Oracle and PeopleSoft: In Dubious Battle?

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Fifteen months after it launched its hostile takeover bid for PeopleSoft, Oracle has won a major victory that brings it closer to acquiring its rival. The question is whether the war of attrition has been worth it.

When Knowledge@Wharton last looked at Oracle's bid for PeopleSoft, uncertainty prevailed and the outcome of PeopleSoft's acquisition of J.D. Edwards was unknown. That deal has been closed for more than a year, but the J.D. Edwards acquisition hasn't helped PeopleSoft elude Oracle's pursuit. When Oracle first bid for PeopleSoft, Wharton professors Morris Cohen and Harbir Singh said it wasn't clear if CEO Larry Ellison was serious or just wanted to upstage rivals. Time will tell, said the professors, adding that perhaps the PeopleSoft bid was just an ego trip. Ego trip or not, it's now clear that Ellison is serious and may just succeed.

On Sept. 9, Oracle won a lawsuit filed by the Department of Justice that sought to block its proposed acquisition of PeopleSoft. Oracle is offering $21 a share in cash for PeopleSoft in a bid that has been raised twice since Oracle's June 9, 2003, initial offer of $16 a share. Barring a DOJ appeal or the European Union preventing an acquisition - securities analysts expect the EU will follow the U.S. ruling - Oracle will have cleared its regulatory hurdles.

Wall Street analysts now put the odds of Oracle success in taking over PeopleSoft at 70%. The catch is that PeopleSoft's board of directors still dismisses Oracle's bid as a lowball offer. And PeopleSoft's poison pill provisions preventing a takeover are also still in place. Unless more shareholders tender shares to Oracle, CEO Larry Ellison will be held at bay despite his mantra that software consolidation is inevitable - a contention few experts will argue.

For Oracle so far, the hostile takeover attempt has improved with age. Oracle has disrupted a key rival while holding its own financially. PeopleSoft, however, is struggling and could ultimately be forced to sell out to Oracle. "PeopleSoft is definitely in trouble," says Wharton operations and information management professor Thomas Lee. "[Oracle's win] adds additional doubt and more uncertainty to PeopleSoft's business."

PeopleSoft CEO Craig Conway is adamant about the company remaining independent. At the PeopleSoft Connect customer conference this week, Conway touted the company's future and unveiled an alliance where its software will be tightly integrated with IBM's Websphere platform. "Today we have eclipsed the competition," says Conway in a news release about the IBM deal.

But is it in PeopleSoft's best interest to keep fighting Oracle and risk that its business further deteriorates? "PeopleSoft is trying to defend itself, but there's this gorilla waiting right offstage," says Lee.

Meanwhile, the war of words goes on.

In a letter written on Sept. 9 to PeopleSoft's Board, Oracle chairman Jeff Henley and CEO Larry Ellison wrote: "With the removal of the U.S. antitrust issue and Oracle's commitment to acquire PeopleSoft, we are hopeful that a transaction can occur."

PeopleSoft's reply: "PeopleSoft's Board has carefully considered and unanimously rejected each of Oracle's offers, including its current offer of $21 per share. On May 25, 2004, the Board concluded that the current offer was inadequate and did not reflect PeopleSoft's real value."

PeopleSoft continued to say it would see Oracle in court again. The company is claiming compensatory damages of more than $1 billion plus punitive damages in a lawsuit against Oracle scheduled to go to trial in Oakland, Calif., on November 1, 2004. PeopleSoft's complaint alleges that Oracle has engaged in unfair business practices, including a deliberate campaign to mislead PeopleSoft's customers and disrupt its business.

What's next? A lot of questions persist. Can PeopleSoft continue to fend off Oracle? Have the assumptions underlying Oracle's bid changed? Has the industry changed? Did Ellison start off a new round of consolidation?

The jury is still out, but Wharton finance professor Andrew Metrick says people should get used to the Oracle-PeopleSoft saga—it could go on for a while. "This could drag on for years," says Metrick. "If PeopleSoft's board continues to refuse the offer, Oracle may have to win it with several proxy fights. It's unusual to see an acquirer this dogged."

Toss in another big factor - the egos of Oracle CEO Ellison and PeopleSoft CEO Conway - and it's clear this could be a protracted war. "This is a big ego battle," says Metrick. And amid this war is a changing industry.

Consolidation Looms

Oracle's rationale for the PeopleSoft acquisition still holds up a year later, says Metrick. Broadly speaking, Oracle contends consolidation in the software industry is inevitable. And for its part, Oracle wants PeopleSoft's large installed base of customer and applications used to run the human resources and finance departments of many companies. In the DOJ trial, Oracle argued successfully that it needs to beef up to compete with the likes of SAP and Microsoft, two giants that even entertained merger possibilities. Oracle's applications business remains weak, but its database sales continue to keep the company on track with Wall Street estimates. Bottom line: Oracle needs a bigger stack of software if it wants to dominate.

Meanwhile, the software industry's rebound from the time of Oracle's initial offer has waned substantially. A host of companies such as Siebel Systems issued profit warnings last quarter. For the Sept. 30 quarter, firms such as Lawson Software have also sounded alarms. Corporate spending is down. The Federal Reserve's Beige Book release for August tells the tale. "A new tone of caution has emerged for the short-term outlook of software and the IT markets," notes the Federal Reserve. All these are factors that favor consolidation. According to Merrill Lynch, the Internet and software sectors are the only two pockets of technology that have shed 20% of their companies since the first quarter of 2002.

One of the bombshells of the Oracle trial was the fact that SAP and Microsoft were pondering a merger. If those two giants felt the need to merge, what's left for the thousands of smaller companies?

A.G. Edwards analyst Kevin Buttigieg says software buyers are on strike because of Sarbanes-Oxley expenditures and uncertainty about the economy. He argues that buyers have no compelling reason to blow their budgets on software, especially without "must have" versions. Metrick agrees and say that's why there's a big push toward consolidation. Customers are seeking out the bigger vendors. "Everything Oracle has said about consolidation in general is true," says Metrick.

No-Win Scenario?

Despite the logic behind consolidation and an Oracle-PeopleSoft deal, it is possible that this war of attrition won't pay for either party. For now, Oracle is holding its own, but doubts remain. In its first quarter ending August 31, Oracle reported net income of $509 million, or 10 cents a share, on revenues of $2.2 billion. The results, coming in a seasonally slow quarter, impressed Wall Street analysts. The biggest issue was applications revenues were down 37% to $497 million.

Fifteen months after its first bid for PeopleSoft, Oracle results are showing pockets of strength and performing well overall compared to other software firms. Nevertheless, Oracle has its critics. "Almost all the investors we have spoken with over the last year are against the deal because of potential integration issues," wrote William Blair analyst Laura Lederman in a research note.

PeopleSoft's position is more perilous. After stringing together a series of quarters where the company delivered good quarterly results, PeopleSoft faltered in the quarter ending June 30. After issuing a profit warning, PeopleSoft delivered second quarter net income of $11 million, or 3 cents a share, on revenues of $647 million. In the same quarter a year ago, PeopleSoft reported net income of $37 million and revenues of $497 million.

And since Oracle won the DOJ trial the uncertainty among PeopleSoft customers is going to persist, analysts say. Schwab Soundview Capital Markets analyst James Mendelson says Oracle's victory "creates additional uncertainty for PeopleSoft and hurts the prospects for its third quarter results."

On the second quarter conference call, Conway refused to call the quarter disappointing, noting that the company's performance was solely related to media coverage of the Oracle DOJ trial. "It was the big elephant in the room on every sale," said Conway. Unfortunately for Conway, the elephant is still there since Oracle won.

An unintended consequence of the Oracle-PeopleSoft standoff is that it benefits SAP, the current enterprise software leader, no matter what the outcome. In a research note, Lederman says SAP may be the biggest winner in the slugfest. "We believe that Oracle's buying PeopleSoft would help SAP," she wrote. "Our belief is that Oracle will not continue to develop PeopleSoft's products, which, over the long run, will cause the base to have to move to either Oracle or SAP products."

That's good news for SAP, since it is already taking PeopleSoft customers. On PeopleSoft's second quarter conference call, CEO Conway acknowledged that SAP is benefiting the most from PeopleSoft's turmoil.

At this juncture the key question of Oracle's hostile bid for PeopleSoft is whether it's really worth all the effort to buy a wounded rival. Metrick believes it still can be worth it because PeopleSoft continues to have a large base of customers. Oracle would inherit those customers and gain from the maintenance revenue. Contrary to early indications, Oracle has been steadfast in saying it would support PeopleSoft's customers. The big issue is price. If Oracle raises its bid to, say, $26 a share and PeopleSoft struggles, Oracle could spark a shareholder revolt among big institutional holders, says Metrick. Lee, however, notes there are no guarantees that Oracle could retain all of PeopleSoft's customers. Some may go to SAP. PeopleSoft customers that use Oracle databases are likely to stay with Oracle just because integration would be easier.

In the coming months, it appears that price may become the biggest obstacle for Oracle. If the price is right, PeopleSoft will have to come to the bargaining table. As Metrick notes, "There's no such thing as a bad company, just a badly priced one."