

# What Oracle's disappointing cloud performance means for its licensees

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Longtime users of Oracle's legacy software products are likely familiar with the company's penchant for aggressive license audits.

These audits have long been a staple of Oracle's business model and can result in claims of large licensing shortfalls against its licensees.

But what licensees may not understand is that Oracle's auditing practices, which at one time were merely a separate revenue stream, have evolved into an integral part of a larger fight for its legitimacy in the cloud-computing industry.

Understanding this larger context is an important exercise for the proactive Oracle licensee who wishes to prepare for the inevitable Oracle audit.

In sum, as a late entrant to the cloud wars, Oracle's much-publicized objective of becoming a major — if not the major — competitor in the provision of cloud-based hosting services has been a hard fight.

Nothing if not bullish, Oracle has made up for lost time by making great fanfare of the fact that it is pouring billions of dollars into creating what it hopes to be a competitive cloud platform. It has also informed the market that its hundreds of thousands of enterprise licensees will be the first to seed its growing cloud.

And, considering its reputation as an aggressive licensor, industry commentators were not surprised when Oracle began to utilize its notorious auditing tactics to move its existing licensees to its newly marketable cloud.

If Oracle's audits are the hammer, its licensees are the nails in Oracle's plan to build out its cloud bona fides.

Without license audits, it is highly unlikely Oracle can legitimately compete with the leading cloud competitors.

For a time, it was easy to believe that Oracle's cloud strategy was succeeding.

Oracle increasingly touted cloud revenue as an ever-growing portion of its reported earnings, and it proclaimed great success in the market.

However, over the past year, Oracle appears to have scaled back its optimism. In June of last year, it reported disappointing

fourth-quarter earnings. Days later, it suffered a disastrous market fall that was generally tied to its waning cloud performance and a change in its revenue reporting.

One year later, Oracle announced a tentative partnership with Microsoft Azure and saw an improvement in its 2019 fourth-quarter earnings. These developments were nevertheless met with skepticism about what they signaled for Oracle's position in the cloud wars and its sizeable investment in its platform.

Regardless of what path Oracle ultimately ends up taking with regard to the provision of cloud services, it is hard not to see this market instability as a bad omen for Oracle and the ultimate fate of its fledgling cloud.

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Because Oracle is likely to double down on the aggressive licensing and auditing tactics that it knows best, its current enterprise licensees should brace themselves to bear the brunt of its cloud anxiety.

This commentary provides a brief summary of Oracle's belated efforts to build a competitive cloud product, the details behind its recent market slip, and how this slip is likely to affect its already fraught relationship with its many enterprise licensees.

### SLEEPING THROUGH THE CLOUD REVOLUTION

In 2006, while the then-nascent cloud computing industry was gaining momentum, Larry Ellison, Oracle's then-CEO, was nothing if not derisive of the growing market for cloud services: "Maybe I'm an idiot, but I have no idea what anyone is talking about," he said. "It really is just complete gibberish. ... It's insane."

As recently as 2009 Ellison continued objecting to the "absurdity" and "nonsense" of cloud innovation. "What are you talking about?" he said. "It's not water vapor. It's a computer attached to a network!"<sup>1</sup>

Notwithstanding Ellison's befuddled criticism, the cloud industry forged ahead.

In 2018 alone, the industry is estimated to have reached \$182.4 billion in revenue and is projected to reach \$331.2 billion in annual revenue by 2022.

Recognizing these formidable returns in a burgeoning industry, Oracle is painfully aware that it needs Wall Street to recognize it as a significant cloud provider, lest it be stigmatized as a “legacy vendor.”<sup>2</sup>

However, some observe that the top cloud providers — AWS, Google, ServiceNow, IBM and Adobe — are “sucking most/all of the application oxygen out of the enterprise marketplace.”<sup>3</sup>

For example, Gartner predicts that by 2021, the top 10 cloud providers will control almost 70% of certain cloud markets, up from 50% in 2016.

So unless it quickly gains a foothold or changes strategy, Oracle is at substantial risk of being left behind by this rapid consolidation of the cloud industry.

Swimming against these currents, Oracle will not get a substantial piece of the cloud market without a fight.

### ORACLE BUILT IT

Oracle’s first step toward securing a place in the cloud wars was to build an infrastructure.

Since launching its first “infrastructure as a service” platform in 2015 — lagging nearly a decade behind most competitors — Oracle has invested billions in a “quest to build and defend a range of cloud services.”<sup>4</sup>

However, its cumulative investment into its cloud platform remains a small fraction of its the investments made by its main competitors, each of which spent more on infrastructure last year alone than Oracle has in total.

This begs a question: How can Oracle compete to gain market share and drive revenues?

### WILL THEY COME?

With an infrastructure in place, Oracle needs customers. Oracle’s prime targets? Its captive base of enterprise licensees.

The methodology? Its tried and tested “business is war” mentality.<sup>5</sup>

Specifically, Oracle has begun to wield its aggressive licensing audits to thrust its cloud services onto its current licensees.

The company’s use of license audits to drive revenues and coerce the renewal of licenses for its legacy products is nothing new. Its well-honed auditing machine was built to find steep licensing shortfalls in nearly all circumstances.

Either because unlicensed features and products are inadvertently installed or because creative accounting yields elevated counts of processor “installation,” an Oracle audit

almost guarantees that the licensee will face an imposing reconciliation demand.

Once a licensee falls into this trap, Oracle offers to make the purported breach notice “go away” by proposing a “business resolution,” which unfailingly entails adding Oracle cloud credits or other services to the license.

Finally, Oracle penalizes customers for using competing cloud services by doubling the cost of running Oracle software on Amazon’s AWS, while the cost of running on Oracle’s cloud remains unchanged.

According to an article in Forbes magazine,<sup>6</sup> Oracle’s notoriously “sticky” license agreements present great risk for businesses considering switching operations away from Oracle.

Few, however, see this as a viable long-term strategy.

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Some analysts have observed that while its competitors prioritize “innovation and customer value,” Oracle prioritizes “short-term profitability and growth,” the article said.

In the eyes of industry experts, customers stick with Oracle “not because Oracle’s products are necessarily any better, but because Oracle has done such a good job putting up roadblocks for any company considering [switching to other vendors],” the article said. “Anti-customer strategies can only take a company so far before people simply won’t put up with them anymore.”

Although Oracle might be winning today with what the Forbes article calls a “ruthless focus on the bottom line,” many predict that it will not win in the future.

Other analysts have observed that as Oracle “continue[s] to lose ground against newer suppliers, it (and its shareholders) should ask why many of its legacy customers are quite so antipathetic to renewing with Oracle.”<sup>7</sup>

Nonetheless, aggressive auditing continues to be Oracle’s standard operating procedure, and licensees should remain vigilant regarding Oracle’s new goal of driving cloud sales.

### TROUBLE ON THE HORIZON: ORACLE’S MARKET SLIP

Based on its initial reports, Oracle’s cloud strategy appeared to be working.

In fact, some sources reported Oracle’s cloud business as the main engine of its recent growth, comprising almost 16% of the company’s total revenues in fiscal year 2018 compared with just 8% two years prior.

Then, about a year ago, the bottom appeared to fall out. On June 19, 2018, Oracle reported its fiscal fourth-quarter earnings, and by the close of trading the following day, share prices plummeted almost 8% to a 15-month low.

Oracle was dubbed at the time “the worst-performing stock in the S&P 500’s Software and Services Group for the year.”<sup>8</sup>

Analysts cited two main reasons for the plunge: discouraging short-term financial predictions and Oracle’s adoption of alarming changes in its reporting format.

As to the first, Oracle announced a “disappointing outlook” for the next quarter. Predicted revenue of \$9.4 billion was lower than Wall Street’s \$9.5 billion estimate, and Oracle’s adjusted earnings near 68 cents per share were also below analyst predictions of 72 cents.

Many saw these discouraging predictions as a signal that Oracle’s cloud business was slowing.<sup>9</sup> However, most attributed the sharp decline to the second factor: a dramatic change in the format of Oracle’s cloud reporting.

Oracle announced that beginning in June 2018 it would bundle reporting of the distinct cloud buckets (such as software as a service, platform as a service and infrastructure as a service), along with on-premise software license updates, product support and license support.

The change, precipitated by Oracle’s relatively new practice of bundling of licenses for cloud with its legacy software offerings, provides even less visibility into the growth of two different business segments.

By way of contrast, at least one report says Amazon and Microsoft “have taken to breaking out more details about their respective cloud services over the last couple of years and have been rewarded richly by investors for it.”<sup>10</sup>

This change in reporting prompted a range of negative responses from financial analysts, many of whom speculated that Oracle may be “trying to hide some sort of weakness in the cloud-computing story,” especially because “slowing cloud growth had hurt the stock in previous quarters.”<sup>11</sup>

In particular, some suspected that “Oracle missed its cloud bookings achievement goals” and “is rapidly losing share in the most interesting areas (PaaS/IaaS) of infrastructure software.”<sup>12</sup>

Those calling the reporting changes a red flag argued that Oracle’s cloud will keep it from achieving “new, more ambitious financial goals.”<sup>13</sup>

Fast-forward to the present day, and Oracle appears to have made up some lost ground in the market in two respects.

In June Oracle announced an interoperability partnership with Microsoft through which Oracle cloud customers can interact seamlessly with Azure cloud offerings and vice versa.

Oracle also announced a higher-than-anticipated increase in revenue June 19, reporting about a 1% overall increase from the previous year to \$11.14 billion.

Between cloud services and license support, Oracle’s revenues grew 0.5% to \$6.79 billion.

Analysts, however, emphasize that this growth came from licensing software — not cloud services — and ultimately does “nothing to dispel the notion that Oracle is still behind in its quest to become a major cloud-computing competitor.”<sup>14</sup>

Another analyst echoed a similar sentiment with the following comment: “Recent reports of Cloud layoffs, combined with the MSFT partnership, potentially indicate that ORCL is continuing to face an uphill battle in its broader cloud strategy and business model transition.”<sup>15</sup>

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While it is too early to understand the impact of the partnership, it appears to represent a “concession by Oracle that it won’t be able to compete against Amazon Web Services alone.”<sup>16</sup>

#### WHAT DOES THIS MEAN FOR ORACLE LICENSEES?

Despite these setbacks, we expect Oracle to remain focused in its effort to emerge as the victor in the cloud wars.

If Oracle’s well-known tactics and business-is-war mentality were not already cause for concern, its recent market slip certainly should be.

And, as its problems mount, licensees should anticipate that Oracle will continue mining its licensees as its greatest source of potential cloud revenue and growth.

As Oracle grows desperate, it is only a matter of time before its licensees begin to feel the impact of its cloud anxiety.

We anticipate, at minimum, an increase in the sheer quantity of software audits.<sup>17</sup>

Oracle is reported to have hired new licensing personnel in Romania to handle an increase in audits, including audits of smaller licensees that may have previously been overlooked in the past.

We also anticipate that Oracle will double down on its standard allegations of under-licensing and increasingly make audit resolution difficult.

In addition, Oracle is likely to continue to expand the scope of audits, including by increasing its focus on Java users

— who may be shocked to learn that they may owe Oracle for their use of Java, which is widely believed across the software sector to be free.<sup>18</sup>

Nor is Oracle’s new partnership with Microsoft likely to reduce the increasing threats of onerous software audits, as Microsoft is even more notorious for its audit-as-revenue strategies.

With Java audits ramping up and Oracle’s investment in an audit organization with instructions to more aggressively audit all licensees, Oracle shows no signs of slowing down.

Now is the time for licensees to review their software licenses and deployment and to arm themselves with the right experts and advocates — those who will navigate Oracle’s treacherous terrain and brave the battleground on behalf of licensees.

## NOTES

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<sup>2</sup> *Gartner Forecasts Worldwide Public Cloud Revenue to Grow 17.5 Percent in 2019*, Gartner (Apr. 2, 2019), <https://gtr.it/2FL5FVv>; Dan Woods, *Oracle’s Strong Arm Cloud Tactics — The 2018 Model*, FORBES (May 21, 2018), <https://bit.ly/307Glg6>.

<sup>3</sup> Bob Evans, *Shakeout in the Cloud: Success of Salesforce, Oracle, SAP and Workday Triggering SaaS Consolidation*, FORBES (June 12, 2018), <https://bit.ly/2OZVVyC>; *Gartner Forecasts Worldwide Public Cloud Revenue to Grow 21.4 Percent in 2018*, GARTNER (Apr. 12, 2018), <https://gtr.it/2N5HJCY>.

<sup>4</sup> Beth Kindig, *Oracle hit from all sides: IaaS cloud and programmatic*, SEEKING ALPHA (June 25, 2018), <https://bit.ly/2KLLfOR>.

<sup>5</sup> Jason Bloomberg, *Oracle’s Cloud Strategy: Ruthless or ‘Byzantine’?*, FORBES (July 11, 2017), <https://bit.ly/2H3eBqT>.

<sup>6</sup> *Id.*

<sup>7</sup> Powell, *supra* note 1.

<sup>8</sup> Dan Gallagher, *Oracle’s Cloud Thickens*, WALL ST. J. (June 20, 2018), <https://on.wsj.com/2yZZqKq>.

<sup>9</sup> *Id.*; Luke Lango, *Oracle Corporation Stock Has Further to Fall Before It Is Priced Right*, YAHOO! FIN. (June 22, 2018), <https://yhoo.it/2TAsokK>.

<sup>10</sup> Emily Bary, *Oracle stock takes a beating as lack of cloud numbers questioned*, MARKETWATCH (June 20, 2018), <https://on.mktw.net/2N5cpmn>; Gallagher, *supra* note 8.

<sup>11</sup> Anders Bylund, *Here’s What’s Wrong with Oracle Corp. Today*, THE MOTLEY FOOL (June 20, 2018), <https://bit.ly/3068Wrl>.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> Asa Fitch, *Oracle’s Revenue Beats Targets in Latest Quarter*, WALL ST. J. (June 19, 2019), <https://on.wsj.com/33DzCBV> <https://cnb.cx/2lVbSQf>; *Oracle up as it beats expectations*, CNBC (June 19, 2019).

<sup>15</sup> *Id.*

<sup>16</sup> Nico Grant, *Oracle Sales Return to Growth, Topping Analysts’ Estimates*, DATA CENTER KNOWLEDGE (June 19, 2019), <https://bit.ly/2yZCUBJ>.

<sup>17</sup> Fredrik Filipsson, *2019 is the Year for Java and Oracle*, PALISADE COMPLIANCE (Feb. 19, 2019), <https://bit.ly/2NaSqvV>.

<sup>18</sup> Julie Bort, *Oracle is starting to fine customers who thought they were using free Java software*, BUS. INSIDER (Dec. 19, 2016), <https://bit.ly/2OXEv5B>; Art Beeman, Joel Muchmore & Molly Jones, *Understanding Your Oracle/Java License — Not Everything is as it Seems*, BLOOMBERG LAW (Sept. 17, 2018), <https://bit.ly/2YSqScD>.

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