ORACLE

FRAMEWORK Investing

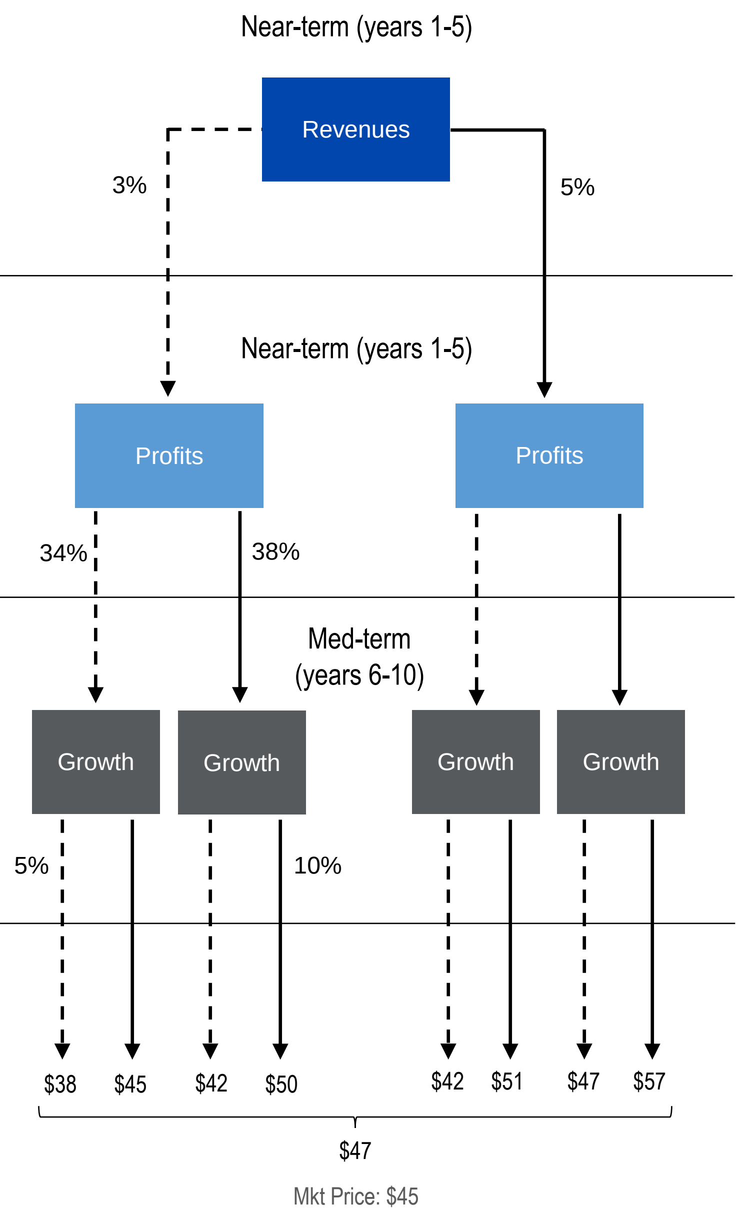
Valuation Waterfall

Revenue Growth
Oracle is undergoing a paradigm shift in its revenue model. Long in the business of selling software licenses and updates for Oracle databases and applications that run on clients' own, on-premise servers, Oracle is now embracing the Cloud model. Some of Oracle's Cloud business is cannibalizing its on-premise business, so top-line revenues have been flat. ORCL's Cloud offerings are growing quickly and hybrid license/Cloud model boosts on-premise sales.

Profitability
The move to the Cloud has lowered Oracle's profitability by a few hundred basis points as the firm has had to build (and depreciate) data centers that it uses to provide its as-a-Service offerings. However, over the past few quarters, Cloud profitability has made a dramatic upturn as ORCL's fixed costs are spread over an expanding client base. ORCL's Bring Your Own License (BYOL) program offers clients Cloud flexibility while maintaining hi-profit licenses.

Medium-Term Cash Flow Growth
ORCL has been investing heavily in the Cloud and has innovated with its BYOL offering in a way that is attractive for customers and owners alike. ORCL's ownership of the Java platform may generate positive cash flow even though it is open sourced. Its hardware offering, from the acquisition of Sun Micro in 2010, is a drag in terms of revenue growth, but a plus in terms of strategic advantage. As Cloud business matures, expect CF growth to speed up.

Fair Value Range
Our fair value range extends from $38 to $57 / share with an average value of $47 / share using a **discount rate of 10%**. We think that the relatively higher valuations are probably more likely, despite recent results which have been closer to our worst-case operating assumptions. Corporate stewardship is an issue. Larry Ellison should stop issuing himself so much stock. Amount spent on "anti-dilutive stock buybacks" was nearly $2B in 2017.



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Methodology

Framework Investing analyses focus on three main valuation drivers: revenue growth, profitability, and medium-term cash flow growth. We estimate a best- and worst-case scenario for each of these drivers resulting in a total of $2^3 = 8$ fair value scenarios based on discounted cash flow methodology. Profitability is measured by [Owners' Cash Profit (OCP)] margin and our measure of free cash flow is termed [Free Cash Flow to Owners (FCFO)]. We use a discount rate of 10% for large capitalization stocks. A wide spread of lowest and highest fair values indicates a firm whose value is uncertain. Risk depends on the stock price's relationship to the valuation range. Best-case scenarios are represented with a solid line; worst-case scenarios, with a dotted one.

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