TOPIC: Leasing of Software by Federal Agencies

BACKGROUND:

Leasing, like technology itself, is neither good nor bad. The issue is always how it is applied. Proper applications of leasing software have led to very positive results, and unfortunately some improper applications have led to less than desirable results.

From an economic perspective, if the best application of leasing we can derive is simply to add financing costs on top of already expensive IT assets, then we should have little use for it. However, when we consider the unique economics that drive software sales, specifically the steep acceleration of discounts that are achieved with relatively small increases in order size, and when we further consider within Government the relatively long IT planning horizons and budget constrained environment, we find an application for leasing that can actually reduce cost, leverage budgets, accelerate the deployment of needed technology, and help to facilitate technology partnerships between Government and the software industry.

For the purposes of this paper we define leasing as a base with options contract consisting of annual payments by the Government, and third party investors that provides up-front funding to the vendor. The Government does not obligate future year funds and can terminate (or not renew) the contract for default, non-appropriation or for its convenience. Federal agencies have embraced this structure using standard GSA terms (SIN 132-3) and most major IDIQ contracts now have provisions for leasing. Further discussion of the contractual aspects of leasing is the subject of a separate paper.

This paper endeavors to answer some fundamental questions about the business side of software leasing by Federal Agencies. Our goal is neither to defend nor condemn the practice, but rather to put it in its proper perspective.

As we begin to look at enterprise acquisitions of software and a potential role for leasing, we must be clear on what we are trying to achieve. What are the objectives we have in sight, and how do we assure that we achieve them? If leasing can help, then let's develop an understanding of how it is to be applied.

GOVERNMENT OBJECTIVES

There are many objectives to consider when structuring a large software acquisition. Some are common to all acquisitions; others are specific to particular programs or systems. We will limit our scope to two over-riding objectives that in our experience are (or should be) foundational objectives in all large software acquisitions.

1. Lower life-cycle cost (Price)

2. Greater flexibility of use (Terms)
3. Year of need funding (Terms)

Lower Life-Cycle Cost
When considering price, avoid focusing all attention on the license price to the exclusion of other elements of cost (maintenance, training, services, etc.). As we evaluate life-cycle cost over increasingly longer intervals, license price decreases in significance, while maintenance costs quickly begin to dominate. Maintenance is actually the larger culprit in driving life-cycle cost because of its size (15% to 20% of license) and because it recurs annually. As a result, the primary importance of negotiating a lower license cost is actually its role in determining the amount of recurring maintenance fees that will be due. The point is that all elements of cost should be evaluated and given their proper importance. Life-cycle cost analysis is a convenient way to evaluate and summarize these costs.

Greater Flexibility of Use
When considering terms, the overriding cry of Government is for increased flexibility of use. Government wants licenses that are transferable across programs, departments and organizations. The ultimate goal might be a perpetual license that is transferable across the Federal Government; some would even include state and local governments. While this grandiose goal may not be achievable for most transactions, IT professionals should seek to provide enough flexibility to satisfy the immediate user requirements, but also consider the license as a Government asset that may outlive the current requirement or program.

Year of Need Funding
Federal acquisition policy requires paying for goods and services in the year in which they are required. The Anti-Deficiency Act prevents Government from committing to spend future-year funds (funds that have not been appropriated by Congress). At the same time, the act prevents Government from paying for goods and services this year that are not required until a future period. Paying large sums of money up-front for assets that will be useful over many years is less preferable than paying each year for the portion of that benefit the Government requires in that year.

This preference sets up fundamental disconnect between Government and software companies that thrive on large sales and up-front payment terms. We see the battle lines drawn on a daily basis. Fully convinced that the Government's buying volume deserves maximum discounts, many buyers have been frustrated in their attempts to capture maximum discounts on BPA's that offer no up-front funding to vendors. Vendors push back, accusing the Government of not acting like a large customer – of fragmented buying patterns that result in higher costs of sales. Meanwhile, we cannot ignore the empirical evidence which supports that large individual sales consistently achieve better discounts than even the largest BPA's.

So what is going on here? Who is right? Who is at fault? Have the BPA's failed us? And what is the way forward?

Before we answer these questions, we turn our attention to the software industry.

Software Industry Objectives:

The first question one may ask is "Why do we care what the software industry wants?" The answer is simple. The best deals are had when the objectives of both parties are satisfactorily met.

Software companies spend countless hours contemplating how to add value to Government with their technology, but pathetically few hours figuring out how to package that value in ways that respect the Government's business environment.

On the other hand, while the Government has made important strides in understanding some of the business pressures that vendors face, there seems to be little understanding of how various deal structures are valued by vendors, and how those structures affect discounting practices. Buyers are often bewildered by how seemingly reasonable demands (like ramping support fees) can torpedo a transaction because of its adverse affect on revenue recognition.

By understanding more of the internal economy of the software industry, Government can structure deals that are more valuable to industry, without necessarily being more expensive to Government. In return for that added (non-price) value, Government can demand more of what it requires (lower cost, greater flexibility). Thus, the best deals are had when the objective of both parties are satisfactorily met.

Having established why we care about software industry's objectives, let's look at what those objectives are. As with the Government, the software industry has many objectives, and they vary from company to company. However the following general objectives consistently affect the majority of transactions we face:

1. Acceleration of Sales – Software companies (generally) will accept less revenue provided that revenue is recorded sooner.

2. Large sales are more valuable than many small sales
    - Large deals facilitate strategic relationships with Government in ways that transactional business does not.
    - Large deals accelerate market penetration. Winning means a much larger foothold, loosing means ceding market share to competitors.
    - Large sales enable companies to meet near-term business goals, which can affect everything from stock price to employee compensation.
    - From a cost of sales perspective, a few large sales are generally less expensive than servicing a transactional sales environment

Software companies are measured (and valued) based on their ability to report consistent sales of licenses. Experiencing quarters or years in which sales are below target, can adversely affect the value of the entire business. As a result, recording a sale on March 31st (the last day of the quarter) can be more valuable than recording that same sale on April 1st if it means the prior quarter did not achieve its sales goal. Many software companies will therefore discount aggressively to bring the sale in sooner.

It is also important to understand that discounting practices are constrained by policies designed to protect the value of the company. A company's total sales potential can be viewed as follows:

(Expected Average License Price) X (Size of the Market) X (Expected Market Share) = Total Sales Potential

Providing large discounts for small orders or for "anticipated demand" (as with many BPA's) can devalue a company by reducing the Expected Average License Price. On the other hand, offering a large discount for a large order affects the equation differently. Because the sale is unique (large) it will not significantly diminish the expected average sales price going forward, at least not for smaller sales. Furthermore, any decrease in the Expected Average License Price may be offset by an increase in the Expected Market Share resulting from the large sale, and the anticipation that other large customers may follow.

Revenue Recognition

Revenue recognition policy governs how software companies record and report sales. Many factors are at work here from GAAP rulings to individual company policy. In order to record the full-value of a sale, most companies require a valid delivery order, completion of delivery and acceptance, and up-front payment terms (usually 30-days to 90-days). In addition, there can be no contingencies; take back clauses or sales assistance clauses, which create contingencies that must be mitigated by holding a portion of the sale in reserve. For many companies even the ramping of maintenance will cause a devaluation of the transaction, often resulting in lower discounts.

In short, the best deals should result when requirements are aggregated (large sale), funding is consolidated (up-front payment), and no adverse terms or contingencies exist.

Preferred Approach vs. the Real World

Arguably the best way forward then is through careful planning and budgeting to assure funds are available for large purchases when needed. This should usually result in favorable pricing and terms.

In reality, the Government is often responding today to challenges that were never anticipated when the current year's budget was planned. As a result, we see ever-increasing requirements placing demands on already tight budgets. The strain is compounded by annual appropriations that effectively spoon-feed program managers

with scarcely enough funds to keep the lights on, much less to field new capabilities. The result is that too often programs simply cannot afford the satisfy all of their IT requirements.

Spiraling Costs
The unfortunate consequence is that programs muddle along doing the best they can by purchasing the bare minimum number of licenses required in each year. These smaller annual buys command smaller discounts from vendors, resulting in higher license costs. Higher license costs mean higher recurring maintenance charges. What results is a negative cycle of budget constraints leading to higher life-cycle costs.

The Case for Leasing
Leasing (applied properly) is a powerful tool in breaking the cycle of constrained budgets leading to higher life-cycle costs. The reasons are simple:

1. Leasing results in more up-front funding to vendors.
2. Up-front funding results in larger discounts from the vendors
3. Larger vendor discounts can far out-weigh the cost of leasing. Stated differently, larger vendor discounts can absorb the cost of leasing and still provide significant incremental savings.
4. Significantly lower software license costs result in reduced recurring maintenance costs (maintenance is a percent of license fee), thus reversing the spiral.

Applied properly, leasing is a powerful tool in reducing life-cycle costs of software.

Common Pitfalls:
1. Don't lease if the net result is a higher cost. Don't avoid preparing a business case
2. Don't lease if the requirement is not solid, and expected to remain so through the term of the lease
3. Evaluate operational vs. capital lease terms to best support the requirement
4. Don't lease an unstable technology
5. Don't stray from life-cycle cost as the over-riding benchmark

A word on BPA's
A lot of important work has been done in negotiating BPA's with Software vendors. Most notable is the work being done by the DOD Enterprise Software Initiative and GSA Smart Buy. Each negotiation results in lower catalog pricing and better terms for Government, yet few result in discounts as deep as those resulting from individual large transactions.

Are the BPA's failing us? Certainly not! The key is to view the BPA in its proper light. BPA's generally do not provide upfront funding to the OEM, making significant discount approvals difficult or impossible.

Many people wrongly expect the BPA to provide the best possible price. In fact, the reverse is true. The significance of the BPA is that it represents the most (not the least) a customer should pay. This common misconception has led to much frustration. The role of the BPA negotiator is to continuously lower the bar that represents the maximum price. Individual buys reach break-through discounts in part because they leverage the BPA's as the starting point for negotiations. Add to that up-front funding and an ability to leverage significant business milestones (year-end, quarter-end, etc.), and the stage is set for success.

Conclusions

The proper question is not whether leasing is better than buying or buying better than leasing. Instead our focus should remain on achieving our primary objectives. These objectives can be summarized as *lower life-cycle cost* and *greater flexibility of use*.

In negotiating these (and other) concessions from software companies, it is useful to structure deals in a manner that maximizes value (but not cost) to the vendor. The more value we can extend to the vendor, the more leverage we have to improve our position. The really good news is that both parties can win. More importantly, both parties should win to ensure that a productive technology partnership emerges from the negotiation.

The ability to extend cash up-front to an OEM is the single most important driver in reducing cost and increasing flexibility of use. Software companies will generally accept significantly less cash if that cash is paid sooner and not encumbered by terms that would jeopardize revenue recognition of the sale.

Leasing is a particularly powerful tool in software acquisition not just because it provides cash up-front to a vendor, but because (applied properly) it does so in a way that is cost effective and respects the business process of the Government. Cost effective because in the economy of most software companies the incremental discounts associated with up-front cash represent many multiples of the cost of financing. That means leasing can be substantially less expensive than buying smaller chunks of licenses over multiple years. Leasing respects the business process of Government because it enables programs to pay for software over the period in which that software provides value to the program. It is the combination of theses attributes (cost savings ***and*** the ability to pay annually for value received) that makes the case for leasing software more compelling than for leasing other assets that are not as discountable.

This should be good news for many departments and agencies that have been caught in a cycle of budget shortfalls leading to smaller incremental software purchases that result in significantly higher life-cycle costs.

ABOUT ESCgov

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