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RAX - Q1 2016 Rackspace Hosting Inc Earnings Call

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Rackspace Hosting Q1 2016 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 begin.

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

Thank you. Good afternoon, everyone. Welcome to Rackspace's first quarter 2016 earnings conference call. We hope that you have had the chance to read our press release which we issued earlier today, as well as review our Q1 2016 earnings slide presentation, which we have made available on our website. If you don't already have a copy of the press release or earnings slide presentation, 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.

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 for these forward-looking statements in light of new information or future events.

Please also note that certain financial measures we will use during this call, such as adjusted EBITDA 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 & CEO*

Thanks, Winston. Good afternoon, and thank you all for joining today's discussion of our financial results for the first quarter. We demonstrated continued growth in Q1, along with consistent profitability, higher capital efficiency, and rising adjusted free cash flow. We continued to return cash to stockholders through share buy-backs.

Our revenue in Q1 was $518 million on a GAAP basis. That figure would have been $9 million higher without the negative impact of foreign exchange rates and the sale of our Jungle Disk business. When adjusted for those items, our year-over-year growth came in at 9.9%. Our adjusted EBITDA margin was 34.5%, and was 120 basis points higher than in the same quarter a year ago.

Our capital expenditures as a percentage of revenue fell to 15.2%, down from 18.8% in the same quarter last year. Our adjusted free cash flow set a new record of $94 million, and our diluted earnings per share rose to $0.34 on a non-GAAP basis, an increase of 19% from the same quarter a year ago.

Our new Head of Global Sales and Marketing, Alex Pinchev, started work at the beginning of Q1. He and his team are moving aggressively to shift resources toward our new fast-growing offers, while sustaining our core business. They are training more of our sales teams to sell our new offers, and are hiring additional specialists in areas of high demand.

We advised you last quarter that these sales and marketing efforts will take time to gain full traction That transition contributed to our slow start to the year, as did two other factors. One was the macro environment that has affected many technology companies this quarter. The other factor was the typical seasonality we experienced in our business.

After a soft start in January and February, we saw a strong finish to the quarter. We can measure robust growth in our sales pipeline, and we set a new record for monthly bookings in March, thanks in large part to demand for AWS and Microsoft cloud offers, and our OpenStack private cloud. We have devoted more resources to the acquisition of new customers, which began to bear fruit in Q1, when our enterprise sales team added four times as many new logos as in the same quarter last year.

We also set a new record in Q1 for deals worth $100,000 or more per month. We closed twice as many of these large deals as we did in any quarter last year. Most of these large deals landed toward the end of the quarter in late March. They will, as usual, take several months to come on line, and will contribute to our growth in the back half of the year.

We're pleased with the progress that we're making in our strategy to provide the best expertise and service for the world's leading clouds. We demonstrated that progress through four recent achievements that I would like to call out.

First, we saw strong demand for our expertise and support on the AWS and Microsoft clouds, and for our OpenStack private cloud offer. Collectively, we now serve more than 400 customers on these platforms, and our demand is scaling rapidly.

From the October launch of our AWS service through the end of April, we've been actively marketing with AWS, and have signed187 customers across every firm size, geography, and vertical. As we've broadened our sales efforts to include more cross-selling to our existing customers, the bookings for our AWS service have been roughly evenly balanced between these customers and the ones who are new to Rackspace.

The large majority of the existing customers who have signed up for our AWS service are bringing us incremental workloads. As we discussed during our last earnings call, this effort is an important part of our strategy to reinvigorate our installed-base growth.

More than 60% of customers for our AWS offer are choosing our highest service level, called Aviator, which indicates that our expertise and support and our proprietary software tools are adding significant value on top of the AWS infrastructure. Our Navigator offer is also seeing increased up-take. We use it as a gateway product to help customers understand the value we provide, and we see the potential to up-sell them over time.

More the 40% of the customers for our AWS service are based outside the US. We are actively leveraging AWS data centers and sales partnerships around the world. We believe we can grow in regions where we previously had no physical presence. Our rackers have now attained more than 260 AWS technical certifications, and more than 1,350 accreditations. These accomplishments place us among the top few AWS service providers in terms of expertise.

The reason that we've been able to rapidly develop this level of expertise at scale is we are the only managed cloud services provider that has created and operated a leading cloud, namely our OpenStack public cloud. Our role as the co-founder of OpenStack has given us unique capabilities in software development, dev-ops, continuous integration and deployment, and other key disciplines. Those capabilities provide a major differentiation for us versus other managed services providers, as we expand to provide managed cloud services on AWS and the Microsoft Cloud.

In Q4, we landed the first six-figure-a-month customer for our AWS service. In Q1 we closed several deals with large enterprises whose spending with us should significantly increase over time. New customers for our AWS service include Digitas, the global digital marketing agency, which also leverages our expertise and support on other cloud platforms.

Our offers for customers that use the Microsoft Cloud are showing similar signs of growth. By the end of April, we had signed 178 Microsoft Cloud customers. We see strong demand for our Microsoft private cloud offer, particularly among enterprise customers who are using both public and private cloud platforms for different workloads. Our new customers of this type in Q1 included two of the world's largest professional services companies, and a global aerospace leader.

We are also gaining increased traction with our Microsoft Azure offering. We have won several large Azure customers, including one of the world's biggest retail companies, and a global giant in commodity distribution. Later this month, we plan to improve and refresh our Azure offering, incorporating suggestions from customers and from Microsoft. These new enterprises that have signed up for our AWS and Microsoft Cloud services tend to start relatively small, but we expect revenue from those deals to ramp up over time.

Our second highlight was the exclusive partnership that we forged with Cloud Technology Partners to offer enterprises a differentiated end-to-end solution for cloud transformation. CTP is the leading cloud services consultancy for enterprises moving to AWS and the Google cloud platform, and it is building a practice for Microsoft Azure. CTP is the only consulting partner certified at the Premiere, or highest level, by both AWS and Google cloud platform.

CTP has helped more than 300 enterprises with strategic consulting, design, build, and migration services on the front end of their move to a public cloud platform. Its strengths fit well with ours at Rackspace, where we provide ongoing expertise, proprietary tools, and managed cloud services. Together, we can help customers migrate from their corporate data centers to a cloud managed by Rackspace. We are proud to invest in CTP and to join its Board of Directors.

Our third highlight was the launch of OpenStack Everywhere, an initiative to accelerate enterprise adoption of OpenStack private clouds. It allows customers to deploy Rackspace-managed OpenStack private clouds in our data centers, our customers' data centers, or co-location facilities around the world. OpenStack Everywhere enables customers to ring maximum value from their own DCs as they modernize their infrastructure. It helps them comply with data sovereignty laws in various countries, and put the cloud resources close to their users and customers.

At the recent OpenStack Summit in Austin, which drew more than 7,500 attendees from around the world, the OpenStack foundation reported that its platform now its used by half the Fortune 100. We believe that most of the rest will adopt OpenStack during the next three years.

Until now, the biggest obstacles to enterprise adoption of OpenStack private clouds has been concerns about complexity, reliability, and scalability. The skills we learned by co-founding OpenStack and creating the world's largest OpenStack public cloud now will enable us to break through these barriers for enterprise private cloud.

We lead the market in the power and simplicity of our OpenStack offering. It is delivered as a service, as clouds were meant to be delivered, without burdening the customer with complex and expensive set-up and configuration projects. We deliver industry-leading reliability, with 99.99% up-time SLA, and we lead the world in the number and scale of the OpenStack clouds we deploy and manage.

As we have reported in recent quarters, growth in our OpenStack public cloud is slowing, but we are encouraged by the strong demand for our OpenStack private cloud. In Q1, we closed deals to deploy OpenStack private clouds for one of the world's leading manufacturing conglomerates, and for a global bank based in Europe. Our OpenStack private cloud set a new record for bookings in Q1. Revenue is growing in the high double digits, and our pipeline is growing even faster.

Our final highlight for Q1 came when Forbes magazine named us as one of America's best employers, and number five among all tech companies. This honor recognizes our long-standing focus on cultivating and engaging work place culture, which empowers and inspires our rackers to go the extra mile for customers. The Forbes list also gives us a valuable advantage as we compete for scarce talent.

I hope these highlights give you a useful update on our progress across several fronts. I will now talk briefly about our differentiated strategy that pulls it all together.

The managed cloud services market that we lead is young and fragmented. It is populated mostly by small providers, none of which operates at anything like this scale that we do, with more than 6,000 rackers on four continents, including hundreds of experts in every leading cloud platform and technology. Our economies of expertise are one reason that we're landing so many enterprise deals, and now serve most of the global giants in the Fortune 100.

Enterprise customers also appreciate that we're the only managed cloud provider that has actually built and operated a major cloud at scale. We're the only Company that Gartner features not only as a leader in its Magic Quadrant for managed cloud providers, but also as a respected player in its Magic Quadrant for cloud infrastructure providers, where we rank ahead of the likes of HP, IBM, and several telecom giants.

The experience we have gained from creating and managing OpenStack provides a major differentiation for us as we expand to provide managed cloud services across multiple platforms. We intend to leverage these strengths to become the dominant managed cloud provider, and benefit from rapid growth of AWS in the Microsoft Cloud.

Our goals for 2016 remain the ones we described last quarter. First, optimizing the mature parts of our business and achieving significant savings. Second, investing those savings in our growth areas and expanding our position as the number one managed cloud provider. In recent quarters, we have shown we can launch and fund new businesses while also keeping margins in line with historical levels. Third, increasing our adjusted free cash flow; and finally, returning cash to stockholders through share buy-backs.

For the full year, we reaffirm the guidance that we gave to you last quarter. We acknowledge that this is a back-end-loaded plan, but we can measure our growing pipeline, and we see several large deals that we expect to close in Q2. We're also encouraged by the deals we've already closed in March, which we believe will benefit our growth in the second half. Both of these factors give us confidence in our guidance range.

In closing, I want to thank our rackers around the world for the difficult, valuable work they do in rapidly creating technical expertise and tools with scale. They are special people who love to relieve our customers of unnecessary complexity and cost, and who take great pride in helping those customers succeed. With that, I will turn the call over to Karl, who can give you more details on our Q1 financials. Karl?

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

Thank you, Taylor, and good afternoon to everyone on the call. Before I discuss our Q1 results, let me refer you to slide 13 of the earnings deck, which has our summary financials.

Revenue for Q1 was $518 million. The decline in GAAP revenue relative to the fourth quarter is due to currency movements and our divestiture of a non-core business called Jungle Disk. Normalized for the $9 million impact of these two factors, our revenue grew 9.9% throughout fQ1 of 2015, and 0.7% relative to Q4 of 2015.

In Q1, we recognized a $24 million gain from our divestiture of Jungle Disk. This positively affected our GAAP profits and cash flow. On a GAAP basis, our diluted EPS was $0.37. This includes a benefit of $0.12 from the gain on our sale of Jungle Disk. In order to improve comparability over time, all of our non-GAAP metrics, adjusted EBITDA, adjusted free cash, non-GAAP EPS, and return on capital are presented without the gain from the Jungle Disk sale.

Our adjusted EBITDA for Q1 was $179 million. Our adjusted EBITDA margin was 34.5%, an increase of 120 basis points relative to Q1 of 2015. Our non-GAAP EPS was $0.34, an increase of 19% relative to the first quarter of 2015. As a reminder, our non-GAAP EPS excludes stock-based compensation expense, net of taxes.

This quarter, our capital expenditure was $79 million, or 15.2% of revenue. CapEx was unusually low, due to the timing of certain expenditures, and improvements in purchase prices and asset utilization. We expect CapEx to increase during the remaining quarters of the year.

Q1 adjusted free cash flow was $94 million, a record high for the Company. Our return on capital for the quarter was 14.4%, 210 basis points higher than in the first quarter of 2015.

We continued our share repurchase program, and retired an additional 3 million shares worth $68 million. This brings the total buy-back under our current program to $435 million as of March 31. We will complete our $500 million re-purchase commitment during the second quarter of 2016.

Moving on to our server count. As in the previous quarter, our server count in Q1 was affected by our ongoing migration of customers from our pre-OpenStack public cloud to our OpenStack public cloud. This is among the capital and cost efficiency initiatives we are working on. The migration will help us raise utilization levels of our OpenStack cloud servers, and reduce our data center space usage. We expect the migration to continue through the rest of the year and into early 2017.

Next, I want to mention a non-material adjustment that we have made. During the first quarter of 2016, we realized that we had under-reported the expense associated with certain software licenses for the period from July 2013 through December 2015. We have revised our past financial statements to reflect this non-material error during this period. This resulted in a reduction to net income of $1.4 million, $3.2 million, and $3.8 million for 2013, 2014, and 2015, respectively.

Let me conclude by giving you our outlook for the second quarter. We expect revenue to range between $519 million and $524 million, which represents approximately 8% to 9% normalized revenue growth year over year. This normalized revenue growth rate excludes approximately 210 basis points of negative impact that we expect from currency movements and the Jungle Disk divestiture. We expected adjusted EBITDA margins to range between 33% and 35%. As Taylor previously mentioned, our outlook for the year remains unchanged. With that, we will open the call for your questions.

QUESTIONS AND ANSWERS

Operator

Thank you, sir.

(Operator Instructions)

Our first question comes from the line of James Breen, William Blair. Please go ahead.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. Can you talk about the guidance for the full year relative to the guidance for the first couple quarters, and how you get comfortable with the pretty decent ramp in the back half of the year? You commented on some of the wins you've seen recently, but how do you feel as though -- you had a good bookings quarter in March. Is that continuing today, and do you think that continues to get better throughout the year? Thanks.

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

Hi, Jim. This is Taylor, thanks for the question. Look, we had -- as we talked about on the last call when we gave the guidance range for the full year, 6% to 10% adjusted for FX and the divestiture, we talked about a few things. One was the decelerating growth rate in the public cloud. The usual, as we get more enterprise-oriented, usually the quarters end up being a little lumpier, and January and February are typically soft for most enterprise technology companies. We baked all that in.

The other factor was that we talked about Alex taking on our global sales and marketing org, and needing to make some changes in the sales model in terms of alignment of resources toward the new offers, and some improvement in execution. All of those things we baked into the guidance range. We frankly saw what we expected, as you see the rev is generally in line with what we guided for Q1. Because the deals we landed in Q1 were largely back-end loaded in March, they won't really have a revenue effect until the beginning of Q3. That's one factor.

Secondly, also we look at our pipeline for Q2. We can look at it. We can see how it's improved quarter over quarter. We see some near-term large deals that we feel confident in that would also close in the quarter, and start to drive revenue in the back half. Lastly, I think over the last any number of years, you can see that our business generally tends to accelerate revenue-wise in the second half of the year. A combination of those factors make us feel good about the range for the back half of the year.

James Breen - *William Blair & Company - Analyst*

Great, thanks. On the revenue mix, you talked about a lot of the new revenue coming from outside the US. What's the mix of US dollar versus non-US dollar revenue?

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

That comment was specifically around the AWS offer, Jim. What we said is that over 40% of the AWS customers are coming from our non-US regions. We like that fact, because one of the advantages we have with these new capital-light business models is that we can really roll out product offers in regions, where in the past, we would roll them out first in the US due to capital intensity, and then we'd phase them out over time into our other regions.

We can get these new offers into regions fast. Our sellers in the other regions are finding traction there, as well. We're able to see a good mix from international locations faster than we could in our historical, more capital-intensive models.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Our next question comes from the line of Tim Horan from Oppenheimer.

Timothy Horan - *Oppenheimer & Company - Analyst*

Thanks, guys. Can you maybe give a little more color on how you've changed your marketing strategy overall? How are you differentiating yourself in the market at this point?

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

Sure. Our number one goal in marketing is to build market power behind the managed cloud business, led by our leadership position in AWS and Azure. You can imagine a lot of our marketing program spend has shifted toward driving brand awareness and demand generation in those areas. We've also done field marketing in the quarter with AWS in certain regions, where we're actually out together generating demand from prospects in the field. The primary shift there has been really putting the emphasis on the leading edge of being the dominant managed service provider in AWS and Azure.

Also, you've heard us talk today about our bullishness on the OpenStack private cloud market. We recently had a very big presence at the OpenStack Summit in Austin. The OpenStack Summit had over 7,500 attendees this year, which is the largest ever. Anecdotally, from our folks there and others that had a much higher representation of potential customer buyers than it has in the past. We had a big presence there, and frankly, expect to generate significant pipeline out of that. Those are some examples of the marketing shift that we're making.

Timothy Horan - *Oppenheimer & Company - Analyst*

Lastly, you sound real bullish, or more bullish on OpenStack than you have for a while. I know it's more private-cloud focus. What's has changed there to cause that bullishness, or caused the increased interest from customers? Thanks.

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

Yes, we've really seen a tipping point, what really looks like a significant tipping point in the market for OpenStack private clouds in the last six to nine months. The last couple of years have really been hallmarked by large enterprises trying to build and roll out their own private clouds. Those have been expensive efforts. Scarce -- skill sets are scarce. The ability to operate OpenStack and scale on your own is hard.

Yet there remains this big pent-up demand in the market, particularly from large enterprises who are running maybe an alternative stack today, who are looking at private cloud architectures but wanting to get to what's the next thing that's going to drive productivity. According to Forrester and others, OpenStack is going to be the dominant private-cloud platform there.

We're seeing a re-acceleration in the pipeline from customers who in the past were trying one- and two-cabinets POCs, now coming back with multiple-cabinet-production workloads. Some of our largest deals that we closed in March were OpenStack private-cloud deals, and some of the largest deals we have in our pipeline today are OpenStack private-cloud deals. Really, that's the traction that we're seeing.

The other thing we're finding is that our heritage in OpenStack public cloud, while our OpenStack public cloud has become one of the world's at-scale public clouds, we've said in the past that we see OpenStack changing shape toward enterprise private clouds. The capabilities we've developed by having to push OpenStack to scaling that other players haven't had to push it to is we now get to apply a lot of that learning, that technology, that operating model into OpenStack private clouds. It really separates us from software vendors out there or other service providers. We think we will be -- really have an unfair advantage in this space.

Timothy Horan - *Oppenheimer & Company - Analyst*

Thank you.

Operator

Our next question comes from Jonathan Atkin from RBC Capital Markets. Please go ahead. Mr. Atkin, your line is open.

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

Operator, let's go to the next question.

Operator

Our next question is from Simon Flannery of Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Okay, thank you very much. I was wondering if you had any more visibility into the margin profile and the returns in the AWS Microsoft business. I know it's still scaling, but any more insight? I think in the past you've said you thought the EBIT margins would be comparable to your core business, but obviously a much lower capital intensity. Any color there?

Then I know you're not breaking out the private cloud versus the public cloud, the legacy public cloud business; but any color you can give us around -- we're going through this transition of the platforms moving, revenue growth is decelerating. When do we get to that point where it all starts to re-accelerate again? Thank you.

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

Hi Simon, this is Karl. I'll take the margin profile and returns first. As you say, it's early days. We have obviously working assumptions in our models, and we're testing those against actual take-rates in the market place as we ramp up the offer. So far, we are on track, or marginally maybe a little bit better. We have certainly a good up-tick on our higher service level offering of the two, which creates a little bit of margin up-lift. The momentum is very positive relative to what we went into this year in terms of expectations. We're on good track. I don't think that qualitatively any of our comments would be different than before.

Simon Flannery - *Morgan Stanley - Analyst*

Okay, thank you.

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

Simon, this is Taylor. In terms of when overall the re-acceleration takes place as we transition from some maturing businesses to these smaller but hyper-growth businesses, our expectations are baked into the guidance range we gave this year. As we've said, these are hyper-growth businesses, but on a $2 billion base they will take time to really move the needle on the corporate metrics. We believe that they are ramping quite nicely. We're seeing good expansion of not only pipeline, but also winning of new customers. We're seeing good revenue ramp on these businesses, but they will contribute much more to 2017 than they will in 2016, and hence the guidance range this year.

Simon Flannery - *Morgan Stanley - Analyst*

Is the macro enough to change more to the low end of guidance, or is that just one head wind you're dealing with?

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

Yes, it's in the mix. It's hard to really tease out how much of a factor it is, Simon. We do know that we saw some potential lengthening of sales cycle in Q1, when customers wanted to debate budget a bit more, or double-check availability of budget, or is this project going forward. We can't directly currently attribute that to macro. You see this from time to time when people are concerned and nervous about the macro, they tend to measure twice, cut once. That can end to a little bit of elongation of sales cycle. That's in the mix, as well.

Simon Flannery - *Morgan Stanley - Analyst*

Thank you.

Operator

Our next question comes from the line of Gray Powell from Wells Fargo Securities. Please go ahead.

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

Great, thanks for taking the questions. A few on the third-party cloud site. The pace of net adds, they're improved nicely in Q1. Should we expect net adds to continue to improve over the course of the year? Then what's the typical monthly RPU you're seeing from your early adopters? Then lastly, is there anything in your 2016 revenue guidance for these initiatives? Thanks.

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

Thank you, Gray, I will answer that last one first. What we've said about their contribution to revenue growth for this year is that they're going to have a fairly minimal impact on overall revenue growth this year. We expect to ramp these. The main thing we're focused on this year is traction. Your comment about net adds and RPUs, who's buying, how many are buying the higher service level, are these net new customers versus incremental workloads from the base. All of those traction are really what we are managing in 2016, and we think that the revenue contribution from them is not expected to be huge in 2016.

The net adds, yes, we expect to continue the rate of net adds over time. That's one of the most important parts of our metric. I will caution that we are still learning whether this is a business that's going to be a high-volume SMB business, or a lower-volume higher-RPU enterprise. Frankly, we're seeing some of both right now, which drives your next question on RPUs. We are seeing a nice RPU expansion on the customers every month since launch. I'm not going to comment specifically on what the RPUs are, but as the mix goes from early large beta customers to what we're winning today, we're seeing that RPU ramp up over time.

We'll keep you posted on what we're learning in the market. Is it a high-volume lower RPU, but still attractive RPU? Is it a lower-volume, higher-RPU enterprise play? As we commented last time, in the mid-market and enterprise, we really feel like that's where a big inflection is happening. The race is on to start to get out of your DC. There's a lot of the big ITO contracts that were signed five, six years ago that are up for re-competition this year and next year. We expect many of those to go cloud. Many of those buyers are traditional managed services buyers. Frankly, we're feeling a draw toward the mid-market and enterprise side of this market, but we'll keep you posted on that.

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

Okay, great. If I can follow up on that. I don't think I'm going to be able to pin you down on a number, but there's a pretty wide range of prices on your Aviator price list. Would it be safe to say that your customers are closer to the $2,200 to $4,000 per month bucket, versus the high end that could be as much as $30,000 per month?

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

As I said in the prepared comments, Gray, we're seeing right now truly a representation across all firmagraphics, so that's my comment. It's too early to tell, but we're seeing the share of those who are coming in and having a $5,000-a-month services bill, and we're seeing a share of those who are coming in with a significantly higher. We will continue to update you. I would give you a number if it meant anything, but it's early stage, and we're still in product-market fit stage on this.

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

Got it. All right, thank you very much. Appreciate it.

Operator

Thank you.

(Operator Instructions)

Thank you. Please limit your questions to only one. Our next question comes from the line of Amir Rozwadowski from Barclays. Please go ahead.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much. I was wondering if we could talk also about your third-party cloud business. Recognizing it's early stage, can you provide us with a little bit more feedback that you're getting from customers as to why they're selecting to go with you folks as opposed to other service providers?

I think one of the questions that has emerged from the investor community as you build this business is trying to understand what the potential differentiating aspects you folks bring to the table versus others. It seems like you're getting a decent amount of initial traction from across the board. I would love to hear what type of insight you may be able to share with us for now, as you've been ramping in terms of that potential differentiating element to your business?

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

Thank you, Amir. Great question, and thank you for that. One of the reasons we sound and feel very confident about this business is frankly, when you look at the universe of competitors, we bring several things that really make us stand out. The first is we think that the data that most customers are operating -- or the data that we see that's indicating what buying patterns are going to be is that customers are going to be using multiple clouds. Our portfolio as being one of the only players out there that can help with your dedicated hosting workloads, as well as AWS Azure, and then manage those across a portfolio is very differentiated.

The second thing is that when we look at companies out there that we're competing with in the AWS and other ecosystems is we have scale, both in numbers of certified technical experts in global footprint and in other important elements that are differentiated.

Finally, very importantly and we're learning this over time, is that when we look at certain companies we're competing with, they have never had to build and run cloud technologies at scale. They come -- first of all, many of them are professional-services-type companies, so they don't really come from an operations heritage like we do.

Second, even of those who come from more of a managed services ops background, they come from an historical -- what we call system administrator mindset. Very pre-cloud. They don't have people who have built and done things like scaling cloud applications across multiple availability zones and data centers, like having to do continuous integration, continuous deployment; like having to do dev-ops. These are very differentiating things.

Our rackers who grew up in these environments -- first of all they've been available, and that's why we can quickly shift and build numbers in this business. The second is, they really kill it compared to other managed service providers, and primarily because of that heritage of having to run these things and build these things at scale. It's very differentiated. We have a very different conversation, and that's a lot of the feedback we get, and why we're winning these customers. Frankly, some of these customers are among the largest at some of our smaller competitors today. We feel very advantaged.

Amir Rozwadowski - *Barclays Capital - Analyst*

Over time, as you build that customer base, is there an ability to potentially productize that knowledge, meaning -- we're still at the early stage, it seems like, with the transition to the cloud. If you're looking at multi-cloud development, is there an opportunity to take that knowledge base and then create additional value-add to new folks that are coming into the ecosystem?

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

Absolutely, and that's exactly what we're doing right now, is taking it and productizing. Remember, what we say is that our offer is a combination of human expertise plus software and tools.

What we're doing with that is, for instance, if you go into our Rackspace.com/AWS page and look at the product offers there, these are products that are not just about humans managing the AWS cloud for you; they are software and tools like our Compass product, which really takes best practices for how to build clouds and how to lay clouds down on top of infrastructures so that you get much higher up-time and performance and reliability for the workload you're running. There's security features that allow people to more securely store and manage keys and access and auditability of who's accessing the cloud and who's doing what.

There continue to be examples where it's not only hey, can you help me solve the technical problem of running these clouds. One of the biggest problems companies are facing is business management and governance of these clouds. Spend is a huge item. Spend management, visibility into what drives spend, which part of the enterprise is spending, are they spending less this month or next month, how do I forecast that? How do I govern this, and make it work with my other products and tools?

You think about the complexity of simply running the AWS stack itself, which is -- literally had 700-plus product features released last year alone. But then the next layer of complexity is they are using that AWS cloud stack with tools like Salt and Ansible to run automation -- tools like Datadog and New Relic for application-level monitoring. It's all about how do you help integrate and create best practices for all of those things coming together. That's where our opportunity is to continue to create products around of and on top of the AWS and Azure clouds.

All right, operator, next question.

Operator

Our next question comes from the line of Heather Bellini from Goldman Sachs. Please go ahead.

Heather Bellini - *Goldman Sachs - Analyst*

Great, just two quick ones. Server counts -- based on your comments, is it fair to say -- and given how your model's shifting -- that server count has peaked and it should be on a slow, steady, sequential decline from here on out? That's one question.

The other, and I know a lot of people have been trying to get at this also, when you think about the success you're having and your comments about the bookings growth in some of these new areas, I know they're not big enough to make an impact on calendar 2016. You mentioned calendar 2017 they could be. Is it enough that you could see top-line growth accelerate that they would be enough in calendar 2017 to offset this slow-down in the legacy business? Thanks.

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

Sure. Thanks, Heather. I'm going to ask Karl to take the server-count question.

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

On the server counts, we have two offsetting factors. We have -- or maybe three. We have ongoing growth expectations, certainly, in our dedicated and private cloud business, which comes with incremental servers. We have an opportunity to rationalize and draw on its higher capacity utilization. The capacity pulls we have in our public cloud, which would lead certainly to server-count reduction going dow. On a per-revenue basis, obviously as the third-party cloud revenue contribution increases, that comes without service and without CapEx.

Which trends will offset which one is very hard to predict right now. We don't see our dedicated or private cloud business go negative or anything like that; but we certainly have rationalization potential in the public cloud, which will continue to bring the number down as one important factor in those three equations -- or three parts.

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

Heather, to your question on 2017, are these businesses enough to -- in the net re-accelerate. Look, first, let's wait until later to give 2017 guidance. We're telling you what we know and see today, and I think there's a lot of variables in that. I will give you -- we'll just keep updating on what we see as we progress into these markets, and I can't give you any other finer answer the that today.

Heather Bellini - *Goldman Sachs - Analyst*

Okay, thank you.

Operator

Our next question comes from the line of Colby Synesael from Cowen. Please go ahead.

Colby Synesael - *Cowen and Company - Analyst*

Great, thank you. I have two fairly brief questions. Number one, is it still management's expectation to start breaking that support business out in terms of its financial impact in 2017 at the earliest? Then the second question is, what was the initial assumption against your guidance in terms of the contribution that Jungle Disk was going to provide? What was your assumption for Jungle Disk revenue when you initially gave your guidance for 2016, so that we can back that out to get a better sense of what that impact is to the guidance on a go-forward basis? Thank you.

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

That's Karl on both of these. The financials will really be driven by the materiality of their contribution. We really don't know it exactly to what level they will go up to by 2017. It's hard to assess when that materiality threshold will be reached, but certainly not before 2017. On the Jungle Disk disposition, you don't have to do anything. We have excluded that from our guidance appropriately, because at the time we knew about it, we already foreshadowed the divestiture, and have adjusted it accordingly.

Colby Synesael - *Cowen and Company - Analyst*

Great, and if I can get one quick one extra in there that's short. Your guidance range now, you're obviously talking about it being back-end loaded. Is it still possible in your mind that you can get to the higher end, or should we as those modeling the Company think of this more as low end to the mid-point is a better range?

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

Well, the range is the range. I don't want to modify the range with you on the call here. We feel like it will be in range. There's a number of variables, so obviously the size of the bookings, how long they take to materialize to revenue, what's the mix of the business. We feel comfortable with the guidance range for the back half of the year. That's the commentary for today.

Colby Synesael - *Cowen and Company - Analyst*

Okay, great. Thanks, guys.

Operator

Ladies and gentlemen, as a reminder, please keep your questions to only one. Our next question comes from the line of Frank Louthan from Raymond James. Please go ahead.

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

Great, thank you. I want to talk about the base business. With some of the server decommissioning and so forth, talk to us more qualitatively about the health of that business. Is there any difference in the churn rate from those customers, and any concern that the overall growth there could take any material difference from the pace that it is right now?

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

Thanks, Frank. When you say base business, I'm assuming you're talking about our dedicated hosting business, so I'll direct my comments there. Looking in Q4, we reported we had a multi-year low churn quarter in Q1. We saw churn return to historical ranges. We have not seen any indication that our long-standing historical churn rate there is deviating outside of the norm. We measure that very closely. No, we don't see anything there that's a red flag.

In terms of the growth, obviously the back-end-loaded quarter, which included many of the large bookings, which would also drive the dedicated hosting business, did influence the growth rate in Q1, and will influence the growth rate in Q2. But the dedicated hosting business is part of our full-year guidance range. In short, we don't see any significant change to the profile of that business. We still win many new customers on a quarterly basis who need dedicated hosting, who were moving three-tier web architecture workloads running VMware out of their data center to create space and capacity to work on more mission-critical things.

We see people who have become very intelligent about cloud, and who our understanding which infrastructure form factor is actually best for the application. We get many customers who are choosing to architect their applications on dedicated hosting, because they get better price per performance, or better isolation of resources, predictability of cost. There's many reasons they companies still choose dedicated hosting, and we still see significant demand, because we are the world's number one in it. When somebody is shopping for dedicated hosting, we generally get the call and a chance to compete.

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

All right, great, thank you.

Operator

Our next question comes from the line of Jonathan Schildkraut from Evercore. Please go ahead.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Thank you for taking the question. Look, I've noticed that this is -- along the lines of the questions that we had earlier on server count, I noticed this is the second quarter in a row where your megawatts utilized at end of period had ticked down ever so slightly from last quarter, but two quarters in a row. I'm wondering now as you talk -- think about Karl's comments about what could happen to server count in the future, and the commitments that you have, and the fact that you own some of these data centers yourself, if there's an opportunity to potentially monetize these assets, or at least look at them differently as they sit inside the balance sheet?

Then -- sorry to ask a second question, but I want to take a look at CapEx, because you talked about capital intensity coming down. When I look at the amount of capital that you're deploying, it's certainly down as a percent of revenue. But when we look at the amount of server-related capital you're deploying to drive an incremental dollar of revenue, it's down slightly from the fourth quarter, but it's actually up pretty significantly on a year-over-year basis. I'm wondering if there's anything we can think about in terms of that level of capital intensity as we look into the forward projections? Thanks.

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

Okay, Let me start with DC capacity. That is correct. We have had two sequential reductions in megawatts utilized that have mainly related to the consolidation of data center space, and the also the first connection migration on the cloud. That will continue.

We have certainly started to watch that very carefully. All these data centers are on different lead schedules. Some of them will be able to maybe decommission over time, or hand back to the provider, or monetize in other ways. But if we end up in a situation where we overestimate maybe the private cloud opportunity, and it's going to be less than needed, and third-party cloud takes up more than what we currently expect, then we will certainly have to adjust this.

Overall, I would say that from a P&L and from a financial management point of view, our DC rent equates to about 3% of revenue. I don't want to say that we -- I'm the first one to say that we don't like to have data centers empty, but from a financial risk management point of view, I think it's a secondary risk factor.

The other thing, also, that has to be seen in context is that there is really, while the average utilization is somewhere in the high 50%s, low 60%s depending, we really have a lot of facilities that are either full, or they're a production facility. It's not that we have an average -- that the under-utilization is representative of all the facilities. We have a much more isolated management problem than what it may suggest if you just look at the average being low. I hope that answers somewhat your data center capacity thing. Look we watch it, and we watch it very carefully. We're not -- you know us well enough to know that we're not just signing up space for the sake of signing up space.

On the CapEx side, I don't think there is really anything unusual in there. We have these migrations have really led to a significant purchase of equipment over the last couple of months -- last couple of quarters, as we brought long size on line, as we facilitated the migration. We have in cloud still the tendency that new workloads are coming to the performance cloud versus old clouds bleeding out. We really have the revenue that we get incrementally on the plus side has really to be supported with new capital, whereas the revenue that we lose is really going off of capital equipment bases that are bleeding out, and they're not being recycled.

What you really see now, that the possibility that we really have in terms of starting to consolidate and migrate and increase the asset utilization on those capacity pulls is the flip side of the higher capital that we spend in previous quarters. Look, 15.2% as I stated before, is probably a number lower than what we should expect for Q2 to Q4. The business gets significantly less capital loaded than we have in the past.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Thanks for taking the questions, Karl.

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

Sure.

Operator

Our next question comes from the line of Jonathan Atkin of RBC Capital Markets. Please go ahead.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, I'm sorry if this was asked earlier, but I'm wondering if you can comment on the relative side from a revenue contribution standpoint of Microsoft versus AWS at this point? You mentioned Microsoft Cloud in the slides. Is that synonymous with Azure, or is there something broader than Azure that you're including in the Microsoft Cloud nomenclature? Thanks.

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

Yes, absolutely Jonathan. This is Taylor. When we say Microsoft Cloud, that is inclusive of the Microsoft private cloud offer and Azure. The reason we break it out that way is frankly, that is lined up with Microsoft's product strategy.

You might have seen recently they launched a product called AzureStack, which is really the connector between their private cloud architecture and their public cloud architecture. I think they have a strategy and a good plan for their customers who have grown up on Microsoft who are running workloads in the corporate data center to have a bridge into public cloud. When we talk about Microsoft Cloud, it's inclusive of both of those, because that's the focus of Microsoft itself.

In terms of the revenue split between the two, you can see the customer counts are fairly similar. The way to think about this is that we see the AWS size of market is significantly bigger than the Azure market. Everybody knows that. We are seeing Microsoft start to tilt up the line in terms of their demand and opportunity. You can imagine that among our third-party public cloud customers we have significantly more AWS customers than we have Azure, and that just mirrors the market.

However, the balance of that Microsoft Cloud number of customers would imply that we have more Microsoft private cloud customers than we have Azure customers. That follows the fact that for many of these customers, they are looking for moving that dedicated or single tenant workload out of their data center into a private cloud to start. We would expect then that we'll see those customers adopt Azure in greater numbers down the road. I hope that helps.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, thanks very much.

Operator

Our next question comes from the line of Lou Miscioscia from CLSA. Please go ahead.

Lou Miscioscia - *CLSA Limited - Analyst*

Okay, thank you. Could you refresh our memories on your go-to-market strategy. A couple quarters ago, my checks suggested your really weren't focusing on your small-medium business customers. I don't mean the tiny ones, ones that could be $10,000, $20,000 a month. It sounds like you started to go back for that. I wasn't sure if that's actually altering your R&D or G&A, which seems to shift around. You've been able to keep it flat year over year, which seems to be a bit of a surprise. Maybe if you could explain that, too? I didn't know if those two were connected?

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

Yes, Lou. I think over time, look, we still have quite a few -- a large number of SMB customers here who pay us good money, and we like those customers. They buy managed services. They look at Rackspace as adding a key part of value that would be hard for them to do. We have very deliberately moved away from the single-server customer, right? We think Digital Ocean and Go Daddy and others have really targeted a market for single-server, couple-server customers. Years ago we really started to de-emphasize that part of our portfolio. That naturally moves us up into the middle market and the enterprise space.

I don't know where your comment would come from that we've seemed to re-accentuate our SMB go-to-market focus recently. I don't know where that would've come from. Our go-to-market strategy is very simple. We want to be the number one managed cloud Company for the mainstream companies moving out of their corporate data center into multi-cloud models.

Generally that leads us into selling more toward medium, so the M part of SMB and up into enterprise, because we're more competitive from an offering and a cost structure there, et cetera, or a pricing structure, et cetera. We tend to focus on the middle up into the enterprise. Also, we've really doubled down on that move in the last I'd say couple of years under my leadership, because frankly we're seeing the telcos make signs of exiting there. We've seen disruption in traditional players like IBM and HPE. We feel like that part of the market is opening up.

Also, as we've talked about, we see the mainstream exit from corporate DCs, from those size companies really starting to hit an inflection point. The new scarcity in the market becomes expertise to help them move and operate these clouds. Our go-to-market strategy focuses more on mid and enterprise.

In terms of the R&D, remember, one of the factors that influences the R&D spend here in the past couple of years versus previous years is in the years of 2010 through say 2013, 2014, we really built a very large engineering organization here to build the world's first OpenStack cloud. We went from very few product and engineering people to a lot of them over that time. The relative ramp on R&D during that time was much steeper.

Today, we get to harvest a lot of the benefit from already having built that, and having those folks. Also, it's very much what I mentioned before about a lot of the benefit and differentiation we're finding now as we move into these new offers comes, from having spent that money on R&D and developing those capabilities in past years.

Lou Miscioscia - *CLSA Limited - Analyst*

Thank you.

Operator

Our next question comes from the line of Siti Panigrahi of Credit Suisse. Please go ahead.

Siti Panigrahi - *Credit Suisse - Analyst*

Thanks for taking my question. You talked about some of the changes in sales and marketing as one of the factors of the softness in Q1. Could you give some color in terms of changes Alex made to the sales and marketing? Is he done -- question, is he done with the changes, and if so, when should we expect to see some kind of benefit of this new sales-marketing initiative?

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

Yes. Thanks, Siti. Alex is a very experienced sales leader, but he's not a magician. What we said on the last call is it would take a couple of months, at least, for him to make the changes happen. Is he completely through them? No. Is he substantially through the big ones? Yes.

Some of the areas of focus, specifically, have been around re-allocation of sales and marketing resources toward our growth areas. That would be AWS, Azure, Microsoft private cloud, Rackspace managed security, OpenStack private cloud -- hiring more sales specialists in those areas, and re-positioning existing sellers and marketing dollars towards those offers.

The other thing that I mentioned on the last call was that in 2014, when we had several quarters in a row of expanding bookings and expanding revenue, we were really very focused on acquiring a certain number of net new customers every quarter, and even more importantly, a certain number of large new logos, over $100,000 a month initially.

Alex has really come back in and put a renewed emphasis there. You heard me talk in my prepared remarks that in the first quarter we acquired substantially more of the new logos, and especially the larger new logos, than we did last year. He's really got an emphasis on the field sales team that is selling to mid-market and enterprise customers, and leveraging our new offers as the foot in the door, and closing more of those deals.

Most of the deals in the Q1, as I mentioned, came in March at the quarter end, which frankly is an attribute of moving further into the enterprise. You get the back-end loaded deals, which then take time to come on line and drive revenue growth, subsequently.

We also are providing a lot of training and enablement to our sales force. You can imagine with the new offers they need to understand them well, so lots of training and enablement has been rolled out, and certification process has been rolled out for the sellers. That's probably a good categorization of the major changes Alex is driving.

Siti Panigrahi - *Credit Suisse - Analyst*

Things for the color, Taylor.

Operator

Our last question comes from the line of Steve Milunovich from UBS. Please go ahead.

Steve Milunovich - *UBS - Analyst*

Thank you, two questions. First of all, Google of course is making a push now in terms of the cloud. Are you expecting to do much work with Google? Second, Amazon is beginning to move a little bit into services, some migration tools. Do you view that as complementary to what you're doing, or over time could Amazon be somewhat competitive?

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

Yes, thanks Steve. Google is clearly making progress on GCP. We do think they will end up being one of the winners in public cloud. You can imagine that at the right time, it fits neatly under our strategy of fanatical support for the world's leading clouds. No specific commentary today, but I think it fits the category. We have a lot of respect for them.

We actually have a lot of relationships with Google through hires that we've made in Alex Pinchev, Scott Crenshaw, and folks who are part of our network who now work at Google. We respect them. We watch it very closely. If the market demand signal is there, we would certainly want to work with them to provide support for the Google cloud.

On AWS, yes, they're making constant -- they are a machine, right? Over 700-plus product features launched last year alone. I believe the product you're referring to, potentially, is called Sentinel, which was written about in a CRN article recently, speculatively. Our product teams do work closely with the AWS product team now. We see them continuing to drive automation into the cloud stack, which frankly for us means that we can adopt the innovations they put in their cloud stack, and use rackers to solve new and interesting problems.

I mentioned some of those before, but one of the issues that customers have, the complexity they have, is not just -- it's hard enough for them to keep up with the pace of change in the AWS cloud and to understand how to adopt and is to adopt; but think about running the AWS cloud with all of the other tools and capabilities that are required to monitor, to secure the applications that sit on top of it; to understand the spend and business governance to make it work with the rest of their IT portfolio and service management systems. Those are all areas that we add value that are outside of the core AWS cloud stack.

Just like in our early days we used to un-crate every server that was delivered in a pallet to our data center and rip the top off and rip out all the RAM and put it in inventory and them re-build it manually. We don't do any of that any more. We have roll-in racks that are configured. Technology continues to push automation and push humans further up the stack. We'll always continue to see that. We've always dealt with it. We'll continue to find new ways to solve customer pain and add value.

We don't see any scarcity. I think in that same CRN article, Terry Weiss from AWS, who runs their global partner network, was quoted as lamenting the lack of at-scale really good MSPs in the AWS ecosystem, and we agree with him. I think that's why we'll do well there.

Steve Milunovich - *UBS - Analyst*

Thanks.

Operator

I turn the conference back to you.

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

Okay, well this ends our Q1 call. Thank you for joining us today.
