FINAL TRANSCRIPT

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, and welcome to Rackspace's Third Quarter 2008 Earnings Conference Call. As a reminder, this call is being recorded. At this time, all lines are in a listen-only mode to prevent any background noise. After the prepared remarks, there will be a question and answer session.

(Operator Instructions)

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

Karl Pichler - *Rackspace Hosting, Inc. - VP - Finance*

Hello, everyone, and welcome to Rackspace's quarterly conference call. Today we will cover Rackspace's third quarter ending September 30, 2008. My name is Karl Pichler and I'm Vice President of Finance. We hope that you had a chance to read our press release, which we issued earlier today. If you do not have a copy, 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 IR site.

For Rackspace on the call today will be Lanham Napier, President and Chief Executive Officer, and Bruce Knooihuizen, Senior Vice President and Chief Financial Officer. Before I read our Safe Harbor Statement, we wanted to let everyone know that we plan to host our First Annual Investor and Analyst Day in early 2009. We will provide further details in a press release.

I need to remind you that some of the comments we'll make today are forward-looking statements that involve risks, uncertainties, and assumptions. If such risks or uncertainties materialize or such assumptions prove incorrect, our results will differ materially from those expressed or implied by such forward-looking statements and assumptions.

All statements other than statements of historical fact are statements that could be deemed forward-looking statements including any statements concerning expected operations and financial results, long-term investment strategies, growth plans including international expansion plans, the performance of market share relating to products and services, any statements of expectation or belief, and any statements of assumptions underlying any of the foregoing.

These risks, uncertainties, and assumptions include the continuation of the current economic difficult conditions or further fluctuations, disruptions, instability, or downturns in the economy, the effectiveness of managing Company growth, infrastructure failures, technological and competitive factors, regulator factors, and other risks that are described in our Form 10-Q for the quarter ended June 30, 2008, which was filed with the SEC on September 10, 2008 and by our Form 10-Q for the quarter ended September 30, 2008, which will be filed with the SEC in November of 2008 and will supplement such information.

These forward-looking statements speak as of today. Except as required by law. We assume no obligation to update these forward-looking statements publicly or to update the reasons actual results differ materially from those anticipated to be forward-looking statements, even if new information becomes available in the future.

Please also note that certain financial measures we will use during this call such as adjusted EBITDA are expressed on a non-GAAP basis. Our GAAP results and GAAP-to-non-GAAP reconciliation can be found in our earnings release for the third quarter of 2008, which is currently posted on the Investor's page of our website at www.rackspace.com. After our prepared remarks this afternoon, we will be happy to take your questions. I will now turn the call over to Lanham.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Thank you, Karl, and thank you all for joining us. Welcome to the Third Quarter Conference Call for Rackspace Hosting. We are pleased to report a strong quarter with four key things we want to emphasize. First, our industry-leading growth continued through the acquisition of new customers and a growth in our existing customer base.

Second, our churn rate is level due to the effectiveness of Fanatical Support. Third, our profits and profit margins are increasing. And fourth, we made two important acquisitions in the cloud hosting space to further solidify our leadership positions and fuel future growth. Let me provide some context around these developments before I hand it over to Bruce for more details around our financial performance.

In the third quarter of 2008, we added more than 2,500 customers to our growing customer base and we now serve more than 36,000 business customers. This represents the most customers we have ever added in a quarter and reflects our leadership position in the market.

Our customers and prospects want to get more value out of their IT budgets. Hosting provides an attractive alternative to the typical in-house approach of deploying and maintaining servers and networking equipment. Hosting further provides cost advantages for our customers and gives them the flexibility to adjust their configurations to their business needs.

We are seeing a flight to quality in the market and our financial stability provides the comfort a customer is looking for when entering a partnership for mission-critical services. With the IPO in our credit facilities, we have a very strong balance sheet and cash reserves that allow us to continue making opportunistic investments.

As we mentioned on our previous call, our focus on new customer acquisition is an example of our ability to capitalize on this and we plan on continuing to capture market share. Our existing customer base continues to grow as well. In the third quarter, the average monthly growth rate in the installed base, net of churn, was 0.6% per month or approximately 7% on an annualized basis.

During the third quarter, we have seen stable churn rates, but a decrease in net upgrades. Giving our customers the flexibility to upgrade and downgrade their IT needs to their business activities is an important factor in establishing a positive and loyal long-term relationship. A specific example is Seawinn, Incorporated. .

They are a leading provider of IT consulting and business process outsourcing services for public education with more than 300 education entities and service centers across the nation, servicing over 1.5 million students. Seawinn came to Rackspace at the end of 2005 and started with two servers to run their website in a single application. Over the past three years, as Seawinn has expanded its business significantly to offer multiple applications to its customers and as a result grown its MRR with Rackspace by more than 15 times.

As mentioned above, our customer base is growing, even after subtracting churn. Nevertheless, churn is on everybody's mind, especially given today's economic conditions. We are happy to report that churn has been stable at 1.2 percent per month for the third quarter . Furthermore, we did not see any systematic deterioration of credit quality of our customers as DSOs in our allowance for doubtful accounts are stable.

The acquisition of new customers and the continued growth in our installed base led to third quarter net revenues of $138.4 million, an increase of 44% relative to last year's third quarter and an increase of 5.8% relative to the second quarter of 2008. Currently, the annualized organic growth rates in our cloud business offerings are greater than 100%.

To summarize the trends on the growth side, we see customer demand being strong and focused on mission-critical activities and services, which are at the heart of our service offerings. As customers prioritize their IT budgets and workloads, they focus on the essentials and look for strong, trustworthy partners that are here to stay.

As a hosting leader, we deliver the reliability, the flexibility, and the stability our customers require to continue running their businesses. All indicators for future growth are pulling in the right direction with leads and bookings remaining strong across our managed hosting and cloud hosting businesses.

We are happy to report that our profits have increased during the third quarter, both absolutely and in terms of margin percentages. Relative to the second quarter, adjusted EBITDA increased by 9.3% and the margin increased from 25.9% to 26.7%. Similarly, net income increased by 25.2% consecutively and the margin increased from 3.2% to 3.8%.

Operational execution and investment scaling are driving the increase in profitability. While we continue to invest in new businesses and new geographies, some of the large infrastructure and organizational investments are now starting to contribute to margin expansions.

Some key examples include a reduction in rent for UK colocation facilities now that we have started consolidating our operations into the new Slough Data Center facility, limited growth in G&A now that the IPO is completed, and a continuous improvement in the contribution from our email hosting business. Bruce will provide some more details on our expenses and profits later on.

Consistent with what we said on our last call about continuing to build out the capabilities of our existing services, just two weeks ago we unveiled our cloud hosting strategy and product suite. We view cloud services as a new generation of hosting and therefore, imperative to our strategy. Our traditional managed hosting business is based on dedicated infrastructures, which can be highly customized.

Cloud hosting uses software to link pools of computing resources together and can be much more efficient and appropriate for certain computing tasks. While customers may lose some flexibility, they gain massive scaling power, simplicity, and most importantly, lower costs. Every IT department today has functions that would be well-suited to be hosted in the cloud and we intend to provide them with the right suite of cloud solutions combined with our traditional managed hosting offering to meet our customers' needs.

At the heart of the announcement were two strategic acquisitions, some key partnerships and the rebranding of our cloud offerings. We were very happy to acquire Slicehost and Jungle Disk, two fast-growing pioneers in the cloud computing space. We welcome these two innovative companies and all of their employees to the Rackspace family.

We also announced innovative relationships with Limelight Networks and Sonian. Finally, we introduced our cloud suite of services, which includes Cloud Sites, Cloud Servers, and Cloud Files. With these capability enhancements and the continued strength of our core offering, we believe we are very well positioned for the future of hosted IT.

Slicehost is a leader in hosting virtualized computing. They offer what's called a slice, which is a virtual server instance that can be provisioned and made available almost instantaneously. The slices come in different sizes and the smallest is priced at only $20.00 a month. Slicehost has built an incredibly lean and highly automated business around this. It has more than 15,000 slices online today. Slicehost will remain a developer-focused brand and offering, but its core technology will form the base for our new cloud service offering.

The second acquisition, Jungle Disk, brings a killer app to our cloud file storage system, which was built by our RackLab's R&D group. Jungle Disk offers reliable cloud storage solutions that allow businesses and individual users to easily use and share in a cloud storage through a secure, mountable network drive and automatic backup tool.

The third building block of our cloud strategy is Cloud Sites, a scalable hosting platform that supports both Linux and Windows. It is intended for sites that need to scale seamlessly when traffic spikes and is accompanied by a pay-as-you-grow pricing model. Cloud Sites was built in-house and continues to gain momentum, running more than 80,000 websites today.

We are very excited about our cloud news and will continue to invest in it, but that in no way diminishes our commitment to our traditional managed hosting business. Certain computing tasks will always require the level of customization, performance, and control that only managed hosting can provide.

Our suite of cloud services combined with our core managed hosting offerings and our dedication to providing a fanatical experience form a highly-differentiated offer in the marketplace. Together they are a powerful combination and will solidify our leadership position in the market for a long time.

A good example of a customer that uses both managed hosting as well as cloud services is the Pangea Foundation. They are a San Diego-based software-as-a-service provider that brings IT solutions to nonprofit organizations. Pangea became a managed hosting customer of ours in 2007. They had a great experience with us and soon after purchased hosted exchange mailboxes from Mailtrust, our email division.

Most recently, Pangea began utilizing our Cloud Sites hosting services for some of its additional needs. And this example illustrates how offering additional hosting solutions and an excellent service experience entices customers to buy more from us and stay longer.

On a personnel note, we are excited to announce the addition of Jim Lewandowski as Senior Vice President of Worldwide Sales to our management team. Jim comes to us after holding executive roles with McAfee, Yahoo, and BMC Software. Since 2003, Glenn Reinus has led our worldwide sales efforts producing phenomenal results, growing the Company's revenue more than 50% a year for the past five years.

As Glenn approaches retirement, Jim will work closely with him to fully transition in his new role. Jim will assume all responsibilities for generating consistent revenue growth globally and across all of Rackspace's businesses.

Let me close by commenting briefly on the economic environment that our customers, our competitors, and Rackspace are facing together. All of us are enduring a higher level of uncertainty and we will have to be deliberate and nimble in adapting to a changing environment.

As we experience growth rates that are slower than those seen historically, we should be able to maintain or increase our profit margins. New businesses and new geographies may temporarily depress margin expansions, but our core business becomes more profitable in the new businesses, such as email hosting and improve their contributions as well.

Capital is difficult to obtain and, if available, expensive. With the IPO and the borrowings on our credit facility, we are well funded, moderately leveraged, and in possession of excess cash to execute and invest through this environment. We continue to carefully deploy capital and adapt to the changing environments as quickly as possible. With this, I'd like to hand it over to Bruce for a discussion of our financial results.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Thanks, Lanham, and good afternoon, everyone. I will provide some additional detail and perspective on the third quarter's financial results. We had a very strong quarter with almost every financial metric improving over the previous quarter. As Lanham mentioned, we delivered continued growth during the third quarter with net revenue of $138.4 million, up 5.8% sequentially and up 44% over the same period last year.

Recurring revenue accounted for 96.7% of the revenue with the remaining attributable to non-recurrent revenue primarily a result of usage charges and setup fees associated with the increase in customers. Our net revenue for the first nine months of 2008 was $388.8 million, an increase of 52.3% over the same period last year.

Lanham talked about the success we had in increasing our business for both new customers as well as our existing customer base. In addition, he spent time talking about our ability to keep churn in check. While it is important for us to demonstrate our ability to grow revenue, it is just as important for us to control our costs. We continue to take the necessary steps to limit our spending on non-customer-facing expenses while continuing our investment in functions that will drive future growth.

We added 114 new employees, or Rackers as we call them, to bring our total employee base to 2,536 Rackers. Of this total increase, 47 were added to our investments including our Cloud, Mail, and Hong Kong expansion initiatives. Another 26 were added to our sales channels to support the growth we continue to see in the demand for our services as reflected in our gross bookings. The remainder went to our technical staff to support our growing customer base.

While we continue to invest in the areas that will drive growth, we are also starting to see our ability to scale certain costs. For example, G&A grew 1.6% sequentially compared to the revenue growth rate of 5.8%. By continuing to grow our top-line and controlling the growth in our overhead costs, we are able to improve our adjusted EBITDA margin from 25.9% to 26.7%.

Our operating margin increased from 6.4% to 6.9% and our net income margin grew from 3.2% to 3.8%. Adjusted EBITDA, which is defined as income from operations before depreciation and amortization as well as non-cash charges for shared-based compensation, was $37 million for the third quarter of 2008, which was a 9.3% increase over the previous quarter and a 39.7% increase over the same quarter last year.

Income from operations was $9.5 million for the third quarter for a 13% increase over the second and net income was $5.2 million for the third quarter, a 25.2% increase over the previous quarter. The improvement in our profitability has also contributed to us increasing our return on capital to 8.4% from 7.6% in the second quarter. We are very focused on our capital efficiency.

As we made certain investments for our future, it negatively affected our returns. It was important to us to come out of that debt and begin earning on those investments as quickly as possible. We are now starting to utilize those investments, which should improve our returns going forward.

To help continue that trend, we have further analyzed our expected capital spend for this year and have reduced our expected capital expenditures from $310 million to approximately $270 million. We now expect to spend $113 million on customer equipment, $81 million on data centers, $44 million in office space, and $32 million on Capitalized Software and other costs.

Customer equipment spend has been reduced because of better pricing, a proportionately larger use of recycled equipment, and the strengthening Dollar versus the Pound. We are looking at alternatives to our original data center plan and have reduced this year's budget for certain setup costs associated with the new data center.

Likewise, we have re-engineered our plans around our headquarters' spend level and have significantly reduced our planned spending levels. For the third quarter, we spent $68.3 million on capital expenditures. To finance these expenditures, we generated $33.2 million from our operating activity and an additional $23 million was financed through capital leases and notes, leaving approximately $12 million funded from our cash-on-hand.

As of the end of the third quarter, we had approximately $260 million cash-on-hand. Included in this total are the funds we borrowed at the end of September from our credit facility. In normal circumstances, it wouldn't be necessary to hold excess cash and incur the interest charges.

But we felt under the current economic conditions it was prudent to draw these funds as a precautionary measure to ensure we had full access to our cash to support our growth plans. We will continue to monitor this situation. The carrying costs could increase our interest expense in the fourth quarter by about $1.5 million to $2 million.

Let me move on to another area that has come up recently. The exchange rate between the Dollar and other currencies has moved significantly over the last four months. Starting with the facts, we derive approximately 26% of our revenue from our international operations. That in turn is mostly from the UK. In the third quarter, the British Pound weakened from $1.99 per Pound to $1.82 for an average of $1.90 for the quarter.

In the third quarter, consolidated revenues would have been approximately $1.5 million higher assuming a constant exchange rate. And the sequential revenue growth rate quarter-over-quarter would have been about 7%. But keep in mind, the expenses are also affected by the exchange rate as well as other items, so that in the third quarter the negative impact on net income due to the exchange rate fluctuation was approximately $130,000.

Yesterday, the exchange rate stood at $1.61 per Pound. For every $0.10 in the average exchange rate, quarterly revenue will be affected by approximately $2 million. For example, if the exchange rate stays at the current level, we could have a foreign exchange impact on revenue of about $6 million in the fourth quarter as compared to the third quarter.

Finally, as we previously announced and as Lanham talked about, we acquired two cloud computing companies -- Slicehost and Jungle Disk. The up-front purchase price was $11.5 million with an additional $6.5 million to be paid over time based on the achievement of certain earn-out provisions.

The payment will be a combination of cash and stock. Based on our forecast, we expect these transactions to be immediately accretive to us. For 2008, these acquisitions will not significantly impact our financial results and we will give you a full briefing at our Investor Conference early next year.

Again, we are very pleased with the progress we made over the previous quarter and will continue to push ahead with the initiatives we believe will further improve the value of Rackspace. Thank you and operator, we are now ready for the first question.

QUESTIONS AND ANSWERS

Operator

And your first question comes from the line of Jason Armstrong with Goldman Sachs.

Jason Armstrong - *Goldman Sachs - Analyst*

Thanks a lot. Good evening. Maybe a couple of questions here. First, on the deals you've done and how we should think about the margin trajectory here. Obviously, you guys moved up margins in the quarter. Before you sort of told us to think about 300 basis points of margin pressure related to growth initiatives, but now I guess as we think about buying versus building into those initiatives, should we expect more margin relief in the near-term?

And then second question just on churn trends in the quarter. I know you said 1.2% and that was relatively flat versus 2Q. I think a lot of people are obviously focused on what happened towards the back-end of the quarter, just given what the macro backdrop looks like? So can you maybe take us month by month on the churn trends and talk to us about the exit rates from 3Q? Thanks.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Sure.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay, Jason. This is Lanham. I'll start with the cloud acquisitions. At this point, the cloud acquisitions obviously had no margin impact on the third quarter. As we look at those companies today, we believe that they will be accretive to us based on the margin structure and the performance they're having.

I wouldn't want to point you to say that because of those acquisitions and the growth associated with them, our margin structure is going to dramatically change. We believe that the 300 basis points you talked about with respect to the investments we made, so that when we talked to you last on the Roadshow and on our call, we talked about our managed hosting margin and the investments we were making was pushing that down about 3%.

Certainly, these acquisitions and given their margin attributes will help lift that a little bit, but we still plan on making investments. So I wouldn't point to any dramatic change there.

Jason Armstrong - *Goldman Sachs - Analyst*

Okay. And on the churn?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

On the churn side, there's really no pattern as you go towards the end of the quarter. Each month has its own unique things. If you have one large person who leaves, it'll spike that particular month. But generally what we're seeing in trends is that from a churn perspective we're continuing to have some months that are good and some months that are bad.

We have seen, though, that some of the downgrades are a little bit higher than they had been in the past and that affected our net growth that Lanham talked about. But on the churn side, we're not seeing any definitive changes in terms of the end of the quarter versus the beginning of the quarter.

Jason Armstrong - *Goldman Sachs - Analyst*

Okay. And has the pace of the -- as you think about the quarter, has the pace of the downgrades picked up sort of exiting the quarter?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. Here, let me give you a little context, Jason. This is Lanham again.

Jason Armstrong - *Goldman Sachs - Analyst*

Sure.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

We had our customer conference last week and basically the way I would characterize what's going on in our customers' minds, churn today is level. As our customers work through their '09 plans, it looks like their IT budgets are flat. All of them have an eye to savings there and how can they get more value out of that budget. And the good news there is that we are running mission-critical services for them and taking care of mission-critical apps.

When you look at our DSOs and some of the credit qualities in our customer base, those have not moved materially. And so that basically when we look at our churn today, we don't have any customer concentration. None of our customers are greater than 1% of sales. And basically, churn today is in-check over the quarter.

When you look at the month of October and you look at the growth in our installed customer base, it looks just like Q3. So that so far the October results from a gross bookings point of view and a growth in our current customer base are very similar to Q3. In fact, gross bookings in October were actually higher on average than what we experienced in Q3. And in Q3, bookings were higher than what we experienced in Q2.

Jason Armstrong - *Goldman Sachs - Analyst*

Okay. That's helpful. Thanks a lot, guys.

Operator

Your next question comes from the line of Chris Larsen with Credit Suisse.

Chris Larsen - *Credit Suisse - Analyst*

Hi, thanks. Can you hear me?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

We can.

Chris Larsen - *Credit Suisse - Analyst*

Great. Hey, Bruce, I apologize. You said the FX numbers and I wanted to just -- I couldn't hear what you said on what equals $2 million in revenues impact. And secondly, can you also give us the cloud hosting number count at the end of the quarter and then I had a couple of questions after that.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes. On the FX standpoint, for every $0.10 change there is in the exchange rate, that equates to about a $2 million impact on revenue. Now keep in mind it also has a similar impact on expenses. So that's not the net income impact; that's just the revenue impact.

Chris Larsen - *Credit Suisse - Analyst*

Great. Thank you.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. With respect -- This is Lanham. With respect to the customer count numbers, we added 2,500 customers in the quarter. We ended the quarter with about 36,000 customers. Half of those are managed hosting customers and half of those are cloud customers. That does not include the customers we acquired in the acquisitions.

Chris Larsen - *Credit Suisse - Analyst*

Oh, right, because that was after the quarter.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes, sir.

Chris Larsen - *Credit Suisse - Analyst*

Okay. Great. And then --

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Chris, we just lost you.

Chris Larsen - *Credit Suisse - Analyst*

How about now? Can you hear me?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes, we can.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

You're back.

Chris Larsen - *Credit Suisse - Analyst*

Great. Can you talk a little bit about spending less on the data centers and the headquarter space? Number one, less on the headquarter space, can this create any peril for your tax incentives? And secondly, on the data center space, is this because of the slower growth that you're seeing in existing customer sales? Is that the read-through to that?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Well -- Go ahead.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay, yes. I think -- This is Lanham. With data centers, basically we are starting to see some opportunities in the marketplace to where we think we will not have to go build a data center next year. So right now we're finishing the expansion in our Dallas-Fort Worth facility. That will conclude this year.

We are looking out into next year and what capacity we're promised we're going to have. At this point in time, we don't think we will have to build one ourselves. We think there are other opportunistic opportunities in the marketplace. On the headquarters--

Chris Larsen - *Credit Suisse - Analyst*

That's a great point. Thanks.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Sure. On the headquarters, we do not believe our incentives are in jeopardy at this point as we look at our internal plans and the requirements to earn those incentives. We feel like we're still in good shape there.

Chris Larsen - *Credit Suisse - Analyst*

Great. Thank you.

Operator

Your next question comes from the line of Jonathan Schildkraut with Jefferies.

Jonathan Schildkraut - *Jefferies - Analyst*

Great. Thanks for taking the questions, guys. If you could talk to us a little bit about what you're seeing in terms of customers' buying patterns, if there's been any change there? You noted that one of the reasons for your decrease in CapEx was that you are seeing a higher reuse of existing servers and maybe give us some commentary around that. Is that economy related? Or is it as you move more people into cloud hosting, they're buying computing as opposed to actual servers? So if you could address that it'd be great.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes. Let me talk a little bit about the reuse of the equipment, then I'll flip it over to Lanham. You hit on a lot of the points. One, I think that from a reuse standpoint, obviously, the cloud area gives us another avenue to use equipment that's being pulled off the shelves from those customers that are leaving us.

But in addition to that, we're spending a lot of time and a lot of efforts on our internal processes and [in class] we're just getting better at those things. And so we're identifying the equipment and finding uses for it better than we had a year ago and so that's helping us as well. But certainly the cloud computing, as we said before, is much more capital efficient just as a pure technology. But in addition to that, it gives us another avenue to use some of the older equipment.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Jonathan, this is Lanham. Regarding the customer buying patterns, if you look at sales cycle time, for example, that is holding steady at 34 to 35 days. So that's a pretty consistent number for us. Regarding what people are thinking about, they're really prioritizing their workload spend. They're focused on the stuff that's mission-critical first. All the feedback we have about IT budgets for next year is that budgets are going to be flat.

A lot of that, when people are trying to save money and get more value out of their spend, a lot of that puts us on trend for them. And so we feel pretty good about our positioning there, so we feel like we have a managed hosting business that's growing at a high rate and we have a cloud hosting business that's growing greater than 100% per year. So we feel like we have a couple of different avenues here to maintain our growth.

And on top of that, our current customer base is still growing. We've launched new services -- our platform hosting service as well as our Hong Kong Data Center -- and so we're taking a lot of the right steps to keep the growth going because strategically we are trying to increase our market share. We feel like there's a golden opportunity out there for us to do that.

Jonathan Schildkraut - *Jefferies - Analyst*

Okay. And actually, that's a good segue into my next question. For the quarter, servers per customer and ARPU per server fell. Even the average revenue per square foot came down a little bit, about 3%, more for the prior quarter. Is that related to currency impacts or are you seeing people purchase at kind of smaller price points or have you become more aggressive on the pricing side to capture that market share that you've been talking about?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes. Let me step through a couple of those things. One of them you mentioned was the average revenue per square foot and that came down because the number of square feet increased. That's not based on an effective amount. Actually, what we're seeing when we look at all those statistics and you dig into them, we're really not seeing them decline at all.

The clients are staying very steady with where they had been in the last quarter and increasing over what we had seen the prior year. Now what we're doing is we're seeing a lot of the same kinds of services we sold on the managed side. But to your point, there are other opportunities as we expand, particularly with some of the new offerings and Slicehost and some of the other things where they come in at a much lower price-point. But obviously, it should help us from a market share standpoint.

Jonathan Schildkraut - *Jefferies - Analyst*

All right. Thank you for taking my questions. I'll circle back in the queue.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Okay.

Operator

Your next question comes from the line of Devang Kothari with JMP Securities.

Devang Kothari - *JMP Securities - Analyst*

Hi. Thanks for taking my questions. The first question is, with the acquisitions that you're doing and with some of the offerings that Slicehost has, you have a pretty dramatic difference in price-points. Just wanted to find out what that means for your sales model and what kind of changes you anticipate there?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay. So let's talk for a second about the Slicehost offering. Slicehost today has about 15,000 slices online. So it's basically virtualized hosting environment. The sales model today is fairly automated. It is applicable to people that are technically pretty proficient. They know what they want. A lot of that sales process takes place online.

The price-points will range from $20.00 a month to $200.00 a month based on the resources in that slice. And so what we are able to do is have a pretty web-centric sales model to do that. And so we think from a productivity point of view, because of the online sales experience, we can have a pretty high level of output per rep that's involved in it. We think much of the activity instead of having a rep involved will be able to have solved through technology.

Devang Kothari - *JMP Securities - Analyst*

Okay. Great. And then, you mentioned, Lanham, that there might be some opportunities for data center expansion in the US without having to build your own. Are you seeing any such similar opportunities in Europe or any other international areas?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

We have not been searching in Europe like we have been in the states. In Europe, we just completed our Slough facility and so we have plenty of capacity already in there. So I couldn't give you a good direction on that.

Devang Kothari - *JMP Securities - Analyst*

Okay. All right. Great. That's all I had. Thank you.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Thank you.

Operator

Your next question comes from the line of Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes. A couple of questions. One is I wonder if you can kind of step us through the integration steps for the two cloud acquisitions. Is that technically pretty straightforward or how long would it take before you consider those assets to be fully integrated? And then, with respect to seasonality given your current customer base, what type of seasonality, if any, do we typically see in the fourth quarter and then moving into the first quarter?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay. So the first is the integration with the cloud hosting acquisitions. These are not large companies. If you look at the employee count, they aren't large businesses. Really what they are is technology acquisitions for us.

The good example of our approach to this is the acquisition of Webmail last year, which forms the core of our mail hosting offering, our cloud mail offering. That was an integration that took place pretty rapidly because it was very similar. There weren't a lot of employees there. It was about integrating systems to make sure we could run it and it was about capitalizing on that technology. It was about us really investing in that company to get it performing at a higher level as opposed to integrating it in.

Now with the cloud hosting, we will certainly from a technology point of view be integrating that into our existing facilities. We think that one of the beauties of our cloud hosting offering is that we can have a pretty integrated suite between our managed hosting offering and our cloud offering.

We think the combination of these two is going to unlock a lot of value for our customers and allow us to get a very tight fit between their needs and what we're going to provide. So the integration here isn't very complicated because these are really capabilities that we've purchased as opposed to big functioning companies.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. And then the seasonality?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. On the seasonality, really, the part where we have a bit of seasonality in our business is that we serve a number of e-commerce companies that have a step-function-up in their activity level during the fourth quarter. And then in the first quarter, they have a step-function-down in it. Other than that, traditionally we haven't had a lot of seasonality in the fourth quarter.

Jonathan Atkin - *RBC Capital Markets - Analyst*

And then, are there any differing -- You could, on-balance decision cycles have kind of been flat, are there other differing segments that you sell into where you're seeing any trends that are worth highlighting? And then finally, if you could just give us a flavor for Europe and Asia and kind of the growth path to expect going forward and how those expansions are progressing? Thank you.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Could you repeat the first part of the question? You broke up a little bit and I just couldn't understand you.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes. Differing verticals that you sell into. Are there notably different trends that you're seeing? You mentioned e-commerce has some seasonality, but with respect to macroeconomic impacts, are you noticing different segments within your customer base changing their purchasing behavior?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

No. We haven't noticed across the customer base any particular pockets of dramatically different behavior. When you think about the European and the Asian expansion, Asia is early in the game. The Hong Kong Data Center has been up a matter of weeks. We are pleased with the progress we've made so far, but we still have a long way to go there, but we're pleased. We've started off well.

When we look at Europe, our business in Europe is primarily in the United Kingdom. When we look at that business and how it's performing, the growth over there, the profitability over there is performing very similarly to what we're experiencing in the states.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. Thank you very much.

Operator

(Operator Instructions). Your next question comes from the line of Erik Suppiger with Signal Hill.

Erik Suppiger - *Signal Hill - Analyst*

Good afternoon.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Hey, Erik.

Erik Suppiger - *Signal Hill - Analyst*

First off, just vendor financing. I think Dell and Cisco are your two partners doing that. Have you seen any issues? Have you seen any higher costs associated with that? And is availability still good?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

We have a great relationship with both of those vendors. They have not put any pressure on us. We still have what we think is great opportunity from a leasing standpoint. In fact, in this economy I think they'd like to lease us more than they had in the past. So we don't see any signs and we don't anticipate any changes in those relationships going forward. They're very strong.

Erik Suppiger - *Signal Hill - Analyst*

Okay. If you look at how you broke your CapEx out, I think you had noted about $12 million or so came out of your cash on hand and the rest was between cash from ops and vendor financing. Is there anything that we might anticipate that would change kind of the spending levels over the next quarter or two? Is there anything that -- is that a reasonable proxy for how we can assume it will look going forward?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. There's really no big items that are coming up. We're in the final stages of our last phase up in Dallas on that data center and that should be online towards the end of this year or the very early part of next year. But other than that, our CapEx should be pretty consistent. Again, we're part-way through the quarter and we don't see any significant changes.

Erik Suppiger - *Signal Hill - Analyst*

You didn't -- relative to your cash position you didn't use a lot of cash. It would appear as though you're in a pretty strong position from a cash perspective. If we look out into '09, is there anything that is going to be using up your cash or is that a pretty generous amount for the time being?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

As we mentioned in the initial statements, we've taken down a lot of our cash as a precautionary measure from the general credit marketplace, but we feel very good about our cash position. We feel very good that we put a lot of efforts in to try to keep our burn rate as low as possible.

Certainly, if some of the opportunities come up where we lease computer space or data space, that helps us conserve our cash and there may be some of those opportunities coming up.

Erik Suppiger - *Signal Hill - Analyst*

Okay. And you gave us the total customers and the mail customers. Did you give us the metric for the number of cloud customers that you have? I know cloud in total was about half, but I think last quarter you had given us the hosted customers, the email customers, and then the cloud customers separate from that.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay. So the total cloud customers were about 18,000.

Erik Suppiger - *Signal Hill - Analyst*

Okay.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

15,000 of that is mail.

Erik Suppiger - *Signal Hill - Analyst*

Okay. All right. Very good.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

And that does not include customers from the acquisitions that we just made.

Erik Suppiger - *Signal Hill - Analyst*

Okay. And then lastly, just in terms of the customer churn, the 1.2%, that's a little bit higher than where it was recently. What types of customers are you seeing? Are you seeing a bigger volume of small customers or are you seeing a notable mid-size customer that's leaving? How would you profile the customers that are going?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

We have one -- for the most part, I would say it's across the spectrum of customers we serve. We did have one large customer that was acquired about a year ago and so they had been in the process of working through their transition out. And so that caused a bit of a spike one month. But really, I would say it's not clustered in any one particular part of our business today.

Erik Suppiger - *Signal Hill - Analyst*

And even that customer, I assume, is notably less than 1%, right?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

That's correct. We don't have any customer over 1%.

Erik Suppiger - *Signal Hill - Analyst*

Yes, okay. Very good. Well, thank you very much.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

You're welcome.

Operator

You have an additional question from Jonathan Schildkraut with Jefferies.

Jonathan Schildkraut - *Jefferies - Analyst*

Thanks. Actually, two questions. First, a little bit more on Slicehost. It seemed that during the Q&A you were talking about price-point. I think you said, Lanham, $20.00 to $200.00 per month. I was wondering if you could maybe talk about what services they're buying for $20.00 to $200.00 per month? Is that going to introduce a new type of customer or are you just going to get a different piece of your customers' spend, maybe an incremental part?

Additionally, is that going to introduce new levels of competition? At those price-points, you may start running in Amazon, Microsoft, and we know that Google is trying to develop some things at the low end here that could certainly be in this price-point. So I was wondering if you could give us some commentary around that.

And then, similarly, as we talk about maybe opening up new customers. You talk about market share capture. And maybe if you could go a little bit deeper into who you're capturing market share from? That could be really helpful. Thanks.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay, yes. Sorry. If I said $200.00 earlier on Slicehost, I misspoke. Their high-end price-point is $800.00. So I'm sorry for those on the call if I stated that incorrectly. So a couple of different things with respect to Slice. One question you had there, Jonathan, was is this incremental? Does it put us into a new market? What's going on?

I can say our customers that are using both our managed hosting offering and the Slicehost offering, it's really based on workload. So what Slice is, Slice is a -- think of it as a technology element. It's basically a set of resource power that you're purchasing. It's fairly unmanaged, so the buyer here is an early adopter who is very technology savvy. One has to be technically competent in order to use those resources.

It's like a dedicated server in that you are getting a distinct set of resources that only you, the customer, has access to. But really, the management around that is minimal. So the distinction here between our traditional managed hosting offering and our cloud offering here through Slicehost is that within our traditional managed offering it's productized in that we have a set of services you can purchase. But it's backed up with a team of technicians providing Fanatical Support to take care of you.

When you get into the cloud today, the cloud is based on more open standards. It does not provide the customization that managed hosting provides in a dedicated environment. You're going to get literally a slice of those resources. So an example of what customers are using it for today, they will have production environments for back-office systems in our managed hosting offering and then they'll put test and dev over into the cloud. So that for their development environments they'll play around in a cloud and use it there first. Then when it's ready, they'll put it back into our traditional managed hosting offering. I do think that the cloud elements here position us into a market that is incremental to what we provide today.

We are going to have current customers that utilize cloud. Our experience with our current customer set is that when they subscribe to our cloud services it increases loyalty. I think a lot of the cloud offering is going to play in an incremental fashion exactly against somebody like Amazon. Amazon has had tremendous success with Amazon Web Services.

We feel like our point of difference into the cloud environment is going to be that we're going to have managed hosting as well as cloud. We're going to back it up with Fanatical Support. Now what Fanatical Support means in a cloud is going to be a bit different than what it means in our traditional managed hosting environment. So I think you're exactly right in that when we get to those price-points it opens up a new market for us and therefore, new competitors.

Jonathan Schildkraut - *Jefferies - Analyst*

Okay, great. I'd like to also do a follow-up question on the vendor financing. It looks like you had, call it $85 million of vendor financing outstanding at the end of the quarter. And I was wondering if there was any cap on how high that vendor financing could go.

Could we see you pulling down an incremental $10 million or $20 million of vendor financing every quarter for the next six, eight, 10, 14 quarters? Just give us a sense as to the magnitude of vendor financing that's available to you.

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

We don't have a limit on it. It's really going to be based on the growth that we see. And keep in mind, as we keep leasing new equipment, there's old equipment that's being paid off. So we're paying it off over time. So incrementally, we've got some new leases coming in, some old ones rolling off. So I would expect that you'll see this leasing to continue to grow, but I don't think you'll see a sharp increase in any particular month or quarter.

Jonathan Schildkraut - *Jefferies - Analyst*

Okay. Thanks, Bruce.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes, and Jonathan, you had asked about market share?

Jonathan Schildkraut - *Jefferies - Analyst*

Oh, yes.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Sorry. And so basically as we think about market share, we look at our growth relative to competitors. So when we survey the market today, we have higher growth rates than others, so we know our relative market power is increasing. And so really as we're in the marketplace competing on things, we think about the profitability of the deal, so when we look at our third quarter results, we had good progress and profitability.

The acquisitions we're making and cloud give us more product leverage. Our investments are scaling with respect to the data centers that we're starting to fill up as well as the G&A investments. And so we believe we have a high growth business today and because of our brand power we have an ability to increase our market share at a time when there's really a flight to quality going on.

As we sit here today, there are a lot of trends out there that play right into us. We're the best capitalized company or industry today. The IT budgets are flat and people are looking for more value. They don't want to go construct a data center. They're looking for a partner to do it. So we feel like right now there are just a lot of advantages headed our way.

So we want to grab share in a disciplined fashion, so we are watching our customer acquisition metrics to make sure that we do profitable deals. We're watching our cost to serve and making sure we make investments to increase our productivity because we like the increase in profitability we just had.

Jonathan Schildkraut - *Jefferies - Analyst*

Great. So you're saying that the market share capture has a lot more to do with capturing a bigger portion of the growth in the overall sector as opposed to taking a customer out of somebody else's data center or offering?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

That's correct. When we think about what we hold ourselves accountable to on growing market share, it's about growing in the opportunities that we have, increasing our win rate against certain competitors. But really, it's getting a larger share of the new stuff as well.

So we think about it in both ways, but we don't have real specific targets relative to a competitor or anything like that. We're more concerned about what we're doing than what the competitors are doing.

Jonathan Schildkraut - *Jefferies - Analyst*

Right. Lanham, in the past we've talked about your competitors ranging at the top end from some of the larger guys. But maybe in the sweet spot really being somebody who could be more of a local integrator as opposed to a national brand. Are you seeing any disruption with those smaller companies that you compete with on a local level?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Well, yes. I would say what's happening as the credit market tightens, people will have restricted access to capital. So I wouldn't tell you that competitors are going to go out of business or anything. I just think they'll have a hard time growing. That's where there's a lot of advantages that point in our direction.

Jonathan Schildkraut - *Jefferies - Analyst*

All right. Wonderful. Thanks again.

Operator

Your final question comes from the line of Devang Kothari with JMP Securities.

Devang Kothari - *JMP Securities - Analyst*

A couple of quick follow-ups, Lanham. The reduced CapEx on the office build-out. Is that just something that's now going into '09 or are you looking at a lower headcount growth? Could you give us some insights there?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes. In terms of the lower capital on the office or mall complex, a lot of it's going to be just dollars saved. We're getting better at how we're configuring folks and making better use of the space. And obviously, we're very focused on our cost structure and we're going to only hire those folks that we think will add value to the Company. So we're taking a hard look at every additional headcount that we add.

Now over the 10 years, depending on how we grow, we may eventually spend all that money. But it's not just a push out of '08 into '09. We are being smarter about how we're building as well.

Devang Kothari - *JMP Securities - Analyst*

Okay, so does that imply kind of a longer period to completion? I think you were looking at end of '09 to complete construction on that project?

Bruce Knooihuizen - *Rackspace Hosting, Inc. - SVP, CFO*

Yes, absolutely. What we're going to do is we're going to time this with the growth in our business. Much like all of our other assets, we try to do just in time and we're going to stick to that philosophy on building out our office space as well. So we'll push it out as long as we can.

Devang Kothari - *JMP Securities - Analyst*

Okay. And then one more follow-up. You guys seem to be doing really great in the market you're in right now, more kind of SMB kind of space. Do you see right now is an opportunity to also get a little bit more aggressive in the enterprise space, direct sales model or is there opportunity for you to start looking at moving upstream a little bit even?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. This is Lanham. I can tell you that part of what's happening -- when we look at our opportunity pipe, what I tell you is that the pipe is doing well. Our marketing programs are effective and demand is there for us. One thing that we have noticed in our mix is that there is an up-front, larger MRR customer opportunity more recently than we had earlier in the year.

And so this is part of what we think is happening with respect to flight to quality is that our brand reputation is building, our service reputation is building, Fanatical Support is effective in the marketplace. And so we have noticed recently a bit of a trend here to where there are larger opportunities up front and we're swinging hard at them and winning them. And so I feel like there is that opportunity there. We'll see to what extent we can capitalize upon it today. I would say it's a nascent trend at the moment that we've had success with.

Devang Kothari - *JMP Securities - Analyst*

Okay. Is there opportunity for you to be a little bit more aggressive in your direct sales model to try to get more of those opportunities or win more of those opportunities?

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Yes. There are some, what I would call, incremental tactics that we testing at the moment to see how it goes.

Devang Kothari - *JMP Securities - Analyst*

Okay.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Because we have noticed this trend. We have noticed people coming to us and we are working to determine how to increase the effectiveness there, but I don't have anything to report on it at the moment.

Devang Kothari - *JMP Securities - Analyst*

All right. Great, great. Thanks a lot, Lanham.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Sure. Thank you.

Operator

This concludes the Q&A portion of the call. I will now hand the call back over to Mr. Lanham Napier for closing remarks.

Lanham Napier - *Rackspace Hosting, Inc. - President, CEO*

Okay. Thank you all for joining us. We were proud to report out third quarter numbers. We think it speaks to the effectiveness of Rackers and the value proposition of Fanatical Support in the marketplace. We look forward to continue to build the business. Thank you.

Operator

This concludes today's conference call. You may now disconnect.