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PRESENTATION

Operator

Good afternoon ladies and gentlemen. Welcome to the Rackspace Hosting Q2 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 second quarter 2016 earnings conference call. We hope that you have had a chance to read our press release, which we issued earlier today, as well as review our Q2 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, long-term investment strategies, growth plans, the impact of new products and services, the impact of divestitures, 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 we will use during this call, such as adjusted EBITDA, revenue growth adjusted for foreign currency and divestiture, and free cash flow are expressed on a non-GAAP basis, and that our GAAP results and GAAP-to-non-GAAP reconciliations can be found in our earnings release, which is currently posted on the investor page of our website.

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

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

Thanks, Winston. Good afternoon, and thank you for joining us today to discuss our financial results for the second quarter.

During this quarter, we made strong progress on our key financial metrics. We demonstrated continued growth in Q2, along with higher profitability, increased capital efficiency, and record free cash flow. We also expanded our leadership of the managed cloud market, and are well on our way to becoming the number one managed cloud provider for customers who use Amazon Web Services. In short, we continue to evolve Rackspace, and position ourselves for our largest opportunity yet.

Our product portfolio includes offerings in the hyper-growth stage, and they are producing a disproportionate amount of our new revenue generation. We are very excited by the results we are seeing to date, especially in our AWS service, which validates what we expected when we launched this service barely nine months ago. At the same time, we have maturing offerings whose growth has slowed. We are leveraging the power of our loyal customer base and the financial health of our core offerings to propel the newer services, which are among the fastest growing we have ever experienced.

The results, as you will see in our second-quarter numbers, reflect our strategy. While our normalized top-line growth is in the range we provided at the start of the year, it is muted, and reflects where we are in our business model evolution. The results further down the P&L show the strength of our core. As we optimize our maturing lines of business, we are becoming less capital intensive, and producing record free cash flow. We will continue to re-allocate investment toward our managed cloud offerings, led by our AWS service.

With this stage set, let's get into our second-quarter results. Our revenue in Q2 was $524 million on a GAAP basis, which represented year-over-year growth of 7%. That figure would have been $9 million higher without the negative impact of foreign-exchange fluctuations and the sale of our Jungle Disk business. When normalized for those items, our year-over-year growth for the second quarter came in at 8.9%.

Our adjusted EBITDA margin was 35.8%, and was 300 basis points higher than in the same quarter a year ago. Our capital expenditures as a percentage of revenue fell to 15.7%, from 31% in the same quarter last year. Our free cash flow reached a record high of $98 million. Our non-GAAP diluted earnings per share rose to $0.38, an increase of 31% from the same quarter a year go.

Our sales teams made progress on several fronts in Q2. They continue to shift resources toward our new fast-growing offers, led by our AWS service, while sustaining our core business. We have been busy training our sales teams to sell our managed cloud offers, and focusing more resources towards the acquisition of new customers.

As a result, we have seen our pipeline growth for the past two quarters. The number of new enterprise and mid-market customers signed in the first half of the year is almost double that of the same period last year. We saw strong demand in Q2, especially for customers who use the AWS Cloud, and also for those who use the Microsoft Cloud, OpenStack private cloud, and Rackspace Managed Security. These deals will as usual take several months to come on line before contributing revenues. While our sales and marketing efforts have improved, we have plenty of work left to do there.

As reinforcement for our sales efforts, we plan to launch a bold marketing campaign to tell the world about the value we can deliver as the number one managed cloud services provider. Businesses today are being told that the cloud is simple, that it's easy to manage on your own, and that whatever platform a vendor is selling or supporting is the complete solution for every workload.

What these businesses are learning, however, is that different workloads require different platforms across public cloud, private cloud, and dedicated servers. They are finding that the cloud is complex and fast-changing, that they need help in managing it, and that expert engineers are expensive and hard to find.

These businesses are also finding that the managed cloud services industry today is populated mainly by providers who can't provide the help they need. Some of these providers are traditional slow-moving technology vendors and systems integrators who are being disrupted by the cloud themselves. Others are small-scale providers who focus on migrations, and offer little help with architecture, security, and ongoing operation.

We plan to make the market aware that there is one provider that operates at scale, covering their needs from end to end, with expertise and managed services for the world's leading clouds. That provider is Rackspace. Look for this sustained marketing campaign to launch in the coming months.

Now, turning to the progress of our AWS service. From the October launch of that service through the end of July, we've signed 277 customers across every size and geography. Buyers for our AWS service are roughly balanced between existing Rackspace customers and the ones that are new to us. The large majority of the existing customers who have signed up for our AWS service are bringing us incremental workloads.

Winning new AWS workloads from our dedicated hosting customers is a big part of our strategy. Our large and loyal base of customers who have trusted us for years gives us a big advantage in managed cloud services versus the sub-scale providers.

More than 60% of customers for our AWS offer are choosing our higher service level called Aviator. This confirms the need in the market for managed services to make clouds more valuable to business users. As the rush to the cloud accelerates among mainstream businesses, so does the demand for help with architecture, migration, security, and operation. The high purchase rate for our Aviator service is validation that access to great cloud infrastructure alone doesn't deliver the value that businesses seek from the cloud.

Nearly half of the customers for our AWS service are based outside the US. We are actively leveraging AWS cloud regions and sales partnerships around the world, and believe that we can grow in geographies in a capital-light manner where we previously had no physical presence.

Our rackers have now attained more than 340 AWS technical certifications, and nearly 1,500 technical and business accreditation. In April, we gained the company-level DevOps competency certification. We recently earned a second such certification to serve AWS customers that need help with e-commerce and marketing. We recently extended our offerings to AWS customers who handle sensitive data governed by HIPAA and PCI regulations. These accomplishments make us attractive to an even larger share of the market, and put us well on our way to becoming the number one AWS service provider.

The reason that we've been able to develop this level of expertise at scale so rapidly, is that we are the only managed cloud services provider that has created and operated a leading cloud. The capabilities we've developed as a cloud tech Company provide a major differentiation for us as we expand to provide managed cloud services on AWS and the Microsoft Cloud.

We're finding that our strengths are clear to prospective customers when they compare us to our competitors in the managed cloud space. They're even clearer to customers who have experienced the capability gaps of those competitors, from whom we are sourcing an increasing number of our deals.

In Q2 we landed several large new customers for our AWS service, whose spending with us should increase significantly over time. Those customers include one of the world's best-known IT hardware and consulting companies, a global food and beverage giant based in Europe, and a top-ten digital marketing agency. The revenue from these customers will start to come on line later this year, and will help fuel our 2017 growth.

Now let's discuss our progress with customers who prefer the Microsoft Cloud, where we are also seeing increasing demand. By the end of July we had signed 211 Microsoft Cloud customers, including enterprise, mid-market, and SMB companies. We see strong demand for our Microsoft private cloud offer, particularly among large enterprise customers who are using both public and private cloud platform for different workloads. Our new customers of this type include one of America's most popular organic grocery chains, as well as other large and well-known brands.

We're also gaining increased traction with our Microsoft Azure offering, especially since we refreshed that offering in April. In Q2 we became one of only ten providers worldwide authorized by Microsoft for two-tiered distribution of Azure and other Microsoft products, which we expect to boost our channel sales.

As we've reported in recent quarters, demand for our OpenStack public cloud is slowing. But as expected, we've seen strong demand for OpenStack private clouds. In Q2, we closed deals to deploy OpenStack private clouds for a leading automaker, and for one of the world's largest IT and management consulting companies.

We also saw a major expansion of our relationship with a very large customer that we landed in Q1, which is one of the world's leading industrial conglomerates. The customers for our OpenStack private cloud tend to need larger, more complex solutions, and these have a longer deployment and revenue materialization cycle, averaging about six months.

I hope this has been a useful update on our progress. I'd like to recap with a few observations about what we're seeing in the market, and the power of our business model.

As we've gained more and more traction with our AWS service, we're finding that our hypotheses about that market are correct. The rates for established businesses to move workloads out of their corporate data centers is well under way. Most of those businesses are finding that managing a single cloud is complex, and managing multiple clouds is even more difficult. Those businesses want the help of an expert and seasoned partner who can operate at scale across all their needs, from architecture and migration to security and ongoing operation.

What we face is a huge opportunity to lead here. Some of you may have wondered at times whether Rackspace matters in a post-AWS world. Our answer is that not only do we matter, we face a bigger opportunity than we have at any moment in our 17 year history, and we are executing against this opportunity at a quickening pace.

This brings me to the flywheel powering our business model, where our leadership and dedicated hosting is a major element. This line of business is stable and operates at scale, and we continue to win dedicated workloads coming out of corporate data centers. As we optimize it, it delivers increasing cash flow. We then invest the cash flow in fast-growing offerings such as our AWS service. These new offerings are capital-light, and deliver even more capital efficiency and free cash flow as they grow in importance.

Looking forward, we expect our 2016 normalized revenue growth to be within our previously guided range. As we have publicly stated, it will be a stretch for us to reach the upper half of that range. Our revenue will be affected by the impacts of asset divestitures and head winds that have developed following the Brexit vote in the UK. Our full-year revenue estimate factors in approximately $70 million of negative impact from currency movement and asset divestitures.

One new factor in our outlook is the sale of our Cloud Sites business unit, which we announced today. This is a non-core business, and by selling it we gain more focus.

We also expect negative impact from the Brexit vote in the UK. Gartner's post-Brexit forecast for IT spending growth of the UK indicates 2016 spending growth will drop by 2 to 5 percentage points into negative territory. Gartner notes that 2017 IT spending growth in the UK will almost certainly be negative, as well.

We've seen somewhat higher churn rates, and some slow-down in spending among our UK customers, some of whose businesses have suffered from the currency fluctuations and uncertainty that have followed the Brexit vote. One of our large customers in the travel business, for example, has recently sought bankruptcy protection, creating an unforeseen churn event for us. We expect this slow-down in spending and up-tick in churn due to several specific customers to affect our business in the second half of the year.

As an offset, we expect continued acceleration of our AWS business, and significantly lower capital expenditure due to increased efficiency, and lower growth-related spending on infrastructure, resulting in higher free cash flow.

In closing, I'd like to thank our rackers once again for the difficult and valuable work they do. They are special people who love to relieve our customers of unnecessary complexity and costs, and who take great pride in helping those customers succeed.

With that, I'll turn the call over to Karl, who can give you more details on our Q2 financials.

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

Thank you, Taylor. Good afternoon to everyone on the call. Before I discuss our Q2 results, let me refer you to slide 11 of the earnings deck, which has our summary financials.

Revenue for Q2 grew to $524 million, up 7% from the second quarter of 2015. Our revenue was negatively affected by exchange rate changes and the divestiture of our Jungle Disk business, which happened during the first quarter. Normalized for those two items, our growth rate was 8.9% relative to Q2 of 2015.

Adjusted EBITDA for Q2 was $187 million, for a margin of 35.8%. Net income was $36 million, for a margin of 6.8%. During the second quarter, we generated $0.28 in diluted earnings per share according to GAAP, and $0.38 in non-GAAP diluted EPS, which excludes stock-based compensation expense net of taxes. Last but not least, return on capital was 16.4% for the quarter, the highest level since 2012.

Our margins were positively affected by a few license-related items this quarter. Excluding the net impact of these benefits, pre-tax margins would have been 120 basis points lower.

Cash flow from operations was $165 million, or 31.5% of revenue. Capital expenditures were $82 million, or 15.7% of revenue.

We are pleased with the strong operating cash flow generation of the business, and the relatively low levels of CapEx we are incurring, due to continued optimization of our capital base. As a result, our free cash flow reached a record level in the second quarter.

To conform with guidelines recently issued by the SEC, we are redefining our free cash flow metrics to be entirely based on the cash flow statement. As such, free cash flow is defined as cash flow from operating activities, minus cash CapEx, plus excess tax benefits from share-based compensation. According to this definition, free cash flow was $98 million for the quarter, an all-time record for the Company.

We continued to re-purchase shares during the second quarter, and completed our $500 million commitment. Our intention is to continue using excess cash to repurchase shares in the future according to our stated financial policy, and our Board-authorized program of up to $1 billion by August 2017.

Before we conclude with our outlook for the third-quarter and the rest of the year, let me remind you that about 20% to 25% of our revenue is invoiced in pounds sterling and euros. Our UK business has been a great contributor to our growth and profitability for many years. While the Brexit vote will have an impact on our UK business, as Taylor noted, we see this business as an important pillar of our Company.

Despite the impact of the currency rate movements on our consolidated revenues, our P&L is naturally hedged, because the data centers and operations supporting the business are based in the UK, as well.

With the recent depreciation of the pound sterling, our results are impacted as follows. For the third quarter, we expect our reported revenue to range between $510 million and $515 million. This sequential decline in revenue is largely driven by the recent and significant depreciation of the pound sterling, and an expected loss in revenue from the planned divestiture of Cloud Sites, one of our non-core businesses.

For the full year of 2016, Rackspace expects revenue to be between $2.06 billion and $2.08 billion. This factors in an estimated $70 million of negative impact from currency movements and asset divestitures. Excluding the estimate a negative impact, we expect our normalized growth rate for the year to range between 6.5% and 7.5%.

For the reasons stated above, our profit margins are largely unaffected by currency movements, and we expect to remain in our previously stated range of 33% to 35% for adjusted EBITDA. Finally, we are reducing our full-year CapEx guidance to a range of 16% to 18% of revenue. This reflects the increased CapEx efficiencies we have achieved, the lower growth-related spend for our dedicated business, and the shift towards our capitalized businesses.

This concludes our prepared remarks. We will now open the call for your questions. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Frank Louthan, Raymond James.

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

Great, thank you. Can you walk us through a little bit more color on the Brexit impact on the guide. What exactly else are you seeing that's causing that? It's a little early in that. What can we see that might change that may be lessen that impact, as you see it now? Thanks.

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

Okay. Hi Frank, this is Karl. I'm going to start with the more numerical answer to this question, and Taylor will follow up with a business and demand-related impact. Let me start by reminding everyone what the rate states. For 2015, the average rate of the pound against the dollar was $1.53. For the first half in 2016, we saw an average rate of $1.43. Then towards the end of the second quarter, the rate declined quite significantly down to about $1.30, and it's bouncing around down there somewhere.

So far, we have an average of $1.37 for the year, which is about a 10% decline in rate if you look at average rate versus average rate year over year. Since we have about 20% to 25% of revenue denominated in pounds, this is about a $500 million revenue base that now gets translated at a 10% lower rate. The overall impact on the top line for the year for our Company is about a negative $50 million, about equally distributed over the first half and the second half, assuming that the rate for the second half remains where it currently is, at the low $1.30s. That's the top-line impact.

As we mentioned before, the P&L is naturally hedged, since all of these revenues are served out of operations in the UK, mostly. The vast majority of non-US operations is located in the UK, with about 1,000 people there. We have big facilities there, two data centers that serves the vast majority of that business. We have a natural hedge, since we incur all these cost in pounds sterling, as well.

That basically means that the margin impact on the P&L, as well as the cash-flow impact, is largely zero. Lastly, the balance-sheet impact, which you see in other comprehensive income, is really a non-realized translation exposure, and that amounts to about $20 million in the second quarter, which obviously fully reflects the swing down to $1.30.

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

Thanks, Karl. Frank, I think from a business perspective, as I mentioned, we've had one major unforeseen churn event, which was not in the forecast. A customer who's fairly large for us in the travel holiday business that was in a razor-thin margin type business, and really suffered as a lead-up to Brexit, and maybe following after that.

We've dived deep into our customer base. We don't have what we would say is a tremendous amount of exposure. We've talked to our large customers. But we are seeing some potential derivative impacts. Our sales forecast out of our UK team for Q3 and Q4 is noticeably lighter than it was in Q1 and Q2. I think that's somewhat of an abundance of caution, but also the effect they are experiencing when they're talking to customers and prospects.

What we've baked in is an assumption of churn ticking up a little bit. We've also baked in an assumption of some lighter sales from that part of our business. You asked what could create up-side. From an FX, the pound could come back. From a sales perspective, things could settle down and get back to business as usual, and that could provide some lift on what we're currently planning. But that's how we've derived the Brexit impact.

Operator

Gray Powell, Wells Fargo.

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

Great, thank you. I think most investors have really been focused on Rackspace as a free cash flow story this year. If I look at the numbers, your CapEx as a percentage of revenue has come down nicely in the first half of 2016. Guidance implies a pretty solid improvement from last year. Can you talk about what the main drivers are of that improvement this year? How should we think of capital intensity longer term? Then how much more room is there to go as third-party cloud initiatives gain momentum? Thanks.

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

Okay, yes, let me take this. This is Karl again. Let me start with the original guidance was 22%. So far this year, we have averaged about 15.5% in CapEx. The reason for this difference is really all the things we talked about in the past. First, let me realize these, or revisit these.

One, we have high capital efficiency due to better equipment pricing, high utilization levels, and continued optimization of our cloud capacity pools. We've talked about that in the past. We have benefited from the fact that we have first-gen to next-gen migration in the cloud. We are actively moving those customers over, and basically re-deployed this old gear, or remove it, freeing up data center space, making it more efficient, both on the P&L and on the capital side.

We've also increased the capacity pool or the utilization of the capacity pools to target utilization of the capacity pools, mainly in cloud, that has led us to basically push revenue up, and without actually having to incur additional CapEx. That's positive. Then on the procurement side, we've also increased better pricing on the purchasing side, which is very positive.

Then secondarily, we have slower growth numerical in dollars in our dedicated business relative to prior years. That's obviously no secret. Since we have this long-standing relationship that still holds true that we have about 10% of revenue is associated with maintenance CapEx, and then we spend about $0.50 on an incremental dollar of revenue on growth CapEx. As that growth slows, the growth CapEx requirement of the dedicated business slows in absolute terms. That's the second big piece.

Then the third piece that the growth contribution from our third-party cloud business or capital-light businesses, they require no growth CapEx at all, and also no maintenance CapEx going forward.

Which brings you to your second question, which is what is the long-term minimum requirements. On the businesses that require us to deploy capital, so our public cloud business and our dedicated hosting business, the minimum, the hypothetical minimum is that 10% maintenance CapEx that we talked about repeatedly in the past. Then on the third-party cloud, there is zero growth requirement, growth CapEx, and maintenance CapEx requirement on that business, which basically means that the more revenue comes from those third-party cloud businesses the lower the CapEx number can be.

Where we are for the year, we've had about 18% of free cash flow margin according to this new definition of free cash flow. For 2016, I would say that we have benefited a little bit in the first half of the year from high operating cash flow; 31.5% for the quarter is high, relatively speaking.

I think where we currently are, we're somewhere in the 30%-plus range on the operating side, and we're about 15% right now on the CapEx side. As now elaborated, the 15% will come down over time. The 30% is largely a result of how we manage margins. Somewhere in the neighborhood of 15% to 20% is where we are tracking right now, with up-side potential as CapEx goes down in the longer term.

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

Got it. That's really helpful. Thank you very much.

Operator

James Breen, William Blair.

James Breen - *William Blair & Company - Analyst*

Thanks for taking the question. On the growth, can you talk about where the incremental growth is coming from, whether it's the core business or some of the new businesses you entered? Then are you seeing any cannibalization of the core managed services business from the AWS business? Thanks.

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

Yes, Jim, this is Taylor. Thank you. I'll address the cannibalization point first. Not yet, and not materially. As you remember from our days when we launched our own public cloud and we were all concerned about cannibalization of dedicated, we never really saw a huge cannibalization effect.

So far, with the new businesses, AWS, Azure, et cetera, that have now been in the market somewhere between nine months or so, we're not seeing cannibalization as a major effect. Just to reiterate, we are getting about half of our business on AWS specifically from existing Rackspace customers, but almost I think eight and ten of those work loads are net new work loads for Rackspace. Cannibalization effect not showing up as a material driver.

Could it in the future? It could. I think one of the things we've always prided ourselves on is a philosophy here that we call customer fit. If our customers on say our OpenStack public cloud at some point in time would like to move to running on AWS or Azure, we certainly can accommodate them, and we like the unit economics on those new businesses. That's a very handy tool for us to have to address customers on an as-needed basis there. We're not seeing the cannibalization effect yet. Good expansion of wallet share from the customers who are bringing us incremental work load.

In terms of the Q3 sequential growth, what we just shared with you is flattish in the core business. Again, that's being driven compared to the last update almost entirely by some of the Brexit impact I just mentioned. You've got a core business still growing. On a year over year, we expect sequential growth in Q3 in particular to be flattish because of some increased churn and slow-down in some of our sales forecasts from the UK team. I think as an offset to that, we see and are absolutely really bullish and excited about the acceleration of our AWS and other offers on the newer side, and lower CapEx as we go through the rest of the year.

James Breen - *William Blair & Company - Analyst*

Great, thanks.

Operator

Amir Rozwadowski, Barclays.

Amir Rozwadowski - *Barclays Capital - Analyst*

Thank you very much, and good afternoon, folks. I was wondering if we could just touch upon the CapEx trajectory just a little bit more. If I take a look at some of your commentary from last quarter, you had suggested that CapEx was unusually low due to some of the timing of certain expenditures. Is there a way to quantify how much of the reduced CapEx outlook is related to some of the slower growth that you are expecting on some of the core business, versus the capital efficiencies, just so we can get a better sense in terms of how sustainable this is over the longer term? Thank you very much.

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

Yes, I think the best way to think about is in terms of our guidance. We reduced our guidance now to 16% to 18%. This is a reflection of the fact that we pushed out certain initiatives and purchases ahead of us into Q3 and Q4. There are some office projects that are being worked on that we have originally allowed for to happening Q2, that are now happening in Q3 and into Q4. Most of the things are success-based.

We also had larger deals booked in the second quarter of the year that are being procured and deployed in Q3 and into Q4. That's a little bit of a delay, but it's not really anything but just the timing to really match CapEx with the revenue that the CapEx is supporting.

In general, I think we have an opportunity that we are exploiting as a business to manage the capital base more tightly as we grow little bit at a slower rate. In the longer-term, the big question will really be the contribution of the third-party cloud that has no capital requirement at all.

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

I think, Amir, just to amplify that a little, I think there are some timing issues of expenditures, as Karl mentioned. But when I net this out in my head, there's three big drivers. One is capital efficiency moves that we're making. As the business and the core does slow its growth rate, we are very deliberately taking capital out of that business. That's one driver.

I think the second is timing of bookings in our subscription businesses, which are dedicated and private clouds, the ones that normally take capital. As you know, those were somewhat back-end loaded from a bookings timing perspective in Q1 and Q2. What we're finding particularly in our OpenStack private cloud business is that these are larger deals that take longer to come on line. We're learning as we go on that, but those are more complex environments that are taking sometimes up to six months to materialize into revenue.

Third, as Karl mentioned, the mix of sales. Incrementally more sales are coming from our third-party cloud offers. Also, the interest level in our OpenStack Everywhere offer, which is OpenStack private cloud running in the customer's data centers really starting to show up as a big demand signal in the pipeline. It's those factors that are driving the mix shift. We've lowered the range this year to reflect those things. As we continue to learn and evolve, particularly on the sales mix issue, we'll continue to provide updates.

Amir Rozwadowski - *Barclays Capital - Analyst*

Great. Thanks very much for the incremental color.

Operator

(Operator Instructions)

Simon Flannery, Morgan Stanley.

Simon Flannery - *Morgan Stanley - Analyst*

Great, thank you very much. Taylor, I was wondering if you could talk a little bit about the Cloud Sites transaction, if you can do any sizing of it? I see you mentioned the $50 million FX hit, and I think you said $70 million from the overall impact of that plus divestiture. Is that $20 million all Cloud Sites? Any color around how much money you're getting from that? Is that out for the whole quarter or just for a few weeks of the quarter? Then just a broader philosophy around -- I think you got rid of Jungle Disk, you got rid of this. How are you thinking about your portfolio? Are there other pieces? Then if you can say anything about the press speculation more broadly, that would be great. Thank you.

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

Sure, I can answer the third one first, Simon. You all will realize that we can't comment. It's been our policy not to comment on speculation and rumors, so I don't have anything else to say on the media speculation. But I think, just to clarify numbers, what we said is that we expect our full-year GAAP numbers to be impacted by approximately $70 million of a combination of FX impact an asset divestitures. That $70 million is the full-year combination of FX and asset divestitures.

We started out the year with that number being closer to $35 million to $40 million, and of course the two new additions are the post-Brexit FX deceleration of the pound, and now the Cloud Sites divestiture. The Cloud Sites figure for the full second half of the year will be somewhere around $8 million of revenue. Timing, we're still -- we'll get back to you on the timing of that, but it's fair to say you should estimate an even spread.

Then on philosophy-wise, yes, we have been looking at the business and finding businesses that are growing at a lower rate than our overall corporate rate, and decelerating but producing healthy economics. Also, these are businesses that if we wanted to keep them, we would need to make substantial new investment.

For instance, in our Cloud Sites business, it runs several hundred thousand websites for its customers. It competes in a market that if we wanted to really focus there, we would have to make some substantial investment. Instead, what we've been able to do is find a strategic buyer in Liquid Web who will buy the company at a higher multiple than it was producing for us, and allow us to both focus our portfolio, as well as find a happy home for that business, and help us raise some incremental funds that we can invest in growth.

It's a good business, but it's non-core. That's the same story for Jungle Disk and Exceptional and the others. Really, you should just think about this as a discipline on the business. As we go from this business model evolution, we want to find every way we can to focus our assets and our resources so that we can really go put all our guns behind AWS, Azure, et cetera.

Simon Flannery - *Morgan Stanley - Analyst*

Great, thank you.

Operator

Jonathan Schildkraut, Evercore.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Great. Answered a lot my questions already, guys, but I'd love it if you could spend a few minutes talking about some of the scale, and maybe the margin opportunity around the new deals that you are signing for AWS and Azure.

Relative to some of the deals that you've signed historically, it sounds like these may be larger. Taylor, in the past I think you've sized some of the deals that you signed on OpenStack. Maybe if you can give us an understanding of how big these deals are, and if they're growing over time, and then what you expect from a margin perspective? That would be helpful as we think about modeling out that business.

As a second question there, at what point do you guys feel that you will have enough metric visibility into that business that you can start breaking out some of the specifics, so that we can look at that business versus the historical one? Thank you.

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

Yes, Jonathan, thank you, good question. In terms of size and scale of the deals, frankly this is a learning exercise for us as we go along, because one we're new, relatively new, to the AWS and Azure ecosystem in terms of really diving in and understanding how customers consume cloud. As you know, these are utility services.

What we're finding is that we have a process that goes from engaging a prospect, the sales cycle, which has actually been fairly quick on most of these deals, even the larger ones.

Then you go through a process of solution. One of the biggest pain points that our customers have, and why they're coming to Rackspace is that they are finding that using AWS or Azure correctly -- and by correctly, we mean securely in a way that adheres with best practices from a governance perspective, in a way that drives the right spend level, in a way that allows ongoing operations to run fairly smoothly. That takes a lot of up-front work from very talented solution architect level people.

That's actually one of the biggest values we bring, is that we understand best practice both from working with AWS as well now having a catalog nearing 300 customers on it, and plus having built our own cloud and run cloud ops at scale. We find that the period of time from signing a contract or a booking with a customer to getting it on line varies.

We've had to learn quite a bit there, and now we're starting to make progress on shrinking that down; but there's still a lot of variability there, depending on the size of the customer, the number of environments, are they already running AWS and we're having to go, as it were, un-do some of the things they've done, or is it a net new green-field environment. That period of time can vary significantly.

Then on the other side of that is the implementation, and what we call getting into activity. Activity is the consumption of the AWS infrastructure, the consumption of our support services. All of that is evolving as we add customers. Therefore, one of the reasons we don't break anything out yet is our end is still sub-300, and a utility business model. We have a lot of variability in the customer behaviors and patterns. Plus, we're still learning on how to fine-tune the overall end-to-end process.

I think we've got to get to an end that is meaningful, so that when we share things with you it's got enough portfolio effects so it doesn't whip around a ton every quarter. That's one of the things we are very mindful of, is we want to break this out and share information with you more, but the end right now would cause you to be frustrated, even more than you might already be. That's how we're seeing.

Some of the customers that we're signing and have signed in Q2 into July are very large enterprise customers, who we believe, if we do a good job initially, can grow into hundreds of thousands of dollars a month usage and support fees. As you know, we get really excited when we sign a deal around here that's more than $100,000 a month. That's why we track that metric.

I think what we will find is that the demand signal for AWS stripes across large enterprise, mid-market, and SMB. We are finding that our relationship with AWS is actually getting closer and more valuable on both sides. We are doing a lot of work with them out in the field now in multiple regions, and our pace of interaction with AWS is increasing.

What we think we will see is an increasing cadence of these medium to large-sized companies, where AWS absolutely feels the need for that front-end architecture migration assistance; how do I make this secure; and certainly on the ongoing operations side, where we bring software and tools and expertise to the table. I think what we'll find is that these large companies will come in, that solutioning and implementation period will be substantial, and then what will happen is they will start to scale into usage quite quickly. But we're learning more about what that end-to-end cycle time looks like.

Jonathan Schildkraut - *Evercore ISI - Analyst*

Thanks, Taylor.

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

Absolutely.

Operator

Heather Bellini, Goldman Sachs.

Nicole Hayashi - *Goldman Sachs - Analyst*

Great, thanks. This is Nicole Hayashi in for Heather. In Q2, did gross margins benefit from consolidating your London data centers from three to two? Could you quantify that? When will this benefit start to phase out?

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

Sorry, I didn't understand the second part.

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

Was there a one-time effect, essentially. Yes, go ahead.

Nicole Hayashi - *Goldman Sachs - Analyst*

Right.

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

Oh, okay, yes. The cost of revenue benefit was really -- there was a little bit of improvement in data center cost, actually, quarter over quarter. It's not so much due to the consolidation. That's already been absorbed. But mainly around power utilities that have been coming in better than the previous quarter. Then the main factor on the cost of revenue and gross margin was that the license benefit that we had. The impact on the cost of revenue was 160 basis points alone in the second quarter.

Nicole Hayashi - *Goldman Sachs - Analyst*

Great, thanks. You've talked about some of the changes Alex has made to the sales force since coming on board. How far along are you in making those changes, and what changes do you have left, particularly in Europe?

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

Particularly in Europe, is that what you said?

Nicole Hayashi - *Goldman Sachs - Analyst*

Yes, given the Brexit vote?

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

Ah, got it, thank you, okay. Look, I think Alex is pretty far down the path on the substantial changes, meaning leaders in key roles as leadership changes need to be made. Do new leaders to bring new capabilities need to be hired, new compensation plans need to be shifted. Do we need to do performance management, et cetera.

A lot of that work has been under way. For instance, Alex has recently brought on board a new channel sales leader, as well as a new professional services leader, both with substantial experience; but they're pretty much brand new to Rackspace in the last couple of months. The effect from those capabilities is up-side for us either later this year or into next year.

When I say we have plenty of work left to do, we are in a business model evolution that is seeing us need to move resources where we're seeing the strongest demand, but also protect and preserve the core business. I think a lot of the balancing work that Alex is doing is being driven by us trying to understand our pipeline as it shifts over time, how many are the right number of resources, where, and continuing to hire and build technical talents around things like AWS and Azure and security, et cetera. When I say more work to do there, that's the type of load balancing that we're doing.

Think about things that could be massively disrupting and destabilizing in the rear-view mirror. Think about continuing to understand resource allocation and building of incremental resources still in front of us.

Particularly in EMEA, look I don't have a crystal ball on this yet, but I do believe that the Brexit vote will have some far-reaching implications, particularly from our customers on the continent who will want us to have more of a continental presence. The good news for us is that we can leverage AWS and Azure for infrastructure on the continent. That really actually makes our model much more effective and efficient to serve those customers than it was pre-having those. I think you should continue to look for us to expand resources in continental Europe, where we've got good demand in places like Amsterdam where we have a sales office, the dock region in central Europe, those are the types of places where Alex is focused.

Nicole Hayashi - *Goldman Sachs - Analyst*

Great, thank you.

Operator

[Daniel Filkosick], JPMorgan.

Daniel Filcosick - *JPMorgan - Analyst*

Hi, guys. Thanks. Recognizing that it's hard for you to talk about things, in 2014 you did a strategic review, and chose to remain independent. Can you talk about anything that may have changed in the way you look at the business, that you might consider selling the Company today compared to what those options were a couple of years ago, and that might influence where you would consider selling that price versus any offers you might have had in the fall of 2014? Thank you very much.

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

I think you can appreciate that I really can't comment on any of that. It would be inappropriate for us, and our policy over time has been to not comment on any of these types of speculations, so thank you for the question.

Daniel Filcosick - *JPMorgan - Analyst*

Thank you.

Operator

Steve Milunovich, UBS.

Steve Milunovich - *UBS - Analyst*

Thank you very much. Two quick ones. Could you share with us the percentage of your pipeline that is represented by this new support business? Second, could you comment a bit about OpenStack Everywhere and where you're seeing success? It seems OpenStack is doing a little bit better in private cloud, and was curious if that's impacting you in a material way yet?

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

Yes, Steve, thanks. In terms of percentage of pipeline, I can't give you an explicit number, but I can characterize it a little bit for you. I think as I mentioned, incrementally more of our new revenue generation is coming from these new offers, and disproportionately so. If they're a relatively small part of our actual revenue base today, more of our pipeline and more of our actual sales activity is coming from these, versus the actual revenue size.

I think about the pipeline, the highest growth in our pipeline is coming from these new areas. You can imagine that things like AWS, Azure, Rackspace Managed Security, these are really attractive -- what I would call in-the-flow offers. If the pipeline mix is growing overall, which it is, then the mix from these new businesses is increasing faster than it is from our core business.

It's also an interesting experiment and learning for us as well on the pipeline, because as you can imagine, these utility cloud opportunities are often hard for a sales rep to accurately size in terms of their actual revenue, because they are cloud. The thing that we measure in the pipe today, also to keep an eye on that, is we measure it from both a dollars in the pipeline, as well as a number of opportunities in the pipeline.

What we're finding is that we want to close as many opportunities as we can, because those will turn into revenue downstream. But we can't always accurately measure at this stage what the actual revenue dollars are until we get them on line. That's a little bit of the learning experiment that we're going through.

In terms of OpenStack Everywhere, look, I would say that we're experiencing a fairly good inflection of demand and conversation and pipeline activity from that. I think it's common sense to understand why. We think generally there is a large base of the market out there that is going to want private IS for some time to come. It may be a transitionary platform that in five to ten years doesn't exist any more, we don't know. But we do know that companies large and medium, particularly in size and in key verticals like financial services, and media and entertainment, are looking at private IS as part of the overall environment.

They've been running VMware or some other stack in their data center. They're looking for their next productivity profile hit, and they believe OpenStack private cloud is a good way to drive that next frontier of productivity, and also answer the mail on having a private solution for certain types of applications that -- whether they're for security or data reasons or what have you -- are not going to the public cloud today.

We're seeing a good up-tick in demand. As we said on the call, we experienced some really large bookings in Q2. They are large and complex environments which will take us some time to get on line, but we're happy with the quality of those bookings.

Steve Milunovich - *UBS - Analyst*

Thank you.

Operator

[Daniel Sheyow] from Bank of America Merrill Lynch.

Daniel Sheyow - *BofA Merrill Lynch - Analyst*

Thanks for taking my question. Looking out long term for the data centers in the UK, as a result of the Brexit and the compatibility with the EU data sovereignty laws, is there a need to relocate those data centers in the long term, or a need to set up new data centers to serve the EU customers?

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

Good question, thank you. Remember that the majority of our business outside the us comes from the UK itself. It's literally a much larger base of business than our continental European business is today. Those data centers are primarily designed to meet the demand in our UK business. We don't see that changing going forward in a material way.

We do think it's too early to tell. I think Brexit's got some shake-out to do. There are different rulings coming out of the EU around data sovereignty and treaties, et cetera, so I think it's all still evolving.

Ultimately, I'd like to reiterate one of the points, and one of the reasons we are excited to get into our AWS and Azure offers, is that we have a very capital-light way now to enter new geographies versus our old model, where it was go put a lot of capital on the ground, build a data center or lease a data center, fill it up with our gear, et cetera. We view us being able to have optionality in a capital-light manner to get into continental Europe, if that needs to become the base of where our infrastructure resides.

Daniel Sheyow - *BofA Merrill Lynch - Analyst*

Okay, thank you.

Operator

Jonathan Atkin, RBC.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you. I was interested in your AWS business, and how much of it is coming from direct sales force, how much of it would be in-bound inquiries, how much of it would be referrals from AWS itself, and maybe a similar set of questions as a relates to Azure? Thank you.

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

Sure, and I hope your flight leaves on time. Sounds like you're in an airport.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thank you.

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

The mix on AWS today is predominantly self-generated demand, meaning Rackspace is spending digital marketing dollars and event dollars, et cetera, to generate the majority of our demand. That's natural at this stage of its evolution, especially knowing that we didn't partner with AWS in the past. Part of our strategy was to go build our own demand engine and see if we could do that without relying on AWS.

As it evolves and we become closer to AWS, we are starting to see more of our relationship in working with their field, and hiring our own channel partner managers who work exclusively with the AWS field force, as starting to produce more demand from that field sales force. I mentioned a couple of deals early in my comments, where AWS is looking for that right partner. Some of the feedback that we get from AWS is that they are challenged with too few partners who have the scale and capability and expertise that we have. We see a building opportunity there.

This week, for instance in New York, the AWS Summit is taking place, and we will be heavily present there at their invitation. I think that is an increasing up side. We are also going to launch around the September time frame a fairly aggressive marketing awareness campaign that is going to go out and let the market know about the need for the managed cloud category, and particularly our capabilities around AWS and Azure.

We believe that will create incremental awareness, not only of the category, which is still new, but also of our position as the leader in it. We've done quite a bit of testing with sample sets on this, and it raises our awareness and preference to buy significantly in that sample set. We're excited to get that out in the market.

From an Azure perspective, we've had a 16-year relationship with Microsoft, where we are one of their largest service provider channels. Therefore, in that business and especially Microsoft itself has been channel-enabled primarily as a Company for a very long time. You would imagine that more of our opportunity there comes through the channel ecosystem relationships; however, we still self-generate the majority of that demand. But we do have a higher proportion of our opportunities that come through the Microsoft channel ecosystem than we do today in the AWS ecosystem.

I would say, summarizing all that, the ability -- particularly with AWS -- to source more from their field and channel ecosystem is up side, and we think that's starting to heat up for us.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. Thank you very much.

Operator

Rich Kugele, Needham & Company.

Rich Kugele - *Needham & Company - Analyst*

Thank you, good afternoon. Taylor, I just wanted to go back to the AWS side just for one moment. If you look at your customer count and the nature of those relationships, can you just talk about where the leading partners are with AWS, and where you think your natural share would shake out over time? Thanks.

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

Yes, thank you. Look, that's one of the reasons, frankly, we feel exceptionally bullish about the future. We don't have customer counts from other AWS ecosystem partners, and they're fairly guarded with that information, as you would expect them to be.

For instance, we do know that a company like Datapipe, who was in earliest is larger than we are today. We believe we'll close that gap quite handily. We've got quite a few advantages over Datapipe when it comes to our heritage as a true cloud Company that brings in knowledge and expertise in software and tools that derive from us building our own cloud at scale. We are seeing more of our pipeline opportunities come from current providers in the space where their capabilities are being gapped out.

When we talk to our AWS partners, it's clear that they've got a lot of partners in the space, but they have a lot of partners who are more what I would call professional services oriented, who focus on the front-end lift and shift, versus really coming in with a point of view on which applications should go where, what's the best migration strategy, how do you architect these according to best practice for security and operational efficiency, et cetera.

I think what we're hearing anecdotally is that now approaching 350th rackers with technical certifications at the highest levels and 1,500 accreditations across the Company, and our global scale as well as our number of people that we can bring to the table versus their other partners, they are positive on us in terms of our opportunity. Frankly, everything that we are seeing so far backs that hypothesis, and we are seeing acceleration of the business.

AWS has over 1 million users. They disclosed that publicly. Again, our research has shown very consistently through multiple survey cycles that somewhere between 20% and 40% of that market is what we call support seekers, people who will buy managed services to help them run AWS better. That is a slice and a taste of what the market looks like. I think that's been validated by other analysts who cover us as well in their own work.

We feel good. We're early. Again, we're really only about six months in. We're nine months in, but the first part of that was really getting it into markets. Early stage, we're on our way. Our absolute laser focus here is to be the number one AWS managed service provider. We're investing there, and we'll continue to do it, and we feel like we're really well-positioned for it.

Rich Kugele - *Needham & Company - Analyst*

Great, thank you.

Operator

Lou Miscioscia, CLSA.

Lou Miscioscia - *CLSA Limited - Analyst*

Okay, thank you. Could you add some clarification? I think you had mentioned that about 120 basis points of operating margin was one-time items?

Then my main question really goes back to the current quarter, and probably the second half. It looks like in comparison to year-over-year growth in the first half, it slowed materially. Do you think that the 5% to 6% in the quarter here -- granted, I understand things are going on in Europe and the UK, but that is part of your business -- is more or less going to be the growth rate leading into 2017 and into the future, or even possibly, do you think it might even be a bit slower than that? Alternatively, do you think it will re-accelerate? Thank you.

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

Okay. Yes, the 120 is all related to license accrual reversals. These are a benefits that have benefited Q2 on a net basis -- 120, about 160 in core, and a negative 40 basis points in G&A.

Lou Miscioscia - *CLSA Limited - Analyst*

Is that just for this quarter, or is that going to be ongoing for the rest of the year?

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

Just for this quarter.

Lou Miscioscia - *CLSA Limited - Analyst*

Okay, thanks, and then the second half on growth?

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

Yes, we will provide 2017 guidance when we get there. I think what we're providing with you is today we've got -- if you look at where we started the year from a GAAP guidance range, we're well within the normalized range. We're where we thought we were. We've got some head wind in one part of our business, and we've got tremendous opportunity and acceleration in our new businesses. We will size that up for you guys, and provide guidance at the right time on what we think our going-in growth rate will be for 2017.

Lou Miscioscia - *CLSA Limited - Analyst*

Okay, thank you.

Operator

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