FINAL TRANSCRIPT

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RAX - Q4 2008 Rackspace Hosting, Inc. Earnings Conference Call

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PRESENTATION

Operator

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

(Operator Instructions)

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

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

Hello, everyone, and welcome to Rackspace Conference Call. Today, we will cover Rackspace's fourth quarter ending December 31, 2008 and the full year of 2008. My name is Karl Pichler, and I am 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. From Rackspace, on the call today will be Lanham Napier, President and Chief Executive Officer, and Bruce Knooihuizen, Senior Vice President and Chief Financial Officer.

I need to remind you that some of the comments we will 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 could 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 operational and financial results, long-term investment strategies, growth plans including international expansion plans, the performance or 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 or further deterioration of the current difficult economic conditions, infrastructure failures, and other risks that are described in our Form 10Q for the quarter ended September 30, 2008, which was filed with the SEC on November 10, 2008, and by our Form 10K for the 2008 fiscal year, which will be filed with SEC before March 31, 2009 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 could differ materially from those anticipated in these 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 reconciliations can be found in our earnings release for the 2008 fiscal year, which is currently posted on the Investors 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 conference call for Rackspace Hosting's fourth quarter and full year 2008 results. We are going to cover three topics on this call. First, we're going to reiterate our strategy for building one of the world's greatest service companies and provide a quick review of 2008.

Second, we're going to provide some details and insights with respect to the current economic environment, what we see right now, and how we are navigating the recession. Third, as always, Bruce will provide important financial details, both for the fourth quarter and for the full year, as well as some indications about what we are planning for in 2009.

Let's start with our strategy. Today, we are a recognized leader in the hosting industry, and our leadership is driven by our ability to provide Fanatical Support. We have created a competitive advantage by providing a differentiated service experience for our customers at a compelling value. We offer a suite of IT services that enables our customers to run a broad set of their IT workloads on our managed hosting and cloud computing platforms.

Rackspace has two primary lines of business, our traditional managed hosting business and our rapidly growing cloud computing business. Our managed hosting business provides IT hosting services on dedicated infrastructure for more than 18,000 customers. We believe our managed hosting business is a long-term growth business.

But as current growth rates slow down along with the economic downturn, our focus in our managed business for this year is on increasing profitability and capital returns. We added approximately 500 customers to our managed hosting business during the fourth quarter.

One example to note is Hearst. Hearst Newspapers, a division of Hearst Corporation, recently signed a 36-month contract with us to host its web content management system that allows them to manage and consolidate all the content created by their 14 newspapers. Comprised of more than 100 devices located in our data centers, Hearst's new system can help streamline its online content delivery and creates a more profitable revenue stream with its online ad sales. They were looking for a hosting partner that could meet its stringent uptime and security standards, while also staying within the budgetary constraints.

During the sales process, our engineering and support team worked closely with Hearst application developers to construct the optimal solution and even recommended a better networking architecture for the system, which led to a more cost-effective solution. Ultimately, Hearst selected Rackspace because they required a vendor who understands the high level of support and service that is required to assist its team in maintaining such an important piece of its online business.

Our cloud computing business is growing rapidly, at an annualized rate of more than 120% per year, and we currently serve more than 34,000 customers. This business provides a set of computing services that are consumed as needed and that seamlessly scale up and down based on the customer's needs. Our cloud applications include mail, collaboration, and backup and are sold as a software as a service offering. While early in its development, we are experiencing rapid traction in the cloud and are building a leadership position. Customers are leveraging Rackspace cloud offerings as a way to easily and cost-effectively manage websites and applications.

Allow me to provide a couple of recent wins for our cloud business. First, Razorfish, one of the largest interactive marketing and technology companies in the world, selected Rackspace to help them seamlessly scale their consumer-facing websites and web applications during major promotions and product launches of brands. Second, the Arizona Cardinals entrusted the Rackspace cloud on Super Bowl Sunday to ensure its website could perform optimally during the major spikes in traffic.

We believe the combination of our managed hosting and cloud computing offerings are a competitive advantage. The breadth of these offerings enables us to provide a tailored fit to our customers' IT needs. Many of our customers are utilizing both our managed hosting and cloud computing services to create a hybrid hosting solution.

Now, let's review 2008. I want to thank all of the Rackers for their hard work in achieving these outcomes. Here are some highlights. First, our revenues grew by 46.9% compared to 2007. And on the profit side, we generated $145 million of adjusted EBITDA and close to $22 million of net income for the year, with profits and profit margins further increasing quarter over quarter. We consider this a huge success and a reflection of our continued commitment to our customers and Rackers.

In our managed hosting business, we added more than 3,000 customers and now serve more than 18,000 customers. We also host more than 1 million mailboxes in our cloud and manage more than 47,500 servers out of our data centers in the US, the UK, and Hong Kong. For two years in a row now, we've been recognized as one of Fortune's top 100 best companies to work for. Those awards are important for our culture and our service quality.

Second, we have largely completed an investment phase that put pressure on our margins and returns in 2007 and 2008. In January of 2009, we completed the build out of our DFW data center and added an additional 22,600 square feet of technical floor space. We opened up our managed data center in Slough, England, which will serve as a consolidation platform for our European operations and to support future growth.

We established our Asian presence with a 6,500-square-foot data center in Hong Kong. We completed phase one and started occupying our new offices in San Antonio. Our build-out plans for this facility remain highly flexible and provide us with office space as needed.

Third, we became a public company and raised $145 million in equity growth capital. The equity funds we raised, in combination with the capital available to us through our credit and lease facilities, are more than sufficient to fund our growth. We are very well capitalized and have plenty of cash reserves.

Our strong balance sheet and low leverage gives us the flexibility to seize opportunities in the marketplace and provides the financial stability our customers expect from a long-term business partner. Fourth, we completed two strategic acquisitions in the cloud space that expand and complement our service and product portfolio and further enhance our leadership position.

Let me now get to the next topic, which is an overview of the current state of our business and how we are navigating through the recession. In 2009, we have a two-part playbook. The first part is to increase the profits and returns from our managed hosting business, and the second part is to continue to rapidly grow our cloud computing business.

We expect our business to grow in 2009, albeit at lower rates than we have experienced in the past. Our hosting services help customers save money and get more value out of their IT budgets, and we will continue our disciplined approach to customer acquisition by investing in the right customers, where we can make a profit and a return.

This year, we have an increased ability to realize greater profitability in returns. As growth slows, we are able to increase our profit margins by more efficiently scaling our business in our customer acquisition, service delivery, and administrative functions. We have completed several large infrastructure projects that we expect to leverage in 2009.

From a productivity perspective, we have improved internal systems and processes that will also positively impact margins. When our growth started to slow in 2008, we responded by deepening our focus on our ability to scale. As a result, profit margins and returns increased throughout the second half of the year. We will continue our focus to improve the profits and returns in our managed hosting business during 2009.

Our capital expenditures are success based, so lower growth rates decrease our capital expenditure requirements. The combination of higher margins and lower CapEx in today's environment positively impacts our free cash flow. As a result, we expect any cash burn in 2009 to be minimal.

To recap the three things we want investors to know about our focus in 2009, number one, we expect our business to grow, albeit at lower rates than the past. Number two, we are focused on scaling our profits and returns. Number three, our capital expenditures are success based and will be lower in 2009 than 2008. Any cash burn in 2009 will be minimal, and under certain scenarios, we could generate positive free cash flow.

Bruce will present additional details on operating results and our financial condition. I would like to close by saying that we are proud of what we achieved in 2008 and thank the Rackers around the world for their dedication and hard work. Bruce?

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

Thank you, Lanham. I'd like to reiterate Lanham's comment about our accomplishments in 2008. It has been a great year for us, and the financial results that we delivered were outstanding, especially considering the adverse conditions in economies worldwide.

Let me start with revenue and growth. Our net revenue for the fourth quarter of 2008 was $143.1 million. This is a 34.2% increase relative to the fourth quarter of 2007 and a 3.5% increase relative to the third quarter of 2008. For the year, this brings us to $531.9 million, for an annual growth rate of 46.9%.

Our customer credit quality remains intact. We have stable account receivable balances, stable allowances for doubtful accounts and days sales outstanding. While our bad debt expense did increase quarter over quarter, the expense as a percent of revenue remains at historically low levels, just over 1%.

In addition to our revenue growth, we had a concerted effort to control costs and increase profitability. Whether we look at adjusted EBITDA margins or net income margins, we have seen steady improvement in the second half of the year, as well as year-over-year quarterly results.

In particular, our EBITDA margins, adjusted for non-cash share-based compensation, was 29.7% in the fourth quarter on a consolidated basis. If we were to look at our managed hosting business, excluding the impacts of our investments and our cloud continuing initiatives, our margins were in excess of 31%.

How did we achieve these results? There are a number of initiatives that we began in 2008, continuing into 2009, which will result in scaling our cost structure. Many of those, as reflected in our results, have already begun producing efficiencies.

First, we continue to closely scrutinize and manage our employee levels. In the fourth quarter, our headcount increased by 75 Rackers globally, of which over half were hired into our fast-growing cloud businesses. In our data centers, we have used the Six Sigma approach to streamline our server production process, which has resulted in less headcount and increased efficiencies.

Our support organization is in the process of a transformation that will allow us to handle an increasing volume at a decreasing rate of headcount growth, while maintaining our commitment to Fanatical Support. We are streamlining the method for processing customer orders, again, increasing efficiencies, reducing error rates, and improving the overall customer experience. We are only at the beginning of rolling out these new initiatives and are confident that we will realize additional productivity enhancements over time.

Second, our data center rate declined due to the decommissioning of 3,000 square feet of collocation space in the UK in July. Rent will decline further because we decommissioned another 3,000 feet in December of 2008. Third, we experienced lower sales and marketing costs, commensurate with lower booking volumes in the fourth quarter. And fourth, we further tightened up our travel and entertainment and professional and other general cost controls.

Overall, our cost of revenues, sales and marketing, and G&A costs actually went down slightly in the fourth quarter from the third. Results from these efforts produced $145 million of adjusted EBITDA for the year, which was a 59.1% increase over 2007, and the fourth quarter alone produced $42.6 million of adjusted EBITDA at a margin of 29.7%.

Net income for the fourth quarter was $6.8 million. This is an increase of 30.7% sequentially and 168% relative to the fourth quarter of 2007. For the year, we generated $21.7 million in net income, for a margin of 4.1%.

This year, the fourth quarter margins have benefited from a couple of one-time items. Specifically, our effective tax rate of 28% in the fourth quarter is unusually low due to R&D tax credits, along with higher-than-expected pretax income in foreign jurisdictions with lower tax rates. This resulted in approximately $750,000 in additional net income for the fourth quarter.

But even normalizing our fourth quarter results downward for the tax adjustment, we still saw continued progress in improving our profitability. Primarily due to the improved profitability, our returns are up as well. For the year, our return on capital was 9.1%, which was down compared to 13.6% in 2007. However, our returns have trended upwards, from a low of 6.7% in the 2007 fourth quarter, reaching 10% in the fourth quarter of 2008. This also reflects the progress we're making as we start utilizing the infrastructure investments we made over the last two years.

Let's move on to capital expenditures. For the year, we incurred a total of $250.9 million in capital expenditures, not including the costs related to the two cloud acquisitions we made in the last quarter. Of this amount, we spent $105.6 million on customer gear, $79.8 million on data center build outs, $41.2 million on office space, and $24.2 million on capitalized software and other. Approximately one third of these purchases, or $85.5 million, was financed through vendor financing companies.

For 2009, we expect to spend significantly less. At this point, we expect to spend between $105 million and $160 million in capital expenditures for the full year of 2009. Note that most components of our capital expenditures are success based and tightly under our control. We keep our build-out plans as flexible as possible and adapt them to changing situations quickly.

Having said that, this is what we currently expect. Of the total capital expenditures, approximately $75 million to $100 million is for customer gear. With the lease arrangements in place with our vendors, we expect that approximately 60% of this capital category will be financed under those agreements. We will continue closely managing the amounts we spend on our office space, significantly reducing the $41 million we spent in 2008, to a range of $10 million to $15 million in 2009.

The next category of capital expenditures is the amount we spend primarily on developing proprietary software. This spend level is expected to be in the range of $10 million to $20 million, also down from the level we spent in 2008.

And finally, we always look for opportunities to find data space at attractive rates. In the past, we generally leased an empty shell and built out our own infrastructure. In today's economy, we found an opportunity to lease data center space with economics that are significantly more attractive to us than building out our own facility.

This is the agreement we recently announced with DuPont Fabros. This allows us to avoid the initial upfront capital required in building our own facility and more closely matches the cost of the facility with revenue received from our customers. This agreement will be accounted for as an operating lease, and the cost of this lease will be recognized in our operating expenses beginning in the third quarter of 2009. These payments will have minimal impact on our gross margins and our EBITDA margins.

Because of this arrangement, along with the completion of most of our other data center builds, data center capital expenditures for this year are projected to be in the range of $10 million to $25 million in 2009, as compared to $80 million in 2008. The biggest part of this spend is for the plant expansion of our UK facility in Slough.

To finance our growth, along with our strong operations, we have a solid balance sheet. We have $238.4 million of cash in our balance sheet as of the end of the year and an additional $44.2 million committed under our revolving line of credit. Our net debt leverage is significantly below one times. Our available cash, the additionally committed amount on our revolver, and our vendor leasing arrangements provide us with strong liquidity.

Taken together with our expected strong operating cash flow and lower levels of capital expenditures, we expect that our cash burn this year will be minimal. And as Lanham said, under certain scenarios, we could generate positive free cash flow. We certainly don't see a need to go back to the markets to raise more capital.

We are continuing our capital allocation discipline and maintain our approach to profitable growth. We have an opportunity to further improve our systems and business processes and to increase efficiencies and productivity. This will drive profit margins and returns and will minimize cash burn. Once the economy shows signs of strength, we will be in the position and have the means to ramp up quickly again. With this, we are now ready to take your questions. Thank you. Operator?

QUESTIONS AND ANSWERS

Operator

Thank you. Today's question and answer session will be conducted electronically. (Operator Instructions). And we will take our first question from Jonathan Schildkraut from Jefferies.

Unidentified Audience Member

Hi, this is actually Ken in for Jonathan because he's traveling. I just had two quick questions for you. One was are you -- what are you seeing in terms of sales cycles? And then the second one was what kind of headwinds are you seeing from FX coming from your British operations? Thanks.

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

Okay, this is Lanham. I'll start with the sales cycles, and then Bruce can comment on the FX. The sales cycle -- really we don't see a whole lot of changes. Across the business, it's staying pretty steady to what we have experienced historically.

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

On the OpEx exposure, if you remember in the third quarter, the exchange rate was about GBP1.9 for every dollar. And we've seen a deterioration in the pound as we've expected. And it's gone down quite a bit.

So when you look at the third quarter, moving into the fourth quarter, that probably affected our revenue by just a little over $7 million. Keep in mind though again, because we do have operations over in the UK, we have a natural hedge. So while we had a $7 million negative impact on revenue, it was substantially less on a net income basis. But that did affect our growth rates when you look at sequential growth.

Unidentified Audience Member

Okay, great. Thanks.

Operator

And we will take our next question from Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Yes, the net upgrade stats that you include, as well as the churn trend, I wondered if you could just identify any moving parts that were different this past quarter compared to what you saw earlier in the year. And then with respect to the headcount increase, wondered what the -- what functions were added that contributed to that.

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

Okay. This is Lanham again. Regarding churn, here's what's going on there. I guess first, it didn't move that much when you look sequentially on a quarterly basis. We are not losing to the competition. And really what's happening, the place that has shifted a little bit is due to the economy.

I would say churn is still in check. And the issue is, people are scaling back their web presence, or the way we talk about it in our parlance internally, it's that people are canceling the projects. This is something we monitor closely.

So when we look at some of our financial metrics, one specifically we look at is bad debt. And is that driving churn? And right now bad debt is -- last quarter 1.15%. So I think part of what's happening here in the -- is that when we go to the market, we charge a premium.

And so we have selected those customers in the market that have a real business need for this. So I think that helps buffer us in times like these. So that's what's happening with the churn.

When you look at the installed base growth and the net upgrades, what's going on there is that I think in today's environment, people are right sizing, and they're trying to squeeze more output from their existing footprint.

This is also something that we actively help customers do. We want to make sure we provide the best service possible for our customers. And so they want to squeeze more out of their configuration. We help them do that.

It creates consolidation opportunities for us. One of the things we're seeing in the marketplace, particularly in our enterprise business, is people asking us to do more for them. That's coming out of other vendors. And right now, when we look at the install base, we are more focused on margins than we are on growth.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Okay.

Operator

And we will take our next question from Erik Suppiger with Signal Hill.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Good afternoon.

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

I'm sorry, we had the second half of that question about headcount adds that we didn't answer. Do you want to come back and do that in a minute?

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

Why don't we come back?

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

Okay, why don't we come back and do it. Okay, sorry about that.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Sure. So on the growth in the installed base, the combination of churn and upgrades, as you look forward, it sounds like the focus is on margins. Could that start to dip into negative territory?

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

Yes, we are -- so a couple things here. We don't have anything today that makes us think that churn is going to go take a step function. Right now churn is holding steady. And so there's no indication that will be materially different than Q4. And I would echo that on the installed base.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

You think -- it's been trending down. But it sounds like then you think it probably stabilizes in terms of the upgrades?

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

Well, I think we're all in a spot right now where the headlines are pretty volatile out there. And so what's happening in the net upgrades line is people are considering how do they get the most output from their configuration.

So we have consolidation opportunities to pick up business from other vendors with our customers. And at the same time, we're helping people squeeze more. So based on everything we have today, we're pretty comfortable where we sit.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Okay. And on CapEx, the spending on your office is coming down fairly significantly from last year. Is that simply because you're just not adding as many heads as you might have anticipated, and therefore you don't need to renovate as much as you would have expected in 2009?

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

Yes, there really are a couple of different reasons. And that certainly is one of them that as our growth had slowed a little bit this year, we have scaled back. And some of our needs from a Racker standpoint.

Also keep in mind that in 2008, we had a lot of initial costs that were associated with building out the space that in an initial phase of a build out, you do certain infrastructure things that will benefit the whole structure. And you incur the cost. So going forward, our incremental build outs are much cheaper than what we saw in 2008.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Okay. Just on the shares and the lock up that expired a month or so ago, do you have a sense for what -- of your major shareholders, of how much of them have reduced their positions or sold their positions or what some of your pre-IPO investors are holding right now?

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

Yes we -- if there's information out there, it's on the 13G forms that I think you can access. But certainly we get a lot of support from a lot of shareholders. And we're working hard to prove their investment was a sound investment.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Then finally, are you going to break out the one time revenue stream versus the recurring revenue stream? Are you going to give us any break out on that?

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

You know, we really don't break that out. But in terms of our revenue stream, it's almost all recurring revenue. We have some non-recurring revenue that's really associated with set up fees and things like that. But it's a small, small percent of our total revenue. It's not more than 2%.

Erik Suppiger - *Signal Hill Group LLC - Analyst*

Okay, very good. Thank you.

Operator

And we will go back to Jonathan Atkin with RBC Capital Markets.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Thanks. I had a question about the managed hosting customers, the -- it increased by about (inaudible) in that -- different than what we saw in each of the previous quarters. So I wondered what was driving that. And on Cloud, specifically if you could give us a little bit of a flavor for what types of businesses are accounting for most of that growth.

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

Okay. You broke up a little bit. Let me just restate the question and make sure we get it right. The first is the trends associated with the managed -- new managed hosting customers that we acquire. It was down quarter-over-quarter.

And then the second part of the question was what's driving the Cloud growth. Okay. With the managed hosting customers, in the fourth quarter, we did add 500 of them. And I think really what is happening there -- because our sales cycle was pretty steady. Our close rates dropped a little bit in the quarter, but not significantly. I think what's happening is that there are just fewer opportunities out there right now.

On the Cloud, what's driving there is it's a pretty broad adoption. Like hosting, the Cloud is a general purpose technology. And so really what drives the Cloud right now is the IT workload. So some of the examples we talked about in our remarks earlier, the Arizona Cardinals. And one of the elements that Cloud enables you to do is have this rapid scaling and bursting. And so for their site during Super Bowl Sunday, they played pretty well in that game, they got a lot of traffic.

So the Cloud adoption is really based on an IT workload. What customers are using the Cloud for, they have dynamic scaling requirements. And the Cloud is one of those things that is hitting a tipping point. And the growth there is pretty impressive.

Jonathan Atkin - *RBC Capital Markets - Analyst*

Great. Thank you very much.

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

Sure.

Operator

We will take our next question from Michael Bowen with Piper Jaffray.

Michael Bowen - *Piper Jaffray - Analyst*

Okay, thank you very much. It's -- first question, is it true that your office space costs this year are going to come down because Karl Pichler has finished upgrading and remodeling his cubicle? We heard about that.

But on a more serious note -- so we've heard from several of the data center companies out there. And I guess I heard this language a little bit from you guys, too. If I get it right -- you said lower sales and marketing costs due to lower bookings in the fourth quarter '08.

So of course that sends a little bit of a shiver through me. And I'm trying to figure out -- or help us think about going into '09 now. Do you think that that's going to continue? My gut is that it will. Or how do you get a handle on whether bookings are going to continue to slow. And I've got some follow ups as well.

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

Okay, so a couple things to think about in terms of the growth. Sales cycles were flat. Our close rate dipped a little bit in the fourth quarter, but not significantly. The opportunity strain that we are seeing right now is really pulling us into a more enterprise type sale. So the number of enterprise opportunities we're working right now are -- it's up.

Our approach to the marketplace is that we're disciplined. So we aren't going to deviate from the discipline around -- we want to invest a customer so we can make a profit and a return. So from a pricing point of view, we will continue to stick with our discipline.

So when you looked at our (inaudible), for example, it's actually up year-over-year, and it's flat quarter-over-quarter in our managed business. So that, to me, speaks to that we are not violating that discipline, and in fact, reinforcing it.

Michael Bowen - *Piper Jaffray - Analyst*

Are you seeing any difference in the bookings rate where the rate of change in the bookings between the Cloud and managed hosting?

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

Well I think what's happening is this growth in managed hosting is slowing right now, and the Cloud is accelerating.

Michael Bowen - *Piper Jaffray - Analyst*

Okay. And then next thing is can you talk about -- is there an optimal utilization rate? And then I guess the next part of that would be as you're looking at utilizing DuPont Fabros, how much cheaper is it per square foot to go into DuPont Fabros versus doing it yourself?

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

Okay, so in terms of targeting the utilization rate, 85% to 90% is what we will get in the facility. We always want to leave a little cushion because our business is dynamic, and things move around.

With respect to getting into the numbers on DuPont, we are very happy with that deal. But we don't want to get into the specifics about the cost difference between the DuPont opportunity versus other opportunities we've pursued in the past.

Michael Bowen - *Piper Jaffray - Analyst*

Maybe come at it a different way. How about time to market? Going into a -- DuPont Fabros site versus doing it yourself? How much time do you think you save?

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

A significant amount. So if we were to go from a shell warehouse building, convert it into a data center, that's a year to eighteen months. The DuPont facility is already operating, so it's literally just going in there and making the space ready to deploy. And that's a matter of four to five months.

Michael Bowen - *Piper Jaffray - Analyst*

Right. Okay. And one last quick housekeeping question, interest expense, you were just very slightly higher than in the fourth quarter. I'm trying to remember the reason why it picked up in the fourth quarter. And then will we see it come back down to more normalized levels for the next several quarters?

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

I'm trying to understand the question there.

Michael Bowen - *Piper Jaffray - Analyst*

I think interest expense in third quarter was 1.9%, and this past quarter I think it was 3.1%. I'm trying to remember what the tick up there sequentially was.

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

In interest expense?

Michael Bowen - *Piper Jaffray - Analyst*

Yes.

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

Well remember in the fourth quarter we drew down on our bank facility to have the cash on our books because of our concern about the marketplace, particularly the financial marketplace.

Now having said that, we've got $238 million of cash on our books right now. We're expecting a minimal burn rate in 2009. And so we're looking very closely at the bank market conditions. And certainly if we see that the markets firm up, the financial markets firm up, we would consider to pay it back.

On the flip side though, our interest rates are very low. Right now Libor is less than 0.5%. And our overall borrowing, if you look at our documents, is under 2%. And so it's very cost effective, but certainly we're keeping our eyes on the marketplace.

Michael Bowen - *Piper Jaffray - Analyst*

All right, so I guess it's fair to say it won't be going down, but you'll be keeping an eye on that. And what -- is it floating on Libor?

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

Yes it is.

Michael Bowen - *Piper Jaffray - Analyst*

Okay. Thanks, guys. Nice quarter.

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

Yes, no thank you.

Operator

(Operator Instructions). And we will take our next question from Sri Anantha with Oppenheimer.

Sri Anantha - *Oppenheimer & Co - Analyst*

Yes, thank you. A couple of questions. One, as I look at the revenue from upgrades from your existing customers, that's been going down for the past couple of quarters. I know you guys specifically don't want to talk about 2009 outlook. Should we expect the trend to stabilize here, or should we expect some more -- some of that revenue to still contract as we model for the first half of 2009 and beyond?

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

Okay. A couple things for you. I think just in terms of growth generally, we still expect to grow. So we have a marginal rate of growth as you look at the fourth quarter. And so we are still -- expect our company to perform well this year and grow.

Regarding the install base itself, we are helping customers right size their config. We have consolidation opportunities along with that. It's something we are actively managing every day. And we're focused on it.

Right now, with that base, we are more focused on margin and profits than we are on growth. Really we think that's just a reflection of what's going on in the world today. But we still expect to grow this company this year.

Sri Anantha - *Oppenheimer & Co - Analyst*

Got it. I know -- just a follow up on the product question, I know you guys talked about some of the good cost controls that you guys had in the quarter that came from lower booking. Is it possible any way to quantify how much of those lower costs came from bookings as opposed to operational efficiencies?

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

Yes, this is Lanham. I'll take the first, and then Bruce -- not very much came from lower customer acquisition, because really the opportunity for a customer acquisition is to be more efficient in how we do it. We've stared on that path. But the lion's share of the cost savings really came from operational efficiencies.

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

In fact, when you look at our financials, you'll see that when you look at cost of revenue, which includes the cost of running our data centers and our support infrastructure, that was actually pretty flat quarter-over-quarter. When you look at the G&A expense line items, that was pretty flat quarter-over-quarter. So as Lanham said, we're gaining efficiencies across the board in all organizations. And very little of it was due to the lowered booking levels.

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

Yes, because -- the short answer is bookings in the fourth quarter didn't drop that much.

Sri Anantha - *Oppenheimer & Co - Analyst*

Got it. Okay, that's good to know. And just one last question. Is it any way possible to quantify the contribution from your acquisitions?

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

Contribution in terms of --

Sri Anantha - *Oppenheimer & Co - Analyst*

Revenue in this particular quarter from the acquisitions?

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

Well, it's -- we don't break that out. But we did break out, on the metric space, the revenue associated with our Cloud initiatives. And that's where our acquisitions were. And as you can see on that page, you'll see that there's a tremendous amount of growth. And as Lanham said, in our core business, it's grown over 100%.

Sri Anantha - *Oppenheimer & Co - Analyst*

Got it. Okay, thanks so much, guys.

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

Yes, thank you.

Operator

We will take our next question from Jason Armstrong with Goldman Sachs.

Jason Armstrong - *Goldman Sachs - Analyst*

Hi. Thanks a lot. Good afternoon. Maybe a couple of questions. EBITDA margins -- I'm just wondering is 4Q '08 -- obviously impressive performance there. Is that a good starting point to think about as we go into '09? And are there any puts and takes related to seasonality that we should be thinking about on the margins early part of '09?

And then the second question on free cash flow breakeven, or mentioning that there might only be a little bit of a drag in '09. You historically have talked about 25% revenue growth as the threshold potentially for being breakeven. Does that still apply here? Is that still how you're thinking about it?

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

Okay, this is Bruce. And the response to the -- what was the first question again? EBITDA margins, I'm sorry. In response to the EBITDA margins, Lanham gave you our indication of where we thought EBITDA margins and profitability would go in 2009.

Now on any particular month or any particular quarter, they could fluctuate a little bit from that. But generally our trend is we expect in the current economic conditions that our margins will grow. If one quarter they slip a little bit, I wouldn't find that necessarily disturbing or unexpected. But overall, we expect them to grow.

Jason Armstrong - *Goldman Sachs - Analyst*

Okay. And on free cash flow?

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

On free cash flow, that's still generally the model. And -- but obviously even on that area, when Lanham talked about some of the -- our goal is to increase our productivity and efficiencies. We're doing as much on the capital side as we are on the expense side in trying to improve that. And so whether it's 25% or a little bit higher, a little bit lower, we're driving hard to get to a free cash flow situation, or improve our ability to get to free cash flow, even at higher growth rates.

Jason Armstrong - *Goldman Sachs - Analyst*

Yes, okay. Great. And just -- if you think about the tuck in acquisitions you have done over the course of '08, should we expect more of that going into '09? Or is the product and portfolio mix essentially where you want it at this point?

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

Well I think right now, Jason, we're working on really getting those things integrated and having a big launch. So we will always look at opportunities. We don't have anything near and close right now that we're looking at.

And then I guess just to add on a little bit to your margin question earlier, if you take a look at 2008, we made a decision there in the second quarter to focus on our operating leverage. And so from that point forward, the margins scale quite a bit.

We aren't done with that work yet. And as Bruce says, there may be some variability in it as we go forward. But we're focused on -- we feel like we're off to a good start. Over the second half of the year, we really grew our margins quite a bit. And so we expect to grow this year. Growth helps with that scaling. And we're doing internal efficiency work to help with the scaling as well.

Jason Armstrong - *Goldman Sachs - Analyst*

That's great. Thanks, guys.

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

Yes, thank you.

Operator

We will take our next question from [Natesh Druth] with Bank of America.

Natesh Druth - *Bank of America - Analyst*

Thank you so much for taking my questions. Nice quarter, guys. One quick question I have is on the CapEx side, more specifically the customer gear side of -- if I look at the CapEx growth in 2009 of $75 million to $100 million on the customer gear side, which is more just in time, I believe, more than the deals under expansion, which is one year out. How should I interpret this in terms of the 2009 growth relative to, let's say, your growth two quarters ago? Or rather, your growth expectations two quarters ago?

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

Well, are you asking how we expect to spend that throughout the year? If that's the gist of the question, then of course that will be a function of how fast we grow each quarter.

Certainly the economy's going to play a big part in that, as we've seen when the growth has slowed down. The faster we grow, the more we'll spend on that. It's highly scalable, or it's highly success based. And as we increase growth rates, we'll increase the spend on that.

Natesh Druth - *Bank of America - Analyst*

But how should I interpret your -- because frankly your CapEx is a little lower than what I had in my model. So do I -- how's your revenue growth rate expectation changed because of this CapEx? How should I extrapolate this information to your growth expectations in 2009 versus two quarters ago?

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

Well again, we're not giving revenue growth expectations, other than we think that growth rates -- we believe growth rates will be slower than they were in 2008.

Natesh Druth - *Bank of America - Analyst*

Okay. And one question on seasonality. How do I model seasonality in the first quarter? Or more specifically, the first half versus the second half of the year?

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

Yes, that's a good question. A lot of businesses have a lot of seasonality. And quite honestly, we have very little seasonality. What little we do have, sometimes in the first quarter, some folks will put on applications for the Christmas selling season. And then they take them off in the first quarter.

And so that impacts churn, for instance, a little bit. But that's about all the seasonality we have. And you can look back last year to see how that occurred between the fourth and the first. But other than that, we really don't have much seasonality.

Natesh Druth - *Bank of America - Analyst*

So I should expect that trend -- or the seasonality trend to continue this year as well?

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

I think, yes.

Natesh Druth - *Bank of America - Analyst*

Okay. And one final housekeeping item. Can you break out the number of customers you got from Slice sales?

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

We don't. What we did provide, though, is our total Cloud initiative, and how many customers we have. And the acquisition we did in Slice host has shown up in the fourth quarter.

And so when you see that number increasing quite a bit, obviously a lot of those customers will be the ones that we got from Slice host.

Natesh Druth - *Bank of America - Analyst*

Got it. And the web mail is included in the Cloud revenues, correct?

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

That's correct.

Natesh Druth - *Bank of America - Analyst*

Thank you so much. That's it for me.

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

Thank you.

Operator

This concludes the Q&A portion of the call. At this time, I would like to turn the call back over to Mr. Napier.

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

Well thank you for your interest in us. We are proud of our accomplishments last year in 2008. I want to thank the Rackers for all they have done. And we look forward to working hard this year for you. Thank you.

Operator

This concludes today's conference call. Thank you for your participation, and have a good day.
