Research Update:

Oracle Corp. Ratings Lowered To 'A+' On Continuing Elevated Share Buybacks; Outlook Negative

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Rating Action Overview

- Oracle Corp.'s adjusted leverage continues to climb as it engages in large share repurchases, leading to leverage near 1.4x as of fiscal 2019, which ended in May 2019. This is above our downgrade trigger of 1.25x.
- Our base case forecast assumes continued share repurchases in excess of cash flow generation in fiscal 2020, which would further pressure leverage despite a generally stable operating environment.
- We have lowered our long-term ratings on Oracle to 'A+' from 'AA-' and affirmed the short-term rating at 'A-1+' given its exceptional liquidity score.
- The negative outlook reflects our view that the current pace of share repurchases will continue in fiscal 2020, given lack of clear financial policy from the management, and that adjusted leverage could climb to the 2x area as a result.

Rating Action Rationale

Oracle Corp. has significantly ramped up shareholder returns since the passage of U.S. tax reform, with share repurchases totaling $36 billion in fiscal 2019. Although it has repaid maturing debt during this period, the shareholder returns in excess of free operating cash flow generation have led to $18 billion in net debt, up from $6 billion in net cash a year ago and $14 billion in net cash in mid-2017. Adjusted leverage now stands at 1.4x, up from 0x a year ago. The depletion of cash raises leverage per our calculation, as we net surplus cash against debt, the latter of which includes the transition tax associated with the repatriation of foreign earnings.

Under our base-case scenario, which assumes share repurchases of $6 billion per quarter over the next four quarters (similar to the fourth quarter of fiscal 2019) we estimate that Oracle's adjusted leverage could reach almost 2x by year-end fiscal 2020. While we acknowledge that the likelihood of large share repurchases may decrease as Oracle's cash position weakens, the company has not provided a clear financial policy, notably its long-term share repurchase and leverage targets, nor has it reduced its shareholder returns over the past year when faced with a potential rating downgrade. Sustained large share repurchases would also limit the company's

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ability for debt-funded acquisitions under the current ratings. As a result, our rating outlook on the company is negative, indicating a one-in-three chance that we could lower the company's rating over the next two years if its adjusted leverage exceeds 2x.

Our assessment of Oracle's business risk profile has not changed and reflects its leading position in database and applications software, significant scale, and strong operating efficiency. Its strength in database contributes to strong recurring revenues and is a key credit support. Oracle has a leading position in the relational database market with market share in excess of 40%. This business is highly profitable and recurring, and allows the company to maintain its substantial research and development (R&D) and merger and acquisition (M&A) spending to broaden its product suite as the enterprise IT industry migrates to the cloud. Oracle's recent sizable acquisitions include MICROS Systems Inc. for nearly $5 billion in 2014 and NetSuite Inc. for more than $9 billion in 2016, both of which added to its software as a service (SaaS) offering. At the same time, competition within the database segment is fierce, with Microsoft a solid No. 2 player and Amazon Web Services growing rapidly from a small base. As a result, we view Oracle's ability to maintain its technology leadership (autonomous database, for example) and migrate its existing customers to the cloud through its own infrastructure as a service (IaaS) platform as critical to its long-term success.

Oracle's primary focus continues to be the cloud. Its SaaS products, Fusion enterprise resource planning (ERP) and NetSuite ERP (for small to mid-market customers) in particular, continue to gain rapid adoption. Oracle's platform as a service (PaaS) and IaaS businesses are more limited in scale and offering, but provide an opportunity for the company to keep its customers, including the critical database customers, on its platform and make their transition to the cloud more seamless. Software remains a sticky, recurring business, but the cloud has disrupted the landscape and made it easier for customers to switch vendors. Oracle's long-term success will depend on its ability to remain a critical vendor as enterprises gradually migrate to the cloud.

Over the longer term, we believe Oracle should be able to grow its revenues in line with global GDP. This would represent growth below that of overall enterprise software spending (about 7% in 2019). However, strong growth in its cloud business is somewhat masked by the legacy and declining software license and hardware businesses. As a result, Oracle could outgrow global GDP as the legacy business shrinks as a percentage of overall revenues. Oracle remains one of the largest software providers in the world with nearly $40 billion in revenues and $15 billion in operating cash flow. However, it faces long-term challenges from pure cloud-based software providers such as Salesforce.com and Workday Inc., as well as hyperscale cloud providers such as Amazon Web Services (a business segment of Amazon.com Inc.) and Microsoft Azure (a business offering of Microsoft Corp.), all of which are growing at a much faster pace. For example, Amazon Web Services has not traditionally competed with Oracle for enterprise customers, but is gradually moving up the technology stack from infrastructure to cloud applications and database offerings. Additional uncertainty, although not an immediate threat, comes from emerging data technologies, such as Hadoop, which has the potential to replace Oracle's products through higher scalability and lower cost.

Outlook

The negative outlook reflects our view that given the lack of clear financial policy guidance from management, the current pace of share repurchases will continue in fiscal 2020, and that adjusted leverage could climb to near 2x area as a result.

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Downside scenario

We could lower our issuer credit rating on Oracle if the company's adjusted leverage exceeds 2x over the next two years as the company engages in large share repurchases. A debt-funded acquisition that pushes leverage over the same level would also be a cause for a downgrade.

Upside scenario

We would consider revising the outlook to stable if Oracle's adjusted leverage settles at comfortably less than 2x and we believe that it can be sustained there.

Company Description

Redwood City, Calif.-based Oracle Corp. provides products and services that address all aspects of corporate IT environment—application, platform, and infrastructure—and are available to customers on cloud, on-premises, or hybrid deployment models. Oracle's products include database and middleware software, application software, and cloud infrastructure software and hardware systems, along with support and related services.

In fiscal 2019, the Americas contributed 55% of Oracle's total revenues, Europe, the Middle East, and Africa contributed 29% and the Asia-Pacific region contributed the remaining 16%. Oracle serves over 400,000 customers worldwide.

Revenue segments include the following:

- Cloud services and license support (68% of sales). This includes revenues from cloud SaaS, PaaS, and IaaS offerings and license support revenues, including product upgrades and maintenance.
- Cloud license and on-premise license (15% of sales).This business includes the licensing of software products including Oracle Applications, Oracle Database, Oracle Fusion Middleware, and Java.
- Hardware (9% of sales). This segment includes revenues from Oracle Engineered Systems, servers, storage, and related hardware support.
- Services (8% of sales). Service segment revenues come from consulting, support, and education services that maximize Oracle applications, platform, and infrastructure technologies.

Our Base-Case Scenario

- Global GDP growth of low-to-mid 3% area in 2019 and 2020;
- U.S. GDP growth of 2.5% in 2019 and 1.8% in 2020;
- Global IT spending growth in the low single-digit percentage area in 2019;
- Revenue growth near 3% in fiscal 2020 and 2021, as growing scale in the cloud business offsets declining license and hardware sales;
- Modest improvement in the EBITDA margin to near 48%-49% in fiscal 2020 and 2021, from 47% in fiscal 2019 as cloud margins continue to expand with scale;

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- Capital expenditures near $2 billion per year;
- Share repurchases near $6 billion per quarter through fiscal 2020 then declining in fiscal 2021;
- Dividends near $3 billion per year; and
- Repayment of debt maturities over the next several years with no new debt issuances.

Based on these assumptions, we arrive at the following credit measures:

- Adjusted leverage near 1.9x in fiscal 2020 and 2021; and
- Free operating cash flow (FOCF) near $13 billion in fiscal 2020 and higher in fiscal 2021.

Liquidity

Oracle's exceptional liquidity assessment reflects our expectation for sources of cash to exceed uses by more than 2x over the next 12-24 months, and net sources to be positive even if EBITDA declines by 50%. We view Oracle to have a generally high standing in the credit markets and well-established solid relationship with banks, as demonstrated by its success in accessing the debt markets on an ongoing basis. We also find the company to have generally prudent risk management, as shown by the company's strong credit metrics and sizable amount of cash on hand.

Principal Liquidity Sources:

- Cash and marketable securities of $38 billion as of May 31, 2019; and
- Cash flow from operations near $15 billion in fiscal 2020 and modestly higher in fiscal 2021.

Principal Liquidity Uses:

- Capital expenditures near $2 billion per year;
- Annual dividends near $3 billion per year;
- Debt maturities totaling $4.5 billion over the next 12 months;
- Discretionary share repurchases near $6 billion per quarter; and
- Potential acquisitions.

Issue Ratings - Subordination Risk Analysis

Capital structure

Oracle's capital structure consists of senior unsecured notes issued at the company level.

Analytical conclusions

Our issue-level rating on Oracle's debt is 'A+', the same as the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

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Ratings Score Snapshot

Issuer Credit Rating

A+/Negative/A-1+

Business risk: Strong

- Country risk: Low
- Industry risk: Intermediate
- Competitive position: Strong

Financial risk: Modest

- Cash flow/Leverage: Modest

Anchor: a+

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Exceptional (no impact)
- Management and governance: Strong (no impact)
- Comparable rating analysis: Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Technology Software And Services Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

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Related Research

- Full Analysis: Oracle Corp., Dec. 28, 2018
- Oracle Corp. Outlook Revised To Negative On Increasing Share Repurchases; All Ratings Affirmed, Sept. 25, 2018

Ratings List

Downgraded	To	From
Oracle Corp.		
Issuer Credit Rating	A+/Negative	AA-/Negative
Senior Unsecured	A+	AA-
Ratings Affirmed		
Oracle Corp.		
Short-Term Issuer Credit Rating	A-1+	
Commercial Paper	A-1+	

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