Stretching IT Budget Dollars Part II:
“Effort” Spells Good Acquisition Decisions

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In the last issue of TrendSetter, I indicated that I would continue with the ideas that pertain to best utilization of IT dollars that serve business initiatives. Negotiating acquisition costs with vendors is one thing; however, there are more questions that often need answering as it relates to the acquisition funding options available to companies.

Acquisition Funding Options
To lease or not to lease is often the question with companies contemplating IT equipment acquisition options. Many articles and books have been written on the lease versus purchase subject. It is amazing to see so many sophisticated companies have a “purchase only policy,” and yet, other equally capable companies have a “lease only policy” as it relates to equipment acquisition practices. Are we all on the same planet?

Why are there so many different views on the subject? It probably stems from the unique experiences in history individual companies can recall that lead to the stance they maintain today. I am often asked if I am a proponent of leasing or purchasing and my answer is… “Neither.” Let me explain.

Many factors come into play in analyzing a particular acquisition event. However, it really is not all that complicated if people become familiar with the factors and if the people involved are reflective of both ends of the corporate spectrum: finance and information technology. In some cases, information technology people have little say in acquisition methodology. It is in the best interest of companies to adopt a policy whereby both finance and IT play a role in the acquisition methodology decision. To leave either out may not yield the best decision possible.

Factors in Decision-Making
The factors that come into play include cost of money, future (residual) value of equipment, the manufacturer’s future plans for the given product line, expected useful life of the equipment, and a host of financial considerations that pertain to how the given company needs to account for acquisitions at a particular point in time. This latter point most often boils down to whether the company wants or needs to expense or capitalize the transaction. Capitalizing is associated with purchasing in one form or another whereby the asset and the liability are displayed on the balance sheet. Expensing involves leasing (or renting) where the monthly payments are expensed as a monthly cost via the P&L with no illustration on the balance sheet. In order to have off balance sheet financing (thus avoid the need to capture the liability or declare the liability) there are several qualifying “tests” applied to given structures to determine whether what a leasing company is proposing is reflective of a “true lease” or not. The most significant test is that the present value of the payment stream cannot exceed 89.9% of the implicit sale price of the equipment.

Often, a finance group might decide to purchase due to a "cost of money" argument. I see this happen with banks very often. However, there are a variety of factors that come into play that can offset a lower cost of money often declared by finance people. One significant factor is the residual position a given leasing company (lessor) is willing to take on the equipment out at this time. As an example, if a lessor was to take a residual position of particularly higher value, this action might more than offset a cost of money advantage the given company has over the base finance rate the lessor is offering.

Blending IT and Financial Needs
Input of information technology management is growing more important in later times. Key information elements IT managers should provide to their finance groups include: what are the future expansion plans of the equipment and can it be cost effectively upgraded? As well as, does the model series’ expected useful life support a purchase and a longer term lock in to the equipment via a purchase?

Questions both IT managers and finance people should collectively ask include:

- Is the residual position the lessor taking higher or lower that the anticipated value at the end of the initial lease term?
- Does the lessor allow for mid term coterminous equipment upgrades without penalty?

- Does the lessor allow for restructuring lease terms in concert with a significant future upgrade to the baseline equipment being proposed during the current period?

In cases where the future residual position a lessor takes is lower and the expected useful life of equipment is longer, purchasing is most often the best decision. In cases where future residual position a lessor takes is higher and expected useful life is shorter, leasing can often be the best choice. There is more involved though than this simplistic view.

The biggest variable is lessor behavior, policies, practices, and specific agreement terms and conditions. Lease calculations, as it relates to payment, term, and residual position, must tie out with financial integrity. Also, the lessee must make sure the lessor has a rich offering of optional features that supports upgrades, trade-ins, and term restructuring with little or no penalty.

Often missed by most companies is a lack of understanding of the given product lines of technical nature as it relates to how upgrades will be handled (with or without serial number preservation and with or without removing significant elements of the machines). Also, what the follow on models will provide in price performance compared to what is being purchased or leased today is a big factor. Decisions to purchase may box an organization into a corner deeper and darker than obvious at first analysis. Typically, IT people want the latest and greatest technology every few years and finance people want to stretch the life of equipment. This sets up a typical polarization of practices and attitudes, possibly leading to incomplete analysis and reviews of all options.

“White Hat” Sessions

What is a pragmatic way companies can best make acquisition decisions? My suggestion is to first develop an olive branch committee made up of both finance and IT people. This committee will first engage in white hat sessions, in which no one is allowed to criticize ideas or information brought forth. The key is to promote the free flow of information and ideas. For example, the finance group speaks to what has been mandated or is present relative to budgets, cost of money, and other events that might influence how acquisitions might need to be captured. Meanwhile, the IT group sets forth facts relative to the growth capacity of the equipment, the manufacturer’s future follow-ons to the product, as well as the business expansion forecasts which the IT group will need to support over the next several years. The mission is to come up with a blend of finance, IT, and business unit requirements.

The blended list of requirements must then be set forth to a lessor as a list of requests of which to manage. The greater flexibility from the lessor, a more aggressive residual position, and an “honest” relationship between term, payment, and finance/funding amount will often allow leasing to offset the cost of money arguments set forth by proponents of purchasing. On the other hand, if it is determined that there is a need to swap platforms in 36 months, and the anticipated value of the equipment will be greater than what a lessor is going to take, the tendency for the best course of decision will be to purchase when the cost of money for the company is lower than industry averages. Certainly, issues of planning for acquiring companies or shareholder return on investment can impact equipment acquisition methodologies pursued by companies as it relates to whether items are expensed or capitalized, but these issues can be reviewed in the white hat session of the olive branch committee.

The key to making the best acquisition decisions is team play and bringing the various business units together, challenging leasing companies and financial institutions to tailor to needs, and to become familiar with the manufacturer’s product plans out into the future. In doing so, you will get the biggest bang for your dollar. “Effort” spells quality acquisition decisions.

Datatrend's TrendSetter eNewsletter
January 15, 2003