UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

☑ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2012.

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______.

Commission file number 001-34143

RACKSPACE HOSTING, INC.
(Exact name of registrant as specified in its charter)

rackspace®
the open cloud company

Delaware	**74-3016523**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**

5000 Walzem Rd.
San Antonio, Texas 78218
(Address of principal executive offices, including zip code)

(210) 312-4000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☑ No ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☑ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☑ Accelerated filer ☐ Non-accelerated filer ☐ Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☑

On November 1, 2012, 136,947,652 shares of the registrant's Common Stock, $0.001 par value, were outstanding.

RACKSPACE HOSTING, INC.
TABLE OF CONTENTS

Table of Contents

PART I – FINANCIAL INFORMATION

ITEM 1 - FINANCIAL STATEMENTS

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)	December 31, 2011	September 30, 2012
		(Unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 159,856	$ 257,651
Accounts receivable, net of allowance for doubtful accounts and customer credits of $3,420 as of December 31, 2011 and $4,031 as of September 30, 2012	68,709	94,271
Deferred income taxes	9,841	7,366
Prepaid expenses	22,006	32,428
Other current assets	2,953	3,733
Total current assets	263,365	395,449
Property and equipment, net	627,490	705,153
Goodwill	59,993	68,742
Intangible assets, net	26,034	25,189
Other non-current assets	49,600	47,232
Total assets	$ 1,026,482	$ 1,241,765
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 156,004	$ 177,328
Current portion of deferred revenue	14,835	15,253
Current portion of obligations under capital leases	66,031	69,961
Current portion of debt	879	2,346
Total current liabilities	237,749	264,888
Non-current deferred revenue	3,446	3,230
Non-current obligations under capital leases	72,216	75,150
Non-current debt	—	2,655
Non-current deferred income taxes	68,781	59,612
Non-current deferred rent	23,343	29,742
Other non-current liabilities	21,524	24,554
Total liabilities	427,059	459,831
COMMITMENTS AND CONTINGENCIES		
Stockholders' equity:		
Common stock, $0.001 par value per share: 300,000,000 shares authorized; 131,912,829 shares issued and outstanding as of December 31, 2011; 136,918,969 shares issued and outstanding as of September 30, 2012	132	137
Additional paid-in capital	383,031	483,196
Accumulated other comprehensive loss	(14,732)	(7,902)
Retained earnings	230,992	306,503
Total stockholders' equity	599,423	781,934
Total liabilities and stockholders' equity	$ 1,026,482	$ 1,241,765

See accompanying notes to the unaudited condensed consolidated financial statements.

**RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)**

(In thousands, except per share data)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2012
Net revenue	$ 264,572	$ 335,985	$ 741,803	$ 956,330
Costs and expenses:				
Cost of revenue	82,445	94,731	226,244	272,023
Sales and marketing	31,838	38,924	93,053	117,039
General and administrative	69,701	93,028	198,232	263,219
Depreciation and amortization	49,518	63,972	140,568	180,931
Total costs and expenses	233,502	290,655	658,097	833,212
Income from operations	31,070	45,330	83,706	123,118
Other income (expense):				
Interest expense	(1,531)	(1,253)	(4,544)	(3,758)
Interest and other income (expense)	(276)	38	(968)	(230)
Total other income (expense)	(1,807)	(1,215)	(5,512)	(3,988)
Income before income taxes	29,263	44,115	78,194	119,130
Income taxes	9,281	16,918	26,830	43,619
Net income	$ 19,982	$ 27,197	$ 51,364	$ 75,511
Other comprehensive income, net of tax				
Foreign currency translation adjustments	$ (3,502)	$ 5,853	$ (633)	$ 6,830
Other comprehensive income (loss)	(3,502)	5,853	(633)	6,830
Comprehensive income	$ 16,480	$ 33,050	$ 50,731	$ 82,341
Net income per share				
Basic	$ 0.15	$ 0.20	$ 0.40	$ 0.56
Diluted	$ 0.14	$ 0.19	$ 0.37	$ 0.54
Weighted average number of shares outstanding				
Basic	130,662	135,946	129,414	134,683
Diluted	138,453	141,474	137,751	140,794

See accompanying notes to the unaudited condensed consolidated financial statements.

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

(In thousands)	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2012
Cash Flows From Operating Activities		
Net income	$ 51,364	$ 75,511
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	140,568	180,931
Loss on disposal of equipment, net	357	962
Provision for bad debts and customer credits	4,462	4,559
Deferred income taxes	9,189	3,793
Deferred rent	8,271	6,329
Share-based compensation expense	21,188	30,302
Excess tax benefits from share-based compensation arrangements	(11,916)	(34,981)
Changes in certain assets and liabilities		
Accounts receivable	(17,363)	(29,103)
Income taxes receivable	4,397	—
Prepaid expenses and other current assets	(10,091)	(11,030)
Accounts payable and accrued expenses	25,329	51,785
Deferred revenue	(1,096)	(292)
All other operating activities	517	524
Net cash provided by operating activities	225,176	279,290
Cash Flows From Investing Activities		
Purchases of property and equipment	(189,898)	(188,034)
Acquisitions, net of cash acquired	(952)	(5,945)
All other investing activities	105	42
Net cash used in investing activities	(190,745)	(193,937)
Cash Flows From Financing Activities		
Principal payments of capital leases	(48,854)	(52,970)
Principal payments of notes payable	(1,476)	(1,911)
Payments for debt issuance costs	(1,114)	—
Payments for deferred acquisition obligations	(2,900)	(4,726)
Proceeds from notes payable	—	691
Receipt of Texas Enterprise Fund Grant	—	3,500
Proceeds from employee stock plans	27,782	31,514
Excess tax benefits from share-based compensation arrangements	11,916	34,981
Net cash provided by (used in) financing activities	(14,646)	11,079
Effect of exchange rate changes on cash and cash equivalents	(46)	1,363
Increase in cash and cash equivalents	19,739	97,795
Cash and cash equivalents, beginning of period	104,941	159,856
Cash and cash equivalents, end of period	$ 124,680	$ 257,651
Supplemental cash flow information:		
Acquisition of property and equipment by vendor financed capital leases	$ 62,755	$ 59,833
Acquisition of property and equipment by vendor financed notes payable	—	5,237
Increase (decrease) in property and equipment in accounts payable and accrued expenses	12,886	(3,437)
Non-cash purchases of property and equipment	$ 75,641	$ 61,633
Shares issued in business combinations	$ —	$ 2,745
Cash payments for interest, net of amount capitalized	$ 4,356	$ 3,588
Cash payments for income taxes	$ 15,417	$ 7,868

See accompanying notes to the unaudited condensed consolidated financial statements.

RACKSPACE HOSTING, INC. AND SUBSIDIARIES—
NOTES TO THE UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Company Overview and Summary of Significant Accounting Policies

Nature of Operations

As used in this report, the terms “Rackspace,” “Rackspace Hosting,” “we,” “our company,” “the company,” “us,” or “our” refer to Rackspace ® Hosting, Inc. and its subsidiaries. Rackspace Hosting, Inc., through its operating subsidiaries, is a provider of cloud computing services, managing web-based IT systems for small and medium-sized businesses as well as large enterprises. We focus on providing a service experience for our customers, which we call Fanatical Support®.

Our operations began in 1998 as a limited partnership, and Rackspace Hosting, Inc. was incorporated in Delaware on March 7, 2000.

Basis of Consolidation

The consolidated financial statements include the accounts of Rackspace Hosting and our wholly-owned subsidiaries, which include, among others, Rackspace US, Inc., our domestic operating entity, and Rackspace Limited, our United Kingdom operating entity. Intercompany transactions and balances have been eliminated in consolidation.

Basis of Presentation

The accompanying consolidated financial statements as of September 30, 2012, and for the three and nine months ended September 30, 2011 and 2012, are unaudited and have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and Rule 10-01 of Regulation S-X. Accordingly, they do not include all financial information and disclosures required by GAAP for complete financial statements, and certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments, which include normal recurring adjustments, necessary for a fair statement of our financial position as of September 30, 2012, our results of operations for the three and nine months ended September 30, 2011 and 2012, and our cash flows for the nine months ended September 30, 2011 and 2012.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto as of December 31, 2011 included in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 17, 2012. The results for the three and nine months ended September 30, 2012 are not necessarily indicative of the results to be expected for the year ending December 31, 2012, or for any other interim period, or for any other future year.

The Company corrected immaterial errors in its Condensed Consolidated Statement of Cash Flows for the nine months ended September 30, 2011 by decreasing purchases of property and equipment reflected in investing activities by $12.9 million with an equal and offsetting reduction in the change in accounts payable and accrued expenses in operating activities. These amounts were inadvertently overstated because property and equipment acquired but unpaid as of the end of the reporting period was included in the amounts previously reported. The correction reduces the Company's net cash provided by operating activities and net cash used in investing activities included within the Condensed Consolidated Statement of Cash Flows by $12.9 million. This correction does not impact the Company's previously reported amounts in its Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2011 or the Company's Condensed Consolidated Balance Sheet as of December 31, 2011.

In connection with (i) the filing of the 2012 Form 10-K and (ii) the filing of the Company's Form 10-Q for the first quarter of 2013, similar adjustments will be made to the Company's Statements of Cash Flows that will decrease (increase) cash flows from operating activities with an equal and offsetting adjustment to cash flows used in investing activities by $23.3 million and $3.7 million for the years ended December 31, 2011 and 2010 and $(7.9) million for the three months ended March 31, 2012, respectively.

Significant Accounting Policies

The accompanying financial statements reflect the application of certain significant accounting policies. There have been no material changes to our significant accounting policies that are disclosed in our audited consolidated financial statements and notes thereto as of December 31, 2011, included in our Annual Report on Form 10-K.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenue and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those related to accounts receivable and customer credits, property and equipment, fair values of intangible assets and goodwill, useful lives of intangible assets, fair value of share-based compensation, contingencies, and income taxes, among others. Whenever possible, we base our estimates and assumptions on historical experience. However, certain estimates require us to make assumptions about expected future cash flow, events and usage patterns that we cannot influence or control. Our judgments, assumptions and estimates are based upon facts and circumstances known to us when we prepare the financial statements and that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities or recording revenue and expenses in our financial statements. Changes in facts and circumstances may cause us to change our assumptions and estimates in future periods, and it is possible that actual results could differ from our estimates. We engaged third-party consultants to assist management in the valuation of acquired assets, including other intangibles.

Recently Adopted Accounting Pronouncements

In May 2011, the FASB issued guidance to amend certain fair value measurement principles and disclosure requirements in order to reduce differences between U.S. GAAP and International Financial Reporting Standards. Specifically, the new guidance limits the "highest and best use" measure to non-financial instruments, provides guidance on the applicability of premiums and discounts, and expands the disclosure requirements related to Level 3 fair value measurements. This guidance became effective for us at the beginning of this year but did not have a material impact on our consolidated financial statements.

In June 2011, the FASB issued guidance that eliminates the option to report other comprehensive income and its components in the statement of stockholders' equity. Instead, an entity will be required to present items of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements. This guidance became effective for us this year, and we have modified our presentation of other comprehensive income accordingly.

In September 2011, the FASB issued guidance that is intended to reduce the cost and complexity of the annual goodwill impairment test by providing entities an option to perform a "qualitative" assessment to determine whether further impairment testing is necessary. Specifically, an entity has the option to first assess qualitative factors to determine whether it is necessary to perform the current two-step test. If an entity believes, as a result of its qualitative assessment, that it is more-likely-than-not that the fair value of a reporting unit is less than its carrying amount, the quantitative impairment test is required. Otherwise, no further testing is required. This standard became effective for our annual and interim goodwill impairment tests performed after January 1, 2012. The adoption of this new guidance did not have a material impact on our financial statements.

2. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per share data)	Three Months Ended September 30, 2011	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2011	Nine Months Ended September 30, 2012
Basic net income per share:				
Net income	$ 19,982	$ 27,197	$ 51,364	$ 75,511
Weighted average shares outstanding:				
Common stock	130,662	135,946	129,414	134,683
Number of shares used in per share computations	130,662	135,946	129,414	134,683
Earnings per share	$ 0.15	$ 0.20	$ 0.40	$ 0.56
Diluted net income per share:				
Net income	$ 19,982	$ 27,197	$ 51,364	$ 75,511
Weighted average shares outstanding:				
Common stock	130,662	135,946	129,414	134,683
Stock options, awards and employee share purchase plan	7,791	5,528	8,337	6,111
Number of shares used in per share computations	138,453	141,474	137,751	140,794
Earnings per share	$ 0.14	$ 0.19	$ 0.37	$ 0.54

We excluded 1.6 million and 1.5 million potential common shares from the computation of dilutive earnings per share for the three months ended September 30, 2011 and 2012, respectively, and 1.1 million and 1.1 million potential shares for the nine months ended September 30, 2011 and 2012, respectively, because the effect would have been anti-dilutive.

3. Cash and Cash Equivalents

Cash and cash equivalents consisted of:

(In thousands)	December 31, 2011	September 30, 2012
Cash deposits	$ 119,115	$ 141,788
Money market funds	40,741	115,863
Cash and cash equivalents	$ 159,856	$ 257,651

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. We actively monitor the third-party depository institutions that hold our deposits. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds.

Our money market mutual funds comply with SEC Rule 2a-7 and invest exclusively in high-quality, short-term obligations that include securities issued or guaranteed by the U.S. government or by U.S. government agencies and floating rate and variable rate demand notes of U.S. and foreign corporations. During the quarter ended September 30, 2012, we modified our cash management strategy to invest a larger portion of our available cash in money market funds rather than in sweep accounts and other cash deposit accounts.

4. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. There is a three-tier fair value of hierarchy, which prioritizes the inputs used in measuring fair value as follows:

Level 1 – Observable inputs such as quoted prices in active markets for identical assets or liabilities;

Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 – Unobservable inputs that are supported by little or no market activity, which require management judgment or estimation.

There have been no material changes to the valuation techniques utilized in the fair value measurement of assets and liabilities presented on our balance sheet as disclosed in our Form 10-K for the year ended December 31, 2011.

Assets and liabilities measured at fair value on a recurring basis are summarized by level below. The table does not include assets and liabilities that are measured at historical costs or any other basis other than fair value.

	December 31, 2011			
(In thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 40,741	$ —	$ —	$ 40,741
Rabbi trust (2)	293	—	—	293
Total	$ 41,034	$ —	$ —	$ 41,034
Liabilities:				
Deferred compensation (3)	$ 187	$ —	$ —	$ 187
Total	$ 187	$ —	$ —	$ 187

	September 30, 2012			
(In thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total Assets/Liabilities at Fair Value
Assets:				
Money market funds (1)	$ 115,863	$ —	$ —	$ 115,863
Rabbi trust (2)	488	—	—	488
Total	$ 116,351	$ —	$ —	$ 116,351
Liabilities:				
Deferred compensation (3)	$ 378	$ —	$ —	$ 378
Total	$ 378	$ —	$ —	$ 378

(1) Money market funds are classified in cash and cash equivalents.
(2) Investments in marketable securities held in a Rabbi Trust associated with a non-qualified deferred compensation plan are classified in other non-current assets.
(3) Obligations to pay benefits under a non-qualified deferred compensation plan are classified in other non-current liabilities.

Our Rabbi Trust was established in 2009, and we elected the fair value option, which allows for the recognition of gains and losses to be recorded in the statement of income in the same period as the gains and losses are incurred as part of the non-qualified deferred compensation plan. During the three and nine months ended September 30, 2011 and September 30, 2012, we recognized minimal net gains as interest and other income.

5. Property and Equipment, net

Property and equipment consisted of:

(In thousands)	Estimated Useful Lives	December 31, 2011	September 30, 2012
Computers, software and equipment	1 - 5 years	$ 898,045	$ 1,103,948
Furniture and fixtures	7 years	34,000	39,086
Buildings and leasehold improvements	2 - 30 years	201,639	212,756
Land		13,860	15,864
Property and equipment, at cost		1,147,544	1,371,654
Less accumulated depreciation and amortization		(582,794)	(716,925)
Work in process		62,740	50,424
Property and equipment, net		$ 627,490	$ 705,153

Depreciation and leasehold amortization expense, not including amortization expense for intangible assets, was $48.5 million and $61.9 million for the three months ended September 30, 2011 and 2012, respectively, and $136.8 million and $174.2 million for the nine months ended September 30, 2011 and 2012, respectively.

At December 31, 2011, the work in process balance consisted of build outs of $28.0 million for office facilities, $3.6 million for data centers, and $31.2 million for capitalized software and other projects. At September 30, 2012, the work in process balance consisted of build outs of $29.6 million for office facilities, $2.9 million for data centers, and $17.9 million for capitalized software and other projects.

There was no interest capitalized during the three or nine months ended September 30, 2011 and 2012.

6. Business Combinations and Goodwill

During the first nine months of 2012, we acquired two companies for total cash and equity consideration of $10.9 million, of which approximately $8.7 million was attributed to goodwill, $2.3 million to acquired intangible assets and $(0.1) million to other net liabilities acquired. The acquisitions were accounted for using the acquisition method, and the purchase prices were allocated based on the estimated fair values of the individual assets acquired and liabilities assumed at the date of acquisition. A portion of the consideration transferred included additional cash payments due in the future. The fair value of the remaining payments to be made of $1.4 million as of September 30, 2012 is recorded as a liability. The consolidated statements of comprehensive income include the results of operations for the acquired companies commencing on their respective acquisition dates. Pro forma results of operations for these acquisitions have not been presented because they are not material to the consolidated results of operations, either individually or in aggregate.

With respect to the intangible assets acquired during the first nine months of 2012, developed technology has a weighted-average useful life of 3.0 years, and customer relationships and other intangible assets have a weighted-average useful life of 7.9 years.

The following table provides a roll forward of our goodwill balance.

(In thousands)		
Balance at December 31, 2011	$	59,993
Acquisitions		8,749
Balance at September 30, 2012	$	68,742

Of the $8.7 million of goodwill recorded for the acquisitions in 2012, $2.2 million is deductible for tax purposes.

In prior periods, we acquired companies that required additional future payments in addition to the initial cash payment. During the first nine months of 2012, we paid $5.3 million related to these previous acquisitions, and as of September 30, 2012, the fair value of the remaining liability recorded was $2.2 million.

7. Accounts Payable and Accrued Expenses

Accounts payable and accrued expenses consisted of:

(In thousands)	December 31, 2011	September 30, 2012
Trade payables	$ 51,097	$ 51,876
Accrued compensation and benefits	41,767	48,894
Income and other taxes payable	16,778	24,873
Vendor accruals	32,458	41,126
Other liabilities	13,904	10,559
Accounts payable and accrued expenses	$ 156,004	$ 177,328

8. Debt

Debt outstanding at December 31, 2011 consisted of current notes payable of $0.9 million, which was paid during the first nine months of 2012. In the nine months ended September 30, 2012, we entered into new financing arrangements with vendors, resulting in a $5.0 million notes payable balance at September 30, 2012, $2.3 million of which was current. The notes require periodic payments of principal net interest through July 2015.

We also have a revolving credit facility, which has a total commitment of $200 million and matures in September 2016. As of September 30, 2012, there were no borrowings outstanding under the facility except for an immaterial outstanding letter of credit. As of the same date, we were in compliance with all of the covenants under our facility.

9. Commitments and Contingencies

Legal Proceedings

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. Although the outcome of these matters is currently not determinable, management expects that any losses that are incurred as a result of these matters, which are in excess of amounts already accrued in its consolidated balance sheet, would not be material to the financial statements as a whole. In addition, we are involved in the following legal proceedings:

On October 22, 2008, *Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston* was filed in the 37th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us . We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

We are also a party to various claims that certain of our products, services, and technologies infringe the intellectual property rights of others. Adverse results in these lawsuits may include awards of substantial monetary damages, costly royalty or licensing agreements, or orders preventing us from offering certain features, products, or services, and may also cause us to change our business practices and require development of non-infringing products or technologies, which could result in a loss of revenue for us and otherwise harm our business. We have disputed the allegations of wrongdoing in these proceedings and intend to vigorously defend ourselves in all such matters.

Contingent Liability

We recorded a $1.0 million charge in the first quarter of 2012 as cost of revenue related to an unresolved contractual issue with a vendor. We have recorded a loss contingency liability with respect to this matter, but due to the uncertainty regarding the interpretation of certain contractual terms, it is possible the ultimate loss may exceed the amount currently accrued.

Incentive Arrangements

During the first quarter of 2012, we received $3.5 million related to our agreement with the State of Texas, under which we are eligible to receive up to an additional $13.5 million from the Texas Enterprise Fund in multiple installments to be used for capital improvements, provided that we meet certain new job levels in the State of Texas. We are responsible for maintaining the jobs until January 2022. If we eliminate jobs for which we have drawn funds, we are subject to a clawback on the amounts we have drawn plus 3.4% interest on such amounts per year. As of September 30, 2012, the total $8.5 million received under this agreement was deferred and recorded as other non-current liabilities. Amounts will be recognized into income upon the achievement of the performance criteria and the determination that the cash is no longer refundable to the State of Texas.

10. Share-Based Compensation

At our 2012 annual meeting of the stockholders held on May 2, 2012, our stockholders approved certain amendments to our Amended and Restated 2007 Long-Term Incentive Plan (the "2007 Plan"). The amendments included, among other things, setting a fixed number of shares available of 12 million, removing the evergreen provision and requiring new grants of restricted stock, restricted stock units, performance units and performance shares to count against the numerical limits of the 2007 Plan as 1.76 shares for every one share that is subject to such an award.

The following have been granted under our 2007 Plan in 2012: stock options, restricted stock units (RSUs) and restricted stock awards (RSAs). Collectively, all such grants are referred to as "awards." All awards deduct one share from the 2007 Plan shares available for issuance for each share granted, except as described above. To the extent awards granted under the 2007 Plan terminate, expire or lapse for any reason, shares subject to such awards will again be available for future grant. In January 2012, an additional 5.9 million shares became available for future awards pursuant to the automatic share reserve increase or "evergreen" provision under the 2007 Plan; however, as stated above, the authorized shares available for issuance under the Plan was reduced upon approval of our stockholders at our 2012 annual meeting of the stockholders. Therefore, as of September 30, 2012, the total number of shares authorized under all of our plans, including shares issued pursuant to awards, total outstanding awards and shares available for future awards under the plans, was 43.0 million shares, of which approximately 10.6 million shares were available for future awards.

Outstanding awards were as follows:

	December 31, 2011	September 30, 2012
Restricted stock	3,446,970	2,832,545
Stock options	12,043,413	9,964,152
Total outstanding awards	15,490,383	12,796,697

Restricted Stock

The following table summarizes our RSU and RSA activity for the nine months ended September 30, 2012:

	Number of Units	Weighted Average Grant Date Fair Value
Outstanding at December 31, 2011	3,446,970	$ 14.87
Granted	872,151	$ 50.83
Released (1)	(1,366,829)	$ 9.22
Cancelled	(119,747)	$ 29.41
Outstanding at September 30, 2012	2,832,545	$ 28.06
Expected to vest after September 30, 2012*	2,550,502	$ 25.85

(1) Includes 5,360 shares of RSUs issued to certain members of our board of directors.
*Includes reduction of shares outstanding due to estimated forfeitures

The weighted average grant date fair value of RSUs and RSAs granted during the three months ended September 30, 2011 and 2012 was $34.85 and $54.10, respectively, and $36.10 and $50.83 during the nine months ended September 30, 2011 and 2012, respectively. The total pre-tax intrinsic value of the RSUs and RSAs released during the three months ended September 30, 2011 and 2012 was $2.4 million and $9.2 million, respectively, and $6.6 million and $73.3 million for the nine months ended September 30, 2011 and 2012, respectively.

We granted 666,462 RSUs and 205,689 RSAs in 2012, of which 712,089 vest as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date. The fair value of these service-vesting awards is measured based on the closing fair market value of our common stock on the date of grant, and share-based compensation expense is recognized ratably over the four-year service period. The remaining awards were granted to members of our executive team. The vesting of 50,611 of these awards is dependent upon the total shareholder return (TSR) on our common stock for a three-year performance period as compared to the components of the NASDAQ Internet Index over this same period. In addition, the company's TSR must be positive for vesting to occur. The vesting of 109,451 of these awards is dependent upon a market condition as well as certain predetermined operating results over the next 3 years. The fair values of these performance-vesting and market-vesting awards was measured using a Monte Carlo simulation based on the date of grant, and share-based compensation expense is recognized ratably over the three-year vesting period.

As of September 30, 2012, there was $63.5 million of total unrecognized compensation cost related to non-vested RSUs and RSAs, which will be amortized using the straight-line method over a remaining weighted average period of 2.2 years.

Stock Options

The following table summarizes the stock option activity for the nine months ended September 30, 2012:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2011	12,043,413	$ 13.22	5.93	$ 358,754
Granted	1,561,553	$ 53.83		
Exercised	(3,252,535)	$ 8.95		
Cancelled	(388,279)	$ 30.95		
Outstanding at September 30, 2012	9,964,152	$ 20.29	5.45	$ 456,360
Vested and exercisable at September 30, 2012	5,140,223	$ 8.20	4.77	$ 297,576
Vested and exercisable at September 30, 2012 and expected to vest thereafter*	9,257,317	$ 18.76	5.39	$ 438,161

*Includes reduction of shares outstanding due to estimated forfeitures

The stock options granted in 2012 vest as the employee continues to be employed with us, in four equal installments, on each of the first, second, third and fourth anniversaries of the grant date and have a term of seven years.

The total pre-tax intrinsic value of the stock options exercised during the three months ended September 30, 2011 and 2012 was $16.9 million and $50.6 million, respectively, and $121.0 million and $149.2 million for the nine months ended September 30, 2011 and 2012, respectively.

The following table presents the assumptions used to estimate the fair values of the stock options granted in the periods presented:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2012	2011	2012
Expected stock volatility	57%	56%	56% - 57%	56% - 58%
Expected dividend yield	—%	—%	—%	—%
Risk-free interest rate	0.85%	0.54% - 0.56%	0.85% - 2.35%	0.54% - 0.77%
Expected life	4.75 years	4 years	4.75 years	4 - 4.75 years
Weighted average grant date fair value of options granted during the period	$16.87	$23.10	$17.99	$24.33

As of September 30, 2012, there was $64.4 million of total unrecognized compensation cost related to non-vested stock options that we have granted, which will be amortized using the straight-line method over a weighted average period of 2.4 years.

Employee Stock Purchase Plan

An Employee Stock Purchase Plan (ESPP) was approved by the Company's Board of Directors in 2011 and adopted by the Company on January 1, 2012. Under the ESPP, eligible employees may purchase a limited number of shares of the Company's common stock at the lesser of 85% of the market value on the enrollment date or the purchase date. The ESPP is made up of a series of offering periods. Each offering period has a maximum term of 24 months and is divided into semi-annual purchase intervals. Eligible employees may enroll at the beginning of any semi-annual purchase interval. During the nine months ended September 30, 2012, the Company issued 68,203 shares under the ESPP. The fair value on each of the dates of enrollment was determined using the Black-Scholes option-pricing model.

The fair values estimated from the Black-Scholes option-pricing model were calculated using the following assumptions:

	1/1/12 Enrollment	7/1/12 Enrollment
Expected stock volatility	48% - 53%	41% - 47%
Expected dividend yield	—%	—%
Risk-free interest rate	0.06% - 0.25%	0.16% - 0.27%
Expected life	0.5 - 2.0 years	0.5 - 1.5 years
Weighted average fair value	$15.51	$14.27

The weighted average fair values per share will be recognized ratably over the remaining term.

Share-based Compensation

Share-based compensation expense was recognized as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2011	2012	2011	2012
Cost of revenue	$ 1,005	$ 1,282	$ 3,173	$ 3,631
Sales and marketing	864	1,943	1,474	4,450
General and administrative	5,526	9,193	16,541	22,221
Pre-tax share-based compensation	7,395	12,418	21,188	30,302
Less: Income tax benefit	(2,323)	(4,729)	(7,270)	(11,095)
Total share-based compensation expense, net of tax	$ 5,072	$ 7,689	$ 13,918	$ 19,207

11. Taxes

We are subject to U.S. federal income tax and various state, local, and international income taxes in numerous jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenue and expenses in different jurisdictions and the timing of recognizing revenue and expenses. As such, our effective tax rate is impacted by the geographical distribution of income and mix of profits in the various jurisdictions. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file.

We expect a taxable profit in the U.S. and U.K. for the full year 2012, and therefore we anticipate utilizing benefits of tax deductions related to stock compensation in 2012. As a result, we have recognized an income tax receivable or excess tax benefit in the U.S. and U.K. during the current period.

The following table provides a roll forward of our balance of unrecognized tax benefits, excluding accrued interest.

(In thousands)		
December 31, 2011	$	16,729
Additions based on tax positions related to the current year		—
Additions for tax positions of prior years		—
Reductions for tax positions of prior years		(11)
Settlements		—
September 30, 2012	$	16,718

As of September 30, 2012, approximately $3.0 million of these unrecognized tax benefits, if recognized, would favorably impact our effective tax rate in any future period. Also included in the balance of unrecognized tax benefits at September 30, 2012 are liabilities of $12.6 million that, if recognized, would be recorded as an adjustment to other current and non-current assets.

12. Comprehensive Income

The income tax expense allocated to foreign currency translation adjustments during the three and nine months ended September 30, 2011 was $0.2 million and $0.1 million, respectively. Minimal income tax expense was allocated to these adjustments during the three and nine months ended September 30, 2012.

The change in accumulated other comprehensive income (loss) for the nine months ended September 30, 2012 was as follows:

(In thousands)		Accumulated other comprehensive loss
Balance at December 31, 2011	$	(14,732)
Foreign currency cumulative translation adjustment, net of taxes		6,830
Balance at September 30, 2012	$	(7,902)

13. Segment Information

We operate as one reportable segment based upon the financial information that our chief executive officer, who is the chief operating decision maker, regularly reviews to decide how to allocate resources and assess performance. We periodically review and align our internal reporting structure as our product and service offerings and our customer base expand in reach and presence to ensure our organization effectively serves the diverse and evolving Cloud Computing market. Since we operate in one reportable segment, all relevant financial information used to allocate resources and assess performance can be found in the consolidated financial statements.

Revenue is attributed to geographic location based on the Rackspace Hosting operating location that enters into the contractual relationship with the customer, either the U.S. or International, primarily the U.K. Total net revenue by geographic region was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2011	2012	2011	2012
United States	$ 198,250	$ 250,445	$ 554,754	$ 712,126
International	66,322	85,540	187,049	244,204
Total net revenue	$ 264,572	$ 335,985	$ 741,803	$ 956,330

Total net revenue by our product categories was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(In thousands)	2011	2012	2011	2012
Dedicated Cloud	$ 213,899	$ 256,559	$ 611,069	$ 739,580
Public Cloud	50,673	79,426	130,734	216,750
Total net revenue	$ 264,572	$ 335,985	$ 741,803	$ 956,330

Our long-lived assets are primarily located in the U.S. and the U.K., and to a lesser extent Hong Kong. Property and equipment, net by geographic region was as follows:

(In thousands)	December 31, 2011	September 30, 2012
United States	$ 485,608	$ 527,492
International	141,882	177,661
Total property and equipment, net	$ 627,490	$ 705,153

ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

References to "we," "our," "our company," "us," "the company," "Rackspace Hosting," or "Rackspace" refer to Rackspace Hosting, Inc. and its consolidated subsidiaries. We have made forward-looking statements in this Quarterly Report on Form 10-Q that are subject to risks and uncertainties. Forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, are subject to the "safe harbor" created by those sections. The forward-looking statements in this report are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as "anticipates," "aspires," "believes," "can," "continue," "could," "estimates," "expects," "intends," "may," "plans," "projects," "seeks," "should," "will" or "would" or the negative of these terms and similar expressions intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this document in greater detail under the heading "Risk Factors." We believe it is important to communicate our expectations to our investors. However, there may be events in the future that we are not able to predict accurately or over which we have no control. The risks described in "Risk Factors" included in this report, as well as any other cautionary language in this report, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of the events described in "Risk Factors" and elsewhere in this report could harm our business.

Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this document completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. 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.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes contained elsewhere in this document.

Overview of our Business

We are the open cloud company, delivering open source technologies at web scale with a portfolio of cloud computing services. Our growth is the result of our technology leadership and our renowned service, known as Fanatical Support. We also distinguish ourselves through our innovative approach to cloud computing, our broad portfolio of services and our leadership in open standards that promote faster innovation and give customers freedom of movement among cloud providers. We are a founder of OpenStack®, the world's fastest-growing open cloud platform and developer community. We are also a pioneer in Hybrid Hosting, which combines the security, performance and scalability of our Dedicated and Public Cloud hosting services, integrated through our RackConnect® offering.

We offer a portfolio of cloud computing services, including Dedicated Cloud hosting, Public Cloud hosting, Hybrid hosting and Private Cloud software and related support. The equipment (servers, routers, switches, firewalls, load balancers, cabinets, software, wiring, etc.) required to deliver services is typically purchased and managed by us. We are committed to delivering Fanatical Support for the open cloud and our entire product portfolio, and we will continue to pursue our vision to be considered one of the world's great service companies.

We sell our services to small and medium-sized businesses, as well as large enterprises. For the first nine months of 2012, 26% of our net revenue was generated by our operations outside of the U.S., mainly from the U.K. Additionally, we operate a Hong Kong data center and sales office and recently announced the opening of a data center and sales office in Australia. Our growth strategy includes, among other strategies, targeting international customers as we plan to continue our expansion in continental Europe, the Asia-Pacific region and Latin America. For the first nine months of 2012, no individual customer accounted for greater than 2% of our net revenue.

Product and Service Offerings

We continue to invest in our Public Cloud service and believe it is a critical part of our future success. Public Cloud continues to emerge as a new technology with high adoption rates and investment, which is reflected in its high revenue growth rate. The primary benefit of Public Cloud is the value proposition that it provides for businesses because it enables them to match costs directly to revenue and to scale up and down on a real-time basis as necessary. We do not believe that Public Cloud will replace traditional Dedicated Cloud hosting offerings because we believe the two complement one another, allowing customers to choose the best platform for each of their applications. A focus in our growth strategy is to build our product portfolio to include higher service levels and additional capabilities. We are investing heavily in this strategy and are creating new technologies to help businesses leverage the benefits of Public Cloud hosting.

Our product strategy includes the development of a variety of new capabilities and features and building a support business around the OpenStack cloud computing platform. In August 2012, we announced the unlimited availability of Cloud Databases and Cloud Servers powered by OpenStack, along with a powerful new Control Panel. These solutions, backed by Fanatical Support, further expand our portfolio. The introduction of these open cloud products marks the first time any company has deployed a large-scale open source public cloud powered by OpenStack. Customers can now select from private, public or hybrid offerings and have the flexibility to deploy their solutions in one of our data centers or another data center of their choice. We also announced the release of Rackspace Private Cloud, powered by OpenStack, making it simple and easy for companies to install, test and run an OpenStack based private cloud environment. The offering enables Rackspace to extend Fanatical Support beyond the bounds of our data centers by remotely supporting and managing OpenStack environments that run in almost any data center and could become a meaningful part of our growth strategy in the long term. In addition to these announcements, we also introduced the following new products and services during the quarter:

- Rackspace Cloud Monitoring, a flexible and scalable solution that empowers customers to track the health of their infrastructure, including websites, ports and protocols. The service provides real-time alerts allowing customers to react quickly and help prevent downtime. With Rackspace Cloud Monitoring, customers can monitor their infrastructure whether it's hosted on-premise, off-premise, with any cloud provider or any location across the globe.

- The industry's first certification program for OpenStack. Rackspace is launching the certification program for application developers and engineers of OpenStack beginning with a Rackspace Certified Technician for an OpenStack certification exam. This foundational certification is earned when an OpenStack professional has demonstrated the skills necessary to utilize and operate an OpenStack cloud.

Subsequent to quarter-end, we launched two additional products: Cloud Block Storage and Cloud Networks. Cloud Block Storage provides a superior approach to attached storage in the Cloud by addressing customer demand for consistent and affordable performance for file systems, databases and other input/output intensive applications. Cloud Networks allows customers to create isolated, multi-tiered networks on our Cloud Servers powered by OpenStack, all with the click of a button.

These initiatives are still in the early stages, and while we believe that these new capabilities and features could drive future incremental demand, there are certain risks associated with such a significant product transition and platform shift.

We believe these risks could adversely impact our ability to execute on our growth strategy and therefore capitalize on the current market opportunity, both in the short and long term. They include: (i) the acceptance by current and prospective customers of our new Public Cloud and Rackspace Private Cloud platform and product set, (ii) increasing competition in our industry by competitors that have greater financial, technical, and marketing resources; larger customer bases; longer operating histories; greater brand recognition; more established relationships in the industry; and the ability to acquire competitors and suppliers to increase their market presence and vertical reach capabilities, (iii) new pricing strategies that may include lowering price points for Cloud products to recognize increasing technological efficiencies and offering discounted usage and volume-based pricing for our Cloud products to certain significant Cloud customers, (iv) the adoption of OpenStack as the ubiquitous open source cloud computing platform standard for public and private clouds, which could be negatively impacted by a delay in product releases, (v) unfavorable economic conditions, worldwide political and economic uncertainties and specific conditions in the markets we serve, including the current volatile economic environment found in Europe, and (vi) other risks as set forth in the section titled "Risk Factors."

Recent Developments

In February 2012 we acquired SharePoint911, an industry leader in SharePoint consulting, training, and "JumpStart" services within SharePoint, and in August 2012 we acquired Mailgun, an email services company. While the acquisitions did not have a material impact on the results of the quarter, the acquisitions further enhance our portfolio of products and services. We expect to make additional, similar acquisitions in the future that can increase our service capabilities and product offerings.

In August 2012, we announced the opening of a data center in Australia, which enables us to offer local Dedicated Cloud solutions to Australian customers who prefer to keep their data onshore. The data center will also provide the infrastructure to launch an OpenStack-based open cloud platform in the future.

Key Metrics

We carefully track several financial and operational metrics to monitor and manage our growth, financial performance, and capacity. Our key metrics are structured around growth, profitability, capital efficiency, infrastructure capacity, and utilization. The following data should be read in conjunction with the consolidated financial statements, the notes to the financial statements and other financial information included in this Quarterly Report on Form 10-Q.

(Dollar amounts in thousands, except average monthly revenue per server)	Three Months Ended (Unaudited) September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012	September 30, 2012
Growth					
Dedicated Cloud, net revenue	$ 213,899	$ 224,808	$ 236,604	$ 246,417	$ 256,559
Public Cloud, net revenue	$ 50,673	$ 58,453	$ 64,751	$ 72,573	$ 79,426
Net revenue	$ 264,572	$ 283,261	$ 301,355	$ 318,990	$ 335,985
Revenue growth (year over year)	32.5 %	31.9 %	31.0 %	29.0 %	27.0 %
Net upgrades (monthly average)	1.8 %	2.0 %	1.5 %	1.7 %	1.6 %
Churn (monthly average)	-0.9 %	-0.8 %	-0.8 %	-0.8 %	-0.8 %
Growth in installed base (monthly average) (2)	0.9 %	1.2 %	0.7 %	1.0 %	0.8 %
Number of customers at period end (3)	161,422	172,510	180,866	190,958	197,635
Number of employees (Rackers) at period end	3,799	4,040	4,335	4,528	4,596
Number of servers deployed at period end	78,717	79,805	82,438	84,978	89,051
Average monthly revenue per server	$ 1,155	$ 1,191	$ 1,238	$ 1,270	$ 1,287
Profitability					
Income from operations	$ 31,070	$ 39,765	$ 37,084	$ 40,704	$ 45,330
Depreciation and amortization	$ 49,518	$ 54,844	$ 55,151	$ 61,808	$ 63,972
Share-based compensation expense					
Cost of revenue	$ 1,005	$ 1,047	$ 1,236	$ 1,113	$ 1,282
Sales and marketing	$ 864	$ 839	$ 1,114	$ 1,393	$ 1,943
General and administrative	$ 5,526	$ 5,699	$ 6,159	$ 6,869	$ 9,193
Total share-based compensation expense	$ 7,395	$ 7,585	$ 8,509	$ 9,375	$ 12,418
Adjusted EBITDA (1)	$ 87,983	$ 102,194	$ 100,744	$ 111,887	$ 121,720
Adjusted EBITDA margin	33.3 %	36.1 %	33.4 %	35.1 %	36.2 %
Operating income margin	11.7 %	14.0 %	12.3 %	12.8 %	13.5 %
Income from operations	$ 31,070	$ 39,765	$ 37,084	$ 40,704	$ 45,330
Effective tax rate	31.7 %	34.5 %	35.5 %	35.7 %	38.3 %
Net operating profit after tax (NOPAT) (1)	$ 21,221	$ 26,046	$ 23,919	$ 26,173	$ 27,969
NOPAT margin	8.0 %	9.2 %	7.9 %	8.2 %	8.3 %
Capital efficiency and returns					
Interest bearing debt	$ 144,152	$ 139,126	$ 143,978	$ 149,226	$ 150,112
Stockholders' equity	$ 551,049	$ 599,423	$ 668,436	$ 714,819	$ 781,934
Less: Excess cash	$ (92,931)	$ (125,865)	$ (150,368)	$ (177,169)	$ (217,333)
Capital base	$ 602,270	$ 612,684	$ 662,046	$ 686,876	$ 714,713
Average capital base	$ 575,298	$ 607,477	$ 637,365	$ 674,461	$ 700,795
Capital turnover (annualized)	1.84	1.87	1.89	1.89	1.92
Return on capital (annualized) (1)	14.8 %	17.2 %	15.0 %	15.5 %	16.0 %
Capital expenditures					
Purchases of property and equipment	$ 67,916	$ 56,629	$ 67,604	$ 65,786	$ 54,644
Non-cash purchases of property and equipment	$ 25,642	$ 22,726	$ 14,712	$ 16,182	$ 30,739
Total capital expenditures	$ 93,558	$ 79,355	$ 82,316	$ 81,968	$ 85,383
Customer gear	$ 53,643	$ 47,376	$ 52,999	$ 53,746	$ 51,026
Data center build outs	$ 16,715	$ 6,568	$ 9,473	$ 3,285	$ 5,767
Office build outs	$ 8,806	$ 9,915	$ 4,666	$ 4,015	$ 3,413
Capitalized software and other projects	$ 14,394	$ 15,496	$ 15,178	$ 20,922	$ 25,177
Total capital expenditures	$ 93,558	$ 79,355	$ 82,316	$ 81,968	$ 85,383
Infrastructure capacity and utilization					
Megawatts under contract at period end	41.9	48.1	47.8	58.0	58.0
Megawatts available for use at period end	29.7	30.7	32.2	32.7	33.7
Megawatts utilized at period end	20.2	20.9	21.4	22.7	23.5
Annualized net revenue per average Megawatt of power utilized	$ 53,994	$ 55,136	$ 56,994	$ 57,867	$ 58,179

(1) See discussion and reconciliation of our Non-GAAP financial measures to the most comparable GAAP measures.
(2) Due to rounding, totals may not equal the sum of the line items in the table above.
(3) Customers are counted on an account basis, and therefore a customer with more than one account with us would be included as more than one customer. Furthermore, amounts include SaaS customers for Jungle Disk using a Rackspace storage solution. Jungle Disk customers using a third-party storage solution are excluded.

Non-GAAP Financial Measures

Return on Capital (ROC) (Non-GAAP financial measure)

We define Return on Capital as follows: ROC = Net operating profit after tax (NOPAT) / Average capital base

NOPAT = Income from operations x (1 – Effective tax rate)

Average capital base = Average of (Interest bearing debt + stockholders' equity – excess cash) = Average of (Total assets – excess cash – accounts payables and accrued expenses – deferred revenue – other non-current liabilities, deferred income taxes, and deferred rent)

Year-to-date average balances are based on an average calculated using the quarter-end balances at the beginning of the period and all other quarter-ending balances included in the period.

We define excess cash as the amount of cash and cash equivalents that exceeds our operating cash requirements, which is calculated as three percent of our annualized net revenue for the three months prior to the period end. We will periodically review the calculation and adjust it to reflect our projected cash requirements for the upcoming year.

We believe that ROC is an important metric for investors in evaluating our company's performance. ROC relates to after-tax operating profits with the capital that is placed into service. It is therefore a performance metric that incorporates both the Statement of Comprehensive Income and the Balance Sheet. ROC measures how successfully capital is deployed within a company.

Note that ROC is not a measure of financial performance under GAAP and should not be considered a substitute for return on assets, which we calculate directly from amounts on the Statement of Comprehensive Income and the Balance Sheet. ROC has limitations as an analytical tool, and when assessing our operating performance, you should not consider ROC in isolation or as a substitute for other financial data prepared in accordance with GAAP. Other companies may calculate ROC differently than we do, limiting its usefulness as a comparative measure.

ROC increased from 14.8% for the three months ended September 30, 2011 to 16.0% for the three months ended September 30, 2012, primarily due to a reduction of operating costs as a percentage of revenue, partially offset by growth in our capital base. Included in the average capital base are capital expenditures of $30.8 million and $41.8 million related to the build-out of our corporate headquarters and data centers, respectively, since the beginning of the third quarter of 2011.

Return on assets increased from 8.6% for the three months ended September 30, 2011 to 9.1% for the three months ended September 30, 2012. This increase was primarily due to operating expenses decreasing as a percentage of revenue, partially offset by growth in our asset base due to the purchase of property and equipment to support the growth of our business.

Table of Contents

See our reconciliation of the calculation of return on assets to ROC in the following table:

(In thousands)	Three Months Ended September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012	September 30, 2012
Income from operations	$ 31,070	$ 39,765	$ 37,084	$ 40,704	$ 45,330
Effective tax rate	31.7%	34.5%	35.5%	35.7%	38.3%
Net operating profit after tax (NOPAT)	$ 21,221	$ 26,046	$ 23,919	$ 26,173	$ 27,969
Net income	$ 19,982	$ 25,047	$ 23,180	$ 25,134	$ 27,197
Total assets at period end	$ 970,677	$ 1,026,482	$ 1,089,393	$ 1,138,728	$ 1,241,765
Less: Excess cash	(92,931)	(125,865)	(150,368)	(177,169)	(217,333)
Less: Accounts payable and accrued expenses	(148,464)	(156,004)	(153,668)	(148,091)	(177,328)
Less: Deferred revenue (current and non-current)	(17,772)	(18,281)	(20,195)	(19,227)	(18,483)
Less: Other non-current liabilities, deferred income taxes, and deferred rent	(109,240)	(113,648)	(103,116)	(107,365)	(113,908)
Capital base	$ 602,270	$ 612,684	$ 662,046	$ 686,876	$ 714,713
Average total assets	$ 929,127	$ 998,580	$ 1,057,938	$ 1,114,061	$ 1,190,247
Average capital base	$ 575,298	$ 607,477	$ 637,365	$ 674,461	$ 700,795
Return on assets (annualized)	8.6%	10.0%	8.8%	9.0%	9.1%
Return on capital (annualized)	14.8%	17.2%	15.0%	15.5%	16.0%

Adjusted EBITDA (Non-GAAP financial measure)

We use Adjusted EBITDA as a supplemental measure to review and assess our performance. We define Adjusted EBITDA as Net income, plus income taxes, total other (income) expense, depreciation and amortization, and non-cash charges for share-based compensation. Adjusted EBITDA is a metric that is used in our industry by the investment community for comparative and valuation purposes. We disclose this metric in order to support and facilitate the dialogue with research analysts and investors.

Note that Adjusted EBITDA is not a measure of financial performance under GAAP and should not be considered a substitute for operating income, which we consider to be the most directly comparable GAAP measure. Adjusted EBITDA has limitations as an analytical tool, and when assessing our operating performance, you should not consider Adjusted EBITDA in isolation or as a substitute for net income or other consolidated income statement data prepared in accordance with GAAP. Other companies may calculate Adjusted EBITDA differently than we do, limiting its usefulness as a comparative measure.

Adjusted EBITDA increased $33.7 million, or 38.3%, from $88.0 million in the three months ended September 30, 2011 to $121.7 million in the three months ended September 30, 2012. Adjusted EBITDA as a percentage of revenue increased from 33.3% for the three months ended September 30, 2011 to 36.2% for the three months ended September 30, 2012. The primary drivers of the increase in Adjusted EBITDA margin were decreases in Cost of Revenue and Sales and Marketing expenses as a percentage of revenue, partially offset by an increase in General and Administrative expenses as a percentage of revenue. Also impacting our results were changes in non-cash deferred rent and non-equity incentive compensation. Non-cash rent decreased from $2.5 million in the three months ended September 30, 2011 to $2.3 million in the three months ended September 30, 2012. Overall, non-equity incentive compensation for the three months ended September 30, 2012 decreased $2.4 million from the three months ended September 30, 2011 due to a decrease in the payout percentage, partially offset by increased headcount. Adjusted EBITDA margin increased from 35.1% for the three months ended June 30, 2012 to 36.2% for the three months ended September 30, 2012 primarily due to a decrease in Sales and Marketing expenses as a percentage of revenue.

Employee non-equity incentive compensation through our current non-equity incentive plan, in effect since January 1, 2009, is dependent upon the financial results of the company in relation to a pre-set target level that is set at the beginning of each quarter. Thus, favorable financial performance in comparison to the pre-set target level is partially offset by increased non-equity incentive compensation expense. If company achievement of the pre-set target results in a 10% increase in the non-equity incentive compensation percentage payout, this would increase total non-equity incentive compensation by approximately $0.7 million on an after-tax basis and increase net income by $0.7 million. Company achievement resulting in a 10% decrease in the non-equity incentive compensation percentage payout would decrease total non-equity incentive compensation by approximately $0.7 million on an after-tax basis and decrease net income by $0.7 million. Additionally, the Compensation Committee has the discretion to increase or decrease a payout under the plan at any time in the event that it determines that circumstances warrant adjustment or to pay bonuses outside of the plan. The Compensation Committee exercised its discretion to decrease the bonus payout for the three months ended September 30, 2012. The metric we use for evaluating the financial results of the company is called NOPAT Before Bonus, which is calculated as NOPAT (as defined above) without the inclusion of any impact of non-equity incentive compensation and assumes a statutory tax rate. This cannot be calculated from our financial statements as we do not separately disclose total non-equity incentive compensation for the period.

Income from operations has been favorably impacted by decreases in our Cost of Revenue and Sales and Marketing expenses as a percentage of revenue. Our operating income margin increased from 11.7% for the three months ended September 30, 2011 to 13.5% for the three months ended September 30, 2012.

See our Adjusted EBITDA reconciliation below.

(Dollars in thousands)	Three Months Ended September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012	September 30, 2012
Net revenue	$ 264,572	$ 283,261	$ 301,355	$ 318,990	$ 335,985
Income from operations	$ 31,070	$ 39,765	$ 37,084	$ 40,704	$ 45,330
Net income	$ 19,982	$ 25,047	$ 23,180	$ 25,134	$ 27,197
Plus: Income taxes	9,281	13,188	12,769	13,932	16,918
Plus: Total other (income) expense	1,807	1,530	1,135	1,638	1,215
Plus: Depreciation and amortization	49,518	54,844	55,151	61,808	63,972
Plus: Share-based compensation expense	7,395	7,585	8,509	9,375	12,418
Adjusted EBITDA	$ 87,983	$ 102,194	$ 100,744	$ 111,887	$ 121,720
Operating income margin	11.7%	14.0%	12.3%	12.8%	13.5%
Adjusted EBITDA margin	33.3%	36.1%	33.4%	35.1%	36.2%

Table of Contents

Adjusted Free Cash Flow (Non-GAAP financial measure)

We define Adjusted Free Cash Flow as Adjusted EBITDA plus non-cash deferred rent, less total capital expenditures (including non-cash purchases of property and equipment), cash payments for interest, net, and cash payments for income taxes, net.

We believe that Adjusted Free Cash Flow is an important metric for investors in evaluating how a company is currently using cash generated and may indicate its ability to generate cash that can potentially be used by the business for capital investments, acquisitions, reduction of debt, payment of dividends, etc. Note that Adjusted Free Cash Flow is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies.

See our Adjusted Free Cash Flow reconciliation to Adjusted EBITDA below, as well as our reconciliation of Net income to Adjusted EBITDA provided above.

(In thousands)	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Adjusted EBITDA	$ 121,720	$ 334,351
Non-cash deferred rent	2,279	6,329
Total capital expenditures	(85,383)	(249,667)
Cash payments for interest, net	(1,091)	(3,526)
Cash payments for income taxes, net	(3,425)	(7,200)
Adjusted free cash flow	$ 34,100	$ 80,287

Net Leverage (Non-GAAP financial measure)

We define Net Leverage as Net Debt divided by Adjusted EBITDA (trailing twelve months). We believe that Net Leverage is an important metric for investors in evaluating a company's liquidity. Note that Net Leverage is not a measure of financial performance under GAAP and may not be comparable to similarly titled measures reported by other companies. We believe that Net Leverage provides an additional indicator when assessing our liquidity, capital structure and leverage and provides insight into a company's ability to assume more debt if and when required. A negative Net Leverage indicates that our cash and cash equivalents is greater than our total debt as of the balance sheet date.

See our Net Leverage calculation below.

(Dollars in thousands)	As of September 30, 2012
Obligations under capital leases	$ 145,111
Debt	5,001
Total debt	$ 150,112
Less: Cash and cash equivalents	(257,651)
Net debt	$ (107,539)
Adjusted EBITDA (trailing twelve months)	$ 436,545
Net leverage	(0.25) x

Results of Operations

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

	Three Months Ended				
(In thousands)	September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012	September 30, 2012
Net revenue	$ 264,572	$ 283,261	$ 301,355	$ 318,990	$ 335,985
Costs and expenses:					
Cost of revenue	82,445	82,851	87,240	90,052	94,731
Sales and marketing	31,838	33,452	38,502	39,613	38,924
General and administrative	69,701	72,349	83,378	86,813	93,028
Depreciation and amortization	49,518	54,844	55,151	61,808	63,972
Total costs and expenses	233,502	243,496	264,271	278,286	290,655
Income from operations	31,070	39,765	37,084	40,704	45,330
Other income (expense):					
Interest expense	(1,531)	(1,304)	(1,272)	(1,233)	(1,253)
Interest and other income (expense)	(276)	(226)	137	(405)	38
Total other income (expense)	(1,807)	(1,530)	(1,135)	(1,638)	(1,215)
Income before income taxes	29,263	38,235	35,949	39,066	44,115
Income taxes	9,281	13,188	12,769	13,932	16,918
Net income	$ 19,982	$ 25,047	$ 23,180	$ 25,134	$ 27,197

Consolidated Statements of Income, as a Percentage of Net Revenue (Unaudited):

	Three Months Ended				
(Percent of net revenue)	September 30, 2011	December 31, 2011	March 31, 2012	June 30, 2012	September 30, 2012
Net revenue	100.0 %	100.0 %	100.0 %	100.0 %	100.0 %
Costs and expenses:					
Cost of revenue	31.2 %	29.2 %	28.9 %	28.2 %	28.2 %
Sales and marketing	12.0 %	11.8 %	12.8 %	12.4 %	11.6 %
General and administrative	26.3 %	25.5 %	27.7 %	27.2 %	27.7 %
Depreciation and amortization	18.7 %	19.4 %	18.3 %	19.4 %	19.0 %
Total costs and expenses	88.3 %	86.0 %	87.7 %	87.2 %	86.5 %
Income from operations	11.7 %	14.0 %	12.3 %	12.8 %	13.5 %
Other income (expense):					
Interest expense	(0.6)%	(0.5)%	(0.4)%	(0.4)%	(0.4)%
Interest and other income (expense)	(0.1)%	(0.1)%	0.0 %	(0.1)%	0.0 %
Total other income (expense)	(0.7)%	(0.5)%	(0.4)%	(0.5)%	(0.4)%
Income before income taxes	11.1 %	13.5 %	11.9 %	12.2 %	13.1 %
Income taxes	3.5 %	4.7 %	4.2 %	4.4 %	5.0 %
Net income	7.6 %	8.8 %	7.7 %	7.9 %	8.1 %

Due to rounding, totals may not equal the sum of the line items in the table above.

Third Quarter 2012 Overview

The highlights and significant events of the three months ended September 30, 2012 and the impact on our operating results compared to the three months ended June 30, 2012 were as follows:

Net Revenue

Net revenue increased $17.0 million, or 5.3%, from $319.0 million in the three months ended June 30, 2012 to $336.0 million in the three months ended September 30, 2012 reflecting slightly lower growth than prior quarters. The market for cloud computing services continues to be highly competitive, and we face competition from existing competitors as well as new market entrants. We continue to grow our Dedicated Cloud and Public Cloud service offerings and believe that this full portfolio of cloud computing services positions us well in the market. During the third quarter, we experienced an unfavorable revenue impact due to a strengthening U.S. dollar relative to the pound sterling, which resulted in a decrease to revenue of approximately $0.1 million, or 0.0%, for the three months ended September 30, 2012 compared to the three months ended June 30, 2012, with minimal impact to our margins as the majority of customers are invoiced, and substantially all of our expenses associated with these customers are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries.

Cost of Revenue

Our cost of revenue was $90.1 million for the three months ended June 30, 2012 and $94.7 million for the three months ended September 30, 2012, an increase of $4.6 million, or 5.1%. Of this increase, less than $0.1 million was attributable to an increase in employee compensation-related expenses. Data center costs including power, rent and maintenance increased $3.4 million and software license costs increased $1.9 million. The remaining variance was due to small changes in other cost of revenue expenses.

Sales and Marketing Expenses

Our sales and marketing expenses were $39.6 million for the three months ended June 30, 2012 and $38.9 million for the three months ended September 30, 2012, a decrease of $0.7 million, or 1.8%. Of this decrease, less than $0.1 million was attributable to a decrease in employee compensation-related expenses. The majority of the decrease was due to a decrease in spending on conventions and trade shows. The remaining variance was due to small changes in other sales and marketing expenses.

General and Administrative Expenses

Our general and administrative expenses were $86.8 million for the three months ended June 30, 2012 and $93.0 million for the three months ended September 30, 2012, an increase of $6.2 million, or 7.1%. Of this increase, $5.7 million was attributable to employee compensation-related expenses. Total compensation increased as a result of salary increases, the hiring of additional personnel, and increases in shared-based compensation expense and payroll taxes, partially offset by a slight decrease in non-equity incentive compensation. The remaining variance was due to small changes in other general and administrative expenses.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $61.8 million for the three months ended June 30, 2012 and $64.0 million for the three months ended September 30, 2012, an increase of $2.2 million, or 3.6%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software. The decrease in depreciation and amortization expense as a percentage of revenue was the result of a $1.1 million expense recorded in the three months ended June 30, 2012 due to a change in the useful life of certain assets.

Net Income and Net Income per Share

Net income was $25.1 million, or $0.18 per share on a diluted basis, for the three months ended June 30, 2012 compared to net income of $27.2 million, or $0.19 per share on a diluted basis, for the three months ended September 30, 2012. The increase in net income was mainly due to sales and marketing and depreciation and amortization expenses decreasing as a percentage of revenue, partially offset by an increase in general and administrative expenses as a percentage of revenue. Additionally, net income was negatively impacted by an increase in our effective tax rate from 35.7% in the three months ended June 30, 2012 to 38.3% in the three months ended September 30, 2012.

Three Months Ended September 30, 2011 and September 30, 2012

Net Revenue

Our net revenue was $264.6 million for the three months ended September 30, 2011 and $336.0 million for the three months ended September 30, 2012, an increase of $71.4 million, or 27.0%. The increase in net revenue was primarily due to an increased volume of services provided, resulting from an increasing number of new customers and incremental services rendered to existing customers. Partially offsetting the revenue increase was the unfavorable impact of a stronger U.S. dollar relative to the pound sterling for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. Net revenue for the three months ended September 30, 2012 would have been approximately $1.5 million higher had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year.

Cost of Revenue

Our cost of revenue was $82.4 million for the three months ended September 30, 2011 and $94.7 million for the three months ended September 30, 2012, an increase of $12.3 million, or 14.9%. Of this increase, $3.0 million was attributable to employee-related expenses due to an increase in salaries and benefits of $4.2 million, and an increase in share-based compensation expense of $0.3 million, partially offset by a decrease in non-equity incentive compensation of $1.5 million. These increases are primarily due to additional headcount and salary increases, partially offset by a lower percentage attainment against the pre-set target for non-equity incentive compensation. The cost increase was further attributable to an increase in license costs of $5.0 million and an increase in data center costs of $4.2 million, mostly related to rent and maintenance. The remaining variance was due to small changes in other cost of revenue expenses. Cost of revenue expenses as a percentage of revenue decreased from 31.2% in the three months ended September 30, 2011 to 28.2% in the three months ended September 30, 2012 primarily due to a decrease in power costs and employee-related expenses increasing at a slower rate than revenue.

Sales and Marketing Expenses

Our sales and marketing expenses were $31.8 million for the three months ended September 30, 2011 and $38.9 million for the three months ended September 30, 2012, an increase of $7.1 million, or 22.3%. Of this increase, $5.0 million was attributable to employee-related expenses due to an increase in salaries and benefits of $4.5 million and an increase in share-based compensation expense of $1.1 million, partially offset by a decrease in commissions of $0.6 million due to sales targets increasing at a faster rate than attainment amounts. Total compensation increased primarily as a result of salary increases and the hiring of additional sales and marketing personnel. Advertising and Internet-related marketing expenditures increased $1.3 million. The remaining variance was due to small changes in other sales and marketing expenses.

General and Administrative Expenses

Our general and administrative expenses were $69.7 million for the three months ended September 30, 2011 and $93.0 million for the three months ended September 30, 2012, an increase of $23.3 million, or 33.4%. Of this increase, $18.8 million was attributable to employee-related expenses due to increases in salaries and benefits of $16.1 million and share-based compensation expense of $3.7 million, partially offset by a decrease in non-equity incentive compensation of $1.0 million. These increases are primarily due to additional headcount, salary increases and new equity grants, partially offset by a lower non-equity incentive compensation payout percentage. Professional fees and legal expenses increased $0.4 million primarily as a result of increased consulting expenses related to tax, legal and general consulting services, and internal software and maintenance costs increased $1.5 million. Additionally, office-related expenses increased $1.0 million, merchant credit card fees increased $0.7 million due to higher volume of sales in the third quarter of 2012, travel and other employee-related expenses increased $0.6 million, and bad debt expense increased $0.2 million. The remaining variance was due to small changes in other general and administrative expenses.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $49.5 million for the three months ended September 30, 2011 and $64.0 million for the three months ended September 30, 2012, an increase of $14.5 million, or 29.3%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software.

Income Taxes

Our effective tax rate increased from 31.7% for the three months ended September 30, 2011 to 38.3% for the three months ended September 30, 2012, due to certain discrete items that were recorded in Q3 2011, the geographic mix of income as well as the amortization of a prepaid tax asset that was established in 2011. Overall, the differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income, certain tax credits, contingency reserves for uncertain tax positions and permanent differences between the book and tax treatment of certain items. Our foreign earnings are generally taxed at lower rates than in the United States.

Nine Months Ended September 30, 2011 and September 30, 2012

The following tables set forth our results of operations for the specified periods and as a percentage of our revenue for those same periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

Consolidated Statements of Income (Unaudited):

	Nine Months Ended	
(In thousands)	**September 30, 2011**	**September 30, 2012**
Net revenue	$ 741,803	$ 956,330
Costs and expenses:		
Cost of revenue	226,244	272,023
Sales and marketing	93,053	117,039
General and administrative	198,232	263,219
Depreciation and amortization	140,568	180,931
Total costs and expenses	658,097	833,212
Income from operations	83,706	123,118
Other income (expense):		
Interest expense	(4,544)	(3,758)
Interest and other income (expense)	(968)	(230)
Total other income (expense)	(5,512)	(3,988)
Income before income taxes	78,194	119,130
Income taxes	26,830	43,619
Net income	$ 51,364	$ 75,511

Consolidated Statements of Income, as a Percentage of Net Revenue (Unaudited):

	Nine Months Ended	
(Percent of net revenue)	**September 30, 2011**	**September 30, 2012**
Net revenue	100.0 %	100.0 %
Costs and expenses:		
Cost of revenue	30.5 %	28.4 %
Sales and marketing	12.5 %	12.2 %
General and administrative	26.7 %	27.5 %
Depreciation and amortization	18.9 %	18.9 %
Total costs and expenses	88.7 %	87.1 %
Income from operations	11.3 %	12.9 %
Other income (expense):		
Interest expense	(0.6)%	(0.4)%
Interest and other income (expense)	(0.1)%	0.0 %
Total other income (expense)	(0.7)%	(0.4)%
Income before income taxes	10.5 %	12.5 %
Income taxes	3.6 %	4.6 %
Net income	6.9 %	7.9 %

Due to rounding, totals may not equal the sum of the line items in the table above.

Net Revenue

Our net revenue was $741.8 million for the nine months ended September 30, 2011 and $956.3 million for the nine months ended September 30, 2012, an increase of $214.5 million, or 28.9%. The increase in net revenue was primarily due to an increased volume of services provided, resulting from an increasing number of new customers and incremental services rendered to existing customers. Partially offsetting the revenue increase was the negative impact of a stronger U.S. dollar relative to the pound sterling for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. Net revenue for the nine months ended September 30, 2012 would have been approximately $5.3 million higher had the U.S. dollar to the pound sterling exchange rate remained constant from the prior year.

Cost of Revenue

Our cost of revenue was $226.2 million for the nine months ended September 30, 2011 and $272.0 million for the nine months ended September 30, 2012, an increase of $45.8 million, or 20.2%. Of this increase, $17.8 million was attributable to employee-related expenses due to an increase in salaries and benefits of $16.7 million, an increase in non-equity incentive compensation of $0.6 million and an increase in share-based compensation expense of $0.5 million. These increases are primarily due to additional headcount and salary increases, partially offset by a lower percentage attainment against the pre-set target for non-equity incentive compensation. The cost increase was further attributable to an increase in license costs of $12.7 million, an increase in data center costs of $11.2 million mostly related to rent and maintenance, and an increase in other cost of revenue expenses of $4.1 million. Cost of revenue expenses as a percentage of revenue decreased from 30.5% in the nine months ended September 30, 2011 to 28.4% in the nine months ended September 30, 2012 primarily due to a decrease in power costs and employee-related expenses increasing at a slower rate than revenue.

Sales and Marketing Expenses

Our sales and marketing expenses were $93.1 million for the nine months ended September 30, 2011 and $117.0 million for the nine months ended September 30, 2012, an increase of $23.9 million, or 25.7%. Of this increase, $17.8 million was attributable to employee-related expenses due to increases in salaries and benefits of $13.5 million, share-based compensation expense of $3.0 million, non-equity incentive compensation of $0.8 million and commissions of $0.5 million. Total compensation increased as a result of salary increases and the hiring of additional sales and marketing personnel as well as the impact of higher commissions associated with increased sales. Advertising and Internet-related marketing expenditures increased $4.9 million, and travel, professional fees and other sales and marketing expenses increased by a total of $1.3 million. The remaining variance was due to small changes in other sales and marketing expenses.

General and Administrative Expenses

Our general and administrative expenses were $198.2 million for the nine months ended September 30, 2011 and $263.2 million for the nine months ended September 30, 2012, an increase of $65.0 million, or 32.8%. Of this increase, $50.1 million was attributable to employee-related expenses due to increases in salaries and benefits of $41.5 million, non-equity incentive compensation of $2.9 million and share-based compensation expense of $5.7 million. These increases are primarily due to additional headcount, salary increases and higher payroll taxes associated with increased stock option exercise activity and the salary increases, partially offset by a lower non-equity incentive compensation payout percentage. Professional fees and legal expenses increased $2.1 million primarily as a result of increased consulting expenses related to tax, legal and general consulting services, internal software and maintenance costs increased $4.1 million, office-related expenses increased $3.0 million, travel and other employee-related expenses increased $1.7 million, and property and other non-income taxes increased $0.9 million. We also experienced an increase in merchant credit card fees of $2.3 million due to higher volume of sales in the first nine months of 2012. Bad debt expense increased $0.2 million. The remaining variance was due to small changes in other general and administrative expenses.

Depreciation and Amortization Expense

Our depreciation and amortization expense was $140.6 million for the nine months ended September 30, 2011 and $180.9 million for the nine months ended September 30, 2012, an increase of $40.3 million, or 28.7%. The increase in depreciation and amortization expense was a direct result of an increase in property and equipment related to depreciable assets to support the growth of our business, which included increases in data center equipment and leasehold improvements due to data center build outs and internally developed and purchased software.

Income Taxes

Our effective tax rate increased from 34.3% for the nine months ended September 30, 2011 to 36.6% for the nine months ended September 30, 2012, due primarily to the geographic mix of income and the amortization of a prepaid tax asset that was established in Q3 2011. Overall, the differences between our effective tax rate and the U.S. federal statutory rate of 35% principally result from our geographical distribution of taxable income, certain tax credits, contingency reserves for uncertain tax positions and permanent differences between the book and tax treatment of certain items. Our foreign earnings are generally taxed at lower rates than in the United States.

Liquidity and Capital Resources

At September 30, 2012, our cash and cash equivalents balance was $257.7 million. We use our cash and cash equivalents, cash flow from operations, capital leases, and existing amounts available under our revolving credit facility as our primary sources of liquidity. We currently believe that cash generated by operations, current cash and cash equivalents, and available borrowings through vendor-financing arrangements and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future.

As of September 30, 2012, we had $51.5 million of cash holdings in foreign countries. If these funds are repatriated, we will need to accrue and pay taxes; however, we do not currently intend to repatriate these funds because we believe cash available in the U.S. is sufficient to meet our domestic operating and capital needs.

Our revolving credit facility has a total commitment in the amount of $200 million and matures in September of 2016. The facility further includes an accordion feature, which allows for an increase in the commitment to a total of $400 million under the same terms and conditions, subject to credit approval of the banking syndicate. The facility is unsecured and governed by customary financial and non-financial covenants, including a leverage ratio of not greater than 3.00 to 1.00, an interest coverage ratio of not less than 3.00 to 1.00 and a requirement to maintain a certain level of tangible assets in our U.S. entities. As of September 30, 2012, we were in compliance with all of the covenants under our facility.

We maintain debt levels that we establish through consideration of a number of factors, including cash flow expectations, cash requirements for operations, investment plans (including acquisitions), and our overall cost of capital. As of September 30, 2012 there was no amount outstanding under the new facility except for an immaterial outstanding letter of credit.

We have vendor finance arrangements in the form of leases and notes payable with our major vendors that permit us to finance our purchases of data center equipment. As of December 31, 2011 and September 30, 2012, we had $139.1 million and $150.1 million outstanding with respect to these arrangements. While we believe our borrowings from these arrangements will continue to be available, we have shifted our current strategy and have begun to pay cash for a greater portion of our equipment purchases rather than financing them through these arrangements.

Capital Expenditure Requirements

For the full year 2012, we continue to expect to have capital expenditures between $335 million and $405 million in the aggregate, consisting of $210 million to $250 million for customer gear, $25 million to $35 million for data center infrastructure costs, $25 million to $35 million for office build-outs, and $75 million to $85 million for capitalized software and other projects.

Our available cash and cash equivalents are held in bank deposits, overnight sweep accounts, and money market funds. During the quarter ended September 30, 2012, we modified our cash management strategy to invest a larger portion of our available cash in money market funds rather than in sweep accounts and other cash deposit accounts. Our money market mutual funds comply with Rule 2a-7 and invest exclusively in high-quality, short-term obligations that include securities issued or guaranteed by the U.S. government or by U.S. government agencies and floating rate and variable rate demand notes of U.S. and foreign corporations. We actively monitor the third-party depository institutions that hold our cash and cash equivalents. Our emphasis is primarily on safety of principal while secondarily maximizing yield on those funds. The balances may exceed the Federal Deposit Insurance Corporation, or "FDIC," insurance limits or may not be insured by the FDIC. While we monitor the balances in our accounts and adjust the balances as appropriate, these balances could be impacted if the underlying depository institutions fail or could be subject to other adverse conditions in the financial markets. To date, we have experienced no loss or lack of access to our invested cash and cash equivalents; however, we can provide no assurances that access to our funds will not be impacted by adverse conditions in the financial markets.

We currently believe that current cash and cash equivalents, cash generated by operations and available borrowings through vendor financing arrangements and our credit facility will be sufficient to meet our operating and capital needs in the foreseeable future. Our long-term future capital requirements will depend on many factors, most importantly our revenue growth and our investments in new technologies and services. Our ability to generate cash depends on our financial performance, general economic conditions, technology trends and developments, and other factors. As our business continues to grow, our need for data center capacity will also grow. Most recently we have financed data center growth through leasing activities, and we will continue to evaluate all opportunities to secure further data center capacity in the future. We could be required, or could elect, to seek additional funding in the form of debt or equity.

The following table sets forth a summary of our cash flows for the periods indicated:

	Nine Months Ended September 30, (Unaudited)	
(In thousands)	2011	2012
Cash provided by operating activities	$ 225,176	$ 279,290
Cash used in investing activities	$ (190,745)	$ (193,937)
Cash provided by (used in) financing activities	$ (14,646)	$ 11,079
Non-cash purchases of property and equipment	$ 75,641	$ 61,633

Operating Activities

Net cash provided by operating activities is primarily a function of our profitability, the amount of non-cash charges included in our profitability, and our working capital management. Net cash provided by operating activities was $225.2 million in the first nine months of 2011 compared to $279.3 million in the first nine months of 2012, an increase of $54.1 million, or 24.0%. Net income increased from $51.4 million in the first nine months of 2011 to $75.5 million in the first nine months of 2012. A summary of the significant changes in non-cash adjustments affecting net income is as follows:

- Depreciation and amortization expense was $140.6 million in the first nine months of 2011 compared to $180.9 million in the first nine months of 2012. The increase in depreciation and amortization was due to purchases of servers, networking gear, computer software (internally developed technology), electrical equipment, and leasehold improvements primarily for data center expansion, as well as the amortization of intangibles related to acquisitions.
- Our provision for bad debts and customer credits increased slightly from $4.5 million in the first nine months of 2011 to $4.6 million in the first nine months of 2012.
- The change in deferred income taxes created a $9.2 million increase to cash flow from operating activities in the first nine months of 2011 compared to a $3.8 million increase in the first nine months of 2012.
- The change in deferred rent created a $8.3 million non-cash increase to cash flow from operating activities in the first nine months of 2011 compared to a $6.3 million increase in the first nine months of 2012. The change resulted from larger cash payments made in the first nine months of 2012 for data center and office lease arrangements with terms that included escalating rental payments. As total rent expense for each of these lease arrangements is recorded on a straight-line basis for the term of the lease, there is a difference between rent expense and cash paid for rent during the period. The largest differences typically occur in the early portion of leases that include rent abatements.
- Share-based compensation expense was $21.2 million in the first nine months of 2011 compared to $30.3 million in the first nine months of 2012. The increase in expense was due to equity awards granted in 2011 and the first nine months of 2012.
- Excess tax benefits from share-based compensation arrangements created an operating cash outflow of $11.9 million in the first nine months of 2011 and $35.0 million in the first nine months of 2012. In accordance with the accounting guidance, Rackspace recognizes an excess tax benefit from the exercise of options to the extent that it will result in a reduction of our current tax payable.

A summary of changes in assets and liabilities impacting operating cash flows is as follows:

- The change in accounts receivable was a cash outflow of $17.4 million in the first nine months of 2011 compared to a cash outflow of $29.1 million in the first nine months of 2012. Accounts receivable increased due to the increase in sales.
- The change in accounts payable and accrued expenses created a $25.3 million cash inflow in the first nine months of 2011 compared to a $51.8 million cash inflow in the first nine months of 2012. The changes resulted from the timing of payments for trade payables and payroll-related expenses.

Investing Activities

Net cash used in investing activities was primarily capital expenditures to meet the demands of our growing customer base. Historically our main investing activities have consisted of purchases of IT equipment for our data center infrastructure, furniture, equipment and leasehold improvements to support our operations as well as payroll costs related to software development.

Our net cash used in investing activities was $190.7 million in the first nine months of 2011 compared to $193.9 million in the first nine months of 2012, an increase of $3.2 million, or 1.7%. The increase was primarily due to an increase in the amount of property and equipment purchases included within accounts payable and accrued expenses from December 31, 2011 to September 30, 2012.

We purchase equipment through capital lease arrangements and other types of vendor financing that do not require an initial outlay of cash. Purchases through these arrangements decreased from $75.6 million for the first nine months of 2011 to $61.6 million for the first nine months of 2012.

Financing Activities

Net cash provided by (used in) financing activities was a $14.6 million outflow in the first nine months of 2011 compared to an $11.1 million inflow in the first nine months of 2012, a change of $25.7 million. Principal payments on capital leases and notes payable were $50.3 million in the first nine months of 2011 compared to $54.9 million during the first nine months of 2012. Cash proceeds from employee stock plans increased from $27.8 million in the first nine months of 2011 to $31.5 million in the first nine months of 2012. Other activity included payments of contingent consideration related to prior period business acquisitions and the receipt of a $3.5 million grant from the Texas Enterprise Fund for meeting certain employment levels in the State of Texas. Additionally, in the first nine months of 2012 we recorded a $35.0 million financing cash inflow for excess tax benefits booked during the period. Our net leverage as of September 30, 2012 was (0.25) times. See above for our discussion of Non-GAAP Financial Measures.

Contractual Obligations, Commitments and Contingencies

The following table summarizes our contractual obligations as of September 30, 2012:

(In thousands)	Total	2012	2013-2014	2015-2016	2017 and Beyond
			(Unaudited)		
Capital leases (1)	$ 150,091	$ 19,266	$ 111,912	$ 18,913	$ —
Operating leases	934,937	9,583	102,208	116,974	706,172
Purchase obligations	34,010	10,822	22,714	474	—
Notes payable (1)	5,396	54	5,217	125	—
Total contractual obligations	$ 1,124,434	$ 39,725	$ 242,051	$ 136,486	$ 706,172

(1) Represents principal and interest.

Leases

Capital leases are primarily related to expenditures for IT equipment. Our operating leases are primarily for data center facilities and office space.

In April 2012, we entered into a lease for a new data center in Ashburn, Virginia with a maximum critical load power of 9.75 megawatts. The lease provides for two separate commencement dates, anticipated as January 1, 2013 and January 1, 2014, with each commencement date applicable to approximately one-half of the maximum critical load power of the total leased space. The initial term is 20 years from each respective commencement date, and upon the expiration of each of these terms, we have the option to renew that portion of the lease for three successive five-year periods. Our total estimated financial obligation for the leased space over the 20-year terms is approximately $280 million to $300 million, inclusive of base lease payments and our pro-rata share of operating expenses, but excluding power costs.

Purchase Obligations

Our purchase obligations are primarily related to costs associated with our data centers including bandwidth, electricity, and consulting services, as well as commitments to purchase hardware and to prepay for certain software licenses.

Notes Payable

We currently finance certain software and equipment from third-party vendors. The terms of these arrangements are up to three years.

Uncertain Tax Positions

We have excluded $3.0 million of uncertain tax positions from the table above as we are uncertain as to if or when such amounts will be recognized.

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities. These entities are typically established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

We have entered into various indemnification arrangements with third parties, including vendors, customers, landlords, our officers and directors, stockholders of acquired companies, and third parties to whom and from whom we license technology. Generally, these indemnification agreements require us to reimburse losses suffered by third parties due to various events, such as lawsuits arising from patent or copyright infringement or our negligence. Certain of these agreements require us to indemnify the other party against certain claims relating to property damage, personal injury or the acts or omissions by us, our employees, agents or representatives. To date, there have been no claims against us or our customers pertaining to such indemnification provisions, and no amounts have been recorded.

These indemnification obligations are considered off-balance sheet arrangements. To date, we have not encountered material costs as a result of such obligations and have not accrued any liabilities related to such indemnification obligations in our financial statements.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with GAAP. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require management’s judgment in its application, while in other cases, significant judgment is required in making estimates and selecting among available alternative accounting standards that allow different accounting treatment for similar transactions. These judgments and estimates affect the reported amounts of assets, liabilities, revenue, costs and expenses and related disclosures. We consider these policies requiring significant management judgment and estimates used in the preparation of our financial statements to be critical accounting policies.

We review our estimates and judgments on an ongoing basis, including those related to revenue recognition, service credits, allowance for doubtful accounts, property and equipment, goodwill and intangibles, contingencies, the fair valuation of stock related to share-based compensation, software development, and income taxes.

We base our estimates on historical experience, expected future cash flows, usage patterns and other relevant assumptions that we believe to be reasonable under the circumstances to determine the carrying values of assets and liabilities. In many instances, we could have reasonably used different accounting estimates, and in other instances changes in the accounting estimates are reasonably likely to occur from period-to-period. Accordingly, actual results could differ significantly from the estimates made by our management. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

A description of our critical accounting policies that involve significant management judgment appears in our Annual Report filed on Form 10-K filed with the SEC on February 17, 2012 under “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates.”

Recent Accounting Pronouncements

For a full description of new accounting pronouncements, including the respective dates of adoption and impact on results of operation and financial condition, see “Notes to the Unaudited Consolidated Financial Statements – Note 1. Company Overview and Summary of Significant Accounting Policies ."

ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no significant changes to our market risks since December 31, 2011. For a discussion of our exposure to market risk, refer to Part II, Item 7A "Quantitative and Qualitative Disclosures about Market Risk," contained in our Annual Report on Form 10-K for the year-ended December 31, 2011.

ITEM 4 – CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

Under the supervision and with the participation of our senior management, including our chief executive officer and chief financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”), as amended, as of the end of the period covered by this quarterly report (the “Evaluation Date”). Based on this evaluation, our chief executive officer and chief financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to the Company, including our consolidated subsidiaries, required to be disclosed in our SEC reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in internal control over financial reporting

There were no changes in our internal controls over financial reporting during our most recent fiscal quarter reporting period identified in connection with management’s evaluation that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent limitations of internal controls

Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

PART II – OTHER INFORMATION

ITEM 1 – LEGAL PROCEEDINGS

We are party to various legal and administrative proceedings, which we consider routine and incidental to our business. In addition, we are involved in the following legal proceedings:

On October 22, 2008, *Benjamin E. Rodriguez D/B/A Management and Business Advisors vs. Rackspace Hosting, Inc. and Graham Weston* was filed in the 37th District Court in Bexar County Texas by a former consultant to the company, Benjamin E. Rodriguez. The suit alleges breach of an oral agreement to issue Mr. Rodriguez a 1% interest in our stock in the form of options or warrants for compensation for services he was engaged to perform for us. We believe that the plaintiff's position is without merit and intend to vigorously defend this lawsuit. We do not expect the results of this claim or any other current proceeding to have a material adverse effect on our business, results of operations or financial condition.

In April 2012, Titanide Ventures, LLC filed complaints against us in two proceedings in the United States District Court for the Eastern District of Texas. The complaints allege, among other things, that our Cloud Files and Jungle Disk remote storage and backup technology infringes U.S. Patent 6,714,968 purporting to cover a "Method and System for Seamless Access to a Remote Storage Server Utilizing Multiple Access Interfaces Executing on the Remote Server" and U.S. Patent 6,735,623 purporting to cover a "Method and System for Accessing a Remote Storage Area." The plaintiff seeks injunctive relief, monetary damages, costs and attorney's fees. We dispute the allegations of wrongdoing and intend to vigorously defend ourselves in this matter.

In May 2012, Clouding IP, LLC filed a complaint against us in the United States District Court for the District of Delaware. The complaint alleges, among other things, infringement of the following nine patents: U.S. Patent No. 7,596,784 purporting to cover a "Method System and Apparatus for Providing Pay-Per-Use Distributed Computing Resources;" U.S. Patent No. 7,065,637 purporting to cover a "System for Configuration of Dynamic Computing Environments Using a Visual Interface;" U.S. Patent No. 6,738,799 purporting to cover a "Methods and Apparatuses for File Synchronization and Updating Using a Signature List;" U.S. Patent No. 5,495,607 purporting to cover a "Network Management System Having Virtual Catalog Overview of Files Disruptively Stored Across Network Domain;" U.S. Patent No. 6,925,481 purporting to cover a "Technique for Enabling Remote Data Access and Manipulation from a Pervasive Device;" U.S. Patent No. 7,254,621 purporting to cover a "Technique for Enabling Remote Data Access and Manipulation from a Pervasive Device;" U.S. Patent No. 6,963,908 purporting to cover a "System for Transferring Customized Hardware and Software Settings from One Computer to Another Computer to Provide Personalized Operating Environments;" U.S. Patent No. 6,631,449 purporting to cover a "Dynamic Distributed Data System and Method;" and U.S. Patent No. 6,918,014 purporting to cover a "Dynamic Distributed Data System and Method." The plaintiff seeks monetary damages and costs. We dispute the allegations of wrongdoing and intend to vigorously defend ourselves in this matter.

In June 2012, Uniloc USA, Inc. and Uniloc Luxembourg S.A. filed a complaint against us in the United States District Court for the Eastern District of Texas. The complaint alleges, among other things, that servers configured with various versions of the Linux kernel infringe Uniloc's U.S. Patent No. 5,892,697 purporting to cover a "Method and Apparatus for Handling Overflow and Underflow in Processing Floating-Point Numbers." The plaintiffs seek monetary damages and costs. We dispute the allegations of wrongdoing and intend to vigorously defend ourselves in this matter.

In September 2012, PersonalWeb Technologies LLC and Level 3 Communications, LLC filed a complaint against us in the United States District Court for the Eastern District of Texas. The complaint alleges, among other things, infringement of the following nine patents: U.S. Patent No. 5,978,791 purporting to cover "Data Processing System Using Substantially Unique Identifiers to Identify Data Items, Whereby Data Items Have the Same Identifiers;" U.S Patent No. 6,415,280 purporting to cover "Identifying and Requesting Data in Network Using Identifiers Which Are Based On Contents of Data;" U.S. Patent No. 6,928,442 purporting to cover "Enforcement and Policing of Licensed Content Using Content-based Identifiers;" U.S. Patent No. 7,802,310 purporting to cover "Controlling Access to Data in a Data Processing System;" U.S. Patent No. 7,945,539 purporting to cover "Distributing and Accessing Data in a Data Processing System;" U.S. Patent No. 7,945,544 purporting to cover "Similarity-Based Access Control of Data in a Data Processing System;" U.S. Patent No. 7,949,662 purporting to cover "De-duplication of Data in a Data Processing System;" U.S. Patent No. 8,001,096 purporting to cover "Computer File System Using Content-Dependent File Identifiers;" and U.S. Patent No. 8,099,420 purporting to cover "Accessing Data in a Data Processing System." Plaintiff PersonalWeb Technologies seeks injunctive relief, monetary damages, costs, and attorney's fees. We dispute the allegations of wrongdoing and intend to vigorously defend ourselves in this matter.

ITEM 1A – RISK FACTORS

Risks Related to Our Business and Industry

Our physical infrastructure is concentrated in a few facilities, and any failure in our physical infrastructure or services could lead to significant costs and disruptions and could reduce our revenue, harm our business reputation and have a material adverse effect on our financial results.

Our network, power supplies and data centers are subject to various points of failure. Problems with our cooling equipment, generators, uninterruptible power supply (UPS), routers, switches, or other equipment, whether or not within our control, could result in service interruptions for our customers as well as equipment damage. Because our hosting services do not require geographic proximity of our data centers to our customers, our infrastructure is consolidated into a few large facilities. While data backup services and disaster recovery services are available as a part of our hosting services offerings, the majority of our customers do not elect to pay the additional fees required to have disaster recovery services store their backup data offsite in a separate facility, which could substantially mitigate the adverse effect to a customer from a single data center failure. Accordingly, any failure or downtime in one of our data center facilities could affect a significant percentage of our customers. The total destruction or severe impairment of any of our data center facilities could result in significant downtime of our services and the loss of customer data. Since our ability to attract and retain customers depends on our ability to provide customers with highly reliable service, even minor interruptions in our service could harm our reputation. The services we provide are subject to failure resulting from numerous factors, including:

- Power loss;
- Equipment failure;
- Human error or accidents;
- Sabotage and vandalism;
- Failure by us or our vendors to provide adequate service or maintenance to our equipment;
- Network connectivity downtime;
- Improper building maintenance by the landlords of the buildings in which our facilities are located;
- Physical or electronic security breaches;
- Fire, earthquake, hurricane, tornado, flood, and other natural disasters;
- Water damage; and
- Terrorism.

Additionally, in connection with the expansion or consolidation of our existing data center facilities from time to time, there is an increased risk that service interruptions may occur as a result of server relocation or other unforeseen construction-related issues.

We have experienced interruptions in service in the past due to such things as power outages, power equipment failures, cooling equipment failures, routing problems, hard drive failures, database corruption, system failures, software failures, and other computer failures. While we have not experienced a material increase in customer attrition following these events, the extent to which our reputation suffers is difficult to assess. We have taken and continue to take steps to improve our infrastructure to prevent service interruptions, including upgrading our electrical and mechanical infrastructure. However, service interruptions continue to be a significant risk for us and could materially impact our business.

Any future service interruptions could:

- Cause our customers to seek damages for losses incurred;
- Require us to replace existing equipment or add redundant facilities;
- Affect our reputation as a reliable provider of hosting services;
- Cause existing customers to cancel or elect to not review their contracts; or
- Make it more difficult for us to attract new customers.

Any of these events could materially increase our expenses or reduce our revenue, which would have a material adverse effect on our operating results.

If we are unable to adapt to evolving technologies and customer demands in a timely and cost-effective manner, our ability to sustain and grow our business may suffer.

Our market is characterized by rapidly changing technology, evolving industry standards, and frequent new product announcements, all of which impact the way hosting services are marketed and delivered. The adoption of new technologies, a change in industry standards or introduction of more attractive products or services could make some or all of our offerings less desirable or even obsolete. These potential changes are magnified by the continued rapid growth of the Internet and the intense competition in our industry. To be successful, we must adapt to our rapidly changing market by continually improving the performance, features, and reliability of our services and modifying our business strategies accordingly. We cannot guarantee that we will be able to identify the emergence of all of these new service alternatives successfully, modify our services accordingly, or develop and bring new products and services to market in a timely and cost-effective manner to address these changes. For example, as the adoption and usage of public cloud in the marketplace has grown, we have had to make strategic decisions around improving our customers' experience on our cloud platform, including committing to replace our legacy cloud platform with an open source cloud platform that was developed under the OpenStack initiative that we founded with NASA in 2010 and building features and products on top of that platform. We believe that such a platform shift improves our customers' experience by providing them with features and services that have become possible through the rapidly changing environment in which we operate and because the adoption of the open source cloud platform provides us with additional opportunities to provide a service layer on top of the platform. However, making such a platform shift and introducing products on top of that platform presents a number of risks to our business, including the risk that current and prospective customers will not like or accept the new platform and/or the products that have been built on it and that the OpenStack open source cloud platform is not adopted as the ubiquitous open source cloud computing platform standard for public and private clouds. Our failure to provide platforms, products and services to compete with new technologies or the obsolescence of our platforms, products or services would likely lead us to lose current and potential customers or cause us to incur substantial costs by attempting to catch our offerings up to the changed environment.

We could also incur substantial costs if we need to modify our services or infrastructure in order to adapt to these changes. For example, our data center infrastructure could require improvements due to (i) the development of new systems to deliver power to or eliminate heat from the servers we house, (ii) the development of new server technologies that require levels of critical load and heat removal that our facilities are not designed to provide, or (iii) a fundamental change in the way in which we deliver services. We may not be able to timely adapt to changing technologies, if at all. Our ability to sustain and grow our business would suffer if we fail to respond to these changes in a timely and cost-effective manner.

Our ability to introduce new products into the market in a timely manner is reliant on how well we can forecast customer demands, develop new products and services and bring the services and products to market. In addition, our ability to develop new products and services is reliant on how accurately we can balance our need to replace our older legacy systems in order to provide scalability with our continued utilization of available resources. If we continue to push our older systems beyond their functional limits, those systems could fail. Such failure could cause us to breach our service level obligations, take resources from ongoing projects to supplement for the non-functionality and distract our management. Alternatively, trying to replace legacy systems on too large of a scale and too quickly could result in material disruption in normal business operations.

Finally, even if we succeed in adapting to a new technology or the changing industry standard and developing attractive products and services and successfully bringing them to market, there is no assurance that our use of the new technology or standard or our introduction of the new products or services would have a positive impact on our financial performance and could even result in lower revenue, lower margins and/or higher costs and therefore could negatively impact our financial performance.

We may not be able to compete successfully against current and future competitors.

The market for cloud computing is highly competitive. We expect to face intense competition from our existing competitors as well as additional competition from new market entrants in the future as the actual and potential market for hosting and cloud computing continues to grow.

Our current and potential competitors vary by size, service offerings and geographic region. These competitors may elect to partner with each other or with focused companies like us to grow their businesses. They include:

- Do-it-yourself solutions with a colocation partner such as AT&T, Equinix, CenturyLink and other telecommunications companies;
- IT outsourcing providers such as CSC, HP, and IBM;
- Hosting providers such as AT&T, British Telecom, CenturyLink, Softlayer, Verio and other telecommunications companies; and
- Large technology companies such as Amazon, Microsoft, Google, IBM, Hewlett-Packard and Dell, who have made substantial investments in cloud computing offerings and initiatives.

The primary competitive factors in our market are: customer service and technical expertise, security reliability and functionality, reputation and brand recognition, financial strength, breadth of services offered, and price.

Many of our current and potential competitors have substantially greater financial, technical and marketing resources; larger customer bases; longer operating histories; greater brand recognition; and more established relationships in the industry than we do. As a result, some of these competitors may be able to:

- Develop superior products or services, gain greater market acceptance, and expand their service offerings more efficiently or more rapidly;
- Adapt to new or emerging technologies and changes in customer requirements more quickly;
- Bundle hosting services with other services they provide at reduced prices;
- Take advantage of acquisition and other opportunities more readily;
- Adopt more aggressive pricing policies and devote greater resources to the promotion, marketing, and sales of their services, which could cause us to have to lower prices for certain products or services to remain competitive in the market; and
- Devote greater resources to the research and development of their products and services.

If we do not prevent security breaches and other interruptions to our infrastructure, we may be exposed to lawsuits, lose customers, suffer harm to our reputation, and incur additional costs.

The services we offer involve the transmission of large amounts of sensitive and proprietary information over public communications networks, as well as the processing and storage of confidential customer information. Unauthorized access, remnant data exposure, computer viruses, denial of service attacks, accidents, employee error or malfeasance, intentional misconduct by computer "hackers," and other disruptions can occur, and infrastructure gaps, hardware and software vulnerabilities, inadequate or missing security controls and exposed or unprotected customer data can exist that (i) interfere with the delivery of services to our customers, (ii) impede our customers' ability to do business, or (iii) compromise the security of systems and data, which exposes information to unauthorized third parties.

Techniques used to obtain unauthorized access to, or to sabotage, systems change frequently and generally are not recognized until launched against a target. We may be unable to implement security measures in a timely manner, or, if and when implemented, these measures could be circumvented as a result of accidental or intentional actions by parties within or outside of our organization. Any breaches that occur could expose us to increased risk of lawsuits, loss of existing or potential customers, harm to our reputation and increases in our security costs. Although we typically require our customers to sign agreements that contain provisions attempting to limit our liability for security breaches, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a security breach that they may ascribe to us. Additionally, we may decide to negotiate settlements with affected customers regardless of such contractual limitations. The outcome of any such lawsuit would depend on the specific facts of the case and legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may significantly exceed our liability insurance coverage by unknown but significant amounts, which could seriously impair our financial condition. The laws of some states and countries may also require us to inform any person whose data was accessed or stolen, which could harm our reputation and business. Complying with the applicable notice requirements in the event of a security breach could result in significant costs. We may also be subject to investigation and penalties by regulatory authorities and potential claims by persons whose information was disclosed, even if such person was not actually a customer.

If we fail to hire and retain qualified employees and management personnel, our growth strategy and our operating results could be harmed.

Our growth strategy depends on our ability to identify, hire, train, and retain executives, IT professionals, technical engineers, software developers, operations employees, and sales and senior management personnel who maintain relationships with our customers and who can provide the technical, strategic, and marketing skills required for our company to grow. There is a shortage of qualified personnel in these fields, specifically in the San Antonio, Texas area, where we are headquartered and a majority of our employees are located. We compete with other companies for this limited pool of potential employees. In addition, as our industry becomes more competitive, it could become especially difficult to retain personnel with unique in-demand skills and knowledge, whom we would expect to become recruiting targets for our competitors. There is no assurance that we will be able to recruit or retain qualified personnel, and this failure could cause a dilution of our service-oriented culture and our inability to develop and deliver new products and services, which could cause our operations and financial results to be negatively impacted.

Our success and future growth also depends to a significant degree on the skills and continued services of our management team, especially Graham Weston, our Chairman; A. Lanham Napier, our Chief Executive Officer; and Lew Moorman, our President. We do not have long-term employment agreements with any members of our management team, including Messrs. Weston, Napier and Moorman. Mr. Napier is the only member of our management team on whom we maintain key man insurance.

We have been accused of infringing the proprietary rights of others and may be accused of infringing on the proprietary rights of others in the future, which could subject us to costly and time consuming litigation and require us to discontinue services that infringe the rights of others.

There may be intellectual property rights held by others, including issued or pending patents, trademarks and service marks that cover significant aspects of our technologies, branding or business methods, including technologies and intellectual property we have licensed from third parties. Companies in the technology industry, and other patent and trademark holders seeking to profit from royalties in connection with grants of licenses, own large numbers of patents, copyrights, trademarks, service marks and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. These or other parties could claim that we have misappropriated or misused intellectual property rights. Any such current or future intellectual property claim against us, regardless of merit, could be time consuming and expensive to settle or litigate and could divert the attention of our technical and management personnel. An adverse determination also could prevent us from offering our services to our customers and may require that we procure or develop substitute services that do not infringe. For any intellectual property rights claim against us or our customers, we may also have to pay damages, indemnify our customers against damages or stop using technology or intellectual property found to be in violation of a third party's rights. We may be unable to replace those technologies with technologies that have the same features or functionality and that are of equal quality and performance standards on commercially reasonable terms or at all. Licensing replacement technologies and intellectual property may significantly increase our operating expenses or may require us to restrict our business activities in one or more respects. We may also be required to develop alternative non-infringing technology and intellectual property, which could require significant effort, time, and expense.

Failure to maintain adequate internal systems could cause us to be unable to properly provide service to our customers, causing us to lose customers, suffer harm to our reputation, and incur additional costs.

Some of our enterprise systems have been designed to support individual products, resulting in a fragmentation among various internal systems, making it difficult to serve customers who use multiple service offerings. This causes us to implement manual processes to overcome the fragmentation, which can result in increased expense and unnecessary manual errors. Some of these systems are also on aging or undersized infrastructure and are at risk of reaching capacity limits in the near future. If we fail to upgrade, replace or increase capabilities on these systems, we may be unable to meet our customers' requests for certain types of service.

We have systems initiatives underway that span infrastructure, products and business transformation. These initiatives are likely to drive significant change in both infrastructure and business processes and contain overlaps and dependencies among the programs. Our inability to manage competing priorities, execute multiple parallel program tracks, plan effectively, manage resources effectively and meet deadlines and budgets could result in us not being able to implement the systems needed to deliver our services in a compelling manner to our customers.

We provide service level commitments to our customers, which could require us to issue credits for future services if the stated service levels are not met for a given period and could significantly decrease our revenue and harm our reputation.

Our customer agreements provide that we maintain certain service level commitments to our customers relating primarily to network uptime, critical infrastructure availability, and hardware replacement. If we are unable to meet the stated service level commitments, we may be contractually obligated to provide these customers with credits for future services. As a result, a failure to deliver services for a relatively short duration could cause us to issue these credits to a large number of affected customers. In addition, we cannot be assured that our customers will accept these credits in lieu of other legal remedies that may be available to them. Our failure to meet our commitments could also result in substantial customer dissatisfaction or loss. Because of the loss of future revenue through these credits, potential customer loss and other potential liabilities, our revenue could be significantly impacted if we cannot meet our service level commitments to our customers.

If we are unable to maintain a high level of customer service, customer satisfaction and demand for our services could suffer.

We believe that our success depends on our ability to provide customers with quality service that not only meets our stated commitments, but meets and then exceeds customer service expectations. We refer to this high quality of customer service as Fanatical Support. If we are unable to provide customers with quality customer support in a variety of areas, we could face customer dissatisfaction, dilution of our brand, weakening of our main market differentiator, decreased overall demand for our services, and loss of revenue. In addition, our inability to meet customer service expectations may damage our reputation and could consequently limit our ability to retain existing customers and attract new customers, which would adversely affect our ability to generate revenue and negatively impact our operating results.

Our existing customers could elect to reduce or terminate the services they purchase from us because we do not have long-term contracts with our customers, which could adversely affect our operating results.

Customer contracts for our Dedicated Cloud hosting services typically have initial terms of one to two years which, unless terminated, may be renewed or automatically extended on a month-to-month basis. Our customers have no obligation to renew their services after their initial contract periods expire on these contracts. In addition, many of our other services and products, including most of our Public Cloud products and services, are generally provided on a month-to-month basis and do not have an extended initial term at all. Our costs associated with maintaining revenue from existing customers are generally much lower than costs associated with generating revenue from new customers. Therefore, a reduction in revenue from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins. Any failure by us to continue to retain our existing customers could have a material adverse effect on our operating results.

Customers with mission-critical applications could potentially expose us to lawsuits for their lost profits or damages, which could impair our financial condition.

Because our hosting services are critical to many of our customers' businesses, any significant disruption in our services could result in lost profits or other indirect or consequential damages to our customers. Although we require our customers to sign agreements that contain provisions attempting to limit our liability for service outages, we cannot assure you that a court would enforce any contractual limitations on our liability in the event that one of our customers brings a lawsuit against us as the result of a service interruption or other Internet site or application problems that they may ascribe to us. The outcome of any such lawsuit would depend on the specific facts of the case and any legal and policy considerations that we may not be able to mitigate. In such cases, we could be liable for substantial damage awards that may exceed our liability insurance coverage by unknown but significant amounts, which could materially impair our financial condition.

Our use of open source software and contributions to open source projects could impose limitations on our ability to provide our services, expose us to litigation, and cause us to impair some assets which could adversely affect our financial condition and operating results.

We utilize open source software, including Linux-based software, in providing a substantial portion of our services. The terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to offer our services. Additionally, the use and distribution of open source software can lead to greater risks than the use of third-party commercial software, as open source software does not come with warranties or other contractual protections regarding infringement claims or the quality of the code. From time to time parties have asserted claims against companies that distribute or use open source software in their products and services, asserting that open source software infringes their intellectual property rights. We have been subject to suits, and could be subject to suits in the future, by parties claiming infringement of intellectual property rights with respect to what we believe to be open source software. In such event, we could be required to seek licenses from third parties in order to continue using such software or offering certain of our services or to discontinue the use of such software or the sale of our affected services in the event we could not obtain such licenses, any of which could adversely affect our business, operating results and financial condition. In addition, if we combine our proprietary software with open source software in a certain manner, we could, under some of the open source licenses, be required to release the source code of our proprietary software.

We have also sponsored an open source project called OpenStack, which is designed to foster the emergence of cloud computing technology standards and cloud interoperability. Our participation in the project includes the release of our previously proprietary core cloud storage code, and we expect to release additional core cloud code in the future and contribute to the ongoing development of all of the OpenStack projects. In addition, we also participate in other open source projects and plan to continue to do so in the future. Our participation in and support for these projects could cause us to change our current software development and data center strategies. Our utilization of open source software and open data center design projects like the Facebook Open Compute project, which may replace our current capitalized design and development projects, could result in an impairment of those design and development assets.

In addition, our activities with these open source projects could subject us to additional risks of litigation including indirect infringement claims based on third-party contributors because of our sponsorship of this project.

We may not be successful in protecting and enforcing our intellectual property rights, which could adversely affect our financial condition and operating results.

We rely primarily on patent, copyright, trademark, service mark, and trade secret laws, as well as confidentiality procedures and contractual restrictions, to establish and protect our proprietary rights, all of which provide only limited protection. We rely on copyright laws to protect software and certain other elements of our proprietary technologies. We cannot assure you that any future copyright, trademark or service mark registrations will be issued for pending or future applications or that any registered or unregistered copyrights, trademarks or service marks will be enforceable or provide adequate protection of our proprietary rights. We currently have one patent issued and a number of patent applications filed in the U.S. and the European Union. Our patent applications may be challenged and/or ultimately rejected, and our issued patent may be contested, circumvented, found unenforceable or invalidated.

We endeavor to enter into agreements with our employees, contractors, and parties with whom we do business to limit access to and disclosure of our proprietary information. The steps we have taken, however, may not prevent unauthorized use or the reverse engineering of our technology. Moreover, others may independently develop technologies that are substantially equivalent, superior to, or otherwise competitive to the technologies we employ in our services or that infringe our intellectual property. We may be unable to prevent competitors from acquiring trademarks or service marks and other proprietary rights that are similar to, infringe upon, or diminish the value of our trademarks and service marks and our other proprietary rights. Enforcement of our intellectual property rights also depends on successful legal actions against infringers and parties who misappropriate our proprietary information and trade secrets, but these actions may not be successful, even when our rights have been infringed.

In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the U.S. Despite the measures taken by us, it may be possible for a third party to copy or otherwise obtain and use our technology and information without authorization. Policing unauthorized use of our proprietary technologies and other intellectual property and our services is difficult, and litigation could become necessary in the future to enforce our intellectual property rights. Any litigation could be time consuming and expensive to prosecute or resolve, result in substantial diversion of management attention and resources, and harm our business, financial condition, and results of operations.

Our corporate culture has contributed to our success, and if we cannot maintain this culture, we could lose the innovation, creativity, and teamwork fostered by our culture, and our operating results may be harmed.

We believe that a critical contributor to our success has been our corporate culture, which we believe fosters innovation, creativity, and teamwork. If we implement more complex organizational management structures because of growth or other structural changes or create disparities in personal wealth among our employees through our compensation philosophy and benefit plan utilization, we may find it increasingly difficult to maintain the beneficial aspects of our corporate culture. If we cannot maintain a favorable corporate culture, then we can lose employee engagement, which can cause employees to lose the desire to innovate, foster teamwork and strive to delight our customers. Ultimately, we believe that the delivery of exceptional service to our customers by our employees is what produces customer "promoters" and fuels our growth aspirations. Therefore, if the corporate culture is not maintained, it could negatively impact our future operating results.

If we are unable to manage our growth effectively, our financial results could suffer.

The growth of our business and our service offerings could strain our operating and financial resources. Further, we intend to continue expanding our overall business, customer base, headcount, and operations. Creating a global organization and managing a geographically dispersed workforce requires substantial management effort and significant additional investment in our operating and financial system capabilities and controls. If our information systems are unable to support the demands placed on them by our growth, we may be forced to implement new systems, which would be disruptive to our business. We may be unable to manage our expenses effectively in the future due to the expenses associated with these expansions, which may negatively impact our gross margins or operating expenses. If we fail to improve our operational systems or to expand our customer service capabilities to keep pace with the growth of our business, we could experience customer dissatisfaction, cost inefficiencies, and lost revenue opportunities, which may materially and adversely affect our operating results.

We may not be able to continue to add new customers and increase sales to our existing customers, which could adversely affect our operating results.

Our growth is dependent on our ability to continue to attract new customers while retaining and expanding our service offerings to existing customers. Growth in the demand for our services may be inhibited, and we may be unable to sustain growth in our customer base for a number of reasons, such as:

- A reduction in the demand for our services due to economic factors in the U.S., as well as the U.K. and European Union;
- Our inability to market our services in a cost-effective manner to new customers;
- The inability of our customers to differentiate our services from those of our competitors or our inability to effectively communicate such distinctions;
- Our inability to successfully communicate the benefits of our services to businesses;
- The decision of businesses to host their Internet sites and web infrastructure internally or in colocation facilities as an alternative to the use of our hosting services;
- Our inability to penetrate international markets;
- Our inability to provide compelling services or effectively market them to existing customers;
- Our inability to strengthen awareness of our brand; and
- Reliability, quality or compatibility problems with our services.

A substantial amount of our past revenue growth was derived from purchases of service upgrades and additional services by existing customers. Our costs associated with increasing revenue from existing customers are generally lower than costs associated with generating revenue from new customers. Therefore, a reduction in the rate of revenue increase or a revenue decrease from our existing customers, even if offset by an increase in revenue from new customers, could reduce our operating margins.

Any failure by us to continue attracting new customers or grow our revenue from existing customers for a prolonged period of time could have a material adverse effect on our operating results.

If we overestimate or underestimate our data center capacity requirements, our operating margins and profitability could be adversely affected.

The costs of construction, leasing, and maintenance of our data centers constitute a significant portion of our capital and operating expenses. In order to manage growth and ensure adequate capacity for new and existing customers while minimizing unnecessary excess capacity costs, we continuously evaluate our short and long-term data center capacity requirements.

If we overestimate the demand for our services and therefore secure excess data center capacity, our operating margins could be materially reduced, which would materially impair our profitability. If we underestimate our data center capacity requirements, we may not be able to service the expanding needs of our existing customers and may be required to limit new customer acquisition, which may materially impair our revenue growth.

In the past, we have leased data center facilities and built or maintained the facilities ourselves. Due to the lead time in expanding existing data centers or building new data centers, if we build or expand data centers ourselves, we are required to estimate demand for our services as far as two years into the future. This requirement to make customer demand estimates so far in advance makes it difficult to accurately estimate our data center space needs. Building and maintaining data center facilities is also quite expensive. Early on in our operating history, we acquired most of our data center facilities relatively inexpensively as distressed assets of third parties. However, any such endeavor to build our own facilities would now likely require us to pay full market rates, which would make the penalty for inaccurate forecasting of our space needs even more detrimental.

More recently, we have leased data centers from data center operators who have built or maintained the facilities for us. If there are facilities available for lease that suit our needs, our lead time to make capacity decisions is decreased. However, there is still substantial lead time necessary in making sure that available space is adequate for our needs and maximizes our investment return. If we inaccurately forecast our space needs, we may be forced to enter into a lease that is not ideal for our needs and may potentially be required to pay more to secure the space if the current customer demand were to require immediate space expansion.

We currently intend to continue to lease from data center operators, but we could be forced to re-evaluate those plans depending on the availability and cost of data center facilities, the ability to impact and control certain design aspects of the data center and economic conditions affecting the data center operator's ability to add additional facilities.

We may not be able to renew the leases on our existing facilities on terms acceptable to us, if at all, which could adversely affect our operating results.

We do not own the facilities occupied by our current data centers but occupy them pursuant to commercial leasing arrangements. The initial terms of our main existing data center leases expire over a period ranging from 2013 to 2033. Upon the expiration or termination of our data center facility leases, we may not be able to renew these leases on terms acceptable to us, if at all. If we fail to renew any data center lease and are required or choose to move the data center to a new facility, we would face significant challenges due to the technical complexity, risk, and high costs of relocating the equipment. For example, if we are required to migrate customer servers to a new facility, such migration could result in significant downtime for our affected customers. This could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Even if we are able to renew the leases on our existing data centers, we expect that rental rates, which will be determined based on then-prevailing market rates with respect to the renewal option periods and which will be determined by negotiation with the landlord after the renewal option periods, will be higher than rates we currently pay under our existing lease agreements. If we fail to increase revenue in our existing data centers by amounts sufficient to offset any increases in rental rates for these facilities, our operating results may be materially and adversely affected.

We rely on a number of third-party providers for data center space, equipment, maintenance and other services, and the loss of, or problems with, one or more of these providers may impede our growth or cause us to lose customers.

We rely on third-party providers to supply data center space, equipment and maintenance. For example, we lease data center space from third-party landlords, lease or purchase equipment from equipment providers, and source equipment maintenance through third parties. While we have entered into various agreements for the lease of data center space, equipment, maintenance and other services, the third party could fail to live up to the contractual obligations under those agreements. For example, a data center landlord may fail to adequately maintain its facilities or provide an appropriate data center infrastructure for which it is responsible. If that were to happen, we would not likely be able to deliver the services to our customers that we have agreed to provide according to our standards or at all. Additionally, if the third parties that we rely on do fail to deliver on their obligations, our customers may lose confidence in our company, which would make it likely that we would not able to retain those customers, and therefore negatively impede our growth and financial results.

We rely on third-party software that may be difficult to replace or which could cause errors or failures of our service that could lead to lost customers or harm to our reputation.

We rely on software licensed from third parties to offer our services. This software may not continue to be available to us on commercially reasonable terms, or at all. Any loss of the right to use any of this software could result in delays in the provisioning of our services until equivalent technology is either developed by us, or, if available, is identified, obtained, and integrated, which could harm our business. Any errors or defects in third-party software or inadequate or delayed support by the third party could result in errors or a failure of our service, which could harm our operating results by adversely affecting our revenue or operating costs.

We engage and rely on third-party consultants who may fail to provide effective guidance or solutions, which could result in increased costs and loss of business opportunity.

We engage third-party consultants who provide us with guidance and solutions relating to everything from overall corporate strategy to data center design to employee engagement. We engage these parties based on our perception of their expertise and ability to provide valuable insight or solutions in the areas that we believe need to be addressed in our business. However, these consultants may provide us with ineffective or even harmful guidance or solutions, which, if followed or implemented, could result in a loss of resources, operational failures or a loss of critical business opportunities.

Increased energy costs, power outages, and limited availability of electrical resources may adversely affect our operating results.

Our data centers are susceptible to increased regional, national or international costs of power and to electrical power outages. Our customer contracts do not allow us to pass on any increased costs of energy to our customers, which could affect our operating margins. Increases in our power costs could impact our operating results and financial condition. Since we rely on third parties to provide our data centers with power sufficient to meet our needs, our data centers could have a limited or inadequate amount of electrical resources necessary to meet our customer requirements. We attempt to limit exposure to system downtime due to power outages by using backup generators and power supplies. However, these protections may not limit our exposure to power shortages or outages entirely. Any system downtime resulting from insufficient power resources or power outages could damage our reputation and lead us to lose current and potential customers, which would harm our operating results and financial condition.

Increased Internet bandwidth costs and network failures may adversely affect our operating results.

Our success depends in part upon the capacity, reliability, and performance of our network infrastructure, including the capacity leased from our Internet bandwidth suppliers. We depend on these companies to provide uninterrupted and error-free service through their telecommunications networks. Some of these providers are also our competitors. We exercise little control over these providers, which increases our vulnerability to problems with the services they provide. We have experienced and expect to continue to experience interruptions or delays in network service. Any failure on our part or the part of our third-party suppliers to achieve or maintain high data transmission capacity, reliability or performance could significantly reduce customer demand for our services and damage our business.

As our customer base grows and their usage of telecommunications capacity increases, we will be required to make additional investments in our capacity to maintain adequate data transmission speeds, the availability of which may be limited or the cost of which may be on terms unacceptable to us. If adequate capacity is not available to us as our customers' usage increases, our network may be unable to achieve or maintain sufficiently high data transmission capacity, reliability or performance. In addition, our business would suffer if our network suppliers increased the prices for their services and we were unable to pass along the increased costs to our customers.

Our operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.

Our operating results may fluctuate due to a variety of factors, including many of the risks described in this section, which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our operating results for any prior periods as an indication of our future operating performance. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of long-term future revenue. Given relatively fixed operating costs related to our personnel and facilities, any substantial adjustment to our expenses to account for lower than expected levels of revenue will be difficult and time consuming. Consequently, if our revenue does not meet projected levels, our operating expenses would be high relative to our revenue, which would negatively affect our operating performance.

If our revenue or operating results do not meet or exceed the expectations of investors or securities analysts, the price of our common stock may decline.

We could be required to repay substantial amounts of money to certain state and local governments if we lose tax exemptions or grants previously awarded to us, which could adversely affect our operating results.

In August 2007, we entered into an agreement with the State of Texas (Texas Enterprise Fund Grant) under which we may receive up to $22.0 million in state enterprise fund grants on the condition that we meet certain employment levels in the State of Texas paying an average compensation of at least $56,000 per year (subject to increases). To the extent we fail to meet these requirements, we may be required to repay all or a portion of the grants plus interest. On July 27, 2009, the Texas Enterprise Fund Grant agreement was amended to modify the job creation requirements. Under the amendment, the grant has been divided into four separate tranches. The first tranche, called “Basic Fund” in the amendment, is $8.5 million with a Job Target of 1,225 new jobs by December 2012 (in addition to the 1,436 jobs in place as of August 1, 2007, for a total of 2,661 jobs in Texas). We received the initial installment of $5.0 million from the State of Texas in September 2007, and, after achieving the Job Target as of December 31, 2011, we received the remaining $3.5 million in March 2012. These amounts were recorded as non-current liabilities. The remaining three tranches are at our option. We can draw an additional $13.5 million, based on the following amounts and milestones: $5.5 million if we create a total of 2,100 new jobs in Texas, another $5.25 million if we create a total of 3,000 new jobs in Texas, and $2.75 million more if we create a total of 4,000 new jobs in Texas. We are responsible for maintaining the jobs through January 2022. If we eliminate jobs for which we have drawn funds, we are subject to a clawback on the amounts we have drawn plus 3.4% interest on such amounts per year.

On August 3, 2007, we entered into a lease for approximately 67 acres of land and a 1.2 million square foot facility in Windcrest, Texas, which is in the San Antonio, Texas area, to house our corporate headquarters. In connection with this lease, we also entered into a Master Economic Incentives Agreement (“MEIA”) with the Cities of Windcrest and San Antonio, Texas; Bexar County; and certain other parties, pursuant to which we agreed to locate existing and future employees at the new facility location. The agreement requires that we meet certain employment levels each year, with an ultimate job requirement of 4,500 jobs by December 31, 2012, provided that if the job requirement in any grant agreement with the State of Texas is lower, then the job requirement under the MEIA is automatically adjusted downward. Consequently, because the Texas Enterprise Fund Grant agreement has been amended to reduce the state job requirement, we believe the job requirement under the MEIA has been reduced to 1,774. In addition, the MEIA requires that the median compensation of those employees be no less than $51,000 per year. In exchange for meeting these employment obligations, the parties agreed to enter into the lease structure, pursuant to which, as a lessee of the Windcrest Economic Development Corporation, we will not be subject to most of the property taxes associated with the property for a 14-year period. If we fail to meet these job creation requirements, we could lose a portion or all of the tax benefit being provided during the 14-year period by having to make payments in lieu of taxes (PILOT) to the City of Windcrest. The amount of the PILOT payment would be calculated based on the amount of taxes that would have been owed for that period if the property were not exempt, and then such amount would be adjusted pursuant to certain factors, such as the percentage of employment achieved compared to the stated requirements.

We have debt obligations that include restrictive covenants limiting our flexibility to manage our business; failure to comply with these covenants could trigger an acceleration of our outstanding indebtedness and adversely affect our financial position and operating results.

As of September 30, 2012, there was no outstanding indebtedness under our credit facility other than an immaterial outstanding letter of credit. Our credit facility requires compliance with a set of financial and non-financial covenants. Those covenants include financial leverage limitations and interest rate coverage requirements, as well as limitations on our ability to incur additional debt or liens, make restricted payments, sell assets, enter into affiliate transactions, merge or consolidate with other companies, make certain acquisitions and take other actions. If we default on our credit agreement due to non-compliance with such covenants or any other contractual requirement of the agreement, we may be required to repay all amounts owed under this credit facility.

We also have substantial equipment lease obligations, the principal balance of which totaled approximately $145.1 million as of September 30, 2012. The payment obligations under these equipment leases are secured by a significant portion of the hardware used in our data centers. If we are unable to generate sufficient cash flow from our operations or cash from other sources in order to meet the payment obligations under these equipment leases, we may lose the right to possess and operate the equipment used in our data centers, which would substantially impair our ability to provide our services, which could have a material adverse effect on our liquidity or results of operations.

If we are unable to generate sufficient cash to repay our debt obligations when they become due and payable, either when they mature or in the event of a default, we may not be able to obtain additional debt or equity financing on favorable terms, if at all, which may negatively impact our ability to continue as a going concern.

We may require additional capital and may not be able to secure additional financing on favorable terms to meet our future capital needs, which could adversely affect our financial position and result in stockholder dilution.

In order to fund future growth, we will be dependent on significant capital expenditures. We may need to raise additional funds through equity or debt financings in the future in order to meet our operating and capital needs. We may not be able to secure additional debt or equity financing on favorable terms, or at all, at the time when we need such funding. If we are unable to raise additional funds, we may not be able to pursue our growth strategy, and our business could suffer. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new equity securities we issue could have rights, preferences, and privileges senior to those of holders of our common stock. In addition, any debt financing that we may obtain in the future could have restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions.

We are exposed to commodity and market price risks that have the potential to substantially influence our profitability and liquidity.

We are a large consumer of power. During the first nine months of 2012, we expensed approximately $16.5 million to utility companies to power our data centers. We anticipate an increase in our consumption of power in the future as our sales grow. Power costs vary by locality and are subject to substantial seasonal fluctuations and changes in energy prices. Our largest exposure to energy prices currently exists at our Grapevine, Texas facility in the Dallas-Fort Worth area, where the energy market is deregulated. Power costs have historically tracked the general costs of energy, and continued increases in electricity costs may negatively impact our gross margins or operating expenses. We periodically evaluate the advisability of entering into fixed-price utilities contracts and have entered into certain fixed-price utilities contracts for some of our power consumption. If we choose not to enter into a fixed-price contract, we expose our cost structure to this commodity price risk. If we do choose to enter into a fixed-price contract, we lose the opportunity to reduce our power costs if the price for power falls below the fixed cost.

Our main credit facility is a revolving line of credit with a base rate determined by variable market rates, including the Prime Rate and the London Interbank Offered Rate (LIBOR). These market rates of interest are fluctuating and expose our interest expense to risk. At this point, our credit agreement does not obligate us to hedge any interest rate risk with any instruments, such as interest rate swaps or interest rate options, and we do not have any such instruments in place. As we borrow more, we may enter into swaps to continuously control our interest rate risk. As a result, we are exposed to interest rate risk on our borrowings. As an example of the impact of this interest rate risk, a 100 basis point increase in LIBOR would increase the interest expense on $10 million of borrowings that are not hedged by $0.1 million annually. As of September 30, 2012, we did not have exposure to interest rate risk as there was no amount outstanding on our revolving credit facility.

The majority of our customers are invoiced, and substantially all of our expenses are paid, by us or our subsidiaries in the functional currency of our company or our subsidiaries, respectively. However, some of our customers are currently invoiced in currencies other than the applicable functional currency. As a result, we may incur foreign currency losses based on changes in exchange rates between the date of the invoice and the date of collection. In addition, large changes in foreign exchange rates relative to our functional currencies could increase the costs of our services to non-U.S. customers relative to local competitors, thereby causing us to lose existing or potential customers to these local competitors. Thus, our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. Further, as we grow our international operations, our exposure to foreign currency risk could become more significant. To date, we have not entered into any foreign currency hedging contracts, although we may do so in the future.

We may be liable for the material that content providers distribute over our network, and we may have to terminate customers that provide content that is determined to be illegal, which could adversely affect our operating results.

The law relating to the liability of private network operators for information carried on, stored on, or disseminated through their networks is still unsettled in many jurisdictions. We have been and expect to continue to be subject to legal claims relating to the content disseminated on our network, including claims under the Digital Millennium Copyright Act, other similar legislation and common law. In addition, there are other potential customer activities, such as online gambling and pornography, where we, in our role as a hosting provider, may be held liable as an aider or abettor of our customers. If we need to take costly measures to reduce our exposure to these risks, terminate customer relationships and the associated revenue or defend ourselves against such claims, our financial results could be negatively affected.

Government regulation is continuously evolving and, depending on its evolution, may adversely affect our operating results.

We are subject to varying degrees of regulation in each of the jurisdictions in which we provide services. Local laws and regulations, and their interpretation and enforcement, differ significantly among those jurisdictions. These regulations and laws may cover taxation, privacy, data protection, pricing, content, copyrights, distribution, mobile communications, electronic device certification, electronic waste, electronic contracts and other communications, consumer protection, web services, the provision of online payment services, unencumbered Internet access to our services, the design and operation of websites, and the characteristics and quality of products and services. These laws can be costly to comply with, can be a significant diversion to management’s time and effort, and can subject us to claims or other remedies, as well as negative publicity. Many of these laws were adopted prior to the advent of the Internet and related technologies and, as a result, do not contemplate or address the unique issues that the Internet and related technologies produce. Some of the laws that do reference the Internet and related technologies have been and continue to be interpreted by the courts, but their applicability and scope remain largely uncertain.

In addition, future regulatory, judicial, and legislative changes may have a material adverse effect on our ability to deliver services within various jurisdictions. National regulatory frameworks have only recently been, or are still being, put in place in many countries. Accordingly, many countries are still in the early stages of providing for and adapting to a liberalized telecommunications market. As a result, in these markets we may encounter more protracted and difficult procedures to obtain any necessary licenses or negotiate interconnection agreements, which could negatively impact our ability to expand in these markets or increase our operating costs in these markets.

Privacy concerns relating to our technology could damage our reputation and deter current and potential users from using our products and services.

Since our products and services are web-based, we store substantial amounts of data for our customers on our servers (including personal information). Any systems failure or compromise of our security that results in the release of our customers’ data could (i) subject us to substantial damage claims from our customers, (ii) expose us to costly regulatory remediation and (iii) harm our reputation and brand. We may also need to expend significant resources to protect against security breaches. The risk that these types of events could seriously harm our business is likely to increase as we expand our hosting footprint.

Regulatory authorities around the world are considering a number of legislative proposals concerning data protection. In addition, the interpretation and application of data protection laws in Europe and elsewhere are still uncertain and in flux. It is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines, this could result in an order requiring that we change our data practices, which could have an adverse effect on our business. Complying with these various laws could cause us to incur substantial costs or require us to change our business practices in a manner adverse to our business.

Our ability to operate and expand our business is susceptible to risks associated with international sales and operations.

We anticipate that, for the foreseeable future, a significant portion of our revenue will continue to be derived from sources outside of the U.S. A key element of our growth strategy is to further expand our customer base internationally and successfully operate data centers in foreign markets. We have limited experience operating in foreign jurisdictions other than the U.K. and Hong Kong and expect to continue to grow our international operations. Managing a global organization is difficult, time consuming, and expensive. Our inexperience in operating our business globally increases the risk that international expansion efforts that we may undertake will not be successful. In addition, conducting international operations subjects us to new risks that we have not generally faced. These risks include:

- Localization of our services, including translation into foreign languages and adaptation for local practices and regulatory requirements;
- Lack of familiarity with and unexpected changes in foreign regulatory requirements;
- Longer accounts receivable payment cycles and difficulties in collecting accounts receivable;
- Difficulties in managing and staffing international operations;
- Fluctuations in currency exchange rates;
- Potentially adverse tax consequences, including the complexities of transfer pricing, foreign value added tax systems, and restrictions on the repatriation of earnings;
- Dependence on certain third parties, including channel partners with whom we do not have extensive experience;
- The burdens of complying with a wide variety of foreign laws and legal standards;
- Increased financial accounting and reporting burdens and complexities;
- Political, social, and economic instability abroad, terrorist attacks and security concerns in general; and
- Reduced or varied protection for intellectual property rights in some countries.

Operating in international markets also requires significant management attention and financial resources. The investment and additional resources required to establish operations and manage growth in other countries may not produce desired levels of revenue or profitability.

We rely on our Channel Partner Program members for a significant portion of our revenues, and we benefit from our association with them. The loss of these members could adversely affect our business.

Our Channel Partner Program drives a significant amount of revenue to our business through referral and reseller arrangements. Most of our member partners offer services that are complementary to our services; however, some of the participants may actually compete with us in one or more of our product or service offerings. These network partners may decide in the future to terminate their agreements with us and/or to market and sell a competitor's or their own services rather than ours, which could cause our revenue to decline.

Also, we derive tangible and intangible benefits from our association with some of our network partners, particularly high profile partners that reach a large number of companies through the Internet. If a substantial number of these partners terminate their relationship with us, our business could be adversely affected.

Our acquisitions may divert our management's attention, result in dilution to our stockholders and consume resources that are necessary to sustain our business.

We have made acquisitions, and, if appropriate opportunities present themselves, we may make additional acquisitions or investments or enter into joint ventures or strategic alliances with other companies. Risks commonly encountered in such transactions include:

- The difficulty of assimilating the operations and personnel of the combined companies;
- The potential post-acquisition loss of personnel acquired through an acquisition;
- The risk that we may not be able to integrate the acquired services or technologies with our current services, products, and technologies;
- The potential disruption of our ongoing business;
- The diversion of management attention from our existing business;
- The inability of management to maximize our financial and strategic position through the successful integration of the acquired businesses;
- Difficulty in maintaining controls, procedures, and policies;
- The impairment of relationships with employees, suppliers, and customers as a result of any integration;
- The loss of an acquired base of customers and accompanying revenue; and
- The assumption of leased facilities, other long-term commitments or liabilities that could have a material adverse impact on our profitability and cash flow.

As a result of these potential problems and risks, businesses that we may acquire or invest in may not produce the revenue, earnings, or business synergies that we anticipated. In addition, there can be no assurance that any potential transaction will be successfully identified and completed or that, if completed, the acquired business or investment will generate sufficient revenue to offset the associated costs or other potential harmful effects on our business.

Concerns about greenhouse gas emissions and the global climate change may result in environmental taxes, charges, assessments or penalties.

The effects of human activity on the global climate change have attracted considerable public and scientific attention, as well as the attention of the United States government. Efforts are being made to reduce greenhouse emissions, particularly those from coal combustion by power plants, some of which we may rely upon for power. The added cost of any environmental taxes, charges, assessments or penalties levied on these power plants could be passed on to us, increasing the cost to run our data centers. Additionally, environmental taxes, charges, assessments or penalties could be levied directly on us in proportion to our carbon footprint. Any enactment of laws or passage of regulations regarding greenhouse gas emissions by the United States, or any domestic or foreign jurisdiction we perform business in, could adversely affect our operations and financial results.

Risks Related to the Ownership of Our Common Stock

The trading price of our common stock may be volatile.

The market price of our common stock has been highly volatile and could be subject to wide fluctuations in response to, among other things, the risk factors described in this periodic report, operating results that do not meet the market analyst expectations, and other factors beyond our control, such as stock market volatility and fluctuations in the valuation of companies perceived by investors to be comparable to us.

Further, the stock markets have experienced price and volume fluctuations that have affected our stock price and the market prices of equity securities of many other companies. These fluctuations often have been unrelated or disproportionate to the operating performance of those companies. These broad market and industry fluctuations, as well as general economic, political, and market conditions, such as recessions, interest rate changes or international currency fluctuations, may negatively affect the market price of our common stock. We may experience additional volatility as a result of the limited number of our shares available for trading in the market.

In the past, many companies that have experienced volatility in the market price of their stock have been subject to securities class action litigation. We may be the target of this type of litigation in the future. Securities litigation against us could result in substantial costs and divert our management's attention from other business concerns, which could seriously harm our business.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008, and the price of our common stock has fluctuated substantially since then and may fluctuate substantially in the future.

Our common stock has only been publicly traded since our initial public offering on August 7, 2008. The trading price of our common stock has fluctuated significantly since then. For example, between December 31, 2011 and September 30, 2012, the closing trading price of our common stock was very volatile, ranging between $41.22 and $66.65 per share, including single-day increases of up to 12.6% and declines up to 8.9%. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this quarterly report on Form 10-Q.

We do not intend to pay dividends on our common stock.

We have never declared or paid any cash dividend on our capital stock. We currently intend to retain any future earnings and do not expect to pay any dividends in the foreseeable future.

The issuance of additional stock in connection with acquisitions, our stock purchase plan, or otherwise will dilute all other stockholdings.

We have a large number of shares of common stock authorized but unissued and not reserved for issuance under our stock option plans or otherwise. We may issue all of these shares without any action or approval by our stockholders. We intend to continue to actively pursue strategic acquisitions. We may pay for such acquisitions, partly or in full, through the issuance of additional equity. In addition, our Employee Stock Purchase Plan contains an evergreen provision, which annually increases the number of shares that can be purchased under the plan. Any issuance of shares in connection with our acquisitions, our Employee Stock Purchase Plan or otherwise would dilute the percentage ownership held by our then-existing stockholders.

Your ability to influence corporate matters may be limited because a small number of stockholders beneficially own a substantial amount of our common stock.

Our directors and executive officers and their affiliates beneficially own a significant portion of our outstanding common stock. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets. Although our directors and executive officers are not currently party to any agreements or understandings to act together on matters submitted for stockholder approval, this concentration of ownership could limit your ability to influence corporate matters and may have the effect of delaying or preventing a third party from acquiring control over us.

Anti-takeover provisions in our organizational documents and Delaware law may discourage or prevent a change of control, even if an acquisition would be beneficial to our stockholders, which could affect our stock price adversely and prevent attempts by our stockholders to replace or remove our current management.

Our restated certificate of incorporation and amended and restated bylaws contain provisions that could delay or prevent a change of control of our company or changes in our board of directors deemed undesirable by our board of directors that our stockholders might consider favorable. Some of these provisions:

- Authorize the issuance of blank check preferred stock, which can be created and issued by our board of directors without prior stockholder approval, with voting, liquidation, dividend, and other rights senior to those of our common stock;
- Provide for a classified board of directors, with each director serving a staggered three-year term;
- Prohibit our stockholders from filling board vacancies or increasing the size of our board, calling special stockholder meetings or taking action by written consent;
- Provide for the removal of a director only with cause and by the affirmative vote of the holders of a majority of the shares then entitled to vote at an election of our directors; and
- Require advance written notice of stockholder proposals and director nominations.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock. These and other provisions in our restated certificate of incorporation, amended and restated bylaws and Delaware law could make it more difficult for stockholders or potential acquirers to obtain control of our board of directors or initiate actions that are opposed by our then-current board of directors, including a merger, tender offer or proxy contest involving our company. Any delay or prevention of a change of control transaction or changes in our board of directors could cause the market price of our common stock to decline.

ITEM 6 – EXHIBITS

Exhibit Number	Description
10.1 *	Agreement and Release of Claims with James Lewandowski
31.1 *	Certification of Principal Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2 *	Certification of Principal Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1 **	Certifications of Principal Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2 **	Certifications of Principal Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS *	XBRL Instance Document
101.SCH *	XBRL Taxonomy Extension Schema
101.CAL *	XBRL Taxonomy Extension Calculation Linkbase
101.DEF *	XBRL Taxonomy Extension Definition Linkbase
101.LAB *	XBRL Taxonomy Extension Label Linkbase
101.PRE *	XBRL Taxonomy Extension Presentation Linkbase

* Filed herewith
** Furnished herewith

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, on November 7, 2012.

Rackspace Hosting, Inc.

Date:	November 7, 2012	By:	/s/ Karl Pichler
			Karl Pichler Chief Financial Officer and Treasurer (Principal Financial Officer)
Date:	November 7, 2012	By:	/s/ Joe Saporito
			Joe Saporito Chief Accounting Officer (Principal Accounting Officer)

AGREEMENT AND RELEASE OF CLAIMS

This Agreement and Release of Claims ("Agreement") is entered into on October 9, 2012, by and between James Lewandowski ("Executive") and Rackspace US, Inc. acting on its own behalf as well as on behalf of all related entities, both parent and subsidiaries, specifically including Rackspace Hosting, Inc. (collectively "Rackspace" or "Company"). Executive and Rackspace shall collectively be called the Parties.

RECITALS:

Executive and Rackspace entered into an offer letter agreement on September 8, 2008 (the "Offer Letter");

Executive is currently employed as Rackspace's Senior Vice President & General Manager, Hybrid - US ("General Manager");

The Parties have determined that it is in their mutual best interests that Executive immediately relinquish his position as General Manager, continue as a Company employee for a definite period of time under the terms of this Agreement, and on the Separation Date (as hereinafter defined) leave employment of the Company, all on the terms and subject to the conditions and post-employment restrictive covenants as set forth in this Agreement.

AGREEMENT:

Now, therefore, for and in consideration of the mutual promises contained herein, and other good and valuable consideration, it being understood that the consideration to be received by Executive hereunder is intended to protect and enhance the Company's goodwill, the Parties hereby agree as follows:

1. Transition and Separation. The Company agrees that by Executive entering into this Agreement, Executive's employment relationship with Rackspace may continue through the close of business on November 12, 2012. On October 8, 2012, Executive will no longer be General Manager, but will continue as a full-time employee, with a primary duty of providing assistance with the transition of his successor at his current rate of pay (in bi-weekly installments, less applicable deductions) unless otherwise agreed by the Parties ("Transition Period"). During the Transition Period, Executive acknowledges and agrees that he will continue to have duties and responsibilities and that he will be provided with access to Company owned confidential information, and that this access to confidential information is a material inducement and valuable consideration being provided to Executive. Executive's final day of employment shall be November 12, 2012 ("Separation Date").

During the Transition Period, Executive will be permitted to continue to participate in certain of the Company's benefit plans in accordance with the provisions of the relevant plan documents, including any amendments to those plans that may be enacted from time to time, and any applicable elections that Executive may have on file with the Company as explained more fully in Section 3 of this Agreement. The Executive will not, however, accrue any vacation days during the Transition Period.

In order to receive the consideration set forth in Section 2 of this Agreement and any payments under this Agreement Executive must satisfy his duties, and work through the Separation Date, and sign and submit this Agreement within 21 days of the date of this Agreement, and must not revoke the Agreement, within the time specified in Section 24 of this Agreement.

2. Payments and Other Consideration.

In consideration of Executive's entering into and compliance with all terms of this Agreement, Rackspace agrees that Executive will have the right to:

a. Continue his employment during the Transition Period, and be paid his current salary, and receive access to confidential information as set forth in Section 1.

b. Receive reimbursement for his reasonable, ordinary and necessary business expenses in accordance with Company policy.

c. After the Separation Date, Executive will receive an amount equal to the sum of $187,000.00 (one hundred eighty-seven thousand dollars and no cents), less applicable withholdings and deductions, which represents six (6) months of Executive's base salary ("Base Salary") for each month that he does not violate Sections 6 and 7 of this Agreement. Executive will receive the Base Salary payments in twenty-six (26) equal installments, paid bi-weekly in arrears, beginning on the first payroll period after the Separation Date and continuing each successive payroll period until twenty-six payments have been made. If Executive breaches his obligations in Sections 6 and 7, the Company shall be entitled to cease making such Base Salary payments.

d. After the Separation Date, Executive will receive an amount equal to the sum of $187,000.00 (one hundred eighty-seven thousand dollars and no cents), less applicable withholdings and deductions, which represents payments for Executive's potential Q3 and Q4 profit sharing bonus at 100% attainment ("Profit Sharing") for each month that he does not violate Sections 6 and 7 of this Agreement. Executive will receive the Profit Sharing payments in twenty-six (26) equal installments, paid bi-weekly in arrears, beginning on the first payroll period after the Separation Date and continuing each successive payroll period until twenty-six payments have been made. If Executive breaches his obligations in Sections 6 and 7, the Company shall be entitled to cease making such Profit Sharing payments.

e. Retain all stock options that have vested and are exercisable as of the Separation Date, under the terms of the stock option agreements entered into pursuant to the applicable stock option awards (the "Vested Options").

Executive acknowledges that pursuant to his stock option agreements, he will have the right to exercise his unexercised Vested Options until three (3) months after Separation Date, and Executive's right to exercise the Vested Options shall not terminate as a result of the Transition Period. All other non-vested options under the stock option agreements shall terminate as of the Separation Date.

Executive acknowledges and agrees that the Base Salary and Profit Sharing Payments amounts are not intended to be liquidated damages or an estimate of the actual damages that would be sustained by the Company if Executive breaches his post-employment obligations. The Company retains the right to seek injunctive relief as set forth in Section 8.

Executive acknowledges and agrees that his continued employment, the payments to be made hereunder, and the availability of the option exercise resulting from stock options which vest during the Transition Period due to his continued employment, shall be accepted by Executive as, and shall be considered as, payments in consideration for this Agreement, including the releases and non-competition and non-solicitation provisions as set forth below, and in lieu of notice for unemployment compensation purposes.

Rackspace shall not be obligated to make any further or additional payment to Executive in any amount or for any purpose whatsoever unless otherwise required by applicable law.

3. Benefits.

a. During the Transition Period only, Executive will remain eligible to participate in the following benefit plans in accordance with the language of the plan: Medical, Dental, Vision, Health Savings Account, Basic Life/Accidental Death and Dismemberment (“AD&D”), Insurance, Voluntary Life, Flexible Spending Account. For those plans requiring premium payments, Executive will be required to pay the same portion of the total premium as an active employee pays. If Executive elects to continue Medical, Dental, and/or Vision coverage, his benefit coverage level will be provided at the benefit coverage level previously selected subject to the Company's right to amend, modify, or terminate such arrangements at any time.

b. Pursuant to 409A, the following rules apply to Executive's continued receipt of the above benefits to the extent that those benefits are not exempt from the requirements of 409A: (i) to the extent that any such benefit is provided via reimbursement to Executive, no such reimbursement will be made by Rackspace later than the end of the year following the year in which the underlying expense is incurred; (ii) any such benefit provided by Rackspace in any year will not be affected by the amount of any such benefit provided by Rackspace in any other year; and (iii) under no circumstances will Executive be permitted to liquidate or exchange any such benefit for cash or any other benefit.

c. Executive's health insurance benefits will cease on the Separation Date subject to Executive's right to continue his health insurance under COBRA. Executive understands that COBRA election and payments are his choice and responsibility. Except as otherwise herein noted, Executive's participation in all benefits and incidents of employment, including, but not limited to, vesting in stock options, and the accrual of bonuses, and earned time off, cease as of the Separation Date.

4. Release.

a. As a material inducement to Rackspace to pay the consideration described above, together with the Executive's agreement to forego the actions herein described, Executive hereby releases, waives, acquits and forever discharges Rackspace, its predecessors, successors, parents, subsidiaries, assigns, agents, directors, officers, employees, representatives, attorneys, affiliated companies, and all persons acting by, through, under or in concert with any of them (“Releases”), from any and all charges, complaints, claims, controversies, demands, rights, disputes, and causes of action of any nature whatsoever, known or unknown, asserted or unasserted, accrued or not accrued, arising before or existing when this Agreement is executed, which Executive may have or claim to have against any of the persons or entities released regarding any matter, including but not limited to any claims that could be raised under the Offer Letter or related to the employment relationship.

b. This release and waiver specifically includes but is not limited to any claim or cause of action arising under Title VII of the Civil Rights Act of 1964, 42 U.S.C.A. §§ 2000 et seq., as amended by the Civil Rights Act of 1991; the Americans With Disabilities Act, 42 U.S.C. §§ 12101 et seq.; 42 U.S.C. §§ 1981; the Civil Rights Act of 1991, as amended; the Texas Commission on Human Rights Act, Tex. Lab. Code §§21.001 et seq.; Texas Labor Code §§451.001 et seq.; the Age Discrimination in Employment Act of 1967, as amended, 29 U.S.C. §§ 621 et seq.; the Older Workers Benefit Protection Act of 1990; the Employment Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001 et seq.; the Family and Medical Leave Act; the Fair Labor Standards Act; the Genetic Information Nondiscrimination Act or any other federal, state or local statute or common law cause of action of similar effect regarding employment related causes of action of employees against their employer, or for breach of contract, promissory estoppel or any other legal theory.

c. This release and waiver specifically includes but is not limited to any claim or cause of action arising under the Age Discrimination in Employment Act of 1967, as amended 29 U.S.C. §§ 621 *et seq*., and the Older Workers Benefit Protection act of 1990. Executive acknowledges that he is not waiving claims that may arise after this Agreement has become enforceable. Executive acknowledges that he is receiving benefits under this Agreement to which he would not otherwise be entitled.

d. **Executive is advised to review this Agreement with an attorney concerning its effect prior to executing it.**

e. Rackspace hereby releases, waives, acquits and forever discharges Executive, his spouse and all persons acting by, through, under or in concert with any of them, from any and all charges, complaints, claims, controversies, demands, rights, disputes, and causes of action of any nature whatsoever, known or unknown, asserted or unasserted, accrued or not accrued, arising before or existing when this Agreement is executed, which Rackspace may have or claim to have against Executive or his spouse or any of the persons or entities released regarding any matter. Notwithstanding the foregoing, this release does not apply to any claims related to unknown criminal or fraudulent acts or gross misconduct by Executive.

f. Executive acknowledges that the payments and other considerations to be received pursuant to this Agreement, as specifically set forth above at Section 2, are more than Executive would otherwise be entitled, and constitutes valid consideration for this Agreement.

g. In further consideration for the payments and other considerations set forth in Section 2, Executive agrees to: (1) not assert any claims described in or otherwise released by the preceding paragraphs against Rackspace or the affiliated or related entities, officers, agents, directors, servants, staff or employees of Rackspace, or any and all parties in privity with Rackspace; and (2) indemnify and hold harmless Rackspace and the affiliated or related entities, officers, agents, directors, servants, staffs or employees of Rackspace and any and all parties in privity with Rackspace, for any claims described in Paragraphs 4(a) and 4(b) which may be asserted by the Executive or any other person or entity claiming by, through, under or on behalf of Executive.

h. Executive agrees that the release set forth in this Section shall be and remain in effect in all respects as a complete general release as to the matters released. This release does not extend to any obligations incurred under this Agreement. This release does not release claims that cannot be released as a matter of law, including, but not limited to, Executive's right to file a charge with or participate in a charge by the Equal Employment Opportunity Commission, or any other local, state, or federal administrative body or government agency that is authorized to enforce or administer laws related to employment, against the Company (with the understanding that any such filing or participation does not give Executive the right to recover any monetary damages against the Company; Executive's release of claims herein bars Executive from recovering such monetary relief from the Company).

i. Executive further acknowledges and agrees that except as set forth in this Agreement, he is foregoing and releasing the right to exercise any options he has, if any, to purchase the securities of the Employer including but not limited to its parent, Rackspace Hosting, Inc. and agrees that all such options, if any, are terminated and no longer in effect.

j. Executive shall return to Rackspace all notebook computers, documents, access badge, cell phone, and any other company property.

5. Unknown Claims. Executive acknowledges that he has been advised to consult with legal counsel and that he is familiar with the principle that a general release does not extend to claims that the releaser does not know or suspect to exist in his favor at the time of executing the release, which, if known by him, would have materially affected his settlement with the released party. Except as set forth in Section 4(b), Executive, being aware of said principle, agrees to expressly waive any rights he may have to that effect, as well as under any other statute or common law principles of similar effect.

6. Non-competition and Non-Solicitation. In consideration of the receipt and retention of the consideration as described in Section 2, and any additional benefits provided to Executive hereunder to which he is not otherwise entitled (including, without limitation, the stock options which will vest during the Transition Period), Executive covenants and agrees to the following non-competition and non-solicitation provisions. During the Transition Period and for twelve (12) months after the Separation Date, Executive shall not, either on Executive's own behalf or as an agent, consultant, partner, employee, owner or representative of any person or entity directly or indirectly compete with the business of the Company and its successors and assigns. Specifically, Executive shall not:

(a) Work, as an employee, contractor, officer, owner, or director, in any business anywhere in the world that sells hosting and information technology services similar to those services provided by the Company, namely (i) provisioning, hosting, management, monitoring or maintenance of computer servers (whether dedicated, shared or virtual) and network connectivity in a datacenter for remote use via the Internet, (ii) hosted email, storage, collaboration, compute, virtual networking and similar services, and (iii) all similar related services, all of the foregoing being defined for the purposes of this Agreement as "Hosting";

(b) Solicit or attempt to solicit customers or prospective customers of Rackspace with whom Executive had contact during his employment that will or may divert business or business opportunities from Rackspace.

(c) Solicit, hire, or recruit, directly or indirectly or aid in the hiring or recruitment of any of Rackspace's personnel.

Executive acknowledges that he has received adequate consideration for the post-employment covenants as set forth herein and that said covenants are a material inducement to Company's agreement to continue Executive's employment through the Transition Period, and are necessary to protect the Company's significant goodwill. Executive agrees to waive any objection to the validity of these covenants and acknowledges that these limited prohibitions are reasonable as to time, geographical area and scope of activities to be restrained and that these limited prohibitions do not impose a greater restraint than is necessary to protect Rackspace's goodwill, proprietary information and other business interests.

7. No Interference with the Company's Relationships. During the Transition Period and for a period of twelve (12) months following the Separation Date, Executive shall not, either on Executive's own behalf or as an agent, consult, partner, employee, owner or representative of any person or entity, directly or indirectly interfere with any of the Company's relationships with the customers and vendors that Executive worked with during his employment at Rackspace. Executive shall not induce or encourage, directly or indirectly, any customer, client, or vendor to stop doing business with the Company or in inducing or encouraging the customer to not retain the services of the Company.

8. Injunctive Relief. Executive acknowledges and agrees that irreparable damages and injury to the Company will result from Executive's breach of the promises contained in Sections 6 or 7. Accordingly, Executive's breach of Sections 6 or 7 shall give the Company the right to obtain a temporary restraining order and preliminary or permanent injunction enjoining Executive from violating this Agreement and all other equitable relief (without the requirement to post bond) in order to prevent immediate and irreparable harm to the Company. These injunctive remedies are cumulative and in addition to any other rights and remedies the Company may have against Executive. Executive will reimburse the Company for any and all reasonable attorney fees and costs incurred by the Company in enforcing this Agreement.

9. Confidentiality and Non-Disclosure of Proprietary Information.

a. Executive shall not, directly or indirectly, for Executive's own benefit or for the benefit of another, reveal or disclose to any other person, firm, corporation, or other party or make, directly or indirectly, any commercial or other use of any information not publicly known about Rackspace or its prospects, services, suppliers, products, customers, finances, data processing, purchasing, accounting or marketing systems, such information being privileged, confidential business and/or trade secret information of Rackspace. Executive agrees that he will not contact any of Rackspace's customers or former customers for a period of twelve (12) months other than in connection with business unrelated to Rackspace. Executive further acknowledges that he has signed an agreement entitled Confidentiality and Intellectual Property Assignment (the "Confidentiality Agreement") to which Executive acknowledges and agrees he is obligated according to the terms set forth therein and reaffirms his obligation to comply with the Confidentiality Agreement as a condition of receiving and retaining the consideration provided pursuant to this Agreement, provided, however, by entering into this Agreement, the "at-will" provision contained in the Confidentiality Agreement are no longer applicable it being understood that such provision is superceded by this Agreement, and Executive's employment is for a definite term and no longer "at will."

b. Further, as a result of Executive's employment by Rackspace, Executive may have had access to, or knowledge of, confidential business information or trade secrets of third parties. Executive also agrees to preserve and protect the confidentiality of such third-party confidential information and trade secrets to the same extent, and on the same basis, as the privileged confidential business and/or trade secret information of Rackspace.

c. All written materials, records, and other documents made by, or coming into the possession of, Executive during the period of Executive's employment by Rackspace which contains or discloses privileged, confidential business and/or trade secret information shall be and remain the property of Rackspace. Upon termination of Executive's employment with Rackspace, Executive promptly shall deliver the same, and all copies thereof, to Rackspace.

10. Non-Disparagement. Executive shall not directly or indirectly through any agent, representative or affiliate, at any time make false, misleading or disparaging statements or representations, or statements or representations that could be interpreted as such, whether written or oral, regarding Rackspace, including but not limited to, statements or representations regarding Rackspace's products, services, management, employees and customers. Additionally, Graham Weston, Lew Moorman, and Lanham Napier, as representatives of Rackspace, shall not, at any time, make any false, misleading or disparaging statements or representations regarding Executive, his performance, his services and/or any other matter relating to Executive.

11. No Cooperation With Third Parties. Executive agrees that he will not counsel or assist any attorneys or their clients in the presentation or prosecution of any disputes, differences, grievances, claims, charges, or complaints by any third party against Rackspace and/or any officer, director, employee, agent, representative, shareholder or attorney of Rackspace, unless under a subpoena, court order, or other legal obligation to do so. Executive further agrees to promptly notify Alan Schoenbaum, Senior Vice President and General Counsel at Rackspace's corporate office located at 5000 Walzem Road, San Antonio, Texas 78218 (aschoenb@rackspace.com) upon receipt of any court order, subpoena, or any legal discovery device that seeks production of the existence or terms of this Agreement, and to furnish to Rackspace, upon request, a copy of such subpoena or legal discovery device from the other party.

12. Cooperation with Company. Executive agrees that Executive shall cooperate fully with Rackspace in the resolution of any matters in which Executive was involved during the course of Executive's employment or about which Executive has knowledge, where Executive's knowledge is necessary for the defense or prosecution, of any claims or actions now in existence or which may be brought or threatened in the future against or on behalf of Rackspace, including any claims or actions against its officers, directors and employees (referred to as "Claims Assistance."). It is anticipated that the Claims Assistance will require only occasional assistance from Executive, and it will be scheduled at mutually agreeable times.

Executive's cooperation in connection with such Claims Assistance shall include, without limitation, being available to consult with Rackspace regarding matters in which Executive has been involved or has knowledge; to assist Rackspace in preparing for any proceeding (including, without limitation, depositions, consultation, discovery or trial); to provide affidavits reflecting truthful written testimony; to assist with any audit, inspection, proceeding or other inquiry; and to act as a witness to provide truthful testimony in connection with any litigation or other legal proceeding affecting Rackspace. In addition to the Claims Assistance, for a period of no more than three (3) months from the Separation Date, Executive agrees to provide occasional advisory services at mutually agreed upon times related primarily to the recruitment and transition of the General Manager role, for no additional consideration other than the severance pay, on an as-needed basis.

With respect to both the Claims Assistance and the advisory services, Executive shall in no sense be considered an employee, agent, partner or representative of Rackspace, nor shall Executive be entitled to, or eligible to, participate in any benefits or privileges given or extended by Rackspace to its employees. For a period of four (4) years after the Effective Date of this Agreement, Executive agrees to keep Rackspace apprised of his current contact information, including telephone numbers, home address, and email address, and to promptly respond to communications from Rackspace in connection with this Section. Executive further agrees that should Executive be contacted by any person or entity that has indicated, or that Executive knows to be, adverse to Rackspace, or any representative of such person or entity, Executive shall promptly, and no later than within three (3) business days of such contact, notify Alan Schoenbaum, Senior Vice President and General Counsel at Rackspace's corporate office located at 5000 Walzem Road, San Antonio, Texas 78218 (aschoenb@rackspace.com). Rackspace shall pay Executive any documented and reasonable costs and expenses incurred in connection with Executive providing the Claims Assistance and advisory services under this Section. Rackspace shall deliver the payments due under this paragraph within thirty (30) business days after receipt of Executive's invoice.

13. Legal Fees. In the event it shall be necessary for any party hereto to institute legal action to enforce any of the terms and conditions or provisions contained herein, or as the result of the breach hereof, the prevailing party in such action or proceeding shall be entitled to costs and reasonable attorneys fees.

14. Breach. In addition to the rights provided in the Legal Fees section above, Executive acknowledges and agrees that in the event of any proven material breach of this Agreement, unless such breach constitutes a legal action by Executive challenging or seeking a determination in good faith of the validity of the waiver herein under the ADEA, or of any provision of the Confidentiality Agreement, Rackspace shall be entitled to recover and/or cease providing the consideration provided to Executive under this Agreement and to obtain damages, except as provided by law.

15. Entire Agreement. This Agreement represents the entire agreement by and between the Parties, and there are no other agreements or understandings other than those contained in this Agreement, with the exception of the Confidentiality Agreement and the Indemnification Agreement between Executive and Rackspace on December 10, 2008 (it being understood that in the event of a conflict between this Agreement and the Confidentiality Agreement or Indemnification Agreement, this Agreement shall control). This Agreement may not be changed except by written agreement executed by the Parties.

16. [illegible] understands and acknowledges that this Agreement constitute [illegible] actual or potential disputed claims by Executive. No action taken by Rackspace hereto, either previously or in connection with this Agreement, shall be deemed or construed to be (a) an admission of the truth or falsity of any actual or potential claims or (b) an acknowledgment or admission by Rackspace of any fault or liability whatsoever to Executive or to any third party.

17. Tax Consequences. Rackspace makes no representations or warranties with respect to the tax consequences of the payments and any other consideration provided to Executive or made on his behalf under the terms of this Agreement. Executive agrees and understands that he is responsible for payment, if any, of local, state, and/or federal taxes on the payments and any other consideration provided hereunder by Rackspace and any penalties or assessments thereon. Executive further agrees to indemnify and hold Rackspace harmless from any claims, demands, deficiencies, penalties, interest, assessments, executions, judgments, or recoveries by any government agency against Rackspace for any amounts claimed due on account of (a) Executive's failure to pay or Executive's delayed payment of, federal or state taxes; or (b) damages sustained by Rackspace by reason of any such claims, but not including attorneys' fees and costs.

18. Binding Heirs, Successors and Assigns. Except as herein expressly provided, the terms and provisions of this Agreement shall inure to the benefit of and be binding upon the heirs, successors, assigns and legal representatives of the respective Parties.

19. Arbitration. All claims and matters in question arising out of this Agreement or the relationship between the Parties, whether sounding in contract, tort, a statutory cause of action or otherwise, shall be resolved by binding arbitration pursuant to the Federal Arbitration Act. Either Party, however, may bring an action in any court of competent jurisdiction to compel arbitration under this Agreement; enforce or vacate an arbitration award; or seek injunctive relief. This arbitration shall be administered by the American Arbitration Association ("AAA") in accordance with the *National Rules for Resolution of Employment Disputes of the American Arbitration Association* ("National Rules") in effect at the time the dispute arose. There shall be one arbitrator selected pursuant to the National Rules, unless the Parties agree on a different arbitration service. The arbitrator shall issue a reasoned award within six (6) months of the filing of the arbitration notice. The Company will pay the fee for the arbitrator and the Executive's initial filing fee to the extent that it is more than a court filing fee. Each Party shall be responsible for its own attorney fees, expenses, witness fees, and costs.

20. Jurisdiction. The substantive laws of Texas govern the validity, construction, enforcement and interpretation of this Agreement and exclusive venue for any dispute between the Parties shall be Bexar County, Texas or the United States District Court in San Antonio, Texas.

21. Headings. The headings in this Agreement have been used for administrative convenience only and shall not be used in interpreting or construing the meaning of any provision in this Agreement.

22. Invalid Provision. If any provision of this Agreement is or may be held by a court of competent jurisdiction to be invalid, void, or unenforceable to any extent, the validity of the remaining parts, terms or provision of this Agreement shall not be affected thereby, and such illegal or invalid part, term, or provision shall be deemed not to be part of this Agreement. The remaining provisions shall nevertheless survive and continue in full force and effect without being invalidated in any way.

23. Counterparts. This Agreement may be executed in a number of identical counterparts, each of which for all purposes is deemed an original and all of which constitute collectively one Agreement.

24. Acceptance and Revocation Procedures. Executive acknowledges that he was given this Agreement on October 8, 2012. Executive has been afforded a full twenty-one (21) calendar days after receiving this Agreement to consider it, and Executive has fully informed himself of and understands the terms, contents, conditions and effects of this Agreement. Executive also has been given an opportunity to review this Agreement, at his own expense, with his counsel and as set forth in Section 4(d), has been specifically advised to consult with legal counsel regarding this Agreement. In addition, Executive acknowledges and understands that he has seven (7) calendar days following his execution of this Agreement to revoke it. To be effective, any such revocation must be communicated in writing to Alan Schoenbaum, Senior Vice President and General Counsel at Rackspace's corporate office located at 5000 Walzem Road, San Antonio, Texas 78218. The Parties agree that changes to this Agreement, whether material or immaterial, do not restart the running of the 21-day period.

25. Effective Date. Executive has seven (7) calendar days after he signs this Agreement to revoke it. This Agreement will become effective on the eighth (8th) calendar day after Executive signed this Agreement, so long as it has been signed by the Parties and has not been revoked by Executive before that date (the "Effective Date").

Executive:

/s/ James Lewandowski Date: October 25, 2012
James Lewandowski

Rackspace US, Inc.

By: /s/ Alan Schoenbaum Date: October 25, 2012
Alan Schoenbaum,
Senior Vice President and General Counsel

Exhibit 31.1

CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, A. Lanham Napier, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rackspace Hosting, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
    a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
    b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
    c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
    d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
    a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
    b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2012

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer and Director
(Principal Executive Officer)

Exhibit 31.2

**CERTIFICATION PURSUANT TO RULE 13a-14(a) OR 15d-14(a)
OF THE SECURITIES EXCHANGE ACT OF 1934,
AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Karl Pichler, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Rackspace Hosting, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
   a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
   a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
   b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 7, 2012

By: /s/ Karl Pichler
Karl Pichler
Chief Financial Officer and Treasurer
(Principal Financial Officer)

Exhibit 32.1

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended September 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), A. Lanham Napier, as Principal Executive Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: November 7, 2012

By: /s/ A. Lanham Napier
A. Lanham Napier
Chief Executive Officer and Director
(Principal Executive Officer)

Exhibit 32.2

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Rackspace Hosting, Inc. for the quarterly period ended September 30, 2012 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Karl Pichler, as Principal Financial Officer of Rackspace Hosting, Inc., hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Rackspace Hosting, Inc.

Date: November 7, 2012

By: /s/ Karl Pichler
Karl Pichler
Chief Financial Officer and Treasurer
(Principal Financial Officer)