ASSET MANAGEMENT

FLASH NEWS

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Oracle's miss: connecting the dots

Oracle's profit warning has obviously stunned investors as the stock has suffered its steepest one day decline in many years. Yet to IT $_{\text{Funds}}$ InfoTech's investors, this hardly should come as a surprise. We have been puzzled for some time already at the discrepancy between Oracle's slow organic growth and its "darling" status among tech investors: some analysts have calculated that software license revenue has increased at an average annual rate of about 1% the past three years once currency effects and acquisitions impact is taken out. Yet nothing in the stock evolution over the last 24 months has reflected this issue, until last week's correction.

Even with this profit warning, it seems that few investors have noticed the q-o-q decline in software-maintenance revenue. Yet software maintenance is a key business that almost makes up half of Oracle's revenues and over 2/3 of its gross profit. And at the same time, whilst software license was expected to increase by 11% it clearly disappointed with just 3% growth.

In December 2010's Monthly letter, we warned our investors on what we believed was a dangerous strategy: effective M&A's masking the difficulty to further grow organically and hiding strategic failures:

"*Oracle* *has decided to ignore SMB, Consumer and Industrials markets. It focuses instead on large enterprises and plays very aggressively the consolidation card. In the May 2005-May 2010 period, Oracle has spent no less than USD 34bn in acquisitions, far outpacing much larger peers such as Cisco (USD 16.1bn), IBM (USD 16.8bn) or EMC (USD 7.4bn). The acquisition list includes Bea Systems, PeopleSoft and Siebel. Oracle successfully managed to encircle SAP and become the strategic vendor of many accounts who had never chosen Oracle before beyond databases. Oracle then went on selling the unified "Oracle stack", rising prices in the process. We admire the well oiled process but remain sceptical about the sustainability of such a strategy. The last IT vendor to follow that path was Computer Associates. It ended pretty badly.*

Moreover, as the software pool started to dry up, Oracle went one step further by absorbing server and storage vendor Sun Microsystems. Oracle argues that, with Sun Microsystems, it can go the same route as Apple, selling integrated offerings encompassing semiconductor, hardware, middleware and application software. The issue here is that, with virtualization, the industry is just moving the opposite way. Virtualization is about dissociating hardware and applications in order to gain flexibility and save costs. We also have a serious issue with a 100% "on premise" strategy at a time when SaaS is gaining considerable ground."

Our analysis of Oracle's difficulties is that they are actually facing a maturing business which is further dented by current corporate spending cautiousness. **But if macro difficulties do not help, let us not forget that many a disruptive technology company is, for the contrary, still growing at double digit pace year on year and even taking profit of the economical crisis to address the corporate's needs to "do more with less".** This is the reason why the IT $_{\text{Funds}}$ Infotech portfolio is concentrating on fast growing SaaS companies among other disruptive technology stocks and carefully avoiding mature mega companies such as Oracle.

Beyond Oracle's strength, we just do not believe that it deserves the high premium it owns to other mature companies and prefer to focus on really strong growing companies.

Coming after Cisco and HP this summer, Oracle is just one more example to our view that the so called "flight to quality" favouring mega caps this summer has no fuel to outlive the next earning seasons: finally the dots are getting connected… It all comes back to a tale of two cities, where, once the dust has settled down, disruptive technology stocks should strongly perform and outperform again while few darlings are taken back at their face value.

To read more about the promising SaaS companies:
http://www.itasset.com/assets/pdf/news/news-successfactors_2.pdf

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