



## Enabling Business Transformation: Focus on Financing

### Infrastructure Strategies

Rob Schafer

#### FOCAL POINT

This Practice will explore how taking a more holistic approach to financing major IT and transformation projects can drive greater and more rapid realization of business value. The rapid growth and evolution of outsourcing from basic IT infrastructure to business process outsourcing (BPO) and business process transformation (BTO) is driving Global 2000 (G2000) users to re-examine outsourcing's management and financing. Indeed, our research indicates that the complexity, costs, and board-level visibility of large-scale IT projects in general, and BPO/BTO initiatives specifically, are driving a fast-growing need for the flexible, agile, and "holistic financing" of prerequisite infrastructure, software, and services (see Figure 1). Although well-crafted large-project financing can remove near-term budget and logistic roadblocks to such lucrative strategic initiatives, let the buyer beware.

#### CONTEXT

To deliver the highest value to the business, it is no longer sufficient for IT management to merely deliver individual projects on time and within budget. The pure project approach to IT has resulted in disconnected, inefficient silos of technology, information, business processes, and financing. Delivering on the larger business vision will require an approach to IT based on a holistic overall business perspective. To reflect the characteristics of agility, speed, and integration currently needed by all businesses, a disciplined process is required — from project planning to financing to implementation — that focuses on the enterprise as a holistic system of systems. If embraced, we believe this approach can be highly effective in evaluating, managing, and financing the project in its entirety — which in turn promises to minimize its risk and maximize its return.

Such trends have not been lost on the IT services industry. Not satisfied with simply running IT infrastructure for their clients (IT outsourcing), leading service providers are extending their reach to applications and systems (BPO), and are now articulating and launching initiatives to operate and transform client business processes. Where successfully instituted, we believe business transformation outsourcing will fundamentally change the provider/client relationship, but the challenges are significant, and the risks are high for both sides. Whereas the CIO has historically been the IT outsourcing sponsor, we believe the CFO will be the required financial sponsor in the brave new world of BPO and, over time, BTO. The business is increasingly looking for the service provider to be held accountable for the specific benefits (and their timing) of such strategic outsourcing initiatives.

#### BPO/BTO Will Be Facilitated By, If Not Require, a Financing Partnership

Indeed, the CFO's central role and the rising financial visibility of such massive BPO/BTO projects are fueling a growing demand for agile financing — far more than simple "meat and potatoes" packaged financing typical of traditional infrastructure outsourcing (see Figure 2).

Outsourcing business processes (and eventually the transformation of the business) will fundamentally change the relationship between client and service provider, and will inevitably give rise to an important role for the holistic financing of that relationship. Indeed, the equitable distribution of risk and reward can be greatly facilitated through a robust financing structure specifically tailored to BPO/BTO in general and the vagaries of IT specifically. We believe a critical requirement of any financing provider must be that the client retains ultimate

**META Trend: During 2004, infrastructure budgets will free up slightly, but all expenditures must have strong business justification, forcing closer alignment of infrastructure planners and business units. Infrastructure decisions will become increasingly centralized. Communications budgets will adjust slightly upward, though carrier pricing will further decline. Through 2005, spending will increase in security infrastructure and operations, storage, database administration, virtual private networks (VPNs), convergence, and high-availability networking.**

control over the timing and amount of funds disbursed. Indeed, as detailed in the case study to follow, the client should require delineated checkpoints throughout the term of the service provider engagement, and the client may change service providers with no penalty at any point.

### Figure 1 — Project Financing: A More Holistic Approach

IT financing has traditionally been almost exclusively associated with basic hardware assets that have some market value and upon which financiers hold a collateral claim. The emerging use of project financing greatly expands this limited view to include such “softer” assets as software (both internally and vendor developed) and internal and external resources and services. ITOs are becoming increasingly sensitive to the fact that, without incorporating such critical elements of larger and more complex IT projects into a more holistic financing purview, the project’s expected ROI, timeline, and ultimate business transformation can be put at serious risk. We are not referring here to just another source of bank funding — the world is arguably awash in conventional sources of liquidity — but rather a financial partner with the resources, experience, and IT/business acumen to facilitate such robust project financing. Indeed, appropriate holistic financing can provide the financial link/bridge between the higher risk of large, complex extended-term projects (e.g., BPO/BTO) and their promise of dramatically higher rewards.

Source: META Group

### Figure 2 — Why Should We Finance Large BPO/BTO Projects?

Recent user surveys indicate the primary drivers for the growing trend toward a software and services financing center around facilitating business transformation and agility via visibly matching an initiative’s projected costs to business benefits. Specifically, the primary drivers include:

- Accelerated time-to-business value
- Risk/reward balance to remove the often artificial tactical budget bias against potentially lucrative long-term projects by smoothing near-term cash flows to match long-term ROI
- Predictability for more accurate, dependable cost projections and timing can yield better, less-risky decisions
- Centralizing financing of all critical project elements to yield more realistic near- and long-term visibility of entire enterprisewide impact and costs
- Simplicity in replacing multiple disparate management and funding sources with a “one throat to choke” approach can further minimize risk
- More even, affordable cash flow encourages quality from Day 1
- Preserving near-term capital for higher-yield investments
- Matching the investment’s accounting/tax treatment with payment flow
- Potential off-balance-sheet financing

Source: META Group

### Harvesting “High Fruit” Project Investments

Although it is clearly incumbent on enterprise management to invest where expected returns exceed a certain “hurdle rate,” our research indicates that the ROI potential of large, highly lucrative projects is too often lost due to their complexity and the consequent uncertainty of forecast costs and benefits. Because traditional investment analysis has been relatively straightforward and empirical, easy “low fruit” investments (e.g., those with a comparatively simple, clean ROI) have largely been harvested. What remains for many large G2000 organizations are more complex, longer-term, higher-risk, large-scale projects that also carry significant promise of high returns. These typically involve major upfront capital investments in hardware and software infrastructure and both internal and external services (e.g., BPO/BTO). Often, they come with two conflicting characteristics: the promise of significant ROI (20%+ returns are not uncommon), coupled with an extended time delay before rich-anticipated benefits begin to accrue (the ROI time horizon can easily stretch to more than five years for a complex enterprisewide initiative).

Although it is becoming clear that such large-scale projects are delivering business agility, differentiation, and consequent competitive advantage, we are also seeing ITOs wrestle with the quantification of the incremental business value of that newfound agility/differentiation/advantage. Specifically, outsourcing's rapid evolution to business process outsourcing and business transformation outsourcing is raising both its visibility and risk and is driving a consequent need for holistic predictable financing and management.

### Project Financing Defined

In traditional corporate finance, it is the balance sheet and the total business and financial resources of the borrower that are ultimately liable for the loan's repayment. However, true project financing can shift repayment responsibility from the borrower's resources to the future cash flows of the project being funded (the project's assets, rights, and interests are typically held as collateral).

The International Project Finance Association (IPFA) defines project finance as:

*"The financing of long-term infrastructure, industrial projects, and public services based upon a non-recourse or limited recourse financial structure where project debt and equity used to finance the project are paid back from the cash flow generated by the project."*

International Advisory and Finance further refines project financing's definition as:

*"An option granted by the financier exercisable when an entity (i.e., project) demonstrates that it can generate cash flows in accordance with long-term cash flow forecasts. Upon exercise of the option, the balance sheet of the entity's parent(s) or sponsor company(s) balance sheet is no longer available for debt service. The assets, rights, and interests of the development are usually structured into a special-purpose project vehicle and are legally secured to the financiers as collateral."*

This shift in liability from the project's sponsor to its (maturing) cash flow can be most attractive when the sponsor requires that some (or all) of its financial risks and liabilities be offloaded to the lending institution. We believe such non-recourse project funding will become increasingly appealing as large business process and transformation projects grow rapidly in cost, complexity, strategic importance/visibility, and enterprise scope (e.g., from standard IT infrastructure to pervasive business transformation).

### Sweating the Details

Fundamentally, the financing of large business process projects is a straightforward, unsecured "money over money" term-debt transaction, with financing rates typically higher than in standard, secured hardware transactions (unsecured financing's higher risk drives higher rates). Users must be cautious when assigning value to out-year (e.g., more than three to five years) costs and benefits, as the risk of inaccuracy rises exponentially with time.

Large-project financing generally applies to the considerable upfront procurement and one-time phase charges of large multistage projects such as BPO/BTO (see EDCS Delta 1064). As continuing monthly charges (e.g., for software and hardware maintenance, travel expenses) are already spread over the project term, they are typically excluded from such deals. Therefore, large-project financing is often used to "prime" the economic pump (i.e., bridge the significant initial outlays to the beginning of robust benefit accrual). The term for such large transactions is typically three years, though four- and five-year financing is not uncommon with an extended business case horizon (e.g., 10 years, as in the case study to follow). Although benefits may continue indefinitely, such intermediate terms of four to five years, including a step structure, may best match the user's business requirements.

Payment terms and conditions can be — and will often need to be — quite flexible (depending on the financing provider), and are determined by such factors as down payment, credit rating, financing provider's IT experience, and appetite. Although large-project financing is usually capitalized on the balance sheet, some portions of such transactions (e.g., hardware) can be classified as an operating lease for off-balance-sheet treatment (users must check with their own accounting/financial counsel for proper accounting treatment of specific financial transactions).

### User Challenge: Finding the Right Financier

The underlying financing objective here is to mitigate the risk and uncertainty of large, complex projects (e.g., BPO/BTO) by matching financing flexibility to business requirements. Therefore, this class of financing is far more than a standard bank loan — and getting it right will inevitably play a critical role in the project's ultimate fate (see Figure 3). The question is less how deep the funding source's pockets/resources are (an increasing commodity), and more what the funding source can enable in terms of the project and its business benefit/transformation.

Most financing organizations (e.g., commercial banks; financing and financial services institutions; captive lessors of hardware, software, and services providers) can provide some form of large-project financing. However, a wide range of motivation (and concomitant ability) exists among such a disparate set of financing providers. Although vendor-captive lessors are most familiar with the vagaries of IT leasing in general, and software and services financing specifically, they typically lack the financial resources to provide total-solution financing, often subcontracting financing to a third party. (IBM's Global Financing [IGF] subsidiary is the exception; with financing origination of more than \$40 billion, it has the resources and motivation to remain a major aggressive player in this market.)

Although most major service providers (e.g., EDS, CSC, the non-tax/audit side of major accounting firms) also offer financing, it is typically limited to the services segment of the project and can have relatively inflexible terms and conditions. The advantage of financial services companies (e.g., GE Capital) can be their significant resources ("deep pockets"), aggressive rates, and initial negotiating flexibility. However, users are cautioned that they are fundamentally generic financing organizations with limited IT-specific expertise. Finally, commercial banks' conservative, non-IT, generic lending market does not typically yield aggressive rates, terms, or conditions, and are usually the least-attractive financing alternative.

### Figure 3 — Getting the Financing Right

Users looking to minimize large-project risk while maximizing return should evaluate external financing as a strategic alternative. Here, we list several characteristics that users will want to consider as best practices in large-project financing:

- Investment repayment schedule timed to match forecast benefits
- Expenditures sized to match the timing of forecast benefits (rolling funding)
- Financing commitment to the project's entire scope and term (e.g., capital requirements, timing of cash flows)
- Project timeline acceleration to drive quicker ROI realization
- A financier with adequate resources, flexibility, breadth, and IT-specific expertise
- Competitively priced financing to minimize its incremental costs to the project
- Interest-rate options (e.g., guaranteed fixed-term rate for the project's duration to minimize risk and uncertainty, or a less costly rate that floats until the funding date)
- Contract terms and conditions tailored to a large project's specific asset and cost elements
- Centralized, focused accountability for the entire project, including financing

Source: META Group

### Financing a Case Study: Large International Financial Services Company

An interesting and even counterintuitive example of such holistic financing of a large, complex, extended-term IT/business project is that of a large international financial services institution that plays a major role in clearing a significant portion of the world's currency transactions through its global real-time settlement system. At first, it may appear odd that such a sophisticated financial services firm should look outside its own robust resources for financing expertise and capital (the basic "knitting" of any world-class financial institution). Indeed, it is precisely because of the unique financing characteristics of the IT and business challenges this institution faced that its management was reluctant to take on the project's financial risks (its 10-year duration and fixed-term interest rate requirements alone made it unacceptable to most traditional sources of financing).

The specific project entailed the outsourced design, build, and operation of the complex settlement system itself — a €240+ million project requiring a long-term (10-year) financing commitment combined with flexibility throughout this extended term (cash flow challenges demanded both financial flexibility and long-term costing predictability). To minimize the project's significant potential risks and to better gauge its costs and eventual ROI, the company's management required fixed costs that included future funding as well.

The solution decided on was supplied by IBM Global Financing and provided a fixed-term interest rate to lock in a predictable cost of financing from the outset (IGF's rate hedging was figured into the fixed rate and was transparent to the financial services company). To further minimize the project's risk, protect its quality, and ensure it remained on time and budget, the company insisted on retaining control over payments. In addition to the standard loan account, a separate trust account was set up. Payments to the service provider were held in escrow and released only when specific milestone criteria were met, as strictly defined by the financial services company. Moreover, the company was able to insert several early termination checkpoints in the final contract, which gave it the flexibility to change service providers without penalty. Typical of many such large outsourced service contracts, the company's management was also nervous and uncertain of exactly how much financing it required and for how long. It further negotiated for the no-penalty early repayment/retirement (within the first year) of up to €20 million of the debt, which further minimized the deal's risk and added to its flexibility by potentially reducing overall interest costs.

Again, this type of intimate involvement in project oversight can be critical to the viability of a large business transformation project, and yet is relatively rare to find from traditional funding sources (e.g., commercial lenders, banks).

The result of such stringently defined yet flexible financing meant that this financial institution had no long-term dependence on either the service provider or the financier — each had to continually earn the business throughout the committed term. Moreover, the timing of the project's ROI was accelerated. When the design and deployment of the (close to) real-time settlement system had first been proposed, the project's scope, scale, and cost drove its time-to-business value out more than five years. The financing package negotiated/tailored for this unique project spread significant startup costs over an extended 10-year life, making the project itself viable, and accelerating its time-to-business value to within three years of inception.

### **Bottom Line**

**Effective management and financing of major IT project initiatives is no longer an intellectual exercise, but a business imperative. The rapid growth of BPO (and eventually BTO) within G2000 companies will increasingly focus board-level scrutiny on the underlying, long-term economics of such fundamental strategic plays. Getting the financing right will be a critical success factor.**

***Business Impact: A closer focus on the financing of large IT and transformation projects can enable the business to make better initial "go/no go" decisions, while lowering the viable project's long-term risk and delivering a more rapid ROI.***