

July 31, 2006

ORCL (NASDAQ) — \$14.97

**ORCL: INITIATING COVERAGE OF ORACLE WITH AN UNDERWEIGHT RATING****Information Technology / Enterprise Software**

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Current	Prior
Rating: <b>Underweight</b>	<b>None</b>
Target: <b>\$17.00</b>	

Risk: <b>High</b>
Industry: <b>Favorable</b>

All important disclosures and Regulation AC disclosure can be found at the end of this report, starting at page 7, under the section entitled Important Disclosures and Regulation AC Disclosure, respectively.

**Includes Option Expenses**

	FY	EPS	P/E	1Q	2Q	3Q	4Q
Actual	5/06	\$0.80A	18.7X	\$0.14A	\$0.19A	\$0.19A	\$0.29A
<b>Current</b>	<b>5/07</b>	<b>\$0.88E</b>	<b>17.0X</b>	<b>\$0.16E</b>	<b>\$0.21E</b>	<b>\$0.20E</b>	<b>\$0.31E</b>
<b>Current</b>	<b>5/08</b>	<b>\$1.01E</b>	<b>14.8X</b>	<b>\$0.18E</b>	<b>\$0.24E</b>	<b>\$0.25E</b>	<b>\$0.34E</b>
EXCLUDING OPTIONS EXPENSE FY EPS IS FY07E \$0.92, FY08E \$1.05							
	Avg. Volume: 43,000,000		Div/Yield: 0.00/			EPS Growth: NA	
	Market Cap: \$79,341 m		52w Range: 15.30-11.70			P/E / Growth: 1.9x	
	Shares: 5,300.00 m						

**HIGHLIGHTS**

- We Are Initiating Coverage Of Oracle With An Underweight Rating.
- Pricing Pressure In The Core And A Difficult Application Market Are Big Headwinds For Oracle.
- The Stock Appears Inexpensive But We Think It's Likely To Stay That Way.
- Applications—Looking For Organic Growth After All The Fruit Has Been Plucked.
- Database—Microsoft Is Taking Lots Of Share, And Open Source Products Are Only Going To Get Better.
- Our DCF Model Suggests The Stock Is Fairly Valued—Opacity Doesn't Give Us Confidence In Our Estimates.

**DISCUSSION****Pricing Pressure In The Core And A Difficult Application Market Are Big Headwinds For Oracle.**

Oracle's core database business, including middleware, represents approximately 25% of the company's revenues (with maintenance and support about 55% of revenue) and about the same percent of the company's profits. We think the company is losing unit share to Microsoft and potentially open source, while in its applications business the company is digesting 3 major acquisitions (15+ total) in 18 months and has a tough product development path ahead of them. In our view this leaves the company with margin pressure and share loss for the foreseeable future—two things that are likely to keep the earnings growth rate and valuation multiple capped at current levels.

**The Stock Appears Inexpensive But We Think It's Likely To Stay That Way.** At just over 16x our NTM EPS estimate of \$0.92, excluding stock options expense, Oracle looks cheap. In fact, ORCL's NTM P/E has traded in a valuation band of 15x to 27x for the last three years, declining fairly consistently to



these trough levels since the peak of 27x in August 2003. However, growth in earnings and free cash flow has averaged just 22% and 12% over that same period. We understand that because Oracle has purchased so many companies over the past few years it is difficult to ascertain the organic growth rate of the company. That said, we think the aforementioned pressures have resulted in meager growth rates, and now that the best acquisitions are behind them, the real work has to be done.

**Applications—Looking For Organic Growth After All The Fruit Has Been Plucked.** Since December 2004, starting with Peoplesoft/JD Edwards, Oracle has acquired more than 15 private and public software companies, including Siebel, Retek, Portal Software, and others. One could certainly argue that consolidating the applications software business is financially advantageous—one sales force and one R&D team can certainly provide more cost leverage than four. The earnings accretion story is fairly clear and makes sense: use 4% interest bearing cash to buy assets yielding free cash flow of 10% or more. However, once the growth from the acquisitions has settled, the company must begin the hard work of integrating and growing the businesses organically. Oracle calls this effort project Fusion—and the first version is currently planned for release in CY2008. We wonder: if the disparate codebases that all these acquisitions represented on a stand-alone basis were not competitive with SAP, how can the “integration” be?

To Oracle’s credit (and benefit in the June quarter), the announcement of the Unlimited Applications Program in April alleviated existing customers’ concerns that Oracle would end-of-life their installed applications. Instead, Oracle will continue to support and update existing applications indefinitely (see Figure 1). Customers paying the 22% annual maintenance fee will continue to receive support and product updates. In addition, such customers would have the option to upgrade to the Fusion Release of comparable functionality without paying a new license fee, making the decision subject to technical evaluation rather than a business decision. To add new functionality not previously licensed, either in the existing application suites or in Fusion, customers would pay a new license fee. By comparison, we note that SAP’s 18% maintenance fee does not entitle customers to an upgrade to mySAP from R/3.

	Scheduled Release Dates				
	Latest Release	2H06	2007	2008	Beyond
<b>PeopleSoft Enterprise</b>	V8.9	V9.0	-	V9.1	Unlimited Updates
<b>JDE EnterpriseOne</b>	V8.12	-	-	V9.0	Unlimited Updates
<b>JDE World</b>	VA7.3 & A8.1	A9.0	A9.1	A9.2	Unlimited Updates
<b>E-business Suite</b>	V11i.10	V12	Post 12 & family packs	-	Unlimited Updates
<b>Siebel</b>	V7.8	V8.0	V8.1	V8.2	Unlimited Updates
<b>Fusion</b>				V1	Unlimited Updates
<b>Other releases</b>		Project Genesis	SBA-based Analytics		

Source: Company reports

**Database—Microsoft Is Taking Share, And Open Source Products Are Only Going To Get Better.**

Over the last four quarters Microsoft grew its SQL Server database revenues by more than 35% versus Oracle's 18%. Because each unit of Microsoft SQL Server is less than an Oracle unit, the unit market share losses for Oracle—the real substitutability measure—have been even worse. We note that Oracle's database can be deployed on top of Microsoft's server operating system but SQL Server is never deployed on top of Linux. In this area Oracle is competing against IBM and increasingly robust open source products from companies such as MySQL. Although at this time we don't believe these products are good enough to take share, this is an area to watch closely—at least for pricing pressure.

**Our DCF Model Suggests The Stock Is Fairly Valued—Opacity Doesn't Give Us Confidence In**

**Our Estimates.** Oracle, with operating margins of 40%, and free cash flow margins of 23%, is definitely a cash flow machine. Our DCF suggests that the company is worth just under \$15, net of debt, which is roughly where the stock trades right now. That said, the multiple pressures on both the profitability of the core and the uncertainty in the applications business suggest to us that the stock should be avoided at this time. We are placing a \$17 price target on ORCL and an Underweight rating on the shares because the 15% potential upside (based on the closing price, July 28) is less than the potential returns of other companies under coverage. For instance, for investors who are looking for value, we prefer Microsoft (MSFT, \$24.06, Overweight), which trades at ~18x our CY07 EPS estimate, net cash, inline with ORCL's multiple, and offers bookings growth of 9%.

**Background**

Oracle Corporation is the world's largest enterprise software company, providing database (#1 market share in databases), middleware, and applications software, and the consulting and education to support these businesses. Oracle's On Demand business provides software as a service. Founded in 1977, the company is headquartered in Redwood Shores, California. Over the last 24 months, Oracle has paid an aggregate of \$19.5 billion for acquisitions, primarily to expand its applications software business.

As of May 31, 2006, Oracle employed 56,133 full-time employees: 13,534 in sales and marketing, 5,500 in license updates and product support, 16,435 in services, 14,432 in research and development and 6,232 in general and administrative positions. Americas represented 53% of revenue in 2006, compared to 33% in EMEA and 15% from Asia Pacific.

**Operating Segments**

Oracle reports revenue from five operating segments: 1) new software licenses, 2) software license updates and product support, 3) consulting, 4) On Demand, and 5) education. The software license and support segments represent 80% of revenue; services accounts for 20%. The company provides perpetual software licenses priced according to the number of processors, named users, or other relevant metrics, and also provides term license agreements. New software license revenues represent approximately 35% of revenue.

Software is offered in three product areas: database, middleware, and applications. Oracle has built its software into a grid infrastructure, which provides customers dynamic flexibility in available computing capacity. The software can operate on single server or clustered server configurations on either Linux, UNIX or Windows operating systems.

Oracle Database 10g, available in four editions (Express, Standard One, Standard and Enterprise), is built with a common code base. Add-ons are available for extra fees, including Real Application Clusters, Collaboration Suite, Enterprise Manager and Secure Enterprise Search.

- Real Application Clusters (RAC) create a shared database across interconnected servers, increasing availability by eliminating any single point of failure. Penetration of the RAC add-on remains low, as there were 8,500+ RAC customers at the end of FQ42006 out of the more than 230,000 database customers (<5%). The company believes more than 50% penetration of the installed base is possible. The growth rate for RAC continues to exceed 25%
- Oracle Collaboration Suite is a single, integrated suite that manages email and voicemail messages, facsimiles, calendaring, conferencing, instant messaging, file sharing, search and workflow.
- Enterprise Manager 10g is designed to monitor and manage the Oracle software infrastructure. For example, it is used to complete backup and recovery, to apply patches without downtime, and to provide remote management access through web browsers and through PDAs.
- Secure Enterprise Search allows users to search content for which they have authorization inside the enterprise, scanning various sources such as web sites, databases, file servers, document repositories, enterprise content management systems, applications and portals.

Oracle Fusion Middleware, which helps users build and deploy their business applications, includes the Oracle Application Server, Oracle Business Intelligence, Oracle Developer Suite and Oracle Service Oriented Architecture Suite, and is built on industry standards such as J2EE, Business Process Execution Language (BPEL) and other web services standards.

- Application Server 10g is an application platform that makes business applications portable across various operating systems (e.g. Linux, Windows, Unix). It includes options such as Identity Management and Oracle Portal, which facilitates the development and deployment of portal sites.
- The Business Intelligence Suite is a family of enterprise business intelligence products that integrates Oracle's existing business intelligence with the acquired Siebel Business Analytics. The Enterprise Edition is open to any enterprise data source; the Standard Edition is optimized to work with Oracle data and applications.
- The Oracle Developer Suite is an integrated suite of development tools for the development of internet database applications and web services and is built on Java (J2EE), XML and HTML.
- The Service-Oriented Architecture Suite (SOA) is a complete set of service infrastructure components for creating, deploying, and managing SOA's, including Oracle Developer 10g, Oracle BPEL Process Manager, Oracle Web Services Manager, Oracle Business Rules Engine, Oracle Business Activity Monitoring, and Oracle Enterprise Service Bus.

Applications software consists of the next generation Oracle Fusion Applications and four enterprise software lines (Oracle E-Business Suite, PeopleSoft Enterprise, JD Edwards EnterpriseOne / JD Edwards World, and Siebel Business Applications). New software license revenues from applications software represented 27%, 19% and 18% of new software license revenues in fiscal 2006, 2005 and 2004, respectively. Fusion Applications are the planned next generation of Oracle Applications, based on a service-oriented platform. Version 1 is planned for release in CY08. Under its Applications Unlimited program, Oracle will continue to support the existing applications indefinitely (Oracle E-Business Suite, PeopleSoft, JD Edwards and Siebel applications) and will not force customers to upgrade to Fusion at any point in the future.

Software license updates and product support revenues, which represent approximately 46% of our total revenues on a trailing 4-quarter basis, is the highest margin business unit. Support margins over the last trailing 4-quarters were 89%, and account for 74% of our total margins over the same respective period. Software license updates provide customers with rights to software product upgrades, maintenance releases and patches released during the term of the support period, which is typically one year. Software license updates and product support are generally priced as a percentage of the new software license fees (i.e., ~22%).

Oracle's services businesses included consulting, On Demand, and education. Consulting performs business requirements analysis, design, configuration as well as support and other services. Consulting, On Demand, and education represented approximately 15%, 3%, and 2% of revenue for the last three years.

Consulting revenues lag software revenues by several quarters, and these have been negatively impacted in recent quarters by attrition, outsourcing to lower cost countries, and a greater focus on partners.

On Demand (formerly advanced product services) includes Oracle On Demand and Advanced Customer Services, whereby Oracle manages the availability, security, performance and change management for its customers. Revenues from On Demand services are recognized over the term of the service contract, which is generally one year.

Oracle uses a direct sales force in the United States but uses its Partner Network internationally. No single customer accounted for 10% or more of revenues for the last three years.

### Competition

The market for enterprise software is coalescing into three layers of a software "stack" (database, middleware and applications) that are designed to work together. The forces shaping Oracle's business also include the programming environments (e.g., industry-standard Java [J2EE] and Microsoft Corporation's .NET) and the underlying operating systems -- Windows Server, Unix (Sun Solaris, HP-UX and IBM AIX), and Linux. Other sources of competition are open source offerings (e.g., MySQL AB in database and Red Hat, Inc. / JBoss in application servers, and SugarCRM Inc. in applications) and vendors providing software as a service. Primary competitors are as follows:

**Database competitors:** IBM (2005 market share 22%), Microsoft (2005 market share 15%), Sybase, Inc., NCR's Teradata, SAS Institute, Informatica Corporation, and the open source databases, MySQL and PostgreSQL, among others (Source: Gartner).

**Middleware:** IBM, Microsoft, BEA Systems, SAP, Sun Microsystems, Sybase and open source projects such as Red Hat / JBoss, Apache Geronimo and ObjectWeb. Business intelligence competitors include Actuate Corporation, Business Objects., Cognos, Hyperion, MicroStrategy, SAS Institute, open source Netezza Corporation, and others. Application server : Borland Software, Fujitsu Software, Hitachi Software Engineering., Adobe, and others.

**Applications software:** SAP is the largest and primary competitor, but there are numerous point solutions companies that compete with one or more of ORCL's products. For example, "software as a service" competitors in customer relationship management include Salesforce.com and RightNow Technologies.

**Additional competitors by product**

- Collaboration products: Microsoft (Exchange/Outlook), IBM (Domino/Notes), Novell (Groupwise) and WebEx Communications.
- Identity management: IBM, CA, Sun, and Hewlett-Packard Company.
- Enterprise Application Integration competitors include webMethods, TIBCO Software, IONA Technologies, Sonic Software, Sun and others.
- Content management: EMC Corporation (Documentum), FileNet, Percussion Software, and Vignette.
- BPM competitors: Lombardi Software, Savvion, Pegasystems etc.
- Enterprise portal competitors: Vignette Corporation, Novell, Fujitsu, and others.
- Development tools: IBM (WebSphere Studio), Microsoft (VisualStudio.NET), Sun Microsystems (Sun Studio), Sybase (PowerBuilder), open source Eclipse and others.

**Risks**

ORCL's risks include: quarter back-end loading, macroeconomic, increasing competition, and integration of products. Like many enterprise software companies, the company's business is decidedly weighted to the last few weeks and days of a quarter. Although deal slippage from one quarter to the next is not likely to affect long-term growth rates, software companies' high fixed cost leverage means that missed deals can cause large earnings misses and sharp, sudden stock declines. Investors need to be aware of this risk. If economic growth were to slow in any of Oracle's geographies and cause IT spending to decline, Oracle would likely be negatively impacted. Increasing competition from SAP, Microsoft, Red Hat, and other open source and On Demand software vendors could also negatively impact Oracle's database and applications revenue and profits. Oracle would also be negatively impacted by delays in integrating the products from its multiple acquisitions.

**BUSINESS**

*Oracle Corp. (ORCL), founded in 1977 and headquartered in Redwood Shores, CA, is the world's leading database company and second largest independent software company. Oracle operates in 60 countries, has 40,000 employees and has been a publicly traded company since March 1986.*

**CHARTS/MODELS**

To view charts associated with those stocks mentioned in this report, please visit <http://cm1.prusec.com>.

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Prudential Equity Group, LLC makes a market in the shares of Oracle Corp, Microsoft.

When we assign an **Overweight** rating, we mean that we expect that the stock's total return will exceed the average total return of all of the stocks covered by the analyst (or analyst team). Our investment time frame is 12-18 months except as otherwise specified by the analyst in the report.

When we assign a **Neutral** Weight rating, we mean that we expect that the stock's total return will be in line with the average total return of all of the stocks covered by the analyst (or analyst team). Our investment time frame is 12-18 months except as otherwise specified by the analyst in the report.

When we assign an **Underweight** rating, we mean that we expect that the stock's total return will be below the average total return of all of the stocks covered by the analyst (or analyst team). Our investment time frame is 12-18 months except as otherwise specified by the analyst in the report.

### ANALYST UNIVERSE COVERAGE:

John McPeake: Adobe, Autodesk, Inc., Art Group Technology, Salesforce.com, JDA Software, Rightnow Technologies, SAP, Microsoft, Oracle Corp., Activision, Inc., Electronic Arts, THQ, Inc., BEA Systems, Red Hat Inc.

### Rating Distribution

07/28/06	Firm	Firm's Investment Banking Clients	Sector	Sector's Investment Banking Clients
Overweight(Buy)*	35%	0%	42%	0%
Neutral Weight(Hold)*	46%	0%	36%	0%
Underweight(Sell)*	19%	0%	22%	0%

Excludes Closed End Funds

06/30/06	Firm	Firm's Investment Banking Clients	Sector	Sector's Investment Banking Clients
Overweight(Buy)*	35%	0%	41%	0%
Neutral Weight(Hold)*	46%	0%	36%	0%
Underweight(Sell)*	19%	0%	23%	0%

Excludes Closed End Funds

03/31/06	Firm	Firm's Investment Banking Clients	Sector	Sector's Investment Banking Clients
Overweight(Buy)*	30%	0%	34%	0%
Neutral Weight(Hold)*	49%	0%	37%	0%
Underweight(Sell)*	22%	0%	29%	0%

Excludes Closed End Funds

12/30/05	Firm	Firm's Investment Banking Clients	Sector	Sector's Investment Banking Clients
Overweight(Buy)*	30%	0%	36%	0%
Neutral Weight(Hold)*	47%	0%	34%	0%
Underweight(Sell)*	23%	0%	30%	0%

Excludes Closed End Funds

\* In accordance with applicable rules and regulations, we note above parenthetically that our stock ratings of "Overweight," "Neutral Weight," and "Underweight" most closely correspond with the more traditional ratings of "Buy," "Hold," and "Sell," respectively; however, please note that their meanings are not the same. (See the definitions above.) We believe that an investor's decision to buy or sell a security should always take into account, among other things, that the investor's particular investment objectives and experience, risk tolerance, and financial circumstances. Rather than being based on an expected deviation from a given benchmark (as buy, hold and sell recommendations often are), our stock ratings are determined on a relative basis (see the foregoing definitions).

Prior to September 8, 2003 our rating definitions were Buy, Hold, Sell. They are defined as follows:

When we assign a **Buy** rating, we mean that we believe that a stock of average or below-average risk offers the potential for total return of 15% or more over the next 12 to 18 months. For higher-risk stocks, we may require a higher potential return to assign a Buy rating. When we reiterate a Buy rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

When we assign a **Sell** rating, we mean that we believe that a stock of average or above-average risk has the potential to decline 15% or more over the next 12 to 18 months. For lower-risk stocks, a lower potential decline may be sufficient to warrant a Sell rating. When we reiterate a Sell rating, we are stating our belief that our price target is achievable over the next 12 to 18 months.

A **Hold** rating signifies our belief that a stock does not present sufficient upside or downside potential to warrant a Buy or Sell rating, either because we view the stock as fairly valued or because we believe that there is too much uncertainty with regard to key variables for us to rate the stock a Buy or Sell.

When we assign an industry rating of Favorable, we mean that generally industry fundamentals/stock prospects are improving.

When we assign an industry rating of Neutral, we mean that generally industry fundamentals/stock prospects are stable.

When we assign an industry rating of Unfavorable, we mean that generally industry fundamentals/stock prospects are deteriorating.

## Ratings History: ORCL

Rating Changes				Target Price Changes			
<u>Date</u>	<u>From</u>	<u>To</u>	<u>Analyst</u>	<u>Date</u>	<u>From</u>	<u>To</u>	<u>Analyst</u>
03/06/06	NTRL	--	Thill	03/06/06	15.00	--	Thill
09/22/05	OVER	NTRL	Thill	09/22/05	18.00	15.00	Thill
12/13/04	NTRL	OVER	Thill	12/13/04	13.00	18.00	Thill
06/01/04	OVER	NTRL	Thill	06/01/04	15.00	13.00	Thill
09/08/03	Buy	OVER	Thill				

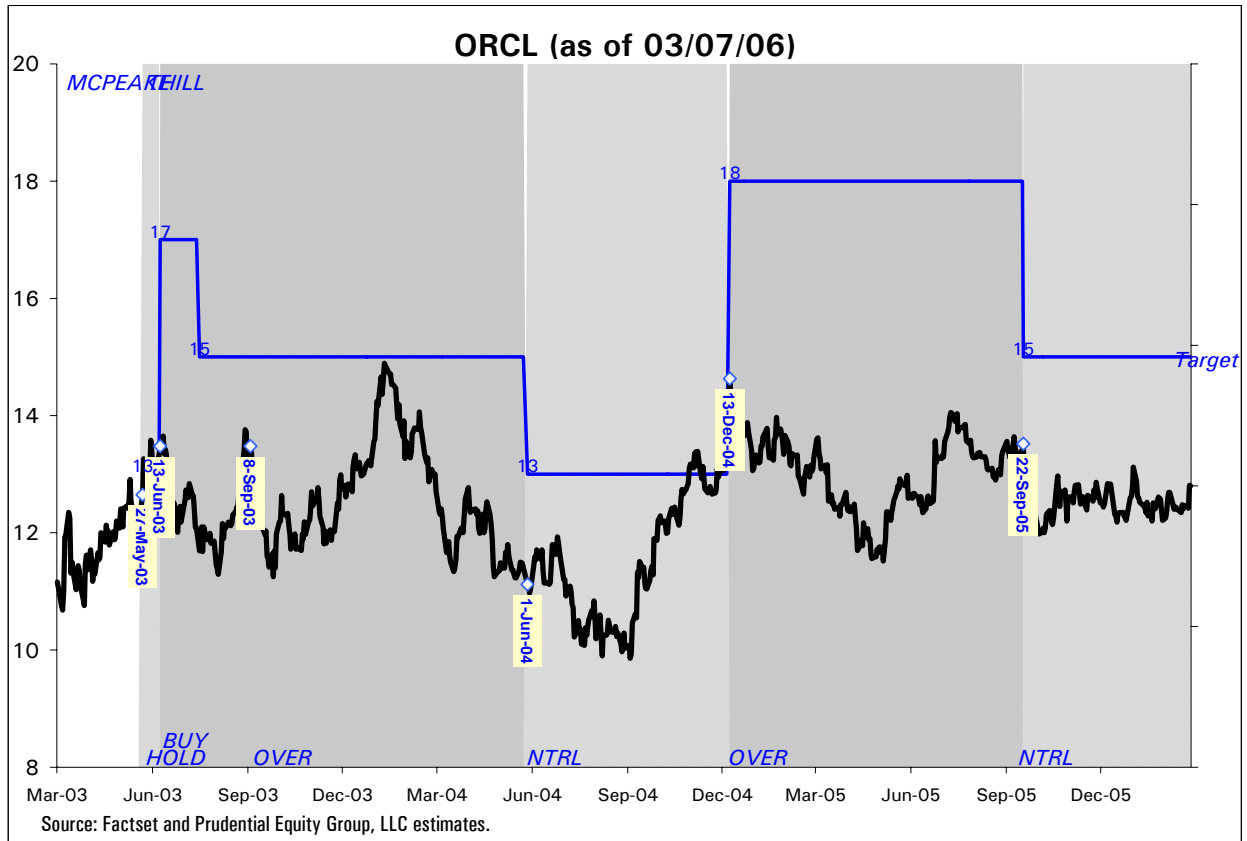
***Additional Information***

## Price Target – Methods/Risks

The methods used to determine the price target generally are based on future earning estimates, product performance expectations, cash flow methodology, historical and/or relative valuation multiples. The risks associated with achieving the price target generally include customer spending, industry competition and overall market conditions.

Additional risk factors as they pertain to the analyst's specific investment thesis can be found within the report.

## Price History: ORCL



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