Changes are coming to Oracle (ORCL)

Our forecast results have been good to date, but Oracle has announced some unexpected news

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Key Takeaways

- **Oracle's (ORCL) stock price fall after announcing 1Q17 earnings prompted us to revisit our earlier projections and valuation.** Quarterly results in themselves looked fine.
- **Our operational forecasts have generally been fairly good.** Actual results have been well within our best- and worst-case forecast ranges.
- **Fiscal Year 2016 results look weak, but there is more to the story.** The most important part of Oracle's business is doing very well; the company is making a conscious strategic choice to forego short-term profits to capture long-term ones.
- **Recent announcements at Oracle's OpenWorld Conference highlight new sources of uncertainty.** We look at each source in this report.

Introduction

One of the cornerstones of the IOI valuation methodology is to review prior forecasts, understand where those forecasts were correct or not, and apply this learning in creating our next round of forecasts. This focus on observation and hypothesis testing is the reason why we say that we rely upon a scientific approach to valuation.

The first part of this research note reviews our forecasts for profitability and cash flow over the last three fiscal years, and highlights areas where we believe we have room for improvement. In general, we find our forecasting efficacy to be good, though we have realized that we underestimated operational uncertainty at the firm during our 2015 re-valuation of the firm.

The second part of this note is a review of Oracle's FY 2016 results (reported at the end of June), with our focused analysis on Oracle's software business. There has been a great kerfuffle made about the problems facing Oracle's software business; specifically, that the firm's rapidly growing Cloud revenues were not enough to offset falls in Oracle's On Premise software revenues. We find the problem less severe than most observers make it out to be and find evidence that Oracle may be foregoing profits in the near term in order to have a stronger competitive position in the long term. This is exactly the type of strategic choices we like to see companies making.

The company has surprised us with several recent announcements. First, we think the company has now more completely embraced the Cloud and realizes that On Premise software as historically implemented has a limited future. Second, the company announced that it had an offering to compete with Amazon's AWS and Microsoft's Azure Infrastructure-as-a-Service (IaaS) products. Both of these surprises have an impact upon our valuation model, both from a revenue standpoint and a capital spending one, and we believe the valuation uncertainty surrounding this firm has increased.

Oracle Forecast Update

With the 5% fall in Oracle's (ORCL) share price after reporting first quarter 2017 results, we took a moment to review Oracle's quarterly numbers and also looked back at our last three years' worth of valuation assumptions for the firm and analyze Oracle's FY 2016 numbers.

Quarterly Results

A post-Brexit currency headwind held back Oracle's quarterly revenue growth, and strong Cloud sales in the U.S. boosted the tax rate a bit, which in turn caused earnings per share to come in a bit weaker than the Street expected.

Quarterly results looked fine to us.

Oracle's On Premise revenues were flat, but overall the software business grew in the mid-single digit percentages – a bit faster than our best-case revenue growth estimate. Profitability on an Owners' Cash Profits (OCP) basis was outstanding, but so much so that we know it will return towards the mid-30% range over the next three quarters. Oracle's first quarter is usually a slow one for the firm, so it is hard to meaningfully extrapolate conclusions from just this one quarter's results.

Long story short, we saw nothing in this announcement to cause us concern regarding Oracle's business prospects or strategy.

Long-Run Forecast Review

We have done two valuations of Oracle over the past three years – one in 2013, the other in 2015 – and we present our review of both here.

2013 Forecasts

We published an IOI Tear Sheet on Oracle in June of 2013 and an update a few months later. This is what our valuation looked like at that time.

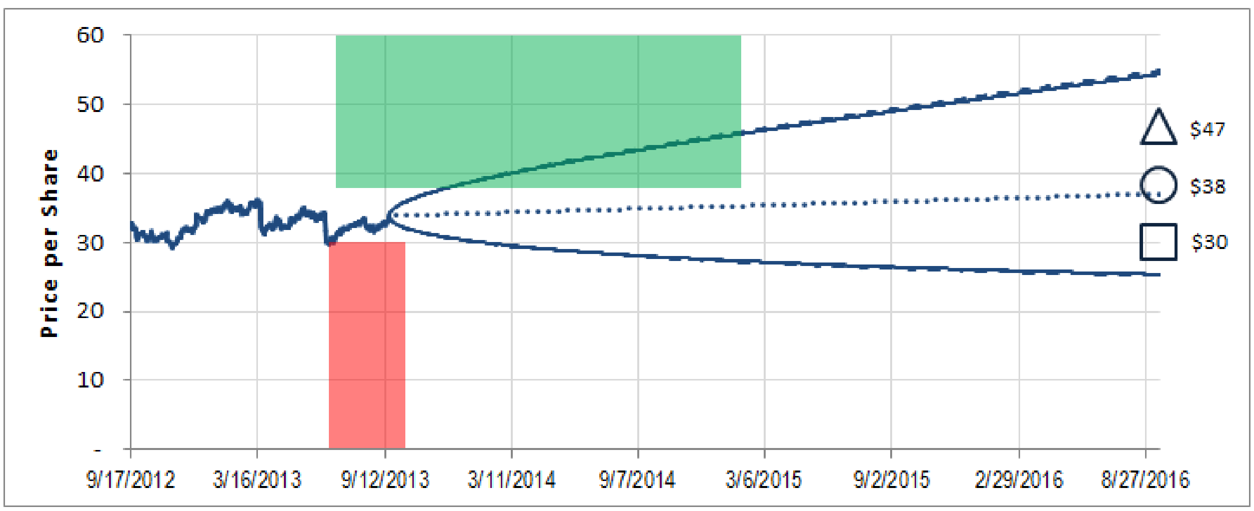

Figure 1. Source: Company Statements, IOI Analysis

Checking our profitability (OCP) and Free Cash Flow to Owners (FCFO) forecasts from that valuation, we find that our accuracy was fairly good, though with some reservations on the OCP side.

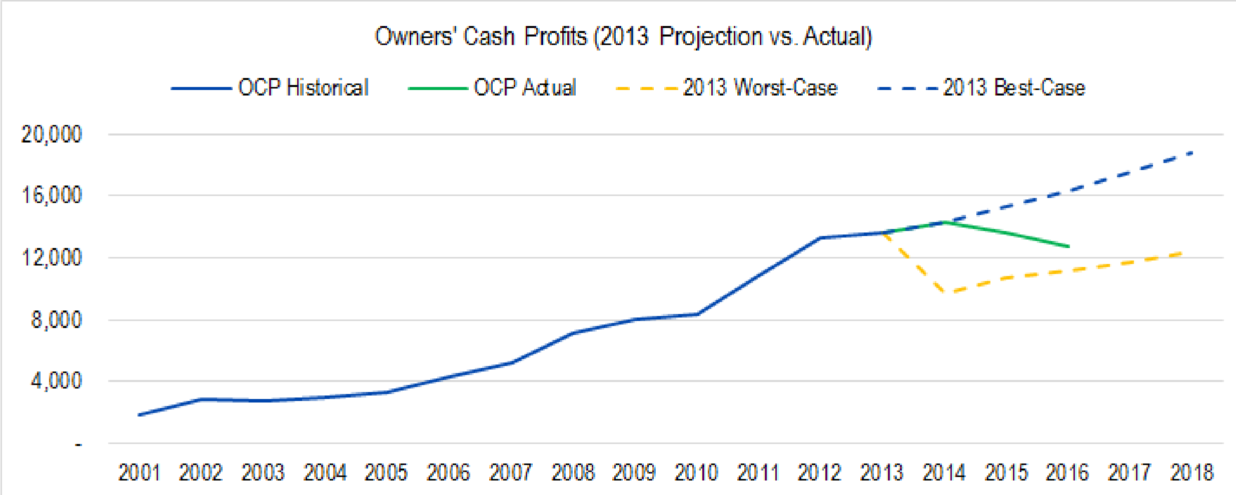

Figure 2. Source: Company Statements, IOI Analysis

The green extension shows actual OCP over the intervening three fiscal years. While still within our original projected range, we see that 2016's value was getting perilously close to the worst-case value. We discuss 2016 results more below.

In contrast, actual FCFO – the cash flow on which we base our valuation – ended up being very close to our best-case forecast.

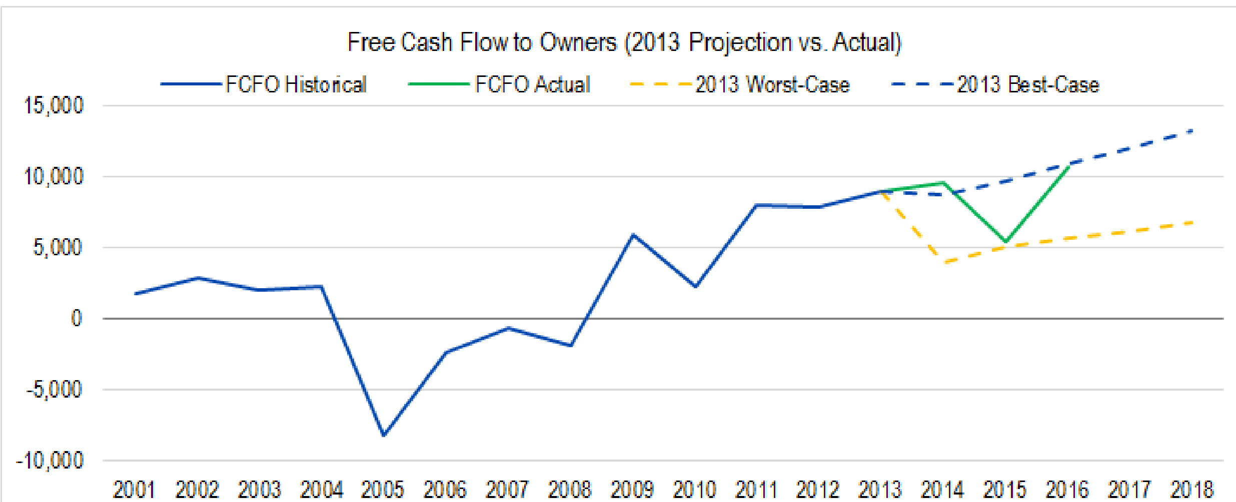

Figure 3. Source: Company Statements, IOI Analysis

FCFO can swing a great year from year to year as the company makes acquisitions or other investments, so we find it helpful to look at FCFO projections on an aggregate level.

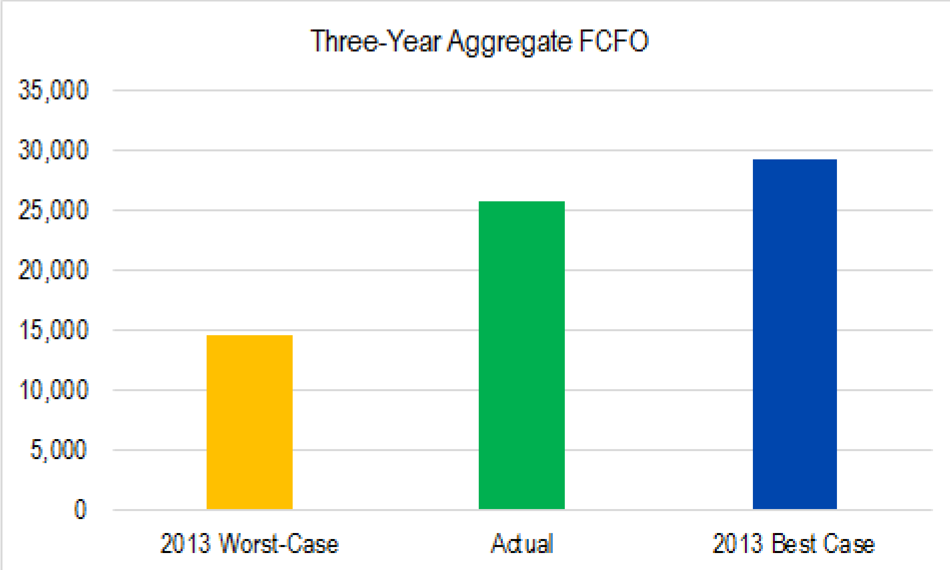

Figure 4. Source: Company Statements, IOI Analysis

Clearly, actual FCFO has been well within and closer to our best-case scenario, implying a valuation at the higher end of our 2013 forecast.

2015 Forecasts

In the fall of 2015, Oracle's stock price was dragged down by the China-influenced macro weakness, so we refreshed our valuation to see if there may be an opportunity to increase our position size or increase our leverage on the position using In-the-Money call options. We originally took the latter route on the strength of this valuation:

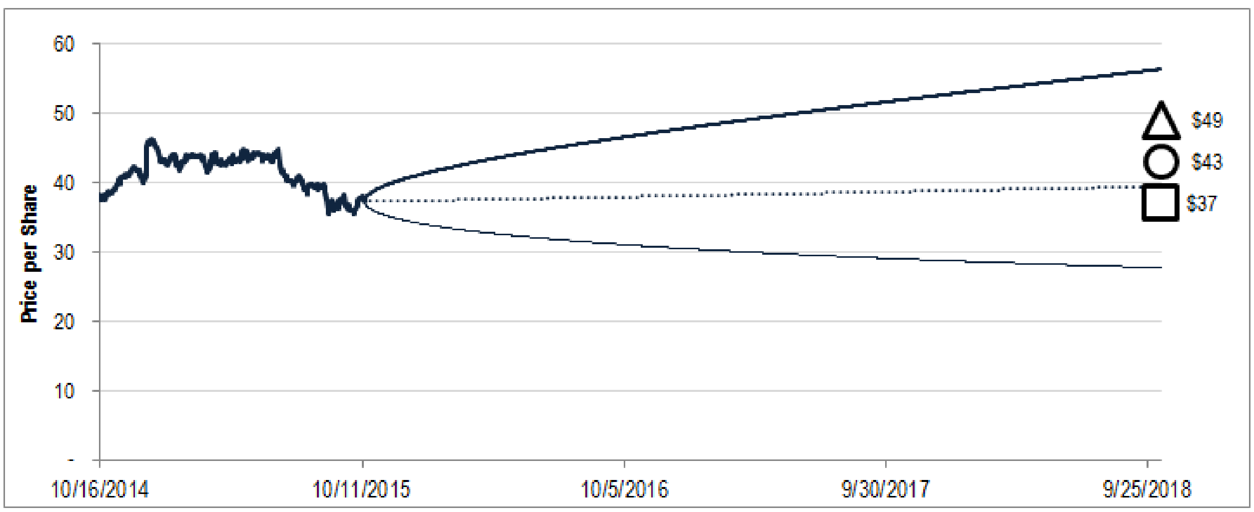

Figure 5. Source: CBOE, IOI Analysis

With a stock price in the mid- to upper-$30 range and a likely valuation in the mid-$40s, we increased our leverage in this position to roughly 1.8. / -1.5 (using the IOI convention explained in The Intelligent Option Investor) using ITM LEAPS.

Because Oracle's profits had been so resilient even in the face of revenue headwinds, we tightened our best- and worst-case OCP margin assumptions. In hindsight, this may have been too hasty of a decision as shown below.

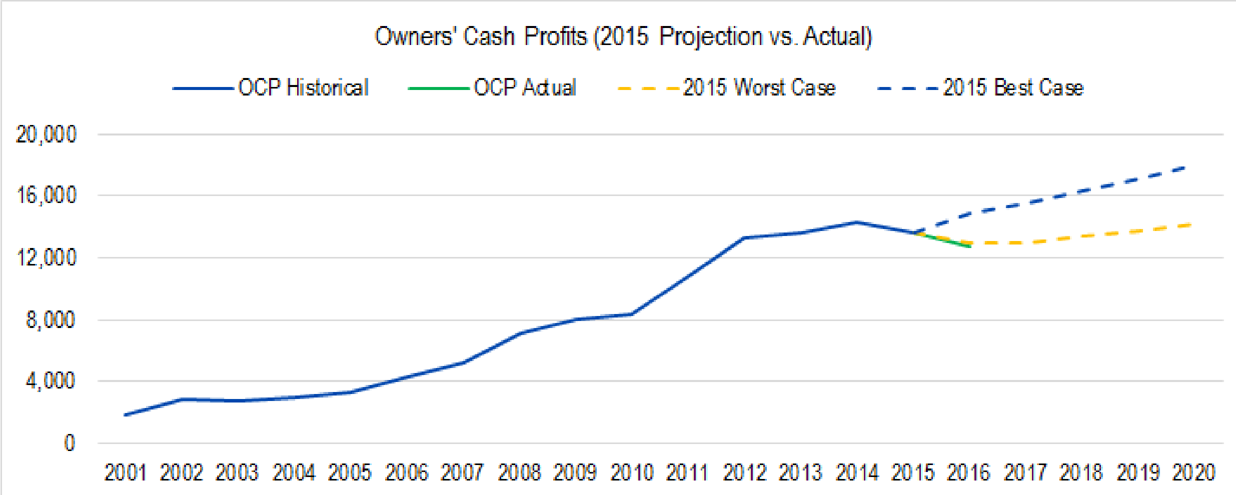

Figure 6. Source: Company Statements, IOI Analysis

As you can see, Oracle's actual 2016 OCP came in just under our worst-case forecast. However, due to relatively low acquisition activity and lowered compensation-related stock issuance, actual FCFO was much higher than our best-case forecast.

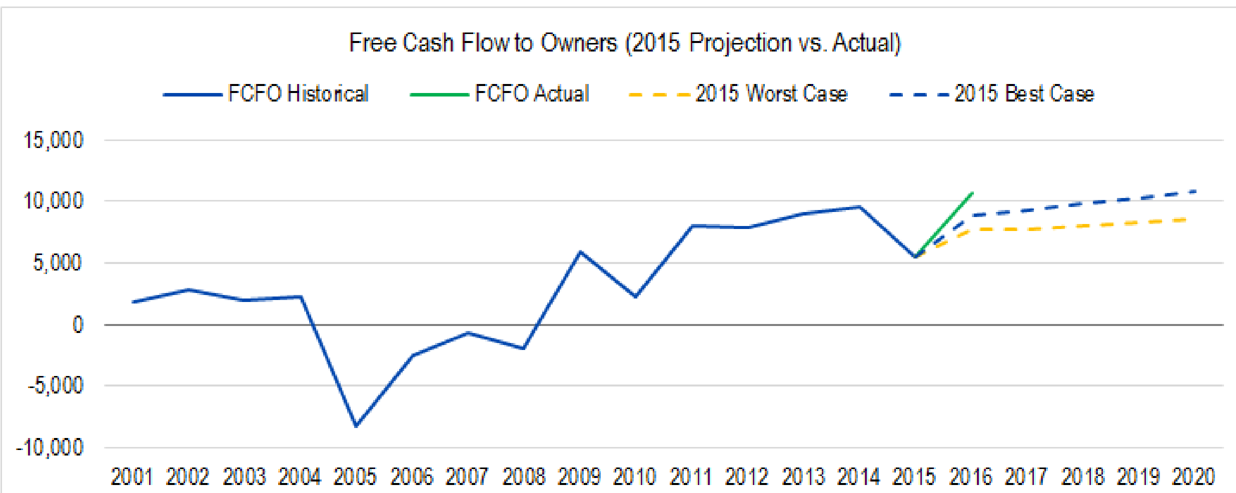

Figure 7. Source: Company Statements, IOI Analysis

Since FCFO is the metric on which we base our valuations and because had significantly overshot our expectations, we left our levered position open. After the 1Q 2017 earnings results, this does not look like a very smart move, but we have no need to look smart in the short run as long as we are correct about value in the long run and our investment is properly structured to take advantage of that.

Fiscal Year 2016 Review

Oracle's Investor Relations website has press releases and financial statements, so I won't repeat what is already a part of the public record. In short, revenues fell by a few percent and profitability (as measured by earnings per share) also lagged.

Part of the reason for the weakness is that the firm has been converting clients from its On Premise software to Cloud software. An effect of this switch is that revenues are depressed and profit margins compressed, but we view this as a non-economic artifact of accounting convention (search our articles archive for "ratable" to find an explanation of why).

Another part of the reason is because a good bit of Oracle's revenues is generated overseas, and thanks to a strengthening dollar, those revenues are translated over into the financial statements at a depressed rate. Again, we view this more as an accounting artifact, rather than a material economic weakness.

Because of these accounting issues and the business changes underlying them, it is hard to get an understanding of the health of the demand environment without doing a little digging. Our digging – the results of which are reviewed here – leads us to believe that the demand environment for the firm's product offering remains strong.

Let's dig into Oracle's software business to test our contention.

Software Revenues

Oracle has historically reported its software-related revenues in two segments: New Software and Software Updates. Over the last few years, revenues in these segments have looked like this:

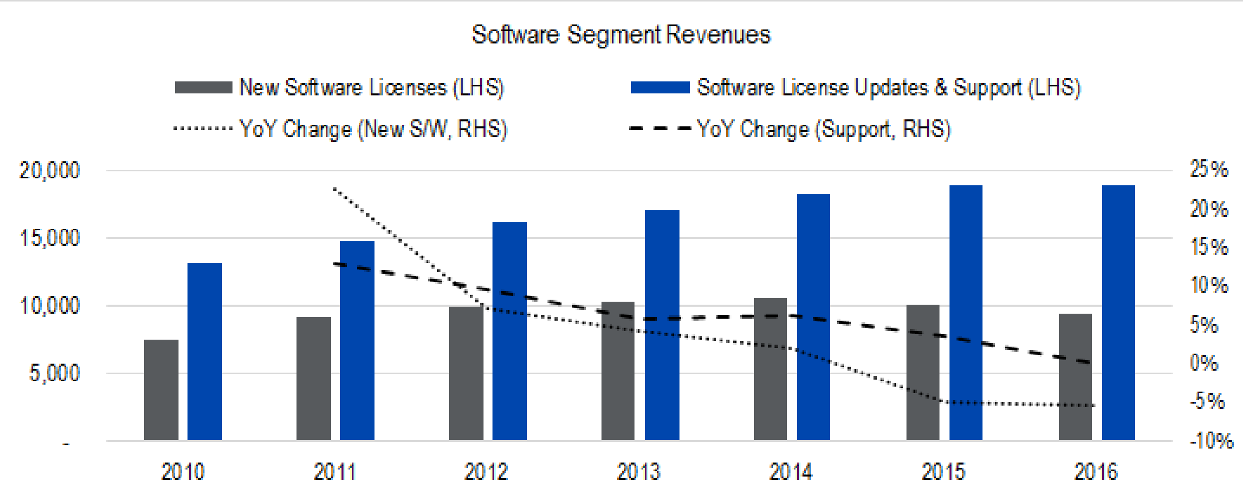

Figure 8. Source: Company Statements, IOI Analysis

The first thing to note is that Software Updates consistently generates more revenues than New Software, and this difference has been growing over time. We'll see below that in terms of Oracle's valuation, the Software Updates segment is much more important than New Software. The Software Updates segment's revenues grew slightly last year despite the currency headwinds.

In the figure above, you can also see that the growth rate for New software has been negative for the past two fiscal years. This decline is one of the reasons the investment community seems to be worried about Oracle. In short, it is killing its old On Premise business and its Cloud business can't make up the difference.

However, just looking at the numbers from these two segments does not give an investor the whole picture. First, Oracle started reporting some of its software sales in a new segment Infrastructure as a Service (IaaS), so to get an apples-to-apples comparison, this segment should be added in. Also, to correct for the accounting artifact mentioned above, one should also include the annual increase in deferred revenues (IOI members who would like an explanation of why this is so, please drop me a line!).

Correcting for these two issues, we get the following revenue chart for the “New Software” segment.

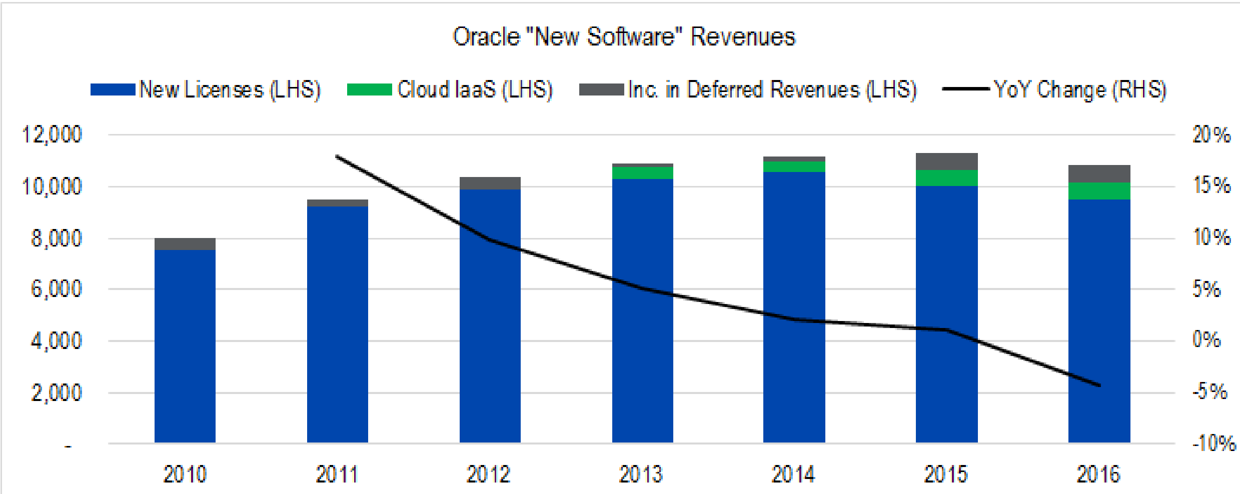

Figure 9. Source: Company Statements, IOI Analysis

The sharp fall-off in revenue growth for this adjusted revenue line is almost entirely due to foreign currency effects, which we believe to be immaterial to valuation (there is one instance where foreign currency effects can have a very severe valuation impact on a firm, but Oracle’s case is not an example).

In general, demand for Oracle’s Cloud offering appears to be exceedingly strong and the company has finally bought into the idea that it will become a Cloud software firm. Some observers criticize Oracle saying that it lags other Cloud providers too much. While Cloud revenues at Salesforce (CRM) or Amazon (AMZN) are indeed larger than Oracle’s, Oracle has advantages (client relationships, broad software offerings, highly-efficient hardware offerings) that still make it relevant and important in this field, in our opinion.

Software Profits

Due partly to the currency issues discussed above and to increased operational expenses related to the shift to the Cloud, profitability (as measured by IOI's preferred metric, Owners' Cash Profits) dipped several percentage points in 2016.

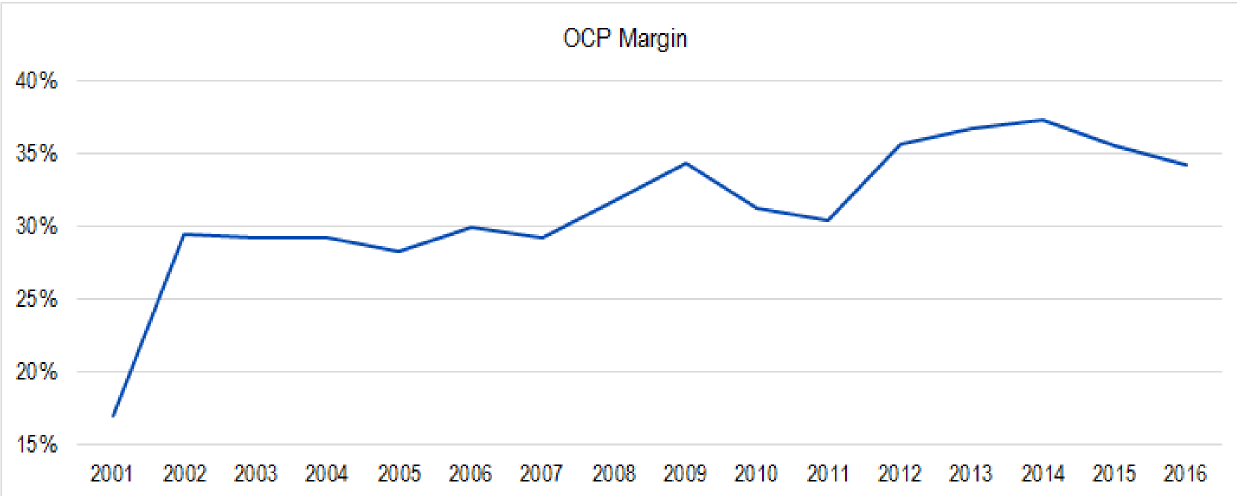

Figure 10. Source: Company Statements, IOI Analysis

We believe that profit margins will once again improve to the 37% level, but the present 34% level is equal to our worst-case scenario.

There is some mixed news here, but in general, it looks as though Oracle is concentrating on the correct strategic goal.

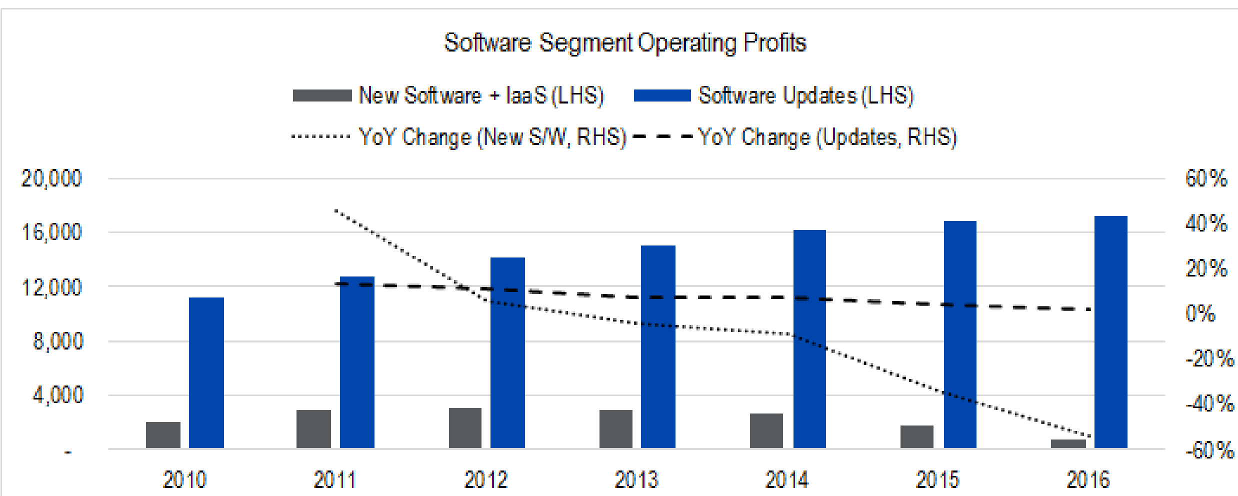

Figure 11. Source: Company Statements, IOI Analysis

In this diagram, we have added the new IaaS segment profits to the New Software segment profits to get a truer picture over time (note also that the numbers below are the operating profit figures provided by the company, not OCP).

The first obvious thing to notice about the figure above is how much more profit the Updates segment generates versus the "New Software" segment. In fact, 82% of Oracle's operating profits in 2016 were generated by this Updates segment; this segment is, in a real sense, the heart of Oracle's business. Updates' profits grew several percentage points during the year on flat revenues; this observation leads us to believe that Oracle's heart is very strong indeed.

Oracle has likely been offering heavy discounts to its software in order to pull business into the Software Updates business.

The second obvious thing to note is the precipitous drop-off in New Software profits in 2015 and 2016. While not shown here, this is a function of the old New Software segment rather than the IaaS segment that we are lumping in. This means that in addition to currency effects and increased operational expenses, Oracle has likely been offering large discounts to entice clients to buy. There is some evidence of this discounting, especially as it relates to Oracle's smaller rival Workday (WDAY), whose software competes with Oracle's Taleo line.

Considering the enormous profitability (91% op margin) and incredible resiliency of the Software Updates business this strategy is smart, in our opinion.

In our view, this discounting, while "irrational" over the short-term, is in Oracle's long-term best interest. It knows that if it can convince clients to buy Oracle software (whether On Premise or Cloud), Oracle has a good chance of keeping clients in the Software Update funnel, which is the true source of its profitability and value. Oracle spent more on research and development in 1Q 2017 than Workday generated in revenues over the past 12 months. As long as Oracle can keep improving its software faster than Workday or other smaller competitors, it has a good chance of dominating the space simply because of its scale.

While this Oracle's 2016 results seem good to us, there are some new sources of uncertainty with regards to the company.

Near-Term Uncertainty

Oracle announced the acquisition of Cloud software provider NetSuite (N), a company partly owned by Oracle founder, Larry Ellison. The first bit of uncertainty relates to both revenue growth and investment spending due to this proposed transaction. The second largest holder of NetSuite shares after Ellison, T Rowe Price, has announced it would vote against the acquisition. If the acquisition is voted down, Oracle saves $9 billion and change, but loses out on a revenue boost of around $1 billion and the chance to fill out its Cloud software offering.

If Oracle is going to compete against Amazon's AWS, it will need to increase investment spending and it's not clear the extent to which this investment will generate additional profits to owners.

Another source of uncertainty is tied to capital expenditures related to Ellison's recently announced plan to take on Amazon's AWS service using a combination of Oracle's high-performance servers and its IaaS offering. Oracle is talking about providing high-performance, low-cost server farms for large corporations to rent out. This plan necessitates that Oracle spend a good bit of money to build and equip these server farms. While it has plenty of money to do this, any cash spent to buy equipment is an investment and investments are risky. If Oracle's investment does not pan out with faster profit growth in the future, Oracle's value will fall.

The last bit of uncertainty relates to recent comments by Ellison that Oracle will be the first company to generate $10 billion in Cloud revenue. Larry seems like a pretty sharp guy, so I figure that he can do arithmetic about as well as I can. Considering that Salesforce already generates nearly $8 billion in Cloud revenues and Oracle only about $2, the arithmetic doesn't work out unless: 1) Oracle's server farm idea is instantaneously successful in stealing a large proportion of AWS revenues and then some, 2) Oracle acquires a company that has about $8 billion in Cloud revenue. Acquiring Salesforce would return order to the universe (in that Benioff, Salesforce's founder and CEO, was Ellison's protégé at Oracle before founding his own company), but it would also mean that something like $65 billion worth of Oracle's profits (roughly equal to the last five years of Owners Cash Profits) would go out the door.

We will take these uncertainties into account when we publish our updated valuation of Oracle to IOI Members.

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