by our desire to provide color and in-depth discussions, but right now the numbers are just small to begin with and so that's why focus on traction metrics.

Colby Synesael - *Cowen and Company - Analyst*

Great, thank you for taking my questions.

Operator

Heather Bellini, Goldman Sachs

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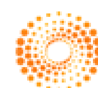

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Heather Bellini - *Goldman Sachs - Analyst*

Hello, I had a couple of questions. Just one to what a lot of people have been following up on in the end just thinking about the OpenStack cloud and the fact that that business isn't growing as quickly, I know you guys seem confident that you're going to maintain your existing deployments, but why is that the case?

If you are not -- why wouldn't those people also take advantage of AWS or Azure or Google instead of being on a platform that seems like maybe it's not going to get the same level of attention from an innovation standpoint otherwise you would see that business be growing more quickly? So I guess that's one question.

And the other would be on your CapEx guidance for this year, I guess I'm wondering because it does seem like you are pivoting to be a lot more of a managed services company. And if I look a lot of the other consulting firms that are out there, your CapEx levels are material lower even though you're having a big step down in CapEx in 2016 versus 2015. Why shouldn't your CapEx come way down and therefore really help free cash flow conversion going forward?

I guess I'm a little confused as to what the aggressive spending on CapEx is for if the majority of what you're seeing is growth on other people's platforms?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Heather, thanks, this is Taylor. On the first question why are we confident about keeping the OpenStack base? I think there's a couple of reasons on that.

The first I would say is that again we have customer intimacy model, we're known as the leader in service and we each have a lot of data from our NPS surveys and interactions with customers that tell us what they like, don't like et cetera, and predominately on our public cloud we see customers with three hallmarks. The first is, again they're open source minded folks, they are support seekers, they are less worried about what the infrastructure and technology is underneath. And a lot of them are again connecting -- their used case of preference is hybrid where they connect to dedicated servers for part of their environment and use the public cloud for part of their environment. And today the only way that we offer that service is with our Rack Connect product that connects our public cloud to our dedicated servers.

All that said if we're wrong on this and these customers choose to go to AWS or Azure we are confident that we'll have the best chance to keep them. And we've done with our economics is we have made ourselves indifferent further down the P&L with lower capital, as you know, higher free cash flow, and we've said publicly in the past similar on EBT et cetera.

So we would certainly want to offer these customers choice of best fit for them. We're very mindful of that, but we don't see huge signs yet or any indication that these customers are all looking at a burning platform that would have them undertake a complex and risky and costly application migration to a new platform. So those with some of the reasons why but again if we do see the migration we will be happy to help them get onto an AWS or an Azure solution. We'll be happy on the way to sell them managed security which is an uplift on the revenue they pay us et cetera, so that's our perspective on that.

I think your question on CapEx is a good one. Remember that we are the number one managed hosting company in the world for dedicated hosting. And also we intended to be number one in private clouds because we seen an increasing buying cycle from particular verticals around that.

That is an area where we deploy the capital, where we build the stack and own and control the stack, and where we've earned very good EBITDA margins and good ROIC. So there will be a part of our business that is on our capital, very sticky recurring subscription revenue models, and we will then marry that up with choice of the world's leading public cloud and operate that as a multi-cloud environment for our customers.

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Heather Bellini - *Goldman Sachs - Analyst*

Great, thank you

Operator

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Great, thanks very much. I'm coming back to the guidance for 2016 by quarters, does Q2 become sort of the low watermark for year-over-year revenue growth and then we re-accelerate? I think you were saying that you would see better growth trends given history in the second half of the year. So how should we think about the year-over-year trends as we go through the year exiting maybe at a higher rate than we might be say in the middle of the year? Is that something you can see at this point or is going to be fairly level beyond Q1?

And then the buyback data -- I think you said you've done $367 million of the $500 million. Is that a year-end number or is that to today and can you provide any color if it is a year-end number of what you've done so far this year? Thanks.

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Simon, this is Taylor, I will tackle the first, Karl can answer the second.

First I want to be clear we're not providing Q2 guidance today. But the second, I think looking at the patterns in our business historically you'll see Q1 low point, you will see Q2 a little bit better there or thereabouts, and then you'll see Q3 and Q4 where a lot of our customers hit their seasonal highs -- the strongest quarters of the year.

History is useful, if history holds that should be a pattern we would see this year. But I want to be careful not to provide you with specific Q2 guidance on this call, but I think you know how to model our business historically, and then in terms of the buyback is that a year-end number, Karl do you want to comment?

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

The $367 million is all the buybacks combined that we executed during 2015, so if you want the year-end number, we've done $250 million in Q3 and $117 million in Q4.

Simon Flannery - *Morgan Stanley - Analyst*

Have you been buying since? How much do you have left in the facility of today of that $500 million?

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Of the $500 million, $133 million

Simon Flannery - *Morgan Stanley - Analyst*

Have you spent some of that in January and February?

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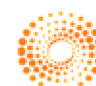

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Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

We can't comment on that.

Simon Flannery - *Morgan Stanley - Analyst*

Okay. Thank you.

Operator

Steve Milunovich, UBS.

Steve Milunovich - *UBS - Analyst*

Thank you. A few summers ago you talked about the difference between managed and unmanaged cloud. And I think made the comment that if you and Amazon were in the same deal somebody was in the wrong place.

And yet today you talk about obviously losing incremental workloads to them. So did that turn out to be a problem particularly in public cloud but not as much in managed and private? How should we think about that in retrospect?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Steve, great question, thank you. I remember when we had that conversation.

Look, I think as we've learned through this there's a couple things that have happened. One, yes it impacted our public cloud growth.

We found that as Amazon really leverage their strengths which are pouring capital into their product, building their developer ecosystem, training people on APIs et cetera, they really picked up a lot of momentum that took public cloud apps further and further into their model, and that was a -- you've seen them right? They are a tornado. So we think that was an impact that was larger to our public cloud than we anticipated at the time.

I think the second thing though is frankly now what we're seeing and hearing when we talk to really anybody who's deep in the market either through the professional services side or large customers who are thinking about what they are doing, the most important thing for us to consider is that whereas we were still in what I would call early adoption a couple of years ago, we are now firmly in central IT land where CIOs have caught up and saying we've got to go drive our businesses to the cloud, we've got to govern it, we've got to understand how to secure it, we've got to understand how to migrate applications et cetera.

So what Amazon is seeing and Azure is seeing, and you can look at their actions to back this up, they are seeing the same hitting of that portion of the market. That's what they are working so hard on enabling the managed service broader ecosystems and putting so much of their efforts there. AWS and Azure sales reps who are trying to cover thousands of opportunities and the feedback we get is anecdotally. We don't have time to be here helping customers with the architecture with the cloud readiness assessment with the migration certainly and certainly with the ongoing operative, put SLAs on it.

We think we've hit that part of the market where you are really seeing the managed service model and the managed service buyer show up at scale, and our intent on getting out of the data center and doing a data center shutdown. So to reiterate these are new offerings that we can benefit from and as AWS proves to be the predominant leader, we are seeing a lot of evidence that the big part of the market that wants to use their technology, that wants help doing is showing up.

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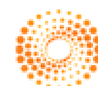

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Steve Milunovich - *UBS - Analyst*

And then can you remind us how you price your cloud support? Is it off of the Amazon bill or is it separate?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

It's on our website, I'd encourage you to go to rackspace.com/AWS. You can see it there, we've been very transparent on the pricing. It's a percentage -- it's a calculation that depends on -- a portion on how much infrastructure spend and then a portion of what service levels you are buying from us, but it's very transparent and readily available if you have any follow-up questions would be happy to take you through that during the interactions in the quarter here.

Steve Milunovich - *UBS - Analyst*

Thanks.

Operator

Jonathan Schildkraut, Evercore.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Great, thanks for squeezing me in on the questions. I guess just one strategic and then a few on the financials if I may.

You know, Taylor, you gave us really good color about AWS and wins around that business. I guess in our conversations we more and more hear how AWS is key for driving wins in sort of the other managed areas of the business, and you gave some good stats about six-figure customer mostly new. But could you give us a sense of whether these customers are also taking other services from you or if they are focused purely on the AWS support side of the business, and then a follow-up with some financial questions?

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Sure, I will caveat the answer is that the data we share with you is less than four months old so very early days. I think one of the things we are seeing though is that -- I'll give you an example, in addition to talking about AWS support many of these customers want to talk about managed security. We have developed an offer that allows the security posture from an application down into the infrastructure to be materially different and better than a customer has to manage complexity terms and cost terms on his or her own.

A good example is being able to say we have built value around the AWS cloud in two ways, three ways really. One is through proprietary software development where if you go to our website you will see products like Compass and others that help customers manage things that are hard for them around the AWS cloud. That's software that makes the AWS cloud more valuable and easier to use.

Second is the world has a scarcity of AWS experts. We have already as I mentioned gotten over 230 technical certifications which are very hard to achieve, and from our anecdotal evidence puts is already the very top. And we've already also earned over 1,100 business accreditations and technical accreditations around the AWS cloud so that our commercial people, our account managers et cetera, are fluent on the product so we're producing expertise at scale, which we believe will also be a huge advantage in this early nascent vulcanized managed service ecosystem.

And the third is the cross-sell/upsell of additional products, so security is a great example. Early anecdotal evidence, but we're also seeing an interest in being able to leverage dedicated servers or bare-metal as a complement to the AWS cloud enabled through direct connect, as another example.

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So we actually have high ambitions and we hear feedback from the field that one of the differentiators is having this portfolio of option. So a lot of medium and large-sized enterprises view AWS as an amazing part of their cloud infrastructure, but it's a component of it, it's not the entire solution, and hence our commentary around multi-cloud buyers.

Jonathan Schildkraut - *Evercore ISI - Analyst*

All right, awesome, I guess the last our final question I have has a little bit to do with some of the other metrics that you put up there.

Karl, you talked a little bit about transitioning some assets into the new London facility, and Taylor you talked about moving some folks off of the older infrastructure onto some of the newer options. I did notice the server count came down and I'm wondering if one or both of those things is tied to that reduction in the server count. But even as I think about that server count falling down -- not falling down but coming down -- it sort of begs the question around what's going on with your sort of power commitments, you guys are obviously committed to a significant amount of megawatts.

You've launched about 90% of those megawatts but you're really only occupying about half, a number which has been somewhat consistent. And I'm just wondering if you have overcommitted on the data center side for what the business will look like in the future?

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay, so let me take that one.

So the server count came down in Q4 mainly for the reasons that we've already talked about or least touched upon. There are two main reasons. One is we have still customers on our pre-OpenStack public cloud variation so to speak that we are actively migrating on now to the OpenStack control plane, which basically increases their features, makes it more attractive for them and allows us to really decommission gear that has reached its end-of-life.

So we have decommissioned thousands of servers from old capacity pulls from pre-OpenStack cloud that have been quality depreciated. So that frees up not so much capital because they are fully depreciated but it certainly frees up power and data center space to be deployed again.

The second thing that we more explicitly touched upon was the consolidation, so we had two facilities in the UK that we've decommission and migrated into London. That is the main reason why we had to take bigger capacity than we wanted. This is not a perfectly granular world where you can take half -- or quarter megawatt chunks. They come in certain minimal sizes and the UK situation it's two megawatts. So the marginal capacity step-up is two megawatts, and it comes in the those chunks.

And so when we did the planning for the migrations and the initial pickup of what we have and the demand for dedicated and Private Cloud et cetera, we determined that the best way of proceeding here is to accelerate the second pickup and really decommission a little bit more than we want to facilitate all the migrations and consolidation.

So we feel pretty good about that. Again we have a long-term expectation of growth that is related to dedicated and single tenancy and our own deployment, and so therefore we're not really concerned about our data center commitments at that point.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Awesome, thanks for taking those questions. Did you guys breakout what you got paid for Jungle Disk or what you expect to get paid?

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Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

We will provide all the detail exposure in our Q1 call.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Awesome, thank you for taking the questions. Appreciate it.

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Thank you.

Operator

Gray Powell, Wells Fargo

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

Great, thank you very much. I just want to follow up on the CapEx side of the equation.

How much more leverage can you get on capital intensity?

On the one hand I'm glad to see it improve in 2016, on the other hand 8% growth is fairly close to what we consider a steady-state. Do you see the potential for CapEx to trend into the mid-to-high teens at some point? And then just in terms of 2016 how should we think about the different components between customer gear, base for builds, capitalized software and that sort of thing?

Karl Pichler - *Rackspace Hosting Inc. - SVP, CFO and Treasurer*

Okay, so look, I think the trend is clear, right? There are two main factors that influence the trend. One is the growth itself.

Obviously -- not obviously but the majority of our CapEx is growth CapEx and is therefore related to the actual materialized growth. It is fairly tightly managed, maybe not on an in-quarter basis but certainly over several quarters and certainly for the year as growth rates come down the growth success-based related CapEx component will just flex accordingly. So that is one component that is -- I wouldn't say automatic because it has to be managed of course, but it is very tightly managed so we've done this for years.

The second component is the revenue contribution that we get from dedicated or from our core business so to speak where we deploy the capital versus the third-party cloud business, so when we provide services on other people's clouds, so that's revenue mix where we still see again demand on both sides. That mix, which is very hard to predict on what specific percentages that comes in at, will determine the capital requirement of course of the business going forward.

The second component we need to do differentiate on is the growth CapEx which I now touched and versus the maintenance CapEx. So the existing business in order for it to basically be seen as a growing concern and continue to provide services as is today requires about 10% of revenue in terms of maintenance CapEx. So we are in this -- I don't want to call it transition but we are in the space where we basically have two contributors lowering the CapEx down to lower levels. But there will always be as long as we are in the managed hosting business where we deploy capital ourselves, there will always be the maintenance CapEx requirement which will somewhat provide a floor to the overall number.

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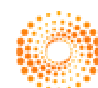

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Gray Powell - *Wells Fargo Securities, LLC - Analyst*

Got it. That's helpful, thanks.

Taylor Rhodes - *Rackspace Hosting Inc. - President*

Okay, so with that we will conclude the Q&A portion of our call. Thank you for the good questions.

Before we wrap up I'd like to share a personal statement with you and acknowledge and address the frustration that many of you may feel about Rackspace as we're making our way through these hard but important changes.

We certainly realize that 2015 was a tough year for our shareholders. We on the leadership team are very aligned and empathetic with you on the loss of valuation in the company and we acknowledge that 2016 has started out that way as well.

The recent market turbulence has hit our stock very hard and while we can't control the day-to-day volatility of our share price, we are very focused on the things we have more control over, issues that have slowed our growth and going after the opportunities that are ahead of us.

As a reminder coming out of the 2014 strategic review we suffered some pretty big hits to our culture and our engagement and the result in employee turnover really affected our momentum. Since then we've worked very hard to reengage our Rackers and our culture. We've hired aggressively to revitalize the organization. Internally I can tell you our engagement scores have rebounded, our attrition is trending back down and those are good leading indicators for us.

Racker belief in our mission for Fanatical Support for the world's leading cloud is getting stronger and a customer loyalty is consistently strong. We've shared with you the caliber of the new hires. I'm excited to be able to recruit two and work alongside veterans like Alex Pinchev to reaccelerates our growth, and we have high confidence in him. But the other major factor that caused our growth to slow was our limited product portfolio.

Frankly until late last year we weren't able to take advantage of the high-growth opportunities in adjacent markets, and it had been too long since we had launched new high-growth opportunities. And new products that added value to customers who were moving out of data centers into the multi-cloud world.

We worked last year to put compelling new offers into the market and now we can, rather than getting fearful when AWS makes a price change we see that as an accelerator on the overall size of the cloud pie, because it further stimulates customers coming out of their data centers, and many of those will want and need offers like managed services, managed security et cetera on top of their cloud. In the meantime we're very mindful of our need to be good stewards for our shareholders. We're managing our costs, we're managing our capital intensity, we are improving the free cash flow of our business, we are returning cash to our shareholders by our buyback program.

We will win is a leader in managed services in the cloud age, where we will deliver Fanatical Support globally, at scale and with an excellence that no one else in this industry can provide. And despite the really hard things we've had to do in the past couple of years to get ready for this opportunity, I and our leadership team are very energized, very excited and very optimistic about our future. So we've never seen a market opportunity that is so large, we've never seen the dislocation that is happening in the market from old tech to new tech, and that creates an opportunity for us to go in and lead.

We feel like we're at that point now where the opportunity is a good fit for us. We've done the hard work around go-to-market, we've done the hard work around product, we've got some more roadmap in front of us in order to get to re-accelerated revenue growth rate, but we're going for it. And in this time we want to thank our customers and our shareholders for their support. We're working very hard to deliver for you.

And with that we will conclude the call. Thank you for joining us.

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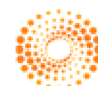

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