

# Strategic Advisory

## Factoring risk into lease versus buy decisions

Leasing IT assets has a history as long as that of information technology itself, and this history reveals innovations in how leasing has been used. At first, due to the investment intensity required for early computers, leasing was used only as a financial vehicle. It was essentially a way to pay for productive assets over time. As the relative amount of IT used by a firm increased (measured as a percent of all capital equipment), leasing began to be used as a way to keep assets/debt off the balance sheet (through operating leases).

A more recent innovation in usage practice was developed in the PC/networking era. IT investment shifted away from large systems only (eg mainframes and enterprise class servers) and began to include distributed assets (eg PCs) as a significant portion of the IT budget. These distributed assets were characterized by:

- low cost
- shorter life spans
- high unit counts.

Even though assets were less expensive on a per-unit cost basis, they quickly became essential to modern business productivity. Leasing distributed assets became a way to maintain technological flexibility and became the standard vehicle for managing technology refresh cycles. Various types of leases created specifically for the challenges of distributed assets were developed, with features such as 'serial number substitution' and 'partial returns' (eg Macquarie's Flex Lease offering) geared to the real world of small, geographically dispersed units.

Leasing benefits for smaller/shorter-life assets became focused on flexibility, while benefits for larger/longer-life assets remained centered around finance/costs (see Figure 1).

**Leasing: flexibility vs. cost**

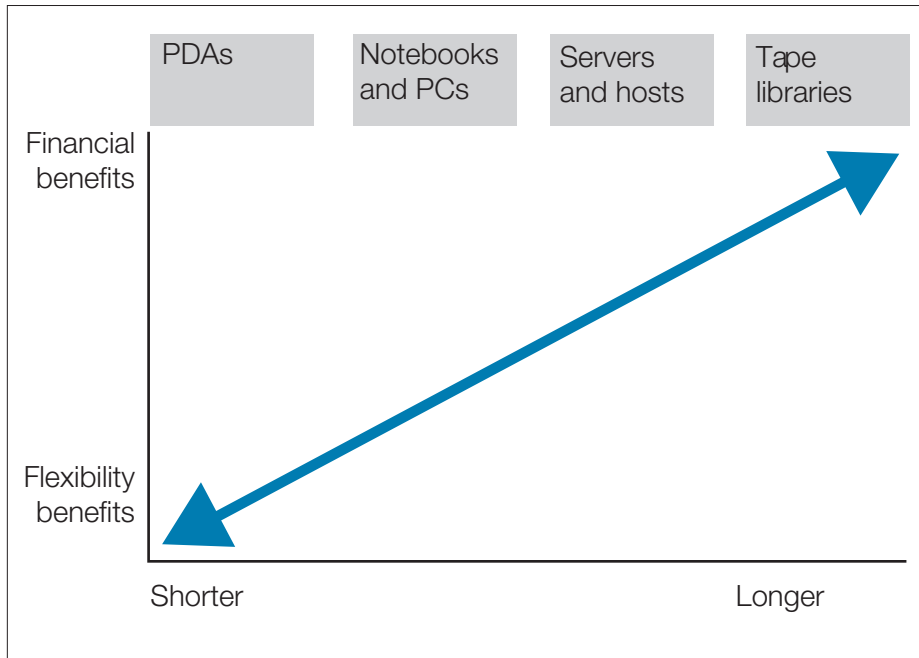


Fig.1

The newest innovation was developed out of this flexibility feature and concerns about using leasing for managing various forms of risk. In most of these cases, the issue is on risk management (loss containment under unfavorable developments). In other cases, the issue is on cost avoidance or business disruption costs.

Three specific vectors of risk are targeted:

- technology
- business
- usage pattern.

Most of these risks involve the possible scenario of having to abandon a technology footprint or of having to bear higher downstream costs.

**Technology risks**

**Suitability risk**

This risk can be articulated with the question: ‘What is the probability that the technology will not meet our specific business need?’

Although it does not occur too often, there is some probability that even the most carefully designed technical solution will simply not work for us. Our understanding of the business requirements, technical capabilities or operational realities are flawed just enough to render the implementation infeasible and has to be abandoned mid-stream. In such a case, equipment that cannot be used elsewhere in the business must be replaced with a solution that will

work. The results can be financially disastrous, if we have no way to recover some of the investment in the first batch of equipment. If we have to ‘eat the whole thing’, then even early-termination fees on leases will result in lower loss than that incurred in a purchase scenario. Accordingly, leasing of such business critical equipment is being used to manage this risk, and lease structures can be negotiated to allow favorable asset transfer/acquisition later, should the implementation end up successful.

**Ecosystem risk**

This risk can be articulated with the question: ‘What is the probability that this technology will not engender adequate after-markets and inexpensive labor pools?’

We are generally dependent on market forces (from large installed bases) to create competitive cost pressures, large labor pools at reasonable prices, vendor alternatives, and a stream of upgrades, add-ons, plug-ins, and peripherals to extend the range and reach of feature sets of any technology we invest in. This factor includes TCO-type costs associated with increasing maintenance expense, repairs, downtime due to failure rates, spare parts availability/pricing, service contract increases, dwindling skill sets, and other legacy-support issues.

If the technology industry goes in a different direction than our selection, or develops alternative standards which become widely popular, we may find ourselves in the unenviable position of having to negotiate service, support, and upgrades with a smaller set of suppliers than are available for the competing technology which we didn’t buy. In such a scenario, at some point it becomes infeasible to stay with that technology choice.

**Product lifecycle risk**

This risk can be articulated with the question: ‘What is the probability that important new technology options will emerge which will not run on our technology?’

This relates to how fast the technology is changing and in what direction the industry is going. This is the basic issue of platform currency, relative to technology industry offerings, and has to do with the ability to exploit current and future market products on top of the technology platform in question. Platform changes generally are linear in nature, but every so often non-linear changes occur: processors go multi-core, addressing mechanisms become 64-bit, and bus architectures radically change. The technology industry as a whole loves platform changes, for this allows the creation of the ‘next generation’ of capability (for sale, obviously), which only runs on the new platform. New features, higher performance, increased manageability, more consistent availability, and sometimes greater cost economies accompany platform changes.

**Industry risk**

This risk can be articulated with the question: ‘What is the probability that my technology vendor will fail at business or be acquired by another firm, with lowered service levels?’

This is a familiar risk and is not unique to IT (for example, supplier risk). One wrinkle in this sector is the propensity for a firm to buy a competitor just to get their rival product off the market. Too often good/better products are discontinued when the vendor is bought by a competitor. This can generate support challenges at the same level as business failure on the part of the original vendor. In fiercely competitive technology sectors, this is a very real risk.

**Business risks**

**Internal project risk**

This risk can be articulated with the questions: ‘What is the probability that the business initiative will be abandoned due to performance or organizational issues?’ and ‘What is the probability that the business initiative will be abandoned due to changes in strategy?’

In this scenario, the technology works well, but the operating unit fails for one reason or another. The project may be abandoned for any number of internal reasons: low-performance, re-orgs, new leadership, change in market strategy, new technology options, etc. In all cases, we are faced with what to do with the (now) unused assets. Again, we are at the ‘return-or-eat’ decision (assuming we can find no better home for them).

**External project risk**

This risk can be articulated with the question: ‘What is the probability that the business or legal environment will force abandonment of a business initiative?’

This is a far too frequent situation for modern businesses—everything was going well, but the environment changed in such a way as to render the project unattractive (or even, prohibitive). Again, we are faced with what to do with the asset and those costs.

**Opportunity cost risk**

This risk can be articulated with the question: ‘What is the probability that we will need our cash or favorable debt for strategic opportunities?’

Healthy companies have many investment alternatives competing for their cash and favorable debt, and each should be evaluated on the basis of expected rate of return. The fundamental financial task has always been to acquire funds at the lowest cost of capital and invest them in projects with highest return on assets/equity. This typically means that cash and favorable debt must be used to procure appreciating assets, in preference to depreciating assets. This principle is known as the ‘strategic use of capital and is seen in Figure 2.

**Strategic use of capital**

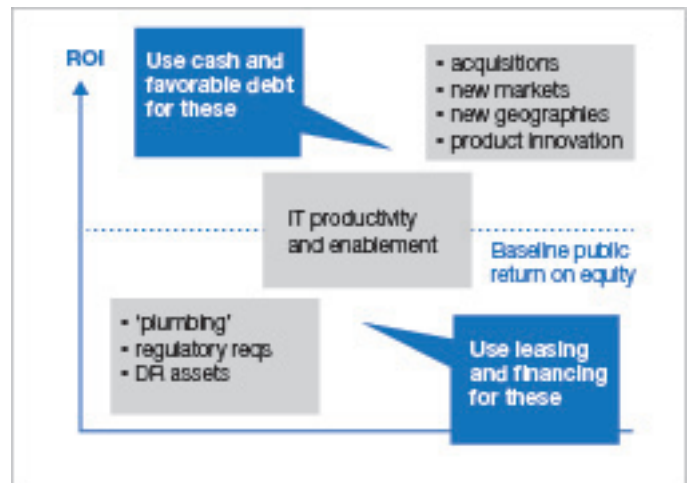


Fig.2

Committing cash to ‘plumbing-level’ ROI projects reduces flexibility for strategic business moves.

## Usage pattern risks

### 'Goodness of fit' risk

This risk can be articulated with the questions: 'What is the probability that the technology we select as our standard will not closely match the actual needs of a specific user group?' and 'What is the probability that the technology we select as our standard will force our user populations to a 'lowest common denominator' feature usage?'

This risk is inherent in all standardization initiatives and is nothing new. However, in the technology space, we have known for quite some time that user populations can vary widely in knowledge, attitudes toward technology, learning/interests, and overall support for our initiatives. The needs of a software engineer at a bank, creating financial platform software are very different from an order entry clerk at a parts distributor. Typically, it is important to hit a happy medium between 'one size fits all' and 'build to order.' This can be accomplished by segmenting the user populations and creating separate funding profiles for each. The goal is to allow technology footprint to change as needed in pockets of strategically important users.

An extension of the principle can also be made from user populations to branch facilities. The needs of an urban office in a Tier 1 metro area can be quite different from one serving a spacious rural geography in the midwest. Technology decisions—and the funding approaches that support them—should recognize the possible risk associated with forcing a single technology template on such diverse operating requirements.

### Utility risk - distributed assets

This risk can be articulated with the question: 'What is the probability that the technology we select will not achieve desired utility rates?'

Distributed IT assets are notorious for under utilization and this fact has created hundreds of centralization and consolidation initiatives over the past 2-3 years. It is much easier to get utility rates up in shared resource environments, but such moves only address cost avoidance (financial) issues, and not cost recovery. We typically cannot sell decommissioned smaller servers. This is another case of 'return-or-eat'. If we are currently still installing large quantities of distributed servers as a company, for example, we might be wise to analyze whether all of them should be bought or some leased. Leasing a subset of these would at least soften the blow should a centralization/consolidation project become important.

## Conclusion

Not all of these risks are pertinent in all cases, but all should be at least considered in evaluating each investment in technology.

In situations where the investment has low risk—according to these vectors—then standard lease versus buy models and approaches can be used. However, when one or more of these risk factors are significant (eg in new markets, products or geographies), the financial executive should carefully consider leasing—simply as a way to provide an 'escape route', created up-front in favorable conditions, well before a situation becomes critical.

As always, we at Macquarie Equipment Finance stand ready to work with you to design financial vehicles tailored to your IT investments, and crafted to achieve the best possible mix of benefits from a financial, flexibility and risk management perspective.

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