Independent Equity Research

December 2006
Equity Research Report

ORACLE CORP. (ORCL)

ANALYST OPINION: NEUTRAL

(in $ millions, except per share data) Year Ends May 31	Q1 FY07	Q2 FY07	Q3 FY07E	Q4 FY07E	FY06	FY07E	FY08E
Total revenues	3,591	4,163	4,347	5,947	14,380	17,858	20,942
Operating income	936	1,357	1,228	2,199	4,736	5,714	6,568
Net income	663	967	831	1,508	3,381	4,024	4,560
Diluted Earnings per share (US GAAP)	$0.13	$0.18	$0.16	$0.28	$0.64	$0.76	$0.86

Source: Analyst estimates, SEC filings.

SUMMARY

We believe Oracle is fairly valued. Oracle is a successful software and IT services company, which has exhibited strong growth, fuelled by an aggressive acquisition-driven strategy. It is a multibillion company with a strong brand name and large customer base. However, the company has been relying on acquisitions for its growth and faces very strong competition, represented by such industry giants as Microsoft, IBM and SAP. The latter is a leader in many business software segments and is developing its own set of SOA tools, an area heavily targeted by Oracle. However, unlike Oracle, SAP has reported strong organic growth and is in no position to give up its market share. Currently, Oracle has built a strong portfolio of companies, but it will need to consolidate them efficiently, recovering the margins that suffered in the past two years. It will also have to make an effort at pushing organic growth to rates comparable with SAP's to keep and gain market share.

INVESTMENT HIGHLIGHTS

Company size
Large size provides numerous benefits: credibility, rich resource base (including human capital, research facilities, intellectual property), cross-subsidization possibilities, relative ease of entry into new industries/segments, possibility to work with large customers (governments, multinationals etc), economies of scale, bargaining power and lobbying, purchasing power for acquisitions.

Wide range of products
Oracle targets the corporate segment of the software consumer market and offers a wide range of business software, developed both internally and acquired through purchase of subsidiaries. The products include:

- Technology Products: Database and Grids, Middleware, Data Hubs, Developer Tools, Security, Search, Enterprise Management, Business Intelligence, Collaboration, Content, Data Warehousing, Linux;
- Application Products: Customer Relationship Management, Financial Accounting, Human Resources, Supply Chain, Public Sector Applications, Banking Applications, Retail Applications, Telecom Applications, Higher Education Applications and other;
- Services: Support, Education, On Demand, Financing, INSIGHT, Consulting.

The company is also developing a new integrated product suite planned for initial release in 2008 – the Fusion Project (discussed below). With such an extensive portfolio and significant expertise, Oracle is a world-class leader and a standard-setting player in its domain.

Expansion into industry subsectors through acquisitions
Oracle has been acquiring subsidiaries in other market segments, benefiting from existing customer bases, technology and trust already gained by the target companies. Oracle's size and customer base both allow and require the company to keep looking for new directions to expand to. In the past several years, Oracle has been very active in terms of acquisitions, buying both small and big IT companies.

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Company	Month/Year	Industry	Valuation
Collaxa	June 2004	Business Process Management	n/a
PeopleSoft	January 2005	Enterprise Software	$11.1 billion
Oblix	March 2005	Identity Management Solutions	n/a
Retek	April 2005	Retail Industry Solutions	$701 million
TripleHop	June 2005	Context-sensitive Enterprise Search	n/a
TimesTen	June 2005	Real-time Enterprise Solutions	n/a
ProfitLogic	July 2005	Retail Industry Solutions	n/a
Context Media	July 2005	Enterprise Content Integration	n/a
i-flex	August 2005	Banking Industry Solutions	$847 million*
G-Log	September 2005	Logistics Hib Solutions	n/a
Innobase	October 2005	Discrete Transactional Open Source Database Technology	n/a
Thor Technologies	November 2005	Enterprise-wide User Provisioning Solutions.	n/a
OctetString	November 2005	Virtual Directory Solutions	n/a
Temposoft	December 2005	Workforce Management Applications	n/a
360Commerce	January 2006	Retail Industry Solutions	n/a
Siebel Systems	January 2006	Customer Relationship Management Solutions	$6.1 billion
Sleepycat	February 2006	Open Source Database Software for Embedded Applications	n/a
HotSip	February 2006	Communications Infrastructure Solutions	n/a
Portal Software	April 2006	Software Suite for Communications Industry	n/a
Net4Call	April 2006	Service Delivery Platform for Communications Industry	n/a
Demantra	June 2006	Demand-driven Planning Solutions	n/a
Telephony@Work	June 2006	IP-based Contact Center Technology	n/a
Sigma Dynamics	August 2006	Real-time Predictive Analytics Software	n/a
Sunopsis	October 2006	Enterprise Integration Software	n/a
MetaSolv Software	October 2006	Solutions for Communications Service Providers	$219 million
SPL WorldGroup	November 2006	Revenue and Operations Management Software	n/a
Stellent	December 2006	Content Management Solutions	$440 million

* As of August 31, 2006.
Source: http://en.wikipedia.org/wiki/Oracle_Corporation, SEC filings.

Oracle leads in many market segments

Oracle is an experienced multibillion company, present in several key software markets. The company is a leader in many of the market segments it is present in, This leadership is the result of both internal developments (such as its database business) and acquisitions (such as the acquisition of Siebel, which allowed Oracle to narrow the gap between itself and SAP in the CRM market from 20 to just 3 percentage points[1]).

Fusion Applications scheduled for release in 2008

Oracle plans to launch a new business software suite that will combine the functionality of its currently separate software packages, offering greater data management capabilities to businesses than standalone applications. An analyst notes that "if Fusion works as advertised, Oracle could wind up dominating the software world this decade much as Microsoft dominated the last one."[2] Fusion

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[1] Based on 2005 data, source: Gartner.
[2] Source: http://news.zdnet.com/2010-3513_22-6130041.html.

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Middleware already has 30,000 users[3] allowing customers to use software from different vendors. However, SAP is planning to launch its own SOA-based suite in 2007, with its NetWeaver SOA platform launched in 2004.

Aggressive business strategy

As illustrated by Oracle's move to provide low cost support to Red Hat Enterprise Linux users and by the announcement to create and offer its own version of Linux operating system, Oracle uses a very aggressive business strategy, trying to "steal" customers from competitors or at least to make competitors' lives harder. This strategy is also exemplified by the acquisition activity discussed above and by numerous partnerships that Oracle keeps establishing with various industry players.

Partnerships with industry leaders

Oracle has partnered with a number of leading companies in the IT industry, among which are Dell, HP, Intel and others. Through such partnerships, Oracle benefits from greater exposure to potential customers, from increased trust inferred from the expertise of its partners and from cross-marketing opportunities. Of course, competitors also rely on partnerships and Oracle partnering with other companies mostly offsets similar relationships between competitors.

Sound financials with healthy balance sheet

Oracle has exhibited accelerating revenue growth rates in the past several years following revenue stagnation in 2003, resulting from its aggressive business strategy and partly fueled by acquisitions. Such high growth rates are not typical for multi-billion companies and represent a strength on their own. However, much of the revenue growth came from acquisitions:

Revenue volume and growth rates
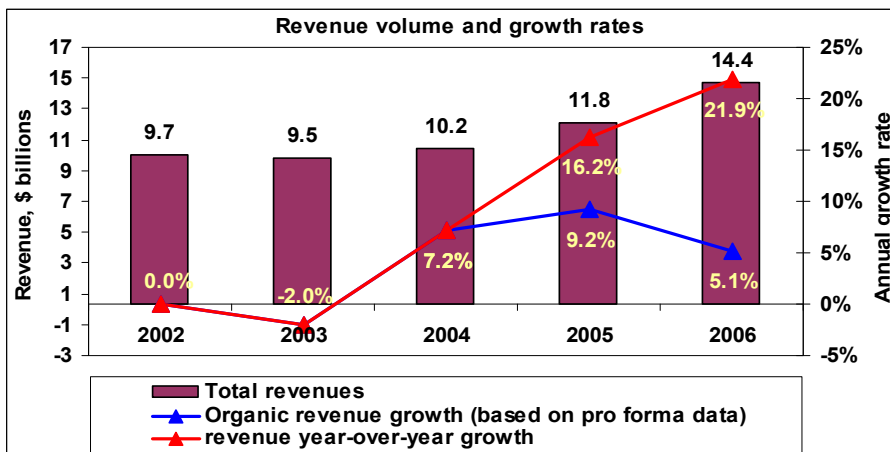
Fiscal year ends May 31.
Pro forma data includes only Siebel and PeopleSoft acquisitions.
Source: SEC filings, our calculations

Nonetheless, in H1FY07, organic revenue year-over-year growth was 17% with 28% total revenue year-over-year growth. In the Q1FY07 Earnings Call[4], the company's CFO noted that in Q1FY07 Oracle had its strongest Q1 licensed growth in more than five years and that the company was gaining share across all product lines. This was also the third consecutive quarter in which Oracle had applications license growth greater than 75%[5].

The company's EPS has also been growing steadily as a result of both revenue increase and share buybacks. The company plans to buy back $1 billion worth of shares every quarter until the end of the fiscal year. Since the inception of Oracle's share repurchase program in 1992 through FY06, the company repurchased 1.8 billion of its shares for a total of $20.7 billion, and in July 2006 the company's Board extended the repurchase program so that another $4 billion worth of shares could be repurchased. During the six months ended November 30, 2006, ORCL repurchased 121.3 million shares for $2.0 billion.

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[3] Source: Q1FY07 Earnings Call, available at http://seekingalpha.com/article/17179.
[4] Transcript available at http://seekingalpha.com/article/17179.
[5] Data from management in this paragraph reflect non-GAAP measures.

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The Q2FY07 balance sheet exhibited decent liquidity, with the current ratio at 1.75, cash & equivalents and marketable securities together accounting for 27% of all assets, and net working capital standing at $5.6 billion. At the same time, financial debt stood at $5.9 billion, or 20.4% of total assets.

Positive guidance provided by management for Q3FY07[6]:
- New software license revenues are expected to be up 16% to 22% year-over-year;
- Total revenue is expected to be up 23% to 25% on a GAAP basis;
- Net income is expected to growth 24% to 29% on a GAAP basis;
- GAAP EPS is expected to be $0.18-0.19, up from $0.14 last year.

INVESTMENT RISKS

Company size

Large size also brings some disadvantages: multiple levels of management increase bureaucracy, small but highly lucrative niches may remain unnoticed/unattended and left to smaller players to fill in, difficulties to implement corporation-wide changes, antitrust attention from governments, any errors/malfunctions in products immediately create bad publicity.

Strong competition

Oracle faces competition from Microsoft, SAP, IBM etc. – some of the biggest corporations in the world. Other competitors are also well established big companies with large resource and customer bases. Thus competing with all of them efficiently requires a lot of financial and marketing resources, as well as management attention. Some moves by the company to fend off competition may prove to be ineffective and considered too costly by shareholders and the professional public. For example, the move to compete with Red Hat in the corporate Linux space has been received by the industry with mixed feelings. On one hand, Red Hat is forced to cut down pricing and faces a threat of customer outflow. On the other hand, analysts observe that customer loyalty and Red Hat's software certification program are very hard to beat. Besides, the revenues that Oracle might take away from Red Hat would not make much of a difference at the bottom line for Oracle[7]. Moreover, a RedMonk analyst Stephen O'Grady considers that "in the short term, this will be a problem in terms of perception and customer apprehension. In the longer term, this could actually reinforce Red Hat's preeminence."

SAP is one of Oracle's main competitors. SAP is the market share leader in the CRM, ERP, and SCM spaces, according to Gartner Dataquest[8], and has partnered with Microsoft to make its applications integrate easily with MS Office applications. SAP is also developing a Services Oriented Architecture suite which may be launched as soon as in 2007, one year before Oracle's Fusion application suite. It's SOA platform – NetWeaver – was launched in 2004. At its recent European TechEd conference in Amsterdam, SAP opened the NetWeaver platform to a broader development community[9]. Via the online SAP Developers Network, developers will be able to purchase individual subscriptions to SAP software, allowing them to test, evaluate and develop tools in NetWeaver. Previously, access to development tools was available only for companies that had purchased SAP software. The subscription program will include access to technical support, premium content and online access for testing enterprise services. The program is scheduled to begin in 2007.

SAP also has a large customer base and a strong brand name. Just like Oracle attacked Red Hat, SAP attacked Oracle earlier this year, offering support to Siebel customers at lower rates[10] than Oracle's. SAP also boasts growing revenues, including in Oracle's home market – the US, where it had 15% growth of Software revenues in Q3FY06, and has issued a positive outlook for the year in October, while stating that SAP was gaining market share and growing mainly organically, as opposed to Oracle's acquisition-driven growth[11]. SAP expects full-year 2006 product revenues to increase by 13-15% year-over-year,

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[6] Oracle F2Q07 (Qtr End 11/30/06) Earnings Call from December 18, 2006, transcript available at http://seekingalpha.com/article/22626.

[7] Some of these opinions can be found here: http://news.zdnet.com/2100-3513_22-6130071.html.

[8] Source: http://www.destinationcrm.com/articles/default.asp?ArticleID=6162.

[9] Source: http://searchsap.techtarget.com/originalContent/0,289142,sid21_gci1225126,00.html.

[10] Source: http://news.zdnet.com/2100-9593_22-6071696.html.

[11] Source: Q3FY06 earnings call, available at http://seekingalpha.com/article/18842.

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based on the expectation for full-year 2006 software revenue growth in the range of 15% to 17%, compared to 2005.

Relative security weakness of Oracle databases

The company's key product suffers from weak security compared to competitors. Recently, a security researcher from NGS Software published a white paper comparing security robustness of database software from several producers[12]. Oracle's products were recognized to contain more security bugs than Microsoft's SQL Server products.

The number of security flaws in the Oracle and Microsoft database servers that have been discovered and fixed since December 2000 until November 2006:
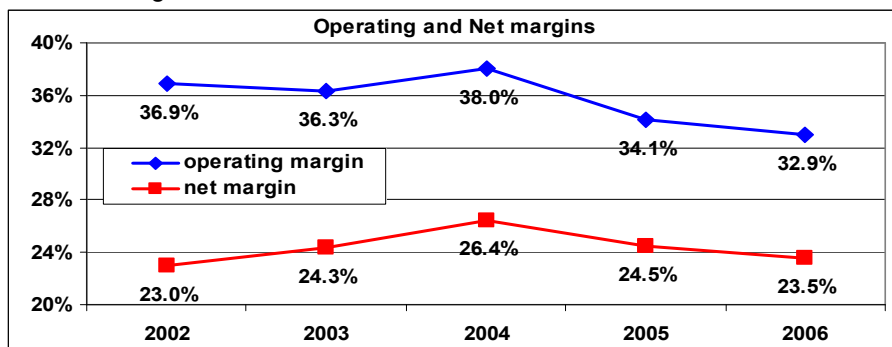

Source: http://www.databasesecurity.com/dbsec/comparison.pdf
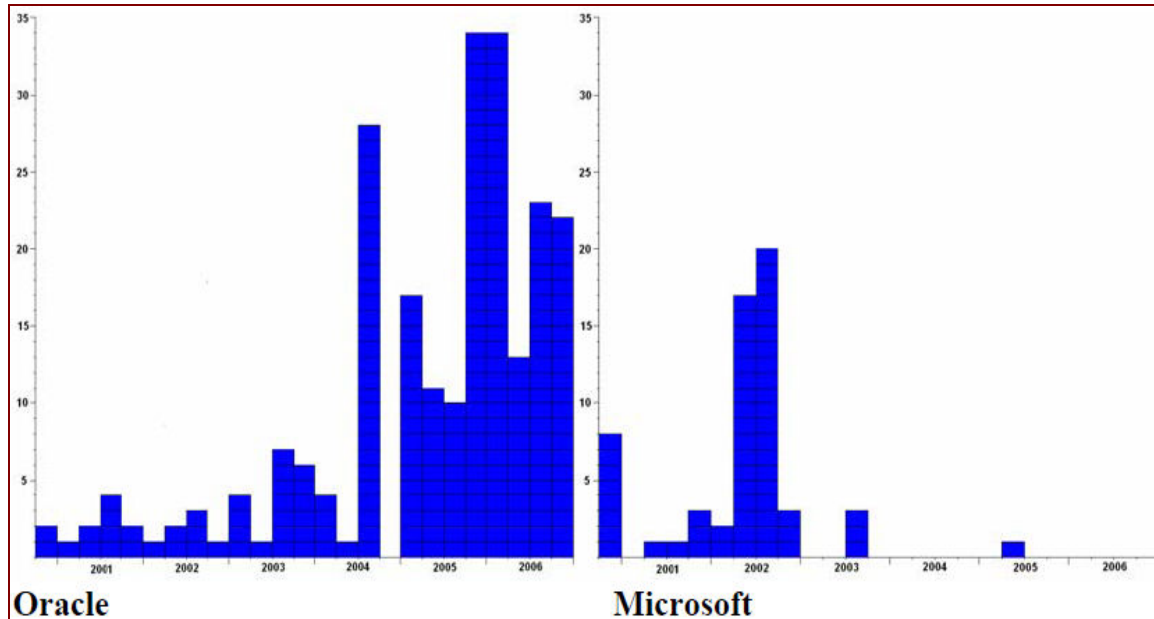
Another report by the Enterprise Management Group[13], also notes Oracle's relatively poor security record. In fact, security vendor Argeniss has announced that it will have a "week of Oracle Database bugs" in December focusing on Oracle's poor security record.

Such poor security record can cast a shadow of doubt on Oracle's other products and reduce customer trust, especially when data security is being addressed on national level in many countries.

Fast expansion and tight competition have eroded Oracle's profit margins

Rapid expansion came at the price of margins, with both operating and net margins experiencing a decline during 2005-2006.

Fiscal year ends May 31.

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[12] Source: http://www.vnunet.com/vnunet/news/2169225/microsoft-beats-oracle-security, white paper available at http://www.databasesecurity.com/dbsec/comparison.pdf.

[13] Source: http://www.microsoft.com/presspass/itanalyst/docs/ESGNov2006SQLServerSecurity.pdf.

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Source: SEC filings, our calculations.

SWOT ANALYSIS

Strengths	Weaknesses
• Big size: large resource base; • Leadership in many market segments; • Strong brand name and reputation; • Partnerships with industry leaders; • Diversified product portfolio; • Strong revenue growth; • Sound financial situation; • Fusion suite to be launched in 2008; • Aggressive business strategy; • Positive guidance.	• Relatively poor safety record; • Acquisitions have been the main source of revenue growth, while organic growth slowed down in FY06. • Mr. Ellison likes to make unsubstantiated statements which eventually may lead to trouble.
Opportunities	**Threats**
• Continuous adoption of BPO and related software; • Increasing adoption of software-as-a-service concept; • Globalization driving multinational companies to implement software that reduces costs and increases efficiency, to remain competitive.	• Tough competition against very large players; • SAP is developing a competing SOA suite; • Fast expansion erodes margins; • Increasing size of corporation may deteriorate management focus.

INDUSTRY OVERVIEW

Enterprise resource planning (ERP) applications market: Oracle is the fastest market share gainer
The ERP applications market is expected to reach $29 billion in 2006[14] or 14.2% higher than in 2005. Also, for the next five years the market is expected to grow at a CAGR of 10%.

While Oracle is expected to maintain its second position in terms of market share, it is likely to enjoy the largest growth in the ERP application segment compared to other Top 5 ERP vendors and at 2x the overall market growth rate.

Top 5 ERP Vendors	2004 Revenue Share	2005 Revenue Share	2006 Revenue Share	Revenue Growth Rate 2005-06
SAP	40%	42%	43%	17%
Oracle	10%	20%	23%	29%
Sage Group	5%	6%	6%	10%
Microsoft	3%	4%	4%	18%
SSA Global	3%	3%	3%	3%
TOTAL MARKET		100% = $25.4 billion	100% = $29 billion	14%

Source: AMR Research (2006)

Business analytics software and data warehousing tools market: Oracle is the market leader

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[14] Source: AMR Research

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Oracle was recognized as the leading business analytics software and data warehousing tools vendor for 2005, retaining a market share of 13.1% or $2.2 billion of the $16.6 billion total market[15]. This market grew by 11% in 2005.

Oracle is the world leader in the data warehousing tools market with a 19.3% market share and $1.9 billion[16] in 2005 software revenues. Oracle is also the leading vendor in the data warehouse management category with a 39.8% market share and $1.6 billion in revenues for 2005. Oracle's closest competitor in the category had a 22.7% market share.

Worldwide relational database market (RDBMS): Oracle is the market leader
Worldwide relational database management systems (RDBMS) total software revenue increased by 8.3% in 2005 reaching $13.8 billion[17]. Of the top 5 vendors, just Microsoft experienced a growth rate above the industry average, primarily due to pent-up demand for SQL Server 2005.

RDBMS, top vendors	2005 Market Share
Oracle	48.6%
IBM	22.0%
Microsoft	15.0%
Teradata	3.2%
Sybase	2.9%
Other	8.2%
TOTAL	100% = $13.8 billion, 8.3% yoy growth

Source: Gartner.

Customer relationship management (CRM) software market: Oracle is much closer to the leading position after the acquisition of Siebel
Worldwide CRM software market reached $5.7 billion, experiencing 14%[18] growth in 2005 over 2004, driven by companies looking for more opportunities to drive revenue and expand business lines.

In 2005, SAP was the top CRM vendor in terms of revenue (26% market share), followed by Siebel (17%), Oracle (6%), Salesforce.com (5%) and Amdocs (5%). However after the acquisition of Siebel Systems in January 2006, Oracle attained a 23% market share.

Application integration and middleware (AIM) market: Oracle has the strongest momentum in the segment
The application integration market reached $8.5 billion in 2005, a 7.1% increase over 2004. The main players were: IBM (a clear leader with market share of 37%), BEA Systems (14.5%), Oracle (8.7%), Microsoft (4.7%) and Tibco (3.7%).

Oracle – with the highest momentum in the segment – witnessed revenue growth of 40% in 2005.

2005 Worldwide Vendor Revenue Estimates for AIM Software (Millions of Dollars)[19]

Company	2004	2005	2004-2005 Growth (%)	2004 Market Share (%)	2005 Market Share (%)
IBM	2,959.8	3,159.4	6.7	37.3	37.2
BEA Systems	1,163.3	1,232.5	6	14.7	14.5
Oracle	529.8	739.4	39.6	6.7	8.7

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[15] Source: IDC.
[16] Source: IDC.
[17] Source: Gartner.
[18] Source: Gartner.
[19] Source: http://www.gartner.com/press_releases/asset_153343_11.html.

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Microsoft	350.3	397.1	13.4	4.4	4.7
Tibco	289.9	314.4	8.5	3.7	3.7
Other Vendors	2,643.0	2,657.3	0.5	33.3	31.3
TOTAL	7,936.1	8,500.2	7.1	100	100

Source: Gartner Dataquest (May 2006)

ORACLE VERSUS PEERS

Despite its aggressive acquisition strategy, ORCL maintains superior profitability level compared to other giants from the IT space; in terms of operating and net margin being exceeded just by Microsoft.

	ORCL	**SAP**	**MSFT**	**IBM[20]**
Market Cap, $Bn:	**101.8**	258.1	295.1	NA
Revenue, $Bn (ttm):	**15.2**	12.1	45.4	15.8
Latest Quarter Rev. Growth (yoy):	**29.7%**	11.5%	11.0%	5.5%
Revenue per employee, Mn	**0.27**	0.34	0.64	NA
Gross Margin (ttm):	**77.1%**	65.9%	82.2%	87.5%
EBITDA Margin (ttm):	**40.5%**	30.1%	41.9%	NA
Operating Margin (ttm):	**34.1%**	27.5%	39.4%	31.0%
Net Margin (ttm):	**23.2%**	18.5%	28.5%	18.0%

Source: Yahoo! Finance, SEC filings.

VALUATION

We expect ORCL to report:
- $18 billion in sales for FY07 and $21 billion in FY08;
- GAAP diluted EPS of $0.76 (FY07) and $0.86 (FY08).

While estimated P/S ratio unveils a premium of ORCL over peers multiple, we believe it is warranted by superior profitability. According to peers' median P/E multiple, ORCL seems fairly valued.

Overall, we are quite optimistic about ORCL and consider it may show further positive developments. But we consider that at current stock price, the investment gain is limited.

12/28/06 COMPANY NAME	TICKER SYMBOL	MRKT CAP (MILS)	PRICE PER SHR	PE CAL 2006	PE CAL 2007	P/S CAL 2006	P/S CAL 2007
AMDOCS	DOX	7,758	38.00	19.69	17.12	2.98	2.59
SALESFORCE.COM	CRM	4,151	36.96	160.70	85.95	8.39	5.81
SAP AG ADR	SAP	66,861	52.82	27.65	24.57	5.57	5.14
TIBCO SOFTWARE	TIBX	1,981	9.41	26.89	24.13	3.83	3.43
MICROSOFT	MSFT	295,110	30.02	24.81	17.87	6.42	5.37
BEA SYSTEMS	BEAS	5,590	12.66	23.44	20.42	3.99	3.73
SYBASE	SY	2,268	24.89	17.05	16.48	2.62	2.27
Median				**24.81**	**20.42**	**3.99**	**3.73**
ORACLE	ORCL	88,843	17.1	22.47	19.82	4.98	4.24
Discount (premium) to peers median					**9%**	**3%**	**-25%**

Source: Analyst estimates for ORCL, other stocks – www.baselinedirect.com

INCOME STATEMENT FORECAST

US GAAP, $ millions, except per share data	Q1 FY07	Q2 FY07	Q3 FY07E	Q4 FY07E	FY06	FY07E	FY08E

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[20] Software segment only; annual (2005) values.

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Fiscal Year Ends May 31							
Revenues:							
New software licenses	804	1,207	1,235	2,364	4,905	5,610	6,174
Software license updates and product support	1,941	2,007	2,143	2,308	6,636	8,399	9,961
Software revenues	**2,745**	**3,214**	**3,378**	**4,672**	**11,541**	**14,009**	**16,136**
Services	**846**	**949**	**916**	**1,137**	**2,839**	**3,849**	**4,807**
Total revenues	**3,591**	**4,163**	**4,294**	**5,809**	**14,380**	**17,858**	**20,942**
Operating expenses:							
Sales and marketing	750	915	954	1,264	3,177	3,883	4,554
Software license updates and product support	200	205	222	251	719	878	1,029
Cost of services	780	820	819	961	2,516	3,380	4,173
Research and development	506	519	588	664	1,872	2,277	2,670
General and administrative	157	170	174	168	555	669	785
Amortization of intangible assets	205	202	222	244	583	873	961
Acquisition related	48	-36	60	70	137	142	156
Restructuring	9	11	11	11	85	42	46
Total operating expenses	**2,655**	**2,806**	**3,051**	**3,633**	**9,644**	**12,144**	**14,374**
Operating income	936	1,357	1,244	2,177	4,736	5,714	6,568
Interest expense	-83	-82	-90	-99	-169	-354	-390
Non-operating income, net	102	79	79	79	243	339	373
Income before provision for income taxes	**955**	**1,354**	**1,233**	**2,156**	**4,810**	**5,698**	**6,551**
Provision for income taxes	292	387	362	634	1,429	1,675	1,991
Net income	**663**	**967**	**870**	**1,523**	**3,381**	**4,024**	**4,560**
Earnings per share: (US GAAP)							
Basic	**$0.13**	**$0.19**	**$0.17**	**$0.29**	**$0.65**	**$0.78**	**$0.88**
Diluted	**$0.13**	**$0.18**	**$0.16**	**$0.29**	**$0.64**	**$0.76**	**$0.86**

Source: SEC filings, analyst estimates.