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In case the music stops

Institutionally sponsored bearbaiting arrived on Wall Street with the Jan. 3 debut of a financial instrument created to punish the short sellers. Deutsche Bank is the promoter of this, the "U.S. Short Squeeze Index." The investor who owns it gains an economic interest in a rotating group of 25 American-listed companies that people who actually read financial filings have gone to the trouble of betting against. Probably, we think, Deutsche Bank would not be marketing the index (only to professional investors, incidentally) unless its clients asked for it, and its clients wouldn't have asked unless they were very sure of themselves. Many seem to be.

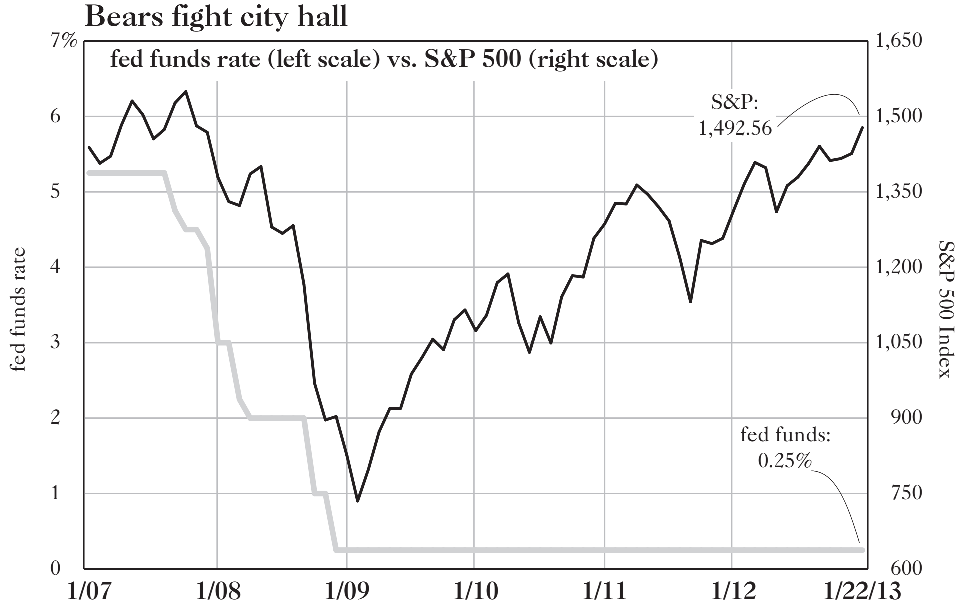
Now begins a survey of the short side of the stock market as well as an analysis of one particular short-sale candidate. Having arrived at the age of wisdom, your editor will forbear from predicting the direction of the S&P 500. However, he will go so far as to say that when—as now—it seems futile to hedge against the downside, it is certainly *not* futile to hedge against the downside.

Generically, stocks are better than bonds, let us say—and at current multiples and interest rates, we so believe. And the Great Rotation out of bonds and into stocks is at last under way, let us also say. Suppose that America's economy will surprise by its strength, even in the teeth of the gale-force winds originating in Washington, D.C. Say it's all true. It does not then follow that the investment road is strewn with rose petals. "The market," observes A. Alex Porter, founding partner of Amici Capital, "is a complex system. Complex systems blow up from time to time." Ergo, hedge—at all times.

Of course, it's not so easy to hedge when the market goes up and up, and when the Federal Reserve buys $85 billion of bonds each month with money that didn't exist until the FOMC conjured it on a computer screen. An insurance policy consisting of a short position in a portfolio of volatile equities is different from a standard homeowners' policy, needless to say. The latter may or may not pay off after a visitation by the storm of the century, but it will never produce marked-to-market losses in a central bank-financed bull stock market. "As long as the music is playing, you've got to get up and dance," infamously quipped Chuck Prince, CEO of Citigroup, in July 2007. The dance floor was crowded when Prince spoke, and—to the strains of Ben S. Bernanke and his Orchestra—it's filling up today.

"Hedge funds are borrowing more to buy equities just as loans by New York Stock Exchange brokers reach the highest in four years, signs of increasing confidence after professional investors trailed the market since 2008," Bloomberg reported on Jan. 14. "Leverage among managers who speculate on rising and falling shares climbed to the highest level to start any year since at least 2004, according to data compiled by Morgan Stanley. Margin debt at NYSE firms rose in November to the most since February 2008, data from NYSE Euronext show." The Bloomberg bulletin quotes James Du-

Bears fight city hall



source: The Bloomberg

nigan, chief investment officer at PNC Wealth Management, as follows: "The first step of increasing risk is just going long, the second part of that is levering up in order to go longer."

Having spent some time on the phone with Porter, who learned the art of hedged investing from the progenitor of the hedge fund, Alfred Winslow Jones himself, colleague David Peligal has wisdom to impart. "Short selling has rarely been easy," Peligal begins by observing. "It wasn't easy in 2006, or in 1999—or, as Porter noted, in the 1960s, when National Student Marketing Corp. doubled in the short sellers' faces, and then doubled again before crashing."

"Different today is ZIRP," Peligal continues. "When nominal rates were measured in more than a few percentage points, the prime brokers paid the short sellers. Now that nominal rates are measured in a small number of basis points, the short sellers pay the brokers. True, there are many fewer buy-ins these days than there used to be, but the cost of borrowing stock, especially heavily shorted stock, has gone way up. Finally, the popularity of exchange-traded funds may make the conscientious analyst wonder why he or she bothers to open the annual report. You might be short a retailer because its inventories are rising faster than its sales or its merchandising is lackluster. But if your particular stock is in the SPDR S&P Retail ETF (ticker: XRT), and if the retail sector is going up, chances are your short-sale target is going up, too. Couple that with the rise in algorithmic trading, and it feels like what happens to the price of the company you shorted (after all that hard work!) has more to do with the S&P or the XRT or the FOMC than with the company fundamentals."

No surprise, then, that the bear population is much reduced, as a *Forbes* piece dated Jan. 10 observes. Maybe the wonder is that there are any short sellers left. Jaime Lester is one of this hardy breed. He is the managing member of Soundpost Partners, New York, whose main fund dates from 2005 and which manages assets of $60 million, down from a peak of $375 million in early 2010. Undaunted, Lester started a short fund in June. He calls it the Soundpost Skeptic Fund, and it manages $20 million. Peligal asked Lester for the name of an actionable short idea, and Lester replied Rackspace Hosting (RAX on the New York Stock Exchange). Having investigated, *Grant's* concurs with Lester.

Rackspace—but there's a price war

source: The Bloomberg

Founded in 1998 in San Antonio, Texas, Rackspace went public in 2008 and maintains data centers in the United States, the U.K. and Hong Kong. Service deluxe is the corporate watchword. You, a business customer looking for a stairway to the cloud, will be treated like royalty. And you will get the same special handling if you need a server on terra firma. No more are businesses content to spend uncounted billions on the inputs to information technology, e.g., servers, software and the salaries of the people who make them work, according to Lanham Napier, the 40-something Rackspace CEO. The new idea—the Rackspace idea—is economical, carefree "outcomes."

Let it be said that, to date, RAX has been what is euphemistically known in the trade as a "tough short." Valued at 106 times earnings, the shares have generally appreciated and have always been pricey. A triple-digit multiple is proof of the existence of a story, if nothing else, and Rackspace's story is one of booming growth in the centralization of information technology resources on the Internet. Why keep your own server when you can buy just that portion of a server you happen to need over the Net? A business should no more produce and maintain its own IT infrastructure than it should its own electrical generating capacity, is the Rackspace pitch.

In a December research note, J.P. Morgan contends that the migration to the cloud is persistent enough to continue to drive Rackspace's 20% revenue growth. The Morgan analysis dangles a December 2013 price target of $83, which is predicated on sticking a fancy multiple—an enterprise value 16 times EBITDA—on a 2014 estimate. Tuesday's closing price was $76.56. The shares, which pay no dividend, are liquid and easy to borrow; the short interest is less than 10% of the float (not big enough, evidently, to warrant admission to the Deutsche Bank Short-Squeeze Index). Earnings are due in mid-February.

No proper short idea hangs on valuation alone, especially these days. Balance-sheet weakness would be a promising thread on which to tug, but Rackspace—despite a recent bump up in capitalized software expense—isn't a balance-sheet story. Still less is it a business-execution story. The "Rackers," as management affectionately knows its more than 4,000 employees, are called to the ideal of "fanatical support," that is, unceasing and cheerful attention to the customer's every need. Rather, Lester advises Peligal, the company's Achilles heel is the competition that Rackspace's very success is ferociously attracting. The newly formed Google Compute Engine is one entrant. Amazon Web Services, now in its 11th year and the acknowledged market leader in the "public cloud" market, is another. There are many more.

"Since the summer," says Lester, "the stock traded from around $40 a share to about $80 a share. So it has roughly doubled in six months. I would argue that the news since the summer has been pretty uniformly negative. Now, there are some positive data points also, but, on balance, I would say this is a company that has had a fair amount of negative news. They missed earnings estimates. They beat sales estimates but by the lowest proportion they had ever beaten it. Historically, they beat sales estimates by 2%; in the last two quarters, they beat by 0.2%—so, very weak quarters. If you look at the growth in their subscriber base, it's decelerating. If you look at their margin structure, it's compressing. They've resorted to more accounting tricks like capitalizing software. They've changed their reporting structure a little bit to obfuscate."

The capitalized software costs relate to OpenStack, Rackspace's open-source cloud-computing platform. To capitalize such outlays adds to assets and income; each is higher, at least in the short term, than it would be if management had chosen to run those costs through the income statement. Over the past four quarters, EBITDA minus capitalized software outlays was effectively flat, a 19% jump in revenue notwithstanding.

"Taking a step back," Lester continues, "the core premise of this business is that I can build a data center and fill it with servers and then lease out that server space to a customer. And I'll call it a 'cloud' or I'll call it 'managed hosting' or whatever I call it. The problem is that there are massive, massive competitors here." Google and Amazon, as noted, do—or try to do—what Rackspace does. So do Microsoft, HP, Dell and Oracle. There's nothing gentlemanly about this competitive jostling. "Amazon Web Services and Microsoft, together with Rackspace Hosting, are staging a price war for their services," said a June bulletin from cloudtimes.org. December brought a parade of 25% and 30% price reductions of cloud-based storage prices by Google, Microsoft and Amazon.

Not only are the Rackspace adversaries big, says Lester, they are also different. Amazon and Google don't have to earn a profit doing what Rackspace does. They have, of course, alternative sources of revenue. Then, again, in fairness to all parties, Rackspace has been beating the competition—much of it, like IBM today or AT&T in the early going, big and seemingly scary—by delivering service that leaves the customers satisfied if not openmouthed.

Observing that Rackspace is no pygmy, either, Peligal asked Lester if the company he's short might be someone's idea of a takeover candidate. "People have certainly put that out there," Lester replied. "It's an $11.5 billion to $12 billion company [in market cap] at this point, with invested capital of about $800 million. The companies that have been rumored to take it over are actually smaller companies. People talked about Dell buying it. Dell had a $5 billion enterprise value until recently. If you wanted to generate $150 million of EBIT from $800 million of invested capital, they can do that if they want to. They just have to invest that capital. I think it's crazy that there's something about Rackspace that means they should pay 15 times invested capital to do that.

"When you've seen these big tech takeovers," Lester continues, "most of the time when they've gotten into really irrational prices, aside from Autonomy [whose acquisition by HP may or may not prove to be fraudulent but is undoubtedly questionable], most of these irrational deals that people cite as having a cloud multiple, they're small companies that can be added to a bigger platform. They're $1 billion to $2 billion acquisitions, whether they're 3Par or Compellent or one of these storage technology companies, or if they're some of these big 'software-as-a-service' revenue multiples for companies like Kenexa or SuccessFactors or some of the 'customer relationship management' companies. They can trade at seven to eight times revenues but they're small revenue numbers. They're really being paid $1 billion to $1.5 billion just for the IP [intellectual property]. Here, you're talking about, with any sort of premium, you're now talking about a $15 billion deal—for nothing. And the question is, 'What sort of board is going to okay that deal in this environment?' I think that's incredibly unlikely."

The aforementioned Rackspace CEO, Lanham Napier, a fifth generation Texan, was quoted as saying in

Rackspace Hosting
(in thousands of dollars, except per-share data)

	12 mos. to 9/30/12	12/31/11	12/31/10	12/31/09	12/31/08	12/31/07
Net revenue	$1,239,591	$1,025,064	$780,555	$628,987	$531,933	$362,017
Cost of revenue	354,874	309,095	249,840	200,943	172,583	118,225
Sales and marketing	150,491	126,505	96,207	79,458	80,323	53,930
General and admin.	335,568	270,581	199,011	168,116	148,706	102,777
Depreciation and amort.	235,775	195,412	155,895	125,229	90,172	56,476
Total costs and expenses	1,076,708	901,593	700,953	573,746	491,784	331,408
Income from operations	162,883	123,471	79,602	55,241	40,149	30,609
Total other inc. (expense)	(5,518)	(7,042)	(8,191)	(8,695)	(7,461)	(2,815)
Income before inc. taxes	157,365	116,429	71,411	46,546	32,688	27,794
Income taxes	56,807	40,018	25,053	16,328	10,985	9,965
Net income	100,558	76,411	46,358	30,218	21,703	17,829
Diluted net inc. per share	0.72	0.55	0.35	0.24	0.19	0.17
Cash and cash equivalents	257,651	159,856	104,941	125,425	238,407	24,937
Total assets	1,241,765	1,026,482	761,577	668,645	685,261	301,813
Long-term obligations	194,943	189,310	133,572	161,024	283,053	96,213
Total stockholders' equity	781,934	599,423	438,863	349,427	269,684	96,873
Price per share	$76.56					
Fully diluted shares outstanding (millions)	148.8					
Market capitalization	$11,392.1					
Price/earnings	106.3x					

source: company filings

Texas CEO Magazine that he doesn't want a "big" company. He wants a "great" company. This was in March, when Rackspace was in the middle of a move to new corporate headquarters it was fashioning out of a 1.2 million-square-foot abandoned San Antonio shopping center. In November, Napier, one of the speakers at a Credit Suisse technology conference, fielded a question about the growing competitive field. "I don't have a crystal ball with respect to how this will emerge," he replied. "I think the secret for us is to play our game, and the cloud is a big market, so what segments are we going to be really competitive in and which ones can we dominate? And I think it's this emerging segmentation around customers with applications who want help in a certain service experience, we can win that. That's what we won in the first round of hosting that made us a victor there, and I think it will play out the same way in this market."

However, just in case he is wrong, Napier has been selling. On Nov. 8, as part of his 10b(5)-1 plan, he exercised and sold 210,494 shares. On Dec. 17 and 18, also as part of his 10b(5)-1 plan, he exercised and sold 46,500 shares. His total holdings consist of roughly 4.57 million shares, of which 892,150 are held directly. Other insiders have been selling, too.

In 2012, *Fortune* magazine named Rackspace one of the "100 Best Companies to Work For." For 2013, *Grant's* names RAX one of the "100 Best Stocks to Sell Short."

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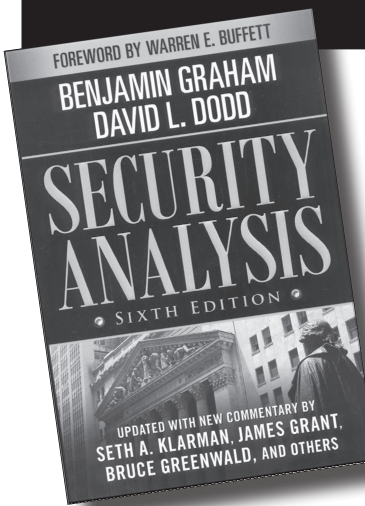

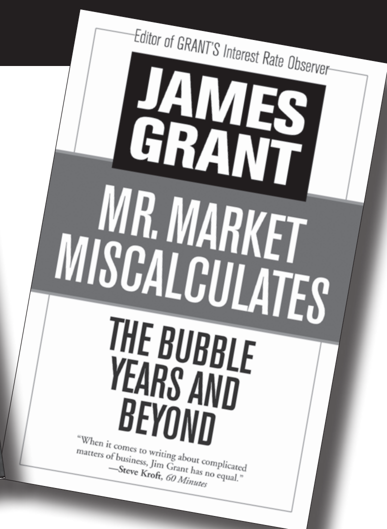

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