the CAPITAL LIST

Capital InFocus

Oracle: The AI Contender

9/23/2024

By Don Yocham, CFA

The AI Contender

There is a massive datacenter expansion underway to meet AI demands.

The best way to gauge the expected growth is through power consumption expressed in gigawatts (GW).

By 2030, U.S. data center power consumption is expected to reach 35 GW, doubling from 17 GW required in 2022. This expansion is fueled by AI-driven requirements for higher power densities and more advanced cooling systems, particularly in hyperscale data centers that serve large-scale cloud services.

So far, the markets attention has largely focused on **Amazon.com Inc (NASDAQ: AMZN)**, **Alphabet Inc. (NASDAQ: GOOG)** and **Microsoft (NASDAQ: MSFT).**

But after stunning earnings results last quarter, **Oracle Corp. (NYSE: ORCL)** has joined the ranks of these Big 4 tech companies as a legitimate contender staking a claim in the AI datacenter space.

On September 10, Oracle reported a 45% jump in revenue from its Oracle Cloud Infrastructure (OCI) business line for the latest quarter.

It also announced a new database partnership with Amazon Web Services.

Oracle's co-founder Larry Ellison expects his company to among the few tech titans, and one country, in position to battle it out for AI technical supremacy. One of its datacenters currently under construction will demand 800-megawatts to power "acres of NVIDIA GPU clusters." It's designing another gigawatt center powered by nuclear reactors.

The company expects to build 100 new datacenters over the next 10 years.

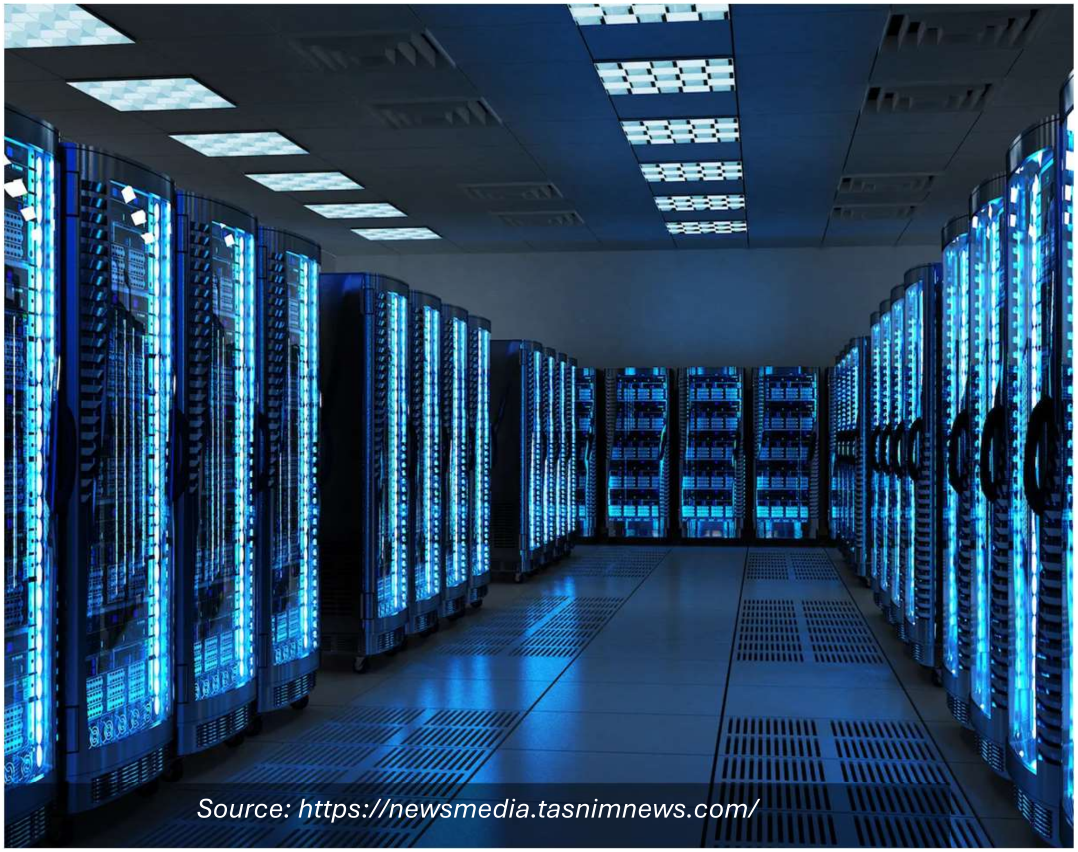
In this *Capital InFocus report*, I'll walk through financial metrics to highlight what you're paying for and why.

Systems Software: Running the Data that Runs the World

Oracle operates in the Systems Software segment alongside **Microsoft Corp. (NASDAQ: MSFT).** These are the two largest companies in the segment with Microsoft sales exceeding Oracle's $54 billion (total sales across all lines of business) by nearly 5 times.

Other companies operating in this segment include Service Now Inc. **(NYSE: NOW), Palo Alto Networks (NASDAQ: PANW)**, **Fortinet Inc. (NASDAQ: FTNT)**, and **Crowdstrike (NASDAQ: CRWD)**, all of which have annual sales under $10 billion.

The big move for Oracle is its OCI business line Oracle Cloud Infrastructure) in which it competes against the likes of Microsoft, **Amazon.com Inc (NASDAQ: AMZN)**, **Alphabet Inc. (NASDAQ: GOOG)**.

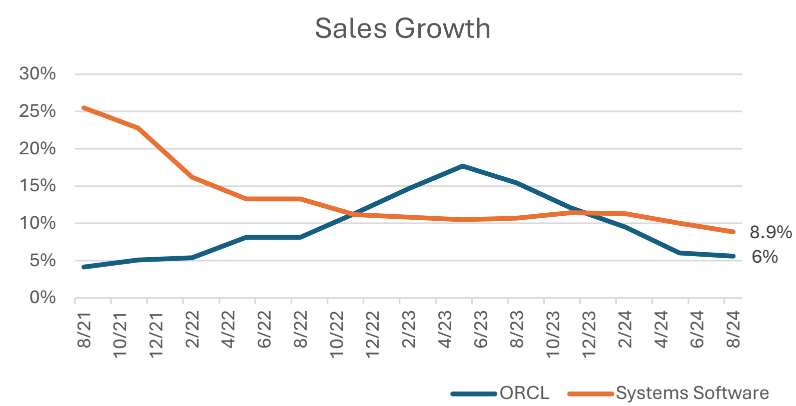


Source: https://newsmedia.tasnimnews.com/

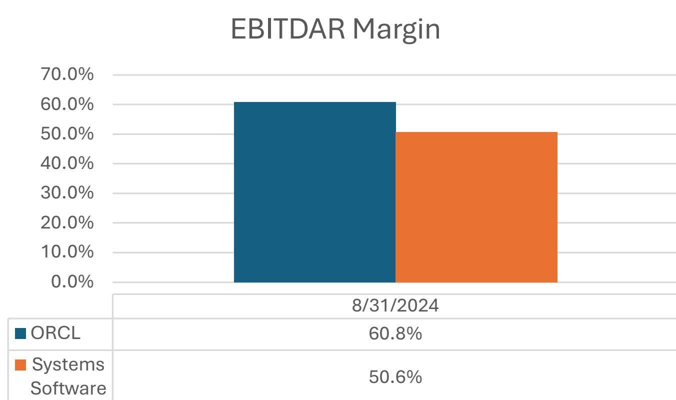
Higher Profits, Less Investment

Oracle's sales growth has slowed over the last year, though from a high pace last year. Currently at 6%, it lags average sales growth among systems software companies by roughly 3 percentage points.

The company's operating profit margin (as measured by Net Operating Profits After Tax) exceeds the segment by 50% and has a wider EBITDAR margin (a proxy for operating cash flow).



Source: ISS EVA Express, The Capital List



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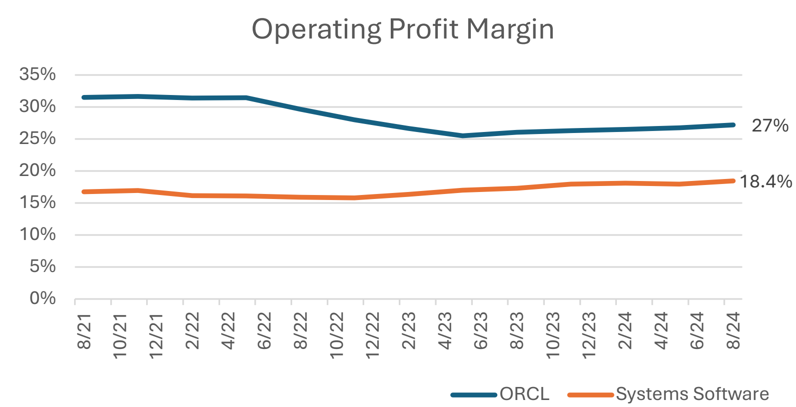

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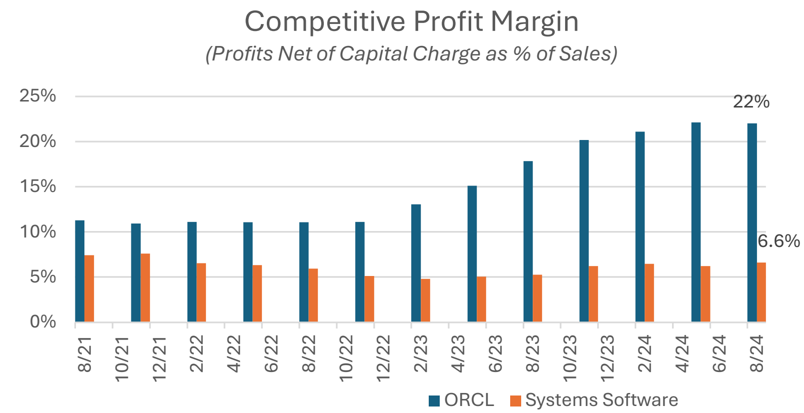
Value Add Profits and Growth

To add value and get a rising stock price over time, profits must exceed the cost to compete to be competitive. Capital costs apply to all companies, depending mostly on debt service costs and the riskiness of the company's stock.

Oracle's competitive profits as a % of sales (Competitive Profit Margin) significantly outperform its competitors at 22% vs. 6.6%. Oracle gets more return per dollar invested in capital.

Those profits are growing at a slower pace than the average systems software company – 1% for Oracle vs. 2.6% average.

But Oracle has invested more heavily than other Systems Software companies relative to sales, which should reaccelerate competitive profit growth given the companies superior ability to deliver competitive profits.



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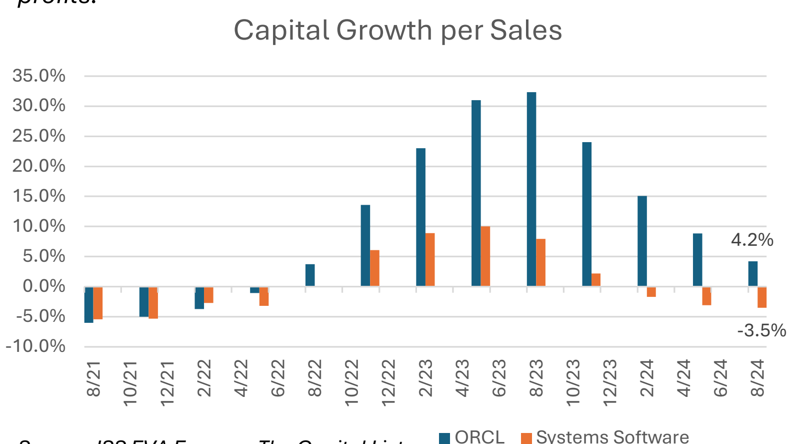

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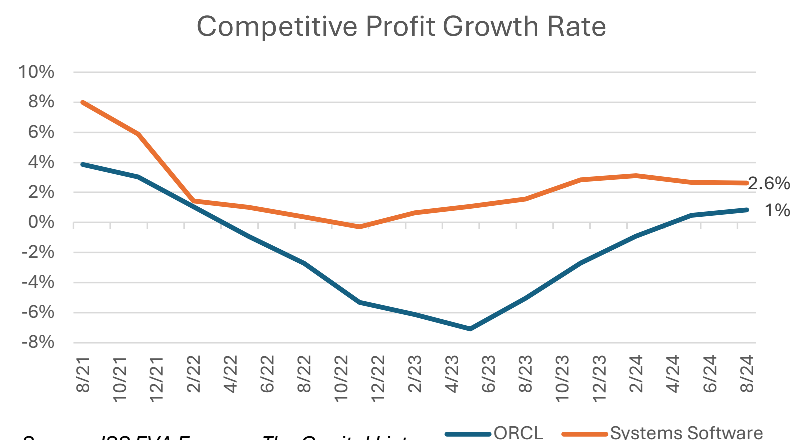


Source: ISS EVA Express, The Capital List

High Quality Profits

It's also important to gauge the quality of a company's competitive profits and cash flows.

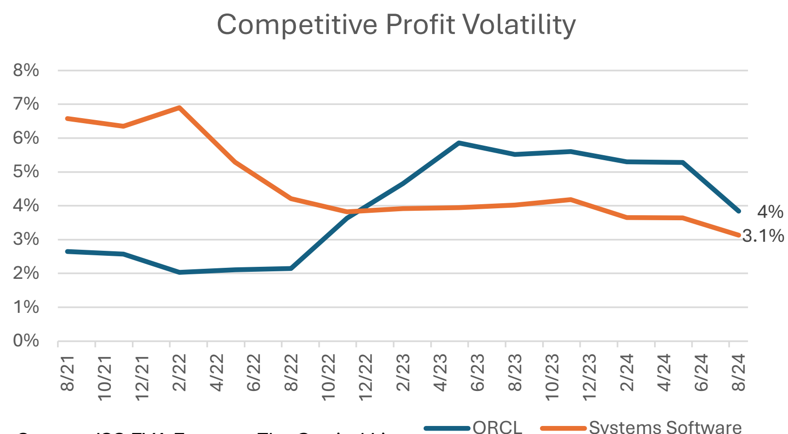
Profits and cash flows are low quality when they are volatile, depend on leverage, or don't cover the capital needed to generate them.

In terms of volatility, Oracle's competitive profits are pretty much in line with other Systems Software companies. 4% is low compared to the more broadly defined Software and Services industry group.

Its free cash flow spread to capital is currently less than half, due in large part to its increasing capital investments but still low in general.

The main risk factor for Oracle high debt level. At 68.7%, its debt-to-capital ratio is higher than 95% Software and Services companies.

Based on these and other "Quality" factors, Oracle has higher than average profit quality, with debt the most significant detractor.



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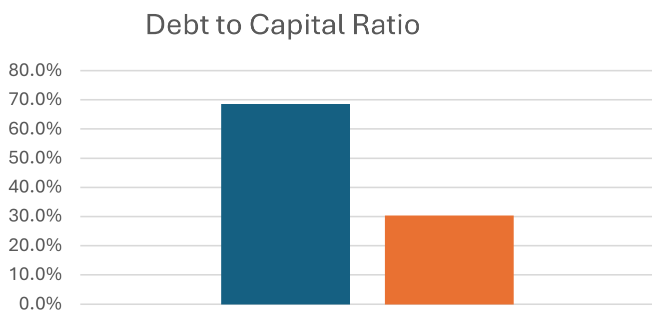
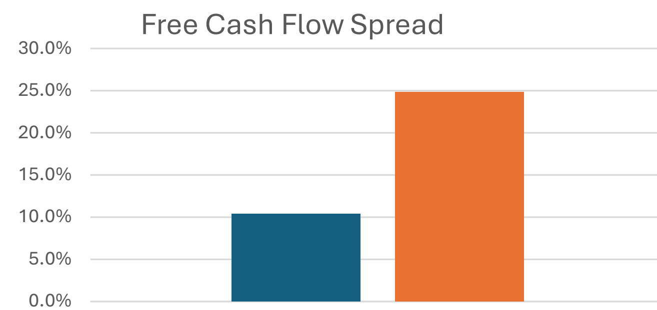


	8/31/2024
ORCL	68.7%
Systems Software	30.3%

Source: ISS EVA Express, The Capital List



	8/31/2024
ORCL	10.4%
Systems Software	24.9%

Source: ISS EVA Express, The Captial List

What You Pay For

Up to this point, all of the data I have shown you have been strictly accounting measures. They involve corporate performance derived from income statements and balance sheets without any reference to the company's stock price.

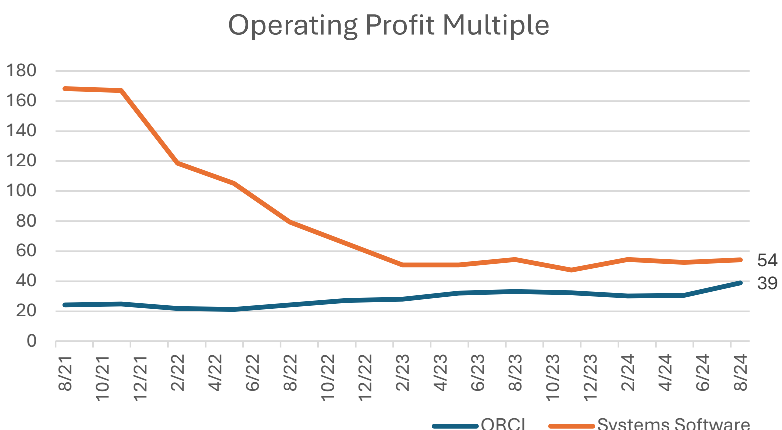
Now we take a look how much you're paying to own these results.

Oracle must grow competitive profits at 7.2% per year for the next several years to justify its $170 per share stock price.

This is basically in-line with the growth required of the average systems software company but significantly greater than the 0.8% competitive profit growth the company delivered during the past 12 months (due to capital investments.)

66.5% of Oracle's market value relies on profit growth and the stock trades at an operating profit multiple of 39 compared to 54 for the group.

Oracle is investing heavily in its business. Sales and profits will take time to catch up with those investments. Overall, Oracle's stock is not richly valued at $170 per share.



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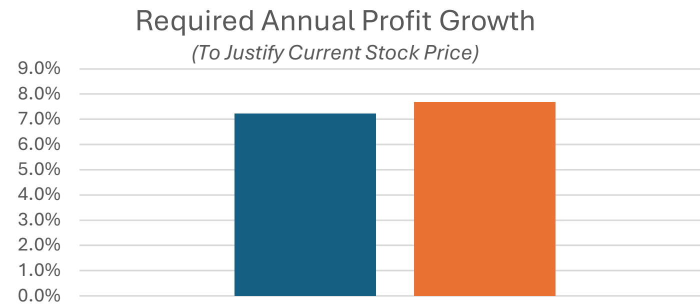
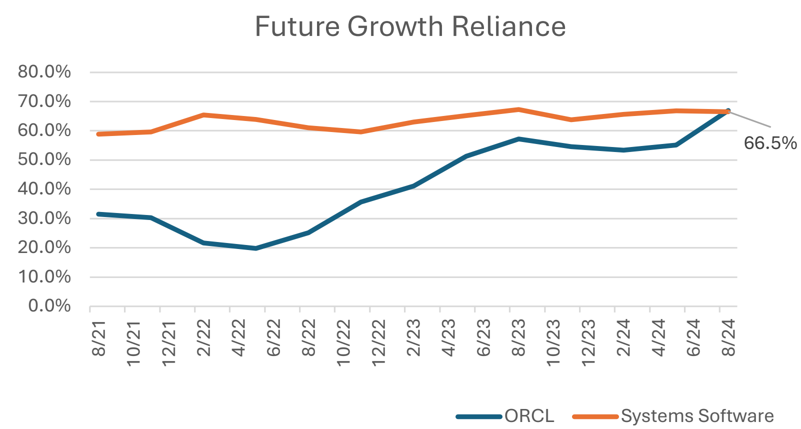


	8/31/2024
ORCL	7.2%
Systems Software	7.7%

Source: ISS EVA Express, The Capital List



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Price Compared to Consensus

To justify Oracle's $170 stock price, profits must grow at just over 7% over the next few years.

Assuming constant operating profit margins, and there is a case to be made that profit margins will improve, the stock is undervalued relative to consensus sales estimates taking sales from $53 billion to $101 billion in 5 years.

Given Oracle's rich competitive profit margins (22%), significant capital investment, reasonable Future Growth Reliance (66.5%), and its cheapness relative to consensus sales, $170 per share is an attractive price to build a position in the Next AI Contender

Think Free, Be Free

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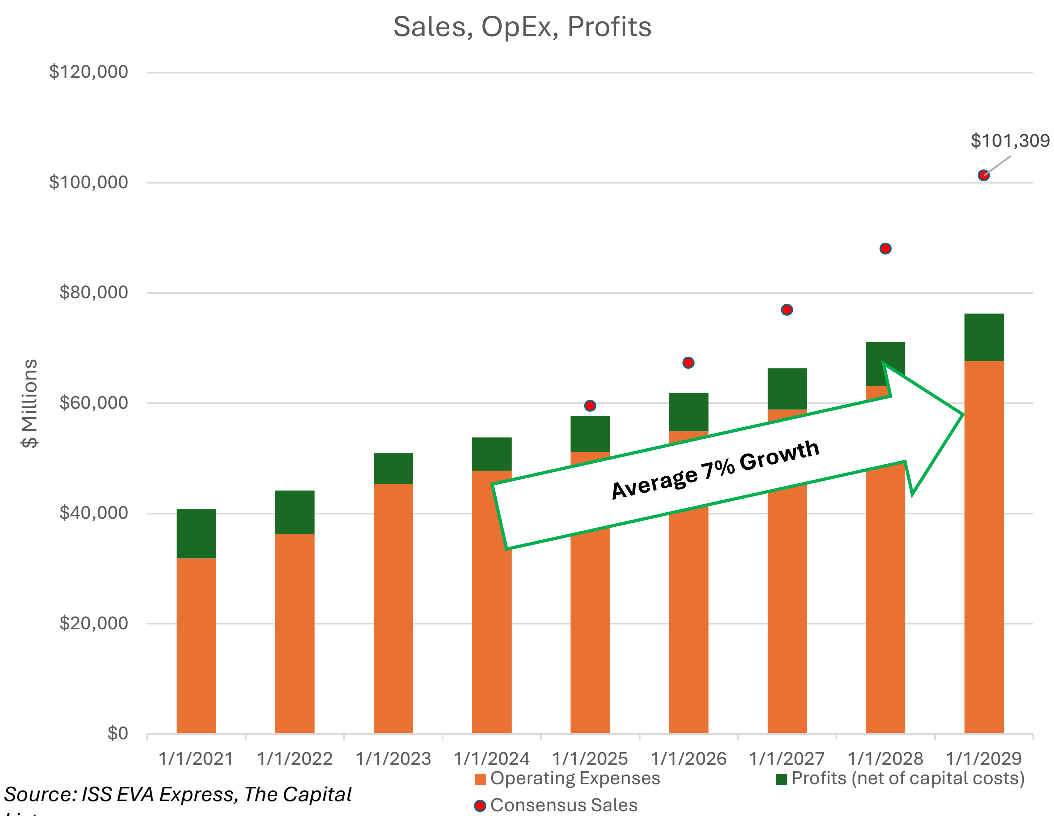

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