



How to Structure More Effective IT Equipment Leases:

*Strategies that Provide a Hedge against
Technology Obsolescence*

An IT Financial Solutions White Paper

whitepaper

Introduction: The IT Equipment Leasing Record

Today, as never before, enterprises are leveraging IT equipment leasing as a hedge against technology obsolescence and changing business needs.

In a recent report released by IDC, the market research firm predicted that the worldwide IT leasing market, encompassing leasing or financing of IT equipment, software, and IT-related services, will hit \$100 billion in 2010 -- up from \$70 billion in 2006. The growth during that period will calculate out to an annual growth rate (CAGR) of more than 8% per year .

Given the rapid rate of technology obsolescence, IT equipment leasing can better position an organization to react to changing business needs.

Despite these statistics, many enterprises still choose to pay cash. The reason has a

lot to do with common misconceptions about leasing and/or prior unpleasant experiences with equipment leases.

But a well known technology statistic is causing many companies to reconsider their positions on equipment leasing. Known as Moore's Law, it states that every 24 months, equipment performance doubles; and the price for that technology is decreased by approximately half its previous cost. As faster technology continues to be developed, and the price for increased levels of performance continues to fall, businesses must now ask themselves whether they should hold onto outdated assets, and if their decision to pay cash for the equipment is a good enough reason to do so.

Given the rapid rate of technology obsolescence, it no longer makes sound business sense to keep IT equipment longer than a three to four year period, which means leasing may now make more sense than purchasing.

However, financial executives who are considering IT equipment leasing, need to approach leasing with acute preparedness. Given the dynamics of the rapidly changing business and technology marketplace, enterprise businesses need to build significant flexibility into their equipment leasing programs to ensure that they can replace outdated equipment when business circumstances

warrant it, even if that need occurs in the middle of a leasing cycle.

This white paper from Optimus Solutions outlines the issues to consider in structuring superior leasing programs that will provide an organization maximum flexibility and ensure the most cost effective and profitable outcomes for their business.

Maintenance and The Total Cost of Ownership (TCO)

Businesses are starting to realize that financing IT equipment should be more about managing their business risks and changing needs than trying to determine how to appropriately depreciate equipment purchased with cash. By continuing to structure equipment purchases on a cash basis, enterprises limit their ability to react to rapidly changing business conditions as well as incur higher operating costs.

Given the rapid rate of technological obsolescence with IT equipment, enterprises are now asking themselves some serious financial questions:

- How often does the current book value for an IT asset end up determining its useful life?
- How many times has our company continued to use older technology that has outlived its usefulness when it should have been replaced years ago?
- Should our organization be tracking IT assets and incorporating built-in financial flexibility to protect us against changing business requirements?
- Given the millions of dollars that our enterprise spends on IT equipment, could we be saving money by structuring an equipment lease that would accurately reflect the product's useful life cycle?
- Could we incorporate the right entry and exit points into a lease so that we are protected from equipment obsolescence?

A variable that clearly differentiates the procurement of IT assets via a lease versus cash is the required maintenance that must be periodically performed on the equipment. Maintenance is one of the variables that are factored into the business principle called

the Total Cost of Ownership or TCO. Most businesses are familiar with TCO which is defined as the total cost associated with purchasing, maintaining and ultimately disposing of a piece of equipment over its useful life.

By leasing IT equipment, enterprises are able to pass the risk of higher operating and maintenance expenses onto the lessor rather than incurring it themselves.

As IT equipment ages, the cost to maintain the equipment goes up, thereby increasing its TCO. In circumstances where a manufacturer has discontinued support for an older system, the customer must incur the additional cost of procuring third-party resources for maintenance, further increasing their TCO. With a lease, enterprises are in a superior position to refresh their equipment more frequently and minimize their bottom line cost of operating and maintaining it.

In the next section, we'll take a closer look at some of the problems associated with a cash acquisition strategy.

Common Problems Associated with a IT Cash Acquisition Model

The problems associated with the cash acquisition model revolve around purchasing rapidly depreciating assets and the inability to accurately forecast changing business needs or the evolving technology marketplace.

Depreciation/The Cash Trap - In a perfect world, the depreciation of IT equipment would match an organization's actual use of that equipment as well as its value in the secondary (or used) marketplace. Unfortunately, this is almost never the case. While most organizations have the intention to properly depreciate the asset on their books, financial managers aren't usually able to predict needs or equipment value into the future. In fact, the majority of enterprise IT infrastructures experience some degree of change with

their equipment over the course of its original useful life.

Figure 1 provides an example of how the cash trap works. Using some common depreciation methods, the table below shows how those methods can ultimately impact a business.

Figure 1: Common Depreciation Methods / Resulting End-of-Year Book Value

Year	3 Year Straight Line	5 Year Straight Line
1	66.6%	80%
2	33.3%	60%
3	0%	40%
4	0%	20%
5	0%	0%

When equipment is purchased, it is considered a capital expense and it is depreciated over the course of its "useful life", which, in most tax perspectives, is approximately five years. Most companies depreciate on a straight line basis. With this approach, at the end of

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only three years, the company will own the equipment at 40% of its original purchase value as shown in Figure 1. But due to the rapid rate of technological obsolescence unique to IT equipment, it may have a much lower fair market value. When this kind of discrepancy occurs, the

difference would have to be reflected in company financial statements as an unexpected loss.

For a publicly-traded company, the ability to accurately forecast revenues and costs is essential to maintaining a high stock rating and high return on shareholder value. If an unexpected loss related to their cash-purchased IT equipment must be posted, it's not a good thing for stock prices or stockholders.

The Boat Anchor Dilemma - The boat anchor dilemma occurs when an organization's business needs require the replacement of IT equipment, but the book value exceeds the current value of that equipment. This is an extremely commonplace occurrence because IT equipment typically depreciates more rapidly than the way most organizations account for it. The end result is that many organizations delay addressing their real business needs to avoid posting these kinds of unexpected financial losses. To compound the situation, the cost associated with maintaining this older equipment also goes up. This problem is referred to as the "boat anchor dilemma". The equipment becomes a boat anchor on the books until it can be liquidated in a more financially-beneficial manner.

The Exaggerated Depreciation Attempt - The exaggerated depreciation attempt occurs when a company decides to accelerate the depreciation of its equipment in the earlier years of the depreciation cycle or simply chooses to depreciate the equipment over a short term (for example 3 versus 5 years). The problem with this approach is that many businesses end up understating their income as compared to what they could have reported simply by structuring an operating lease and only expensing the monthly lease payments. In other words, the monthly lease payments are typically less than the depreciation expense using these depreciation models.

Sarbanes-Oxley (SOX) Compliance - For any publicly traded company, the Sarbanes-Oxley Act (SOX) has changed the reporting and disclosure of financial information. The SOX act puts public companies in an inflexible position with regard to reporting the value of their IT equipment assets. Under SOX, an asset must be monitored to ensure that its fair market value is being accurately represented on the company's balance sheets. To accomplish this, the asset must be tracked within the organization to ensure that it has not been lost, stolen or damaged, which results in additional inventory and management costs for the organization. A company that chooses to own their IT assets with a cash purchase must account for these SOX stipulations and incorporate strict asset tracking measures as part of their overall compliance planning process.

Resale Challenges - Most organizations are not positioned to get the maximum value out of used IT equipment when they try to resell it in the secondary (or used) marketplace. In addition, they also face the additional costs of advertising, brokering, moving and/or

disposing of the equipment which can create further financial losses.

The Advantages of IT Equipment Leasing

There are numerous advantages IT equipment leasing offers an enterprise versus purchasing the equipment with cash.

1. Protection Against Changing Business Needs - Leasing provides a built-in insurance plan to protect an enterprise against changing business needs. Should an organization's equipment needs change, a well-structured leasing plan passes the depreciation risk of the IT equip-

ment onto the lessor, who is often in a better position to take on that risk.

2. Greater Operational Efficiencies - As mission-critical enterprise applications are updated, older systems are often unable to run them at peak efficiencies, or in some cases, at all. By replacing older systems with newer ones via a lease,

enterprises can run these applications using the latest processors, greater amounts of memory, and increased storage capacities. This allows the enterprise to be more responsive to changing customer needs, create greater internal operating efficiencies, and provide a platform to continuously support those applications as future updates are released.

3. Significant Cost Savings - Leasing saves businesses significant amounts of money. In most cases, a company can obtain a lease where the present value of the base term lease payments are far less than the original purchase price of that same equipment acquired with cash. Additional savings are achieved by eliminating the costs associated with maintaining the equipment beyond its useful life. Lease savings are further magnified when factoring in the costs associated with asset disposition.

IT budgets are more predictable with leasing, improving financial forecasting and lowering the risk of financially-related embarrassments when a publicly-traded organization is required to post book losses for their IT equipment.

4. More Predictable IT Budgets - IT budgets become more manageable and predictable with leasing, improving financial forecasting and lowering the risk of financially-related embarrassments when a publicly-traded organization is required to post book losses for their equipment.

The ability to capitalize on these advantages requires a well thought out IT equipment strategy and a well-structured lease that provides an enterprise with a degree of flexibility to support that strategy. As a result, there are several important attributes that an enterprise needs to consider when planning to lease IT equipment.

Things to Consider When Planning to Lease IT Equipment

Companies embarking on a leasing strategy would do well to ensure that the following points are taken into consideration as part of their leasing plans:

Selecting a lessor with a proven track record in remarketing IT equipment in the secondary market is one of the most overlooked, but likely most important factors in structuring a good IT leasing program.

Choose a Lessor Experienced With Remarketing IT Equipment - Selecting a lessor with a proven track record in remarketing IT equipment is one of the most overlooked, but most important factors in structuring a good IT leasing program. While the lowest lease rate is an important consideration, a leasing company

with in-depth knowledge and access to the secondary market can offer greater flexibility should the organization's equipment needs change in the middle of the lease term. Such lessors are able to offset the costs associated with lease payouts and the related new equipment acquisition by maximizing the return on the replacement equipment.

Carefully Structure the Back End – Many companies see the value of leasing from a minimized cash outlay perspective but remain concerned about additional costs that leasing can incur. An example would include any fees that the lessor might charge in the event that the equipment is needed beyond the original term

of the lease. In response, companies considering leasing should structure the lease to include back-end protection such as upfront renewal options to protect themselves from excess charges in the event the equipment is needed beyond the original term of the lease.

Tracking Strategy – Another important part of a well-structured leasing program is its ability to incorporate a well-orchestrated asset and lease tracking process. Organizations are usually concerned about the potential of incurring “end-of-lease” expenses in the event that the equipment has been lost, stolen, or damaged. However, in today's increasingly regulated environment, many organizations are required to accurately track all of their IT assets and risks. Failure to adequately account for them can result in costly audits and/or fines. As a result of federal regulations such as SOX, a strong internal asset monitoring and tracking program is no longer an option, but a requirement and organizations should investigate this option with their leasing company during the lease negotiation process.

Short Term Rentals – Working with a lessor that can provide short term solutions is another important aspect of a good leasing program. Many lessors do not like to provide terms of less than two years, let alone consider anything less than one year. However, many businesses need short term solutions such as the retail industry, where seasonal peaks associated with customer demand require increased storage with their IT assets. The ability of a lessor to provide a short-term rental program can create significant bottom line savings for an organization, which might otherwise incur the full cost for the additional storage capacity during that period.

Concluding Summary

Today's business environment is rapidly changing, and the information technology associated with day-to-day operations is changing even more quickly. Businesses need the flexibility to structure the financing of their IT equipment so they can respond to changing business requirements. This includes the ability to upgrade to newer technologies while avoiding costly non-hardware related expenses, or incurring any financial losses.

IT equipment leasing should be a key component of every organization's IT infrastructure. However, structuring an appropriate lease involves more than just finding the lowest monthly rate. Flexibility must be another key consideration, and the ability for a business to align themselves with an experienced IT leasing provider that can provide both mid and end-of-lease options is essential when essential business needs change.

To summarize, there are three bottom line business advantages associated with leasing IT equipment:

- **Transferred Depreciation Risk** – Leasing places the risk of obsolescence on the leasing company so that the enterprise isn't required to find a way to sell or liquidate that equipment when it becomes outdated.
- **Greater Flexibility** – Leasing provides an enterprise with the ability to react to changing business conditions or market circumstances.
- **Long Term Savings** – Leasing lowers the overall costs of operating and maintaining IT equipment by positioning businesses to choose the right entry and exit points in a product's life cycle.

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