Creative Financing Can Solve New Business Requirements and Constraints

RFG believes executives should take advantage of the many creative financing solutions that enable them to reduce their technology spend rates while gaining access to new capital sources so that monies can be reinvested in ongoing projects. Though leasing options are increasingly understood by IT and business executives, the full range of choices available from banks and captive lessors extends beyond simply low-rate financing and leasing selections. Options worth consideration include project and software leasing and financing, sale/leaseback alternatives, timed payment plans that coordinate with cost savings derived from infrastructure upgrades, and used equipment alternatives. IT executives under pressure to make the most out of limited budgets should work with their financial teams and lending agents to understand the funding types available to them, and pair alternatives to evolving business and fiscal requirements.

Business Imperatives:

- The merits of leasing are becoming increasingly well known, as corporations investigate leasing options for low-, mid-, and high-end hardware. Leasing is not as widely adopted as it should be given its effectiveness lowering TCO, particularly on smaller systems. Leasing now accounts for 10 percent or less of total hardware market spend, and an even smaller portion of software funding methodologies. Funding vendors are working hard to change this fact as they search for opportunities to move to more rapid refresh cycles and resell and upsell opportunities. Thus, an increasing amount of creative funding options are being launched now, with the captive IT lenders offering the first and most progressive options. IT executives should look to leverage the lower cost, improved vendor accountability, and pay-as-you-go abilities afforded by these funding strategies across the range of IT assets and services purchased to more effectively utilize the limited amounts of available capital.

- Corporations are continuously purchasing and refreshing systems, and participating in services engagements to ensure that business requirements are appropriately met by new hardware and applications. As such, IT executives have recurring opportunities to discuss the merits of alternative financing with financial teams and line of business (LOB) executives, as well as move existing and new funding strategies over to pay-as-you-go methodologies based on cost/benefit analyses. This requires a substantial shift to occur in the funding decision making process, with discussions between IT executives and the financial team to take place earlier and more frequently in the solution and vendor evaluation methodology. Corporations must remap how and when business and financial teams collaborate in the apportionment of budgets and funding activities, and work together to overcome the political and ownership issues that typically accompany such endeavors.

- IT executives should also revisit some of the older, but frequently overlooked, hardware funding opportunities to further reduce the expenditures. Sale/leaseback provides corporations with the ability to free up capital already invested in hardware by transferring ownership of the asset back to a leasing vendor. IT executives can use the resulting capital infusion to fund the project(s) of their choice, and lease the systems back from the lessor. A second option is to take advantage of the certified used equipment programs in place at the major hardware vendors to purchase both newer and older technology at reduced rates. While these opportunities may not be advantageous for all purchasing scenarios, IT executives desirous of freeing up capital should evaluate opportunities where these offerings can be used strategically as part of the corporate funding portfolio strategy. Additionally, IT executives should identify opportunities to wrap new and existing infrastructure and services purchases into project financing portfolios to better leverage available budget allotments.
Non-traditional funding opportunities present interesting options for corporations to finance ongoing project and hardware expenditures, but become a concern for some IT and finance executives lately due to poor performance in several market indicators. Namely, several poor credit consumer and business clients have defaulted on their loans for various reasons ranging from dips in the housing market, job losses, and stronger business competition. While banking institutions – particularly those that cater to the subprime end of the consumer market by lowering their lending requirements and raising interest rates attached to leases and loans – have suffered from higher than expected deficiency rates, this has very little effect on their corporate commercial lending businesses. In particular, captive IT lessors have typically targeted well-established entities for their lending activities, and thus, have not been affected by these happenings. By in large, the funding solutions available to large companies are growing in availability and popularity, and highly competitive rates are available for both purchase and lease options. (See the RFG Research Brief "Leasing's Legs."

**Hardware Leasing**

Leasing opportunities are, by far, the preeminent solutions being offered by lending institutions given the new directions desired in building long-lasting client relationships and annuity businesses. RFG research has demonstrated that three-year refresh strategies, as enabled through leasing, can offer savings of up to 15 percent using a fair market value (FMV) lease compared with traditional five-year purchase methodologies. This is due to a variety of contributing factors, including lower administrative costs by avoiding excessive operating system, application, and hardware maintenance; high residual values; predetermined end-of-life data wipe and disposal, and reduced warranty expenditures.

The largest contributor to leasing's cost savings is the radically lower amount of upkeep required to maintain systems operating environments, including system patching and update, password resets, and re-imaging. The biggest pitfalls for IT executives lie in the areas of asset management and tracking, as cost savings are only derived if the majority of systems can be relinquished on the pre-planned three-year basis. Systems that are kept for 39 or more months will erode costs such that the enterprise will forfeit hardware cost savings, though it will still take advantage of reduced TCO by avoiding the troubles that plague hardware during its later life. IT executives must work to build effective support capabilities to effectively capitalize on the reduced TCO delivered via three-year refresh and leasing, and should work both internally and with preferred vendors to enact or outsource the necessary capabilities. (See the RFG Research Notes "Demystifying PC Total Cost of Ownership: How Leasing Can Help" and "Demystifying Commodity and Blade Server TCO – Part Three: Leasing Analysis.

**Software Leasing**

Though not as as popular in its traditional form, software leasing is another avenue that can offer IT executives the ability to pay for an asset as its value is realized while simultaneously forgoing large up-front capital expenditures. As with other forms of leasing, software leasing allows the financial team to pay for products using operational expenses rather than acquiring a large, depreciable asset. Unlike hardware leasing, software leasing does not provide a residual value as a means of reducing total spend, as software leasing requires a full payout (FPO) lease methodology. Other, newer forms of application delivery can arguably be included in the software leasing category, including software as a service (SaaS) and application service provider (ASP) products. Most software leasing products encompass not just the software in the monthly rental fee, but also the support and maintenance required over the life of the
lease. The software leasing industry continues to grow, with 2006 total spend rising beyond $2 billion in sales, not including hosted software models.

IT executives must be careful with software leasing models as there can be a tendency to overpay, particularly if an upgrade is not purchased after the lease term ends and if the enterprise is forced to run the older application in parallel with an application that requires costly and time consuming data migration efforts. IT executives should understand how these transitional periods are handled and be sure to negotiate proper migration time and the support required should another vendor's solution be selected as the successor. As with most contract negotiation processes, the devil lies in the details and all scenarios must be carefully planned out to ensure costs and support levels remain at or below straight purchasing or leasing options. If done correctly, IT executives and their financial teams can save significantly using software leasing due to the allowance of operational expenditures. Hosted software leasing models can offer potentially greater savings to enterprises by shifting application management and update responsibility to the vendor. (See the RFG Research Brief "Software Leasing: Benefits and Pitfalls.")

Project Financing

Project financing options are structured to incorporate a combination of financing, hardware, maintenance, professional services, and software into a single structured offering. Any vendor offering funding for a combination of the above can technically be considered a project financing, although many different names are being used to describe the offering to allow vendors to differentiate themselves by focusing on particular business needs or trends. Project financing can be structured to incorporate either purchasing or leasing of hardware and software, in addition to the full payout of implementation, maintenance, support, and other non-assets. As project financing comes in many flavors and using many different names, IT executives should be sure to understand the full range of structures available to them and select the option that provides the maximum amount of flexibility to meet changing business demands. With flexibility as the key enabler able to mold project financing to business needs, this research note will briefly profile two such flexible offerings from IBM Global Financing (IGF).

IGF's Open Infrastructure Offering (OIO) is designed to help corporations pay for major infrastructure upgrades and implementations by allowing the purchaser to bundle together the hardware, services, and software funding from numerous vendors under one agreement. IBM assists its customers in helping define the target infrastructure as well as the implementation milestones required to provide value in the necessary time frame. Budgeting, payment, planning, procurement, and asset disposition are all planned for at the outset; however, IBM allows for changes in direction to made during the long-term engagement should business conditions require it. IBM believes that acting as the primary delivery channel through which solutions are provided allows it to keep costs down by leveraging its purchase power and negotiation capabilities, as well as providing customized and flexible offerings tailored to match the needs of evolving environments.

A second IGF offering was launched in coordination with IBM's "The Project Big Green" campaign to help customers cut power and cooling costs out of their enterprises. The packaged offering is designed to enable corporations to replace older equipment with more powerful and energy efficient solutions with less cooling requirements. Old equipment is removed from the data center, wiped to ensure data is properly cleansed, and then disposed of in accordance with legal guidelines. The particularly unique part of the offering is the so-called "green wrapper of financing solutions" IGF provides along with the technology upgrade. During the planning phase, IBM will help customers identify and determine the cost
savings derived from the refresh process and base payments in part on the cost savings derived from the updates. This unique spin on project financing is targeted at the growing infrastructure consolidation and power and cooling initiatives in which virtually all corporations are currently engaged.

Due to its all-encompassing nature, project financing presents both the greatest opportunities and biggest challenges for enterprise cost and improvement savings. IT and financial executives stand to gain significantly from the innovative ways in which funding can be provided to tackle initiatives that would have potentially remained in the backlog due to lack of sufficient funds, but must be careful to ensure that they have full comprehension on all of the elements contained within the project financing endeavor and the manner in which payments are expended. Scrupulous attention must be dedicated to ensure that goals can be met on the needed time table, and that roles and responsibilities for the corporation, lending agent, and vendors are tightly detailed and agreed upon. IT executives should ensure that penalties are provided for delivery failures and that appropriate backups remain in place to prevent costly outages resulting from improper project management or premature removal of old infrastructure components.

Project financing deals can take significantly longer to negotiate due to the myriad of components requiring planning and long implementation periods. Done correctly, IT executives will have far greater abilities to tackle projects deemed unfundable during a given budget cycle. Properly implemented offerings can deliver business transformation value ahead of competitors, and ultimately provide the company with access to new revenue streams and lower costs per application and/or transaction.

**Sale/Leaseback and Used Equipment**

Sale/leaseback and used equipment possibilities are nothing new, but the implications and value offered by them are not always well understood by either IT or business executives. By selling existing hardware to the financing company, which is then leased back to the corporation for the duration of its intended operating life cycle, enterprises can enjoy significant cash infusions for project funding. Hardware ownership is transferred to the lessor, and end-of-life requirements are addressed as part of the leasing package. IT and treasury executives must be careful to ensure that the sale price of the equipment and lease rate provided are advantageous; thus homework on both these fronts is necessary. Corporations should also be aware that this is an opportunity for vendors to engage in gouging if not properly watched. The ability to deliver manageable monthly payments and also provide cash for other investments provides two forms of value worth consideration by enterprise IT and treasury executives.

Used equipment is an area that is both often omitted from enterprise consideration and a bit of a misnomer. While older equipment – which is valuable in scenarios including building disaster recovery facilities with the identical equipment used at the primary location – is part of the used equipment portfolio, corporations should also be aware that current-generation equipment is also available. Frequently termed "certified used equipment" by the major hardware vendors, many original equipment manufacturers (OEMs) stand behind the hardware offered by extending the same hardware warranty coverage as found on new systems. Vendors have set up rigorous recertification efforts that ensure that "as new" quality standards are met with used equipment, and then deliver solutions with the same cables, manuals, and packaging. Pricing on current-generation hardware that is sold as "certified used equipment" can range from three to five percent below standard new pricing. Thus, high levels of quality accompanied with manufacturers' guarantees are available while delivering lower pricing.
**RFG believes** enterprises should work with their preferred lending institutions – especially those attached to the IT vendors – to understand the advantages afforded by creating financing alternatives. IT executives should collaborate with financial teams to understand financial motivations and overcome budgetary limitations by understanding and using the available funding solutions to best meet changing business requirements. Few organizations are best served by only using straight purchasing or financing options; thus, IT executives and financial teams should look to adopt funding strategies that coordinate expenditures with the value realized from the acquired offerings. Creative funding opportunities ideally inextricably marry the successes and failures of the corporation, lending agent, and solution providers, such all parties reap benefits and suffer failures together. The proper interlocking of each party's respective cash flows can best help ensure that stakeholders meet their obligations and are properly focused on delivering enterprise value.

*RFG analyst Adam Braunstein wrote this Research Note. Interested readers should contact RFG Client Services to arrange further discussion or an interview with Mr. Braunstein.*