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GLOBAL IDEAS

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Oracle - Don't give up on them yet

Investment thesis

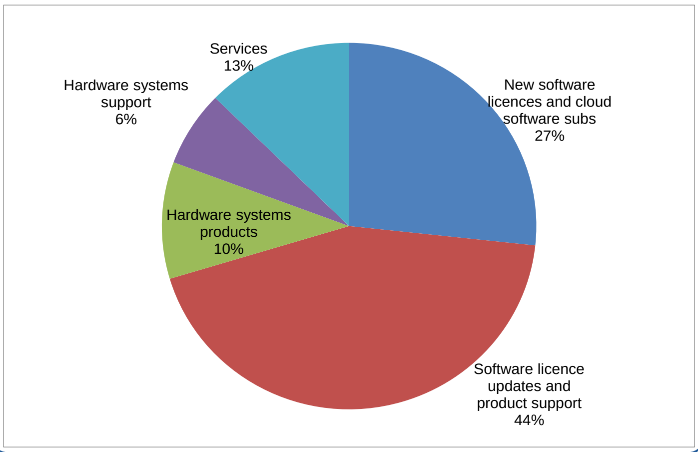
- Growth is the challenge for a big, primarily software, company like Oracle and revenue growth over the past few years has been modest.
- Competition from new cloud-based enterprise software providers has put some pressure on their Applications division but they have responded, (albeit a little late), with their own cloud-based Fusion range of products. While the core database business should have a good future because of growing emphasis by corporates on data management, the rise of unstructured and semi-structured data used by companies could impact.
- The outlook for Oracle should be secure. They have refreshed their product offering to compete effectively against new entrants.
- The recent quarterly results, where revenues were down slightly on an organic basis, led to an 8% drop in the price. However if sales recover, as management have forecast and as their new product launches would suggest, we may just be surprised by Oracle. Conversely if their cloud offering doesn't attract or retain customers and their database systems are bypassed by cheap and cheerful distributed systems, Oracle will disappoint.
- We would recommend an investment in Oracle. The expectations are modest and the multiples are low. On a DCF basis, we have a value for Oracle of over $45/ share.

Oracle key data:

Spot ($)	32.67
Mkt Cap $bn	153.8
EPS to May 2013 ($)	2.60
EPS to May 2014 ($)	2.80
P/E to May 2013	12.1
P/E to May 2014	11.3
10-year average P/E	41.3
FYE	31-May
P/Book ratio	3.56
12M trailing DY	0.73
12M fwd DY	0.89

Source: Bloomberg, Anchor Capital

Oracle 2012 revenue split:



Source: Company data, Anchor Capital

Combined software revenues are 71% of total revenue. New software licence revenues is split 70/30 between Database/ Middleware and Application revenues.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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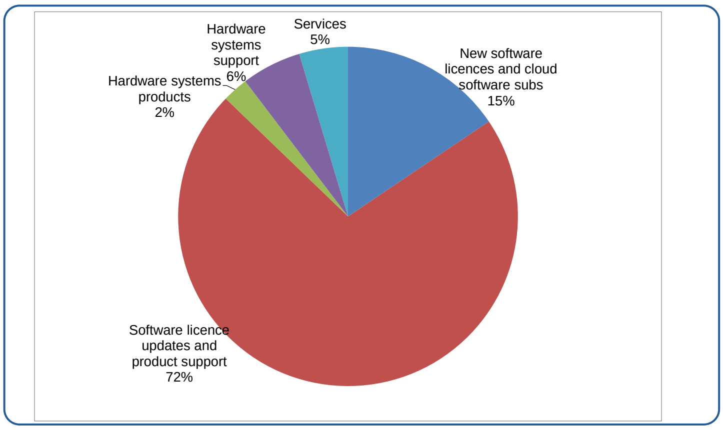
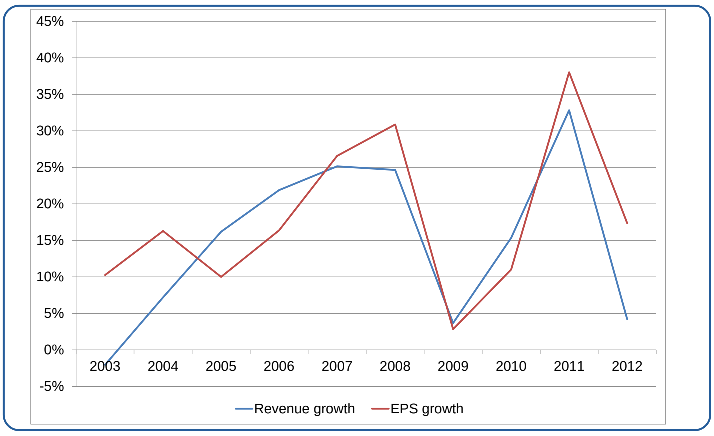
<u>Oracle 2012 profit split — *earnings come from software*:</u>



Source: Company data, Anchor Capital

Profit margins on Software updates and support are 87%.

<u>Oracle earnings and revenue growth, YoY % change:</u>



Source: Bloomberg

If you exclude the Sun Micro acquisition of 2010, revenue growth in 2010, 2011 and 2012 drops to 5%, 17% and 7% respectively. Revenue growth in the first nine months of F2013 is flat. This may be a reflection of a raft of new products that are in the process of being launched, resulting in some delays in purchasing decisions from customers. But it may also be because of competition from cloud-based technologies sold by Salesforce.com, Workday etc.

History

This is one of the oldest technology companies, having been started by Larry Ellison in 1977 under the then name of Software Development Laboratories. Ellison was originally inspired by a paper written by Edgar Codd about relational database systems. Oracle is now, amongst other things, the largest database company in the world, allowing businesses to store and manage large amounts of data. Oracle has also expanded into servers and storage, middleware, applications and the cloud, putting them in the somewhat unique position of being able to provide everything in the technology stack – from hardware, to programming language, to operating systems and software applications. Most of the profits come from software. Ellison is the fifth-richest person in the world at $43bn, via his 23.5% stake in the company. At the age of 68, he remains a very active CEO.

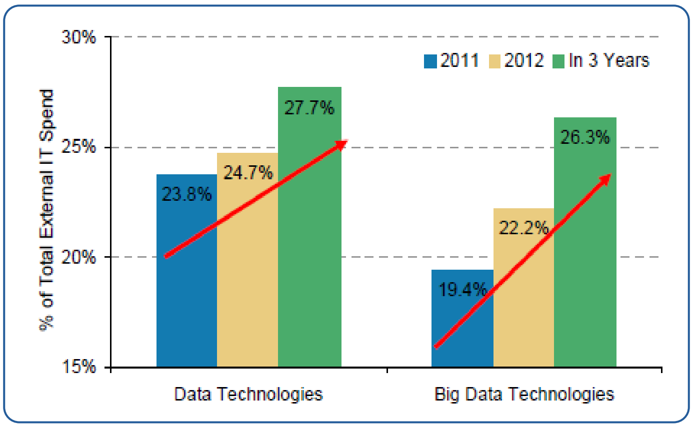
Comment

What are the key drivers of a business like Oracle? This is one of those nebulous companies that is far more difficult to understand than Apple or Microsoft, although there are parts of Microsoft that are equally nebulous. Oracle's origins are in relational databases, but over the years they have made several acquisitions that have taken them into a range of other areas like software applications, servers and storage devices. Revenues are broken down roughly as follows:

- 50% - Database and Middleware (estimated 70/30 split)
- 21% - Applications
- 16% - Hardware products and support (servers and storage devices) ex Sun Microsystems
- 13% - Services

Database and Middleware (D&M) are still by far the largest contributors to revenues and, considering the high margins, even more so to profits. The outlook for the D&M market is very good. 'Big Data' is one of the hottest topics in tech. Aside from just the talk about 'Big Data', we do know that corporates are spending an increasing share of their technology budgets on data management (refer graph).

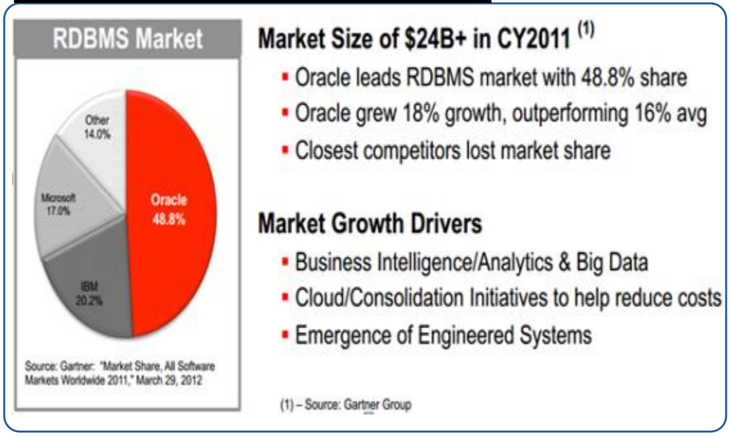
<u>Data management taking an increasing share of IT spend:</u>



Source: Company data, Morgan Stanley research

Although Oracle is the biggest player in the traditional market for structured data (as opposed to unstructured or semi-structured data) with its almost 50% share of the relational database market (refer chart below), new, often cheaper, technologies have entered this market. Some of these are open-source and others are designed for unstructured data (& semi-structured) that large data users like Google and Facebook may prefer. So although relational databases have continued to grow relatively well, the database market has become a broader category and Oracle doesn't have a hold over the new categories of data.

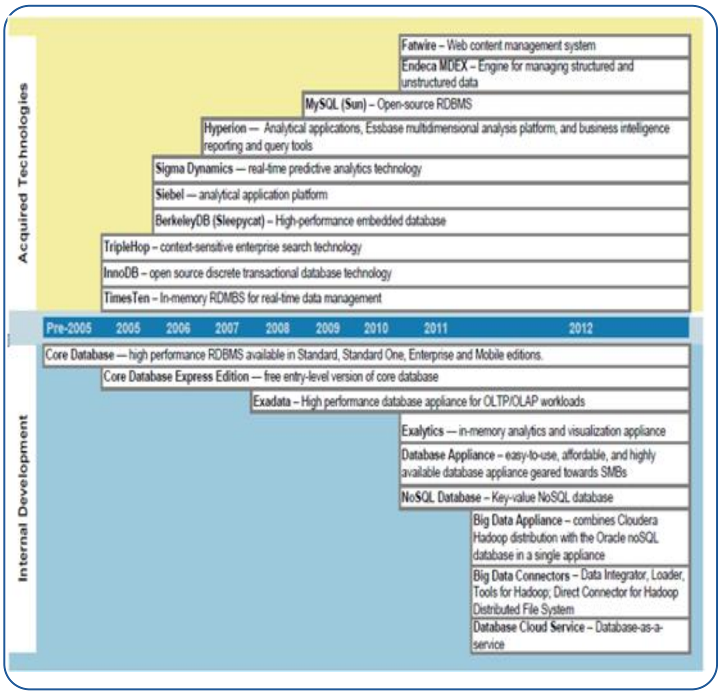
Relational database (RDBMS) market:



Source: Gartner Group

Oracle has responded by expanding their range of offerings (refer table below) but the core Oracle D&M business remains in relational databases. Obviously the company has also upped the ante in relational databases by improving the speed and performance of their traditional products.

Oracle has significantly expanded its data management portfolio over the past seven years:



Source: Company data, Morgan Stanley research

The outlook for D&M looks good as long as Oracle remains innovative, and does not become the equivalent of a stodgy Microsoft in the battle with more innovative companies like Apple or Google. Ellison understands this but it is still difficult to compete with new entrants when you have a massive installed base of legacy business.

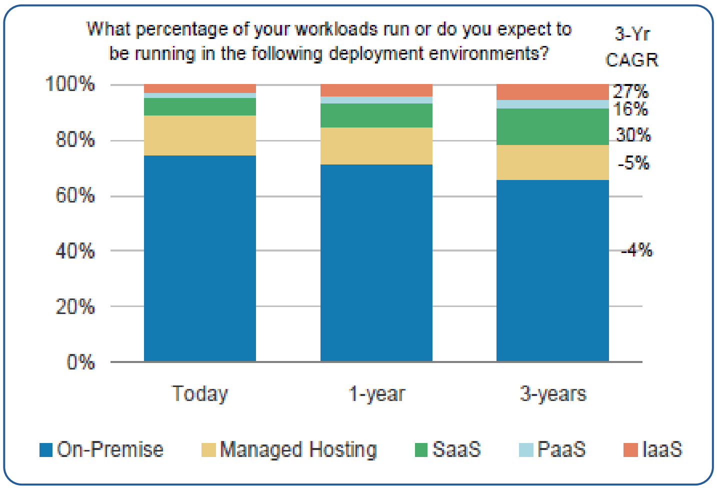
Note that IBM is bigger than Oracle in the Middleware market (but not in Database).

Applications is the second-largest contributor to revenues (21%) and profits. Although this is not where Oracle's origins lie, Applications has become a key part of the business. The arch enemy here has historically been SAP, but now the real threat is from fast-moving cloud-based companies like Salesforce.com (Customer Relationship Management [CRM] system) and Workday (Enterprise Resource Planning [ERP]). SAP and Oracle primarily sell on-premise software.

Here is some background to the market. The entire enterprise application software market is worth about $120bn p.a. The largest sub-category is enterprise resource planning or ERP ($25bn market). SAP is the largest player with roughly 25% of this market while Oracle is in second place with approximately 15% (2011 market shares). Business intelligence or BI ($13bn) looks similar with SAP in the lead followed by Oracle (24% vs 16% market share, respectively). Customer relationship management or CRM (also $13bn market) is the most interesting with SAP in the lead, but cloud-based operator Salesforce.com in second place, having overtaken Oracle in 2011. Salesforce.com has now taken a big slug of the fast-growing CRM software as a service or SaaS (i.e. online) market.

Oracle was slow to respond to this threat from cloud operators and only launched their cloud offering, called Fusion, last year. By mid-2012, 35% of the CRM market had already moved to SaaS. This means that Oracle can still potentially rebuild market share through Fusion but it has been a scare for the company. CRM appears to have moved much faster than ERP, and the other categories, to SaaS and the cloud. The bar chart below shows the dominance of on-premise software usage (based on a 2012 US survey of CIOs) and the expected decline in share vs the growth in share for SaaS. The Fusion product range is therefore very important to Oracle. In their latest quarter, cloud subscriptions had risen to 3.6% of software revenue (vs 1.7% a year ago).

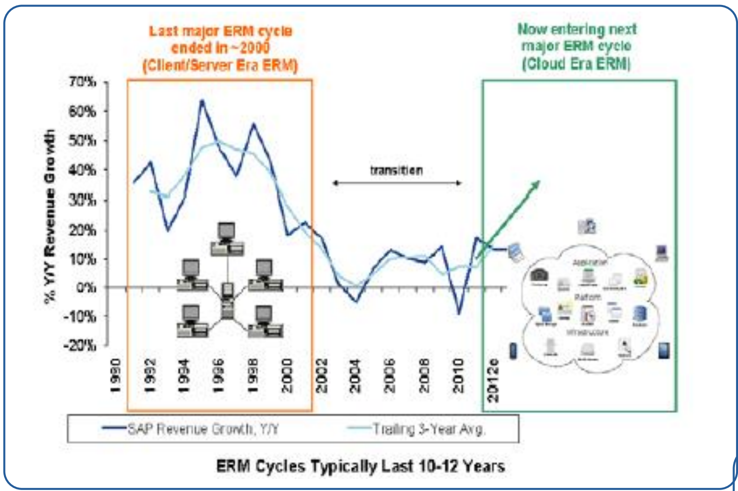
Broad cloud-computing adoption trends intact:



Source: Morgan Stanley April 2012 CIO survey

The last point to make on Applications is that many corporates are due to refresh their business application software (10-12 year cycle from Y2K) and this may coincide with greater emphasis on cloud-based solutions. This corresponds with a major refresh of many Oracle products so the company is well prepared for the refresh cycle. The key will be to regain some market share.

<u>Applications built and deployed around Y2K are due for refresh:</u>



Source: Gartner Group

Hardware products and support are only 8% of profits so they won't get much comment. This division came with the acquisition of Sun Microsystems with effect from 2010. Like many other hardware businesses, this category has been under severe pressure with revenues and profits declining. The launch of a range of new products in March 2013 may arrest this decline, potentially leading to a stabilisation of this business in F2014.

Oracle is a smaller player in these markets with single-digit market shares (but bigger in servers vs storage).

Conclusion

Growth is the challenge for a big, primarily software, company like Oracle. Revenue growth over the past few years has been modest.

Competition from new cloud-based enterprise software providers has put some pressure on their Applications division (say 21% of sales). However, they have responded, albeit little late, with their own cloud-based Fusion range of products. The core database business should have a good future because of the growing emphasis by corporates on data management. But here again, the party has been spoilt a bit by the rise of unstructured and semi-structured data used by companies like Google and Facebook that don't always need an expensive Oracle relational database.

So the outlook for Oracle should be fine but because their markets have opened up somewhat the company has been scrambling to refresh the product offering to be in a position to compete better against the new entrants. Oracle is a well-run business. The founder, Larry Ellison, may not be the visionary that his old best friend Steve Jobs was, but he is still one of the best in the tech business.

Fortunately the stock market doesn't have great expectations for Oracle. The recent quarterly results, where revenues were down slightly on an organic basis, led to an 8% drop in the share price. The P/E to May 2013 is only 12x earnings (at $31.53). If sales do recover as management have forecast and as their new product launches would suggest, and that corporate spend on data management rises as a percentage of total tech spend, as is forecast, then we may just be surprised by Oracle. However if their cloud offering doesn't attract or retain customers and if their state-of-the-art database systems are bypassed by cheap and cheerful distributed systems, then Oracle will disappoint.

We would recommend an investment in Oracle. The expectations are modest and the multiples are low. On a DCF basis, we have a value for Oracle of over $45/share. The current share price is $32.67.

<u>Oracle share price performance:</u>

Source: Bloomberg

Appendix- other information

The table below gives a sense of the number of customers across the whole of Oracle. Applications have far fewer customers than both Database and Middleware. Nevertheless, it remains an important division and it does allow Oracle to provide a complete offering for clients i.e. along with the database and hardware divisions etc.

Oracle customer base breakdown:

Total	*380,000*
Applications	*70,000*
Oracle E-biz Suite	~30,000
PeopleSoft	~8,000
Siebel	~6,000
Hyperion	~6,000
Database	*305,000*
Middleware	*110,000*
Hardware	*48,000*

Source: Company data, Morgan Stanley research

Peoplesoft was acquired by Oracle in 2004 in a hostile takeover. The founders left to start Workday, which has become a cloud-based ERP competitor.

Siebel was acquired in 2005. Other than competing with SAP, Salesforce.com has become a major cloud-based competitor.

Other comments on market share:

Relational database – Oracle dominates with a 48.8% share of this $24bn market. Oracle is followed by traditional competitors, IBM (DB2) and Microsoft (SQL Server). SAP is fast growing and ambitious in this market but still has a small share of the market (2011 – 4.6%).

The overall RDBMS market grew 16.3% in 2011. 2010 was also a strong year, bouncing back from a recession-plagued 2009.

Application infrastructure and middleware (AIM) – IBM leads this $19.3bn market with a 32% share, followed by Oracle with 17%.

Oracle product stack:

Source: Oracle

David Gibb

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