



Comments on a financial structure for office build-out and IT equipment

ABC—Thanks for the opportunity to comment on your work for XYZ Real Estate development company, and especially for your commitment to our clients' success.

Looking over the scenario described by the client documents (under NDA) and described by you, I can make a couple of observations and suggestions for their consideration:

- ❑ The plans and calculations (in the document and spreadsheet) dealing with **facility and furniture** costs seems to be fairly straightforward. The cash flow projections look reasonable to me, and lease financing looks like a smart move—in order to keep other capital and favorable debt for more strategic uses.
- ❑ I did not see **any technology assets** in the plans, but I would highly recommend that they evaluate these equipment costs up-front, **under two categories**: distributed assets (e.g., PCs and LCD's) and shared infrastructure assets (e.g. large printers, network gear, servers). Since IT assets have a much different life cycle profile than do furniture and fixtures, criteria for deciding on the use of lease financing are correspondingly much different (i.e. not simply cash-flow models).
- ❑ In the case of distributed assets (e.g. PCs , laptops, small printers, and monitors), these are **generally leased for other reasons than for simple financing**. Unlike commercial real estate, IT assets are typically financed for process management and obsolescence-related cost avoidance.
- ❑ According to a survey by *Global Insight* in 2004, the top five reasons for leasing PCs, for example, would not appear in most standard Lease-versus-Buy financial models:

Top Five Reasons for Leasing PCs*	
Discipline imposed on maintenance and replacement	cited by 65%
Protection against obsolescence	cited by 54%
Off-balance-sheet accounting	cited by 53%
Convenience	cited by 51%
Efficient use of tax incentives	cited by 36%

*Based on Global Insight survey findings reported in "(Don't) Look Deep into My Lease," *CFO Magazine*, 07/01/2006).

Leasing as a way to be able to finance equipment is important to many firms, but most IT equipment leases (at least for distributed assets) are not the result of simple 'cost of money' comparisons—they are the result of *strategic* and *operational* management needs. Generally, this means that lease term on this class of assets runs between 2 and 3 years.

- ❑ Distributed, shorter-term leasing is **about flexibility, process discipline, and life cycle cost avoidance**. Most of these variables are difficult to incorporate in classic 'lease versus buy' models, although they are all known to be very, very important. Modern lease structures for 'small' IT assets like these involve significant flexibility features, often unknown in non-IT contexts: serial number substitution, partial returns, shared back-end economic recovery, ease of lease modification, favorable short-term structures, documentation of data destruction.
- ❑ The **second class of IT assets** is that of shared infrastructure equipment, such as large printers, network equipment, and shared servers. Even though these technologies change *at least as rapidly as* the 'smaller' systems, they can often be held a bit longer before refresh. Terms of 3-4 years are optimal in these cases (especially considering the cost of extended warranties and service), but a few of the more advanced units (e.g. high-end network switches) can be stretched into the 4-5 year range—if the company gets a unit with enough 'extra headroom' for the inevitable growth in demand upon that resource.
- ❑ This means that some of these larger assets might be incorporated into the lease structures for the facility and furniture. It might be useful to your client to look at both options: two separate leases or one consolidated lease (but excluding the smaller, distributed assets—these should be on a separate structure to facilitate flexibility and modifications).
- ❑ For both classes of IT assets, another financial factor should be considered: **risk**. In every initiative **there is the risk that the initiative might be abandoned** or that the equipment acquired for the initiative might not actually perform its intended purpose. These 'abandoned equipment' scenarios are expensive if the equipment was fully paid for via capital expense, but less so if the equipment can be returned to a lessor for a much smaller fee (if any). This is for the situation in which some asset has to be retired early, due to a change in business requirements or in economic situation.
- ❑ Related to this is the **risk of 'forced replacement'**. In addition to 'eating' the book value of an asset which had to be retired early, we often have to replace the unit with a new/different one. This often occurs in a 'forced refresh' scenario: where systems must be *replaced* early, due to change in ISV support policies, forced compliance upgrades, or sudden architecture changes. The cost savings can be modeled on the basis of *percentage of assets which must be replaced earlier* than planned. A sample model can be constructed showing the break-even point between purchase and lease. Although leasing is generally less expensive from a cash-out-the-door standpoint anyway, *even in cases* where there is a small premium over purchase costs, a forced refresh of as little as 2.5% of units can justify any such premium.

That's all that came to mind in studying the plans. I will be happy to discuss any of these points with them on a concall. Let me know how I can support you, as you support them--Glenn Miller, VP Strategic Advisory Services (Sept 2011)