ROBERT FRANCES GROUP IT AGENDA
Business Advisors to IT Executives

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Best Practices for Creative Financing

RFG believes alternative financing methods that forgo or delay upfront costs can help to reduce capital and operational expenses, and get IT more in line with business cash flow objectives. Most IT executives are unaware of the payment options available from vendors, and do not solicit input from finance teams about financing structures that best fit with cash flow strategies. Vendors should be made to compete aggressively on financing terms, just as they are on price, service level agreements (SLAs), and terms and conditions (Ts & Cs). Additionally, expanding the project to include other hardware, services, and software acquisitions can help the enterprise achieve lower pricing and free vendor services. IT executives should collaborate with the CFO and finance team to determine how to align project financing with money management goals, and work with vendors to structure deals that maximize benefits for both the enterprise and vendor.

Business Imperatives:

- Creative financing models are increasingly available from vendors in response to customer demands and in an effort to make project funding less onerous on corporations. The software-as-a-service (SaaS) model, wherein corporations rent access to either hosted or site-based applications, is of particular interest to enterprises, as it moves what is typically a capital expenditure off of the balance sheet to become an operating expense. Other financing strategies also help match payments to the attainment of project implementation metrics. IT executives should work with finance departments to align financing options with business needs.
- Matching project financing options to business requirements requires detailed knowledge about corporate financial goals and tightly constructed project milestones and success measurements. Since most enterprise acquisitions end up having useful lives that can extend beyond three or four times the contract period, IT executives should ensure that favorable long-term licensing and support options are included in the contract. For lengthy projects requiring protracted testing and professional services, IT executives should select a financing option that motivates services companies to meet quality and deadline requirements while timing funding to coincide with performance metrics.
- Bundling together hardware, services, and software into contracts can help enterprises obtain deeper pricing discounts and financing for third-party solutions required for the project. This is particularly true when enterprises expand the base of solutions they acquire from vendors to include complementary offerings that have sales incentives, and at the closure of a reporting cycle. Vendors may also be able to offer no-cost services, including consolidation, performance, and other studies, to win the business. IT executives should employ timing and bundling strategies to reduce the project costs.

Most hardware, services, and software purchasing deals traditionally call for corporations to pay a significant amount of the fees due upon contract signing or 30 days thereafter. In many cases, these payments come far before the value of the acquired offerings can be realized in the enterprise. Complex projects require implementation, porting, setup, transformation, and thorough testing before projects can go live, all of which incur steep capital and/or operating expenditures that impact the bottom line. Successful projects may be able to meet projected returns; however, the attainment of those returns may not offset costs for months or years. Increasing pressure on IT executives and heightened levels of competition incent vendors to offer more creative financing solutions that allow corporations to render payment more in line with the value derived from the solutions purchased.

A typical hardware or software acquisition situation requires the enterprise to pay for everything up front. While this can be logically explained when purchasing finished goods, many of the elements bundled into contracts are for components that will be delivered over time, and therefore, require no initial investment for the vendor to recoup. For example, a standard software contract includes up-front payment for all

projected enterprise licenses and the first year(s) of maintenance. Many new projects remain in a test phase for a year or more, thereby negating the rationale of paying for end-user licenses and maintenance on those licenses that are not in use during the test period. IT executives should therefore avoid paying for everything in advance, and not pay for contract elements that cannot be used until later phases of the project.

Creative Financing Taxonomies

One model that eliminates advance charges altogether is the "software as a service," or the rental paradigm. In this model, customers pay a flat, fixed charge per month over a specified number of months or years. The SaaS model accounts for approximately 20 percent of the software market today, but is growing in popularity. Microsoft Corp. employs the SaaS model extensively in its software lineup, and corporations are attracted to the built-in maintenance, elimination of high capital expenditures, and predictable pricing.

For vendors, the lengthened payment structure still allows vendors to accumulate the same amount of revenue as an outright purchase over the three-year payment period. The distributed payments come at a cost for enterprises, as the corporations must continue to pay the rental charge for as long as they use the software, and they do not have perpetual ownership of the licenses. Maintenance and software upgrades are included in subscriptions. This can help to defray some of that cost. The annuity structure of the SaaS model is attractive for vendors because of the ongoing sustainability of the relationship over the long term. These types of subscriptions tend to be favored by financial analysts and the stock market.

With outsourcing on the rise – particularly in areas that do not require business-specific knowledge – the SaaS, with its per-user pricing capability, can lend itself to being delivered and managed remotely. Many vendors with subscription models also offer their software online rather than as an enterprise-installed solution, either acting as an application service provider (ASP) or allowing a third-party to manage hosted infrastructure.

The SaaS model fits well for applications that can simply replace legacy software or business processes and be used very quickly or immediately. IT executives will find that applications that must be molded to fit enterprise needs and experience long testing and integration periods are not ideal candidates for the subscription model. This is because payments must still be made before value can be captured. Instead, IT executives would rather compensate software vendors based on the achievement of the metrics related to the relative success or failure of the project being implemented.

Matching Financing Options with Projects

Depending on the project, appropriate payment measurements may tie to income, a percentage of carried assets (as is a common metric in the financial community), revenue, etc. Furthermore, vendors can construct multiple types of payout forms within the contract. Corporations may need to pay something at the contract's inception to help offset vendor costs, but could then select from multiple options. These can include starting payment only after the project is in full production, or paying a lower rate during setup and configuration and then a higher rate once full production is reached. Tying vendor compensation to revenue achievement is also appropriate when hardware, services, and software are bundled together and sold as a package under a single contract.

Two examples of deals between an RFG client and an enterprise software vendor can help illustrate the point. One agreement was for a flat payout per month to the vendor over five years. In the second case, a

second five-year deal was constructed that had incremental payouts. The first two years offered smaller payout rates, and years three through five were attached with larger, balloon payments. In these cases, the subsidiaries both succeeded in getting terms from the vendor that met their cash flow needs. However, the enterprise as a whole might have gotten an even better deal had it selected to bundle all the deals that it had with this vendor, and negotiate terms from a total enterprise volume perspective.

Professional service charges for both fixed-price and time and materials bases can likewise be financed creatively. Although vendors usually levy a surcharge on fixed-price service offerings, corporations have succeeded in pushing that rate down to zero. Moreover, IT executives can construct shared risk/reward scenarios for service financing, wherein vendors are paid incentives for delivering work with the required quality ahead of schedule. On the other hand, poor quality and/or delayed work payments have penalties attached to them. This is an excellent motivator for professional service organizations to adhere to cost, quality, and time constraints.

Another approach to use with professional services firms is to force them to use a standard enterprise skills level taxonomy and rate card rather than their own. This normalizes the skills levels from different firms, and enhances the firm's ability to negotiate better prices. Also, as part of the contract, substitution of skills and personnel should be allowed. However, if a vendor brings in a skilled individual whose level exceeds those agreed to in the contract, the fees charged should not exceed those of the highest level to which the enterprise agreed. In the services business, it is not unusual for swaps to occur and for invoices to include skill levels and rate card fees not in conformance with contract terms.

Additionally, another technique companies should employ is to align the product capabilities to company requirements, not vice versa. Many vendors have products with tremendous feature/function capability. The tendency is to convince companies to pay for the entire product (or product suite) capability, whether it is used or not. Instead, RFG recommends that IT executives insist that vendors only charge for the functional capabilities that the company needs. IT executives have been doing this for years in the mainframe environment. Most companies actually have a mainframe fully configured with all CPUs embedded. Typically, MIPS are only paid for when they are used, and CPUs are simply turned on as they are needed. There is no reason IT executives cannot use this practice with other IT purchases.

IT executives will also find that the more the contract is worth (or closer the vendor is to the end of a fiscal reporting period), the more inclined that vendor will be to offer more compelling financing options. The big hardware vendors, including Hewlett-Packard, Co. (HP), IBM Corp., and Sun Microsystems, Inc., offer financing for many other vendors' products and services as well. IT executives should therefore try to combine acquisitions whenever possible to motivate vendors and exert leverage. The more purchases are bundled within a single contract, the greater the opportunity to create financing models that closely match to enterprise revenue recognition or another model that best suits enterprise motivations. Hence, for example, a purchase of Unix servers from one of the aforementioned vendors along with the associated software stack and professional services can all be bundled into a single deal. This is true even if the hardware came from one of these three, software came from one or more independent software vendors (ISVs), and the services came from a systems integrator.

IT executives should not expect vendors to necessarily offer to construct such deals. In many cases, the local sales person is not familiar with the extent of the vendor's financial offerings. Thus, IT executives should outline the type of arrangements that would best suit the desired cash flow requirements, and push the vendor to come back with a creative offering.

Avoiding Typical Financing Pitfalls

IT executives frequently get in the way of successful financing. For instance, many IT executives do not listen to the financing options proposed by the vendor, and make assumptions about how the corporation wishes to pay for expenditures. Even when non-traditional financing options are entertained, IT executives and procurement personnel may not have the corporate perspective, and often do not have the professional background needed to select or construct the right financing option. Furthermore, strategies for cash management are somewhat fluid within most companies, as CFOs and their teams reevaluate and retool plans on (at least) an annual basis. Thus, building and selecting the right financing model requires input from the finance department, so that asset management, cash preservation, and financial accounting considerations can be properly metered into the process.

Licensing terms can often be complex because of the very nature of enterprise life cycles. Once a product is installed in the enterprise, it becomes increasingly difficult to remove or replace it, as business processes and other applications rely on its presence. In the case of software, its legacy tends to last far past the retirement date considered when the product was purchased – with many corporations often leaving applications in place up to 20 (or more) years. IT executives therefore need to take care to ensure that discounts given at the beginning of the project can be extended to future purchases or renegotiated to provide preferred pricing. Furthermore, the entire organization should be able to take advantage of agreed-upon pricing, such that contracts include loyalty tiering structures that guarantee additional sales either meet or beat the contracted rate. In instances where contraction is required to reduce costs, maintenance terms should allow the corporation to cut costs without penalty, or reinstatement fees, while still providing the proper level of support.

With hardware pricing, IT executives should keep vendor internal incentives in mind, and consider expanding the range of products purchased beyond a single class of products, such as servers. In some cases, vendors are willing to negotiate better deals on a different set of products, such as storage. Structuring a deal that combines both these products can often yield better terms. In fact, increasing the total size of a bid can also improve the enterprise's leverage. As the size of the project rises, vendors also become more willing (and able) to offer added services, gratis or at reduced rates. Because new server and storage products are being acquired in this example, IT executives could request a complimentary server and/or storage consolidation analysis. IT executives could also request a performance study or an analysis of infrastructure life cycle management (ILM) capabilities and hierarchical stores, among others.

For enterprises that have preferred vendor relationships, or in cases where vendors want to have that status, IT executives should pressure vendors to provide pilot equipment and the necessary hardware and/or software to prove the products' capabilities. Thus, IT executives can forgo spending until products are proven and ready to enter the production phase. This puts the risk on the vendor to demonstrate product abilities to meet requirements. Should the pilot prove unsuccessful, the only expenditure the enterprise has made is in employees and time. Conversely, if the enterprise has contractually committed to purchases and the project proves unsuccessful, the corporation would be left paying for unneeded solutions. Some of those solutions may not be able to be repurposed effectively.

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RFG believes enterprises should closely examine their financing requirements, including financial considerations, timetables, and when value can be realized from investments. Rather than paying for everything in advance, IT executives can pay a flat rate over time, or construct a financing model that compensates vendors based on delivery timetables and relevant business metrics. IT executives should employ enterprise motivations and constraints as the basis for vendor financing negotiations. Companies should also encompass multiple hardware, professional services, and software products into a single contract bid, and even include third-party offerings in the financing request. This can make a deal more attractive to vendors, and prompt vendors to work harder to provided deeper discounts and free added services.

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.