Finance 1 Coursework

Oracle Corporation: Credit Rating Report

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1 Oracle overview

Oracle sell a wide range of enterprise IT solutions, including databases, middleware, applications, and hardware. Software license updates and support, (its most profitable segments), account for about 50% of revenues. An active acquisition program is a fundamental component of the company's strategy. Oracle has issued $27.8bn[1] of debt, which accounts for almost 50%[2] of the total rated debt in the sector.

2 Business risk

	Band	*My Rating*
Industry	Competitive young market with high margins and strong growth	AA
Competition	Very strong competition but Oracle is ranked number 1 or 2 in its key markets	A
Management	Stable, experienced management	AA
Other risks	Minor	AA

2.1 Global software industry

The software industry is relatively young but has shown huge growth since the 1980s. The increased use of debt financing within the software industry was partly driven by the stable revenue streams from enterprise software and the benefits of consolidating a fragmented market. Consolidation is being driven by IT commoditization and customer demands for a broader suite of linked products. The nature of the IT industry creates a competitive landscape that is constantly evolving as firms emerge, expand or are acquired. In addition, the low barriers to entry in many market segments regularly introduce new technologies and new competitors.

Typical margins in the industry can be as high as 85% for license updates and support however there are large research and development costs required to maintain long-term competitive advantage.

DataMonitor forecasts that in 2013, the global software market will have a value of US$457 billion, an increase of 51% since 2008[3].

2.2 Competition

Oracle is the second largest company in the industry (behind Microsoft) but still faces intense competition in all aspects of its business and competes directly with Microsoft, IBM, HP, SAP and Intuit. These competitors all have the resources to compete with Oracle, but Oracle

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[1] Source Morningstar: http://quicktake.morningstar.com/StockNet/bonds.aspx?Symbol=ORCL&Country=USA

[2] See appendix E for a full breakdown

[3] Source Datamonitor: http://www.infoedge.com/product_type.asp?product=DO-4959

benefits from exceptional brand recognition in the enterprise software market, strong customer loyalty and a reputation for providing outstanding service and support to its customers.

Over the last three years Oracle has increased its research and development budget year-on-year to $3.3 billion (2010) to enhance its portfolio of products and to develop new ones.

2.3 Management

Analyst consensus ranks Oracle's executive management team very highly, partly due to the continuity of leadership from co-founder Larry Ellison who has been CEO since the company was incorporated in 1970. There are concerns around a succession plan and how the market will react when Ellison retires.

Oracle is a very acquisitive company and the management team have very effectively structured new acquisitions so that they maintain their competitive leadership whilst benefiting from the enlarged Oracle group.

2.4 Other risks

Oracle operates in a rapidly changing economic and technological environment that presents numerous risks, many of which it cannot control.

- A prolonged recession could adversely affect the enterprise software market, which so far been fairly resilient.
- The acquisition of Sun and entrance into the hardware systems business may not be successful.
- Oracle's acquisition program could lead to unanticipated costs, integration issues or disruption of existing operations.
- Intense competitive forces demand rapid technological advances and frequent new product introductions.
- Growing Interest in on-demand, software-as-a-service and cloud computing continue to present challenges for incumbent providers.

3 Business profile

Diversification	*Band*	*My Rating*
Product Line Diversity	Operates a broad portfolio with limited products in only one segment	AA
Geographic Diversity	Globally diversified; no single region has more than 45% of revenue	A
End-Market Diversity	Largest market up to 20% of sales	A
Market position		
Market Share	#1 or #2 market share in all key markets	AA

3.1 Business diversification

There has been a lot of industry consolidation (led by Oracle) to **diversify product lines**, as increasingly customers want an integrated solution. Oracle's acquisition of Sun represents a bold move into the hardware market, which if successful will open a large new market. However there are concerns around whether Oracle has the core competencies to compete in the highly competitive hardware market.

Oracle has wide **global diversification** with over 370,000 customers in more than 145 countries. However America still makes up around 50% of its revenue, so it is more exposed to the US economy in an industry downturn.

Oracle has widened its **end market diversity** and now operates in database, middleware, applications and hardware. The middleware and application divisions are the ones showing the most growth in recent years but revenue is still dominated by database sales.

3.2 Market position

Oracle is the world's largest enterprise software company; their customers include every one of the Fortune 100 companies.

Market share[4] is important to credit ratings indicating the level of competitive success and future prospects. Oracle has very high recurring revenues, as enterprise software customers do not change vendors easily. Oracle dominates the markets that it competes in and grows by offering an integrated product offering or acquiring market leaders.

[4] There is little public data on market share so I used a combination of analyst reports, consulting company awards and interviews with Oracle employees (see appendix D).

4 Financial risk

Scale and flexibility	*Value*	*My Rating*
Revenue	$26,820m	A
Free Cashflow	$7,447m	A
Profitability and coverage		
Operating profit	33.79%	AAA
Operating income ROA (net cash)	20.12%	A
Debt coverage and liquidity		
Debt / EBITDA	0.88	A
EBITDA - CAPEX / Interest	16.83x	AA
Free cash flow / Debt	50.82%	AA
Cash + Mkt Sec / Debt	126.03%	AA
Interest cover	12.02x	AA
Capital structure		
Long-term debt to equity	36.89%	BBB
Debt to equity	46.97%	BBB

4.1 Scale and flexibility

Although Oracle has the second highest **revenues** (a good indicator of scale) in the global technology sector it's rating is skewed downwards due to the massive scale of the industry leader Microsoft.

Moody's use **free cash flow** to measure profitable scale and flexibility. Again Oracle has the second highest FCF in the industry (after Microsoft) and has almost $10 billion in cash reserves. Technological change tends to move very quickly and this flexibility allows for better strategic decisions around acquisitions, product development and the ability to alter the timing of capital requirements.

4.2 Profitability

Moody's formula for **operating income ROA** benefits companies that develop new products internally rather than through acquisitions. An acquisitive company such as Oracle tends to pay in excess of development costs when making acquisitions so this skews their rating downwards.

Because of its high recurring revenues Oracle is in the top 15%[5] of the industry for **operating profit** margin.

[5] Source http://ycharts.com/companies/ORCL/profit_margin

4.3 Debt Coverage and Liquidity

Oracle ranks very highly in measures of financial flexibility, long-term viability and indicators to the timely payment of debt obligations. Enterprise software customers require long-term viability of their software vendors, for continuing support and upgrades.

The **debt to EBITDA** measure is a strong indicator of rating as it provides a measure of debt serviceability. Companies like Oracle with strong recurring revenues, may rate higher than the sub-factor implies.

With 12 times **interest cover** Oracle has as a high capacity to service their interest payments.

4.4 Capital structure

With an aggressive acquisition programme Oracle has raised a lot of debt ($27.8bn) to fund acquisitions. While the industry average for debt-to-equity is 25%, Oracle's 47% seems high but it is no means the highest in the industry. Oracle's **debt-to-equity** has been consistent for the last three years and it reflects the management's belief in the growth prospects of the business.

4.5 Financial policy

Oracle has a well thought-out financial policy that has remained stable for the last five years. Ratios have remained stable, and management have shown a lot of discipline in maintaining tight control of the business.

5 Credit rating assessment

Oracle is a global leader with large, dependable cashflows and excellent growth prospects and is the second largest company in the industry after Microsoft (AAA).

Oracle is rated A2 by Moody's and A by S&P, the second highest rating in the industry after Microsoft[6]. My analysis rates Oracle AA[7]; so some reasons for the differences might be:

- Ratings need to be forward looking whereas I have used historical data.
- Moody state ratings might depend on confidential information they cannot publish.
- Some hard-to-measure qualitative factors affect ratings.
- Oracle's high debt levels relative to the industry[8] may bring the rating down.
- I used a small sample of interviews with Oracle employees to validate qualitative findings, which introduces subjectivity and bias.

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[6] Source Moody's Global Software Industry Rating Methodology (see table E1 Appendix E)

[7] See appendix F

[8] See appendix E which shows Oracle has raised $16,236m of rated debt from the industry total of $38,468m

Appendix A – Financial Calculations

Inputs	*Figure (in millions)*	*Source*
Revenue	$26,820	Income statement
Operating profit	$9,062	Income statement
Interest	($754)	Income statement
Depreciation	($1,885)	Income statement (notes)
Amortisation	($1,973)	Income statement (notes)
EBITDA	$12,920	Calculated (Earnings + Interest + Tax + Depreciation + Amortisation)
Dividends	($1,004)	Income statement
Cashflow from operations	$8,681	Cash flow statement
Capital expenditure	($230)	Cash flow statement
Average assets (net of cash)	$45,043	Calculated (Total assets less cash in 2010 + Total assets less cash in 2009 % 2)
Debt	$14,655	Short and long term debt (plus pension deficit and lease holdings)[9]
Long-term debt	$11,510	Balance sheet
Cash	$9,914	Balance sheet
Marketable securities	$8,555	Balance sheet
Shareholder’s equity	$31,199	Balance sheet

[9] This was confirmed by Moody analyst on 09/12/10. See note 8 of the Oracle 10K report for full breakdown.

Ratios	*Formula*[10]	*Figure*	*Rating banding*	*Rating*
Revenue	N/A	$26,820m	$15 - 30 Bn	A
Free cash flow	Cash flow from operations less capital expenditure (including capitalized software) less dividends	$7,447m	$3.75 - 7.5 Bn	A
Operating profit	Operating profit / Revenue	33.79%	>22.2%*[11]	AAA
Return on Assets	Operating profit / Average assets (net of cash)	20.12%	20 - 25%	A
Debt to EBITDA	Debt / EBITDA	0.88	0.75 - 1.25x	A
EBITDA-Capex to Interest	EBITDA – Capex / Interest	16.83x	14.0 – 20.0x	AA
Free Cash Flow to Debt	Free cash flow / Debt	50.82%	45 - 60%	AA
Cash and Marketable Securities to Debt	Cash + Marketable securities / Debt	126.03%	125 - 175%	AA
Interest cover	Operating profit / Interest payable	12.02x	7.6-17.5x*	AA
Debt to equity	Total debt / Equity	46.97%	46.8-40.2%*	BBB
Long-term debt to equity	Long term total debt / Equity	36.89%	43.8-34.7%*	BBB

[10] Formulas derived from Moody's Global Software Industry Credit Methodology

[11] Where a * is used this rating was taken from S&P financial ratios by bond rating the rest were from Moody's Global Software Industry Credit Methodology

Appendix B – Assumptions

- Unless stated otherwise, all calculations and interpretations are stated before exceptional items for comparability
- Financials were taken from the Oracle Corporation FORM 10-K For the fiscal year ended May 31, 2010 (http://www.oracle.com/us/corporate/investor-relations/financials/10k-2010-152558.pdf)

Appendix C – Methodology

For this report I have used predominantly followed the Moody's rating methodology for the "Global Software Industry" (http://v3.moodys.com/viewresearchdoc.aspx?docid=PBC_117478), with elements of the finance 1 lecture notes and the S&P credit notes (http://www.standardandpoors.com/prot/ratings/articles/en/us/?assetID=1245199861546)

Appendix D – Interviews and research

I conducted interviews with industry experts who specialise in Oracle technology. Each interview lasted fifteen minutes and comprised questions designed to get insights about:

- Oracle's market share
- Structure of management
- Management style
- Business risks
- Future products
- Future strategy

Appendix E – Tables and statistics

Table E1 illustrates the distribution of Moody's ratings in the software industry:

Company	Sr. Unsecured or Corporate Family Rating	Outlook	Domicile	Approximate Rated Debt ($ Millions)[1]
Microsoft Corporation [2]	Aaa	Stable	United States	$5,750
Oracle Corporation [3]	A2	Stable	United States	$16,236
Intuit Inc.	Baa2	Stable	United States	$998
BMC Software Inc.	Baa3	Stable	United States	$298
CA, Inc.	Ba1	Stable	United States	$1,312
Open Text Corp.	Ba3	Positive	Canada	$368
Datatel, Inc.	B1	Stable	United States	$185
JDA Software Group, Inc.	B1	Stable	United States	$50
Nuance Communications, Inc.	B1	Stable	United States	$730
Hyland Software, Inc.	B2	Stable	United States	$118
Intergraph Corporation	B2	Stable	United States	$627
Kronos Incorporated	B2	Stable	United States	$1,083
RedPrairie Corporation	B2	Stable	United States	$256
Serena Software, Inc.	B2	Stable	United States	$562
SS&C Technologies, Inc.	B2	Stable	United States	$484
Activant Solutions Inc.	B2	Negative	United States	$634
Corel Corp.	B3	Positive	Canada	$231
Aspect Software, Inc.	B3	Stable	United States	$1,001
Attachmate Corporation	B3	Stable	United States	$687
Infor Global Solutions Holdings Ltd.	B3	Stable	United States	$4,423
Allen Systems Group, Inc.	B3	Developing	United States	$330
Open Solutions, Inc.	B3	Negative	United States	$960
Consona ERP Inc. [4]	B3	Stable	United States	$193
Telcordia Technologies Inc.	B3	Negative	United States	$955
Total				$38,468

Notes:

1 - Rated debt includes both drawn and undrawn portions of rated revolving credit facilities. Unrated convertible debt, PIK loans and other are excluded. Debt amounts for most companies are as of most recent available financials.

2 - Microsoft's rated debt includes a $2 billion short-term commercial paper program. As of March 31, 2009, approximately $2 billion was outstanding. Microsoft issued $3.75 billion in long-term debt in May 2009.

3 - Oracle has a $1 billion note maturing May 2009. Additionally, the company maintains access to a $5 billion commercial paper program. As of February 28, 2009, the facility had no borrowings.

4 – Consona ERP Inc. is an operating subsidiary of Consona Corporation.

Appendix F – Weighted Rating

The weighting was derived from a points system that is outlined in the Moody's rating methodology for the "Global Software Industry":

AAA	*AA*	*A*	*BBB*	*BB*	*BB*
1	3	6	9	12	15

The converted scores are weighted and aggregated and the final rating figure is given by the table below.

Indicated rating	*Weighted score*
AAA	$x < 1.5$
AA	$1.5 \leq x < 4.5$
A	$4.5 \leq x < 7.5$
BBB	$7.5 \leq x < 10.5$
BB	$13.5 \leq x < 16.5$
B	$13.5 \leq x < 16.5$

Oracle rated weighting

	Rating	*Weighting*	*Score*	*Weighted Score*
Industry	AA	10%	3	0.30
Competition	A	5%	6	0.30
Management	AA	5%	3	0.15
Diversification	AA	5%	3	0.15
Market position	AA	10%	3	0.30
Scale and flexibility	A	10%	6	0.60
Profitability and coverage	AA	20%	3	0.60
Debt coverage and liquidity	AA	20%	3	0.60
Capital structure	BBB	15%	9	1.35
Oracle total score				*4.35*

This final score converts to a final rating of AA ($1.5 \leq x < 4.5$).