



Software and Services Financing

“Software and Services Financing” is one of a series of topical papers prepared by IBM Global Financing to acquaint interested parties with timely subjects related to the financing of information technology.

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Executive Summary

Software and services form the largest and fastest-growing part of the information technology market. Worldwide in 2004, commercial and government entities will spend more than \$697 billion on software and services, accounting for more than 72% of the total information technology market. Over the period 2004 through 2006, spending on software and services is anticipated to grow at an 8% compound annual rate versus a 4% annual rate for information technology hardware.

In terms of financing for software and services, originations are estimated to total \$26 billion in 2004, flat from 2003. Together, software and services account for more than 30% of worldwide information technology financing.

Software and services financing is growing rapidly due to growth in the two underlying business segments. In addition, market dynamics—such as the desire for total solutions and the drive to implement e-business infrastructures—are increasing clients' propensity to finance software and services. Integrated solutions and e-business transformation lend themselves to financing because they can require considerable up-front spending. In addition, financing enables clients to match payments with the realization of business benefits from their software and services initiatives; conserve cash for use in other parts of the business; and simplify financial management of complex projects.

Software and Services Financing

One of today's greatest information technology challenges isn't technological—it's financial. A major challenge confronting decision makers is making wise choices when it comes to paying for the technical assets essential to business operations. The growth of today's overall technology marketplace is being driven by faster product cycles, faster depreciation schedules, e-business implementation and a focus on integration and infrastructure.

Spending on e-business applications is growing rapidly. Among those businesses that have already deployed early generation e-business applications, the priorities are shifting to infrastructure and better integration. Finally, companies realize that technology is required if their businesses are to survive and prosper.

Financing information technology equipment is an accepted way of doing business...but clients are discovering the benefits of financing software and services and, in the process, making the financing of software and services one of the fastest-growing segments of the information technology financing industry.

Market Growth

Software and services are viewed as the keys to business advantage in today's marketplace. As a result, software and services are already the largest segments of the information technology-related market. In 2004, more than \$697 billion is expected to be spent worldwide on information technology and telecom with software and services accounting for more than 72% of the market.

A number of factors are acting as drivers propelling the rapid growth of software and services. One is e-business, which creates demand for consulting, systems integration services, network services, Web hosting, security software, database management and application development tools. A second driver is the shortage in information technology skills, which creates demand for automation and systems management software as well as outsourcing and consulting. Another source of growth is enterprise resource planning (ERP) and other enterprise-wide software deployments, which are aimed at transforming processes within a business in order to enhance competitiveness, reduce costs and boost productivity. Finally, companies seek to rapidly expand their middleware deployments to power their e-business architecture.

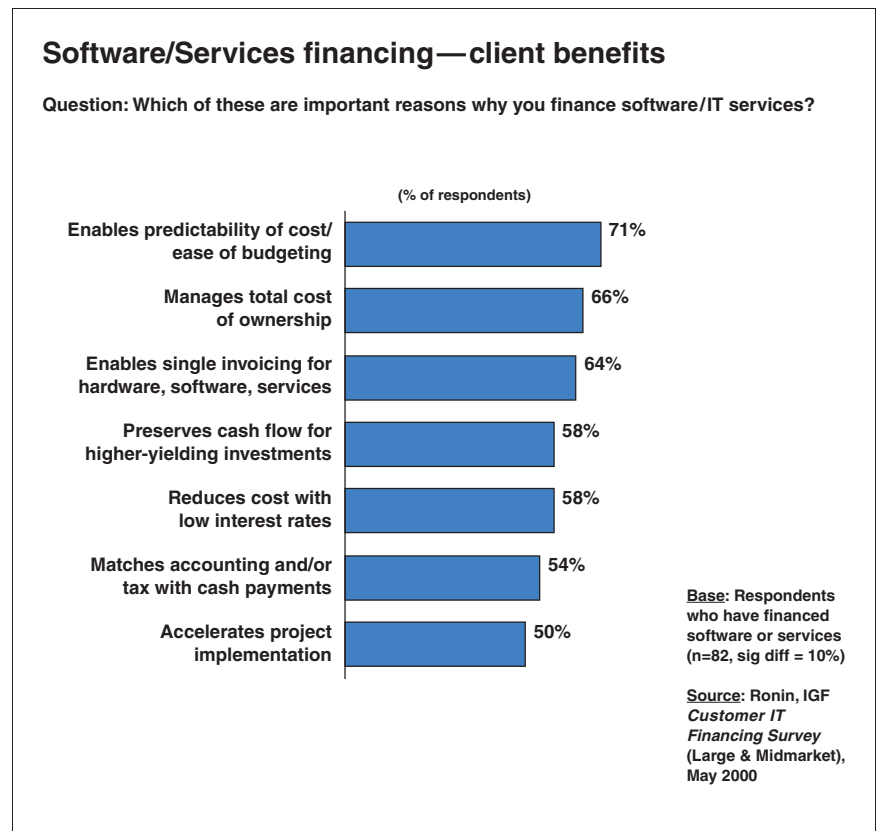
Factors Driving Clients

In terms of financing for software and services, 2004 originations are estimated to total \$26 billion in 2004, flat from 2003. Together, software and services account for more than 30% of worldwide information technology financing.

When considering the factors driving clients to finance software and services spending, there are several that emerge, beginning with the trend away from components and toward total solutions:

1. When hardware, software and services are acquired together, they are more likely to be financed than when acquired separately. About half of all software and services financing is part of a bundled solution.
2. There is the greater demand for large, mission-critical enterprise solutions — ERP, e-business, client relationship management (CRM) and business integration — that tend to entail large front-end expenditures that can overwhelm information technology budgets.
3. There is the increased availability of financing. Traditional hardware financing companies are turning to software and services financing. In addition, banks with an appetite for lending are buying information technology financiers — financing companies have decided they must be prepared to finance software and services if they are to remain competitive.
4. More companies are changing their policies to permit financing of software and services.
5. Clients want to conserve cash for other strategic investments.

There are a number of reasons given for financing software and services according to respondents in a study conducted for IBM Global Financing. Respondents said the main reason for financing was that information technology financing results in predictable and easy budgeting.



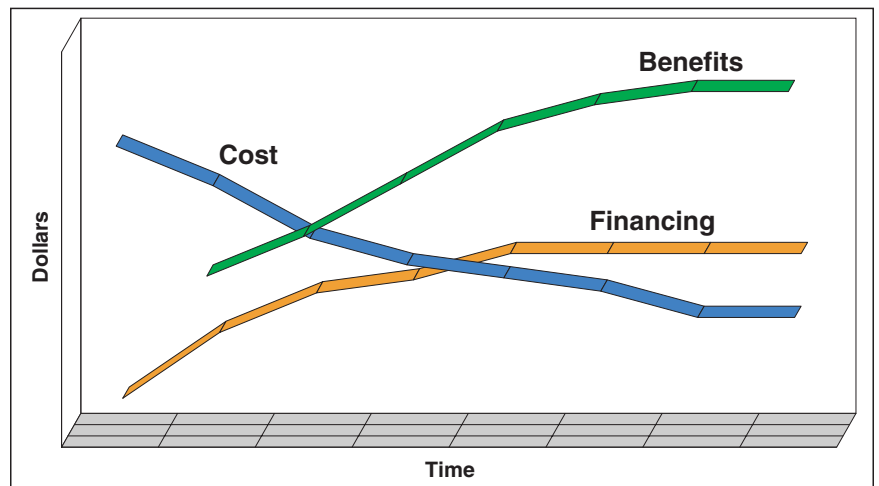
Generally, financing of software and, especially, services is focused on up-front, one-time charges or phased-in charges for multistage projects. Ongoing outsourcing or maintenance charges do not lend themselves to financing (an exception being ongoing charges that are annualized into a single payment).

Software and services financing is generally considered as unsecured financing compared to secured financing for hardware products. Rates for software and services financing reflect the unsecured risk. Typical term for software and services financing is three years. Down payment and other covenants could be required based on a client's credit rating.

When asked about their main reasons for financing software and services, most companies said that it facilitates the predictability of costs and eases budgeting.

Several types of companies offer software and services financing. They include: commercial banks (regional and large money-center banks); commercial financing companies; diversified, multiline financial services companies; and the so-called “captive” financing providers, which are subsidiaries of equipment manufacturers that finance their parent’s products.

When asked about their main reasons for financing software and services, most companies said that it facilitates the predictability of costs and eases budgeting. There are several additional reasons, beginning with the ability of companies to match costs with the realization of benefits, which the following chart demonstrates:



Cost-benefit matching is a major reason for financing software and services implementations. As this chart illustrates, costs are heaviest at the front end, while benefits do not fully accrue until the project is implemented. When the project is financed and structured accordingly, costs and benefits track much more closely.

Organizations that look at the total solution early on in the process and engage a financing partner are more likely to achieve greater long-term economies.

Another major reason for financing software and services is managing the total cost of ownership. An integrated information technology solution will include hardware and software as well as the cost of deploying, managing and servicing it. Organizations that look at the total solution early on in the process and engage a financing partner are more likely to achieve greater long-term economies. Another factor that companies consider is that financing has the ability to accelerate the implementation of large and important projects.

Another facet of this benefit is doing the software or services implementation “the right way”—in other words, not scrimping because of a burdensome one-time payment. Receiving a single invoice for hardware, software and services financing is another benefit. There is a reverse side to this benefit: Clients should make certain that, if they are dealing with four or five different suppliers, they don’t receive four or five separate financing contracts. Additional benefit includes preserving cash for higher-yielding investments or meeting other strategic business needs.

Conclusion

Businesses seeking to finance software and/or services commitments should consider several factors as they evaluate alternative financing providers.

Knowledge of and commitment to the information technology market are important. The more the financing provider knows about the information technology market, the better able it will be to understand client needs and add value when it comes to terms and structure. The provider should come to the table with innovative ideas that will benefit the borrower. Commitment can be measured by longevity and staying power through all market and economic conditions.

As discussed earlier, an ability to finance the total solution is key. Without it, a client may have to deal with individual financing sources for hardware, software and services and end up with multiple payment schedules and far more complexity than is necessary.

The provider should offer flexible payment terms. Most often, payments are structured on a monthly basis. However, industry or seasonal factors may mean that alternative schedules—e.g., quarterly or semiannual—would benefit the borrower, and the financing provider should be open to negotiating payment and other terms to provide the borrower with the greatest possible flexibility.

Software and services form the largest and fastest-growing part of the information technology market. It is critical that companies making large investments in their technologies understand the acquisition options open to them and partner with a financing provider best suited to meet their specific needs.

About IBM Global Financing

As the largest information technology financier in the world, IBM Global Financing offers clients in more than 40 countries leasing and financing solutions for hardware, software and services acquired from IBM and other vendors. With more than \$36 billion in annual financing originations in 2003, IBM Global Financing also provides flexible channel-financing products for inventory, accounts receivable and other working capital requirements. In the United States, IBM Global Financing clients are served by IBM Credit LLC.



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