Bundled Solutions

EQUIPMENT FINANCING WITHOUT THE EQUIPMENT?

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The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

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Forward

The Equipment Leasing & Finance Foundation presents the following study, researched by Accenture on behalf of the Foundation. ***Bundled Solutions: Equipment Financing Without the Equipment?*** is a study on a topic of long-term strategic importance to the equipment finance industry, the use of Bundled Solutions Financing across the technology acquisition spectrum. Broadly defined, this spectrum encompasses U.S. spending on IT, including associated software and services, telecommunications equipment, and office equipment. Several in-depth interviews with finance company executives in the first half of 2009, completed largely over the telephone, drove the insights and conclusions detailed in this study. The executives interviewed represent the full range of the equipment finance business: captives (wholly owned finance subsidiaries of larger technology manufacturers), independent lessors, and bank equipment financing units. Nearly all of the study's respondents currently provide some form of Bundled Solutions Financing (also referred to as bundling or solutions financing) to a broad cross section of customers, ranging from small-business buyers of office computers to multinational enterprises making multiple-year, cross-border "transformational" IT investments.

The Equipment Leasing & Finance Foundation and Accenture Research believes it is essential the equipment finance industry (the Industry) gain a better understanding of the bundling trend, especially as technology solutions financing continues to evolve. As underscored in this study, there is an increasing demand for Bundled Solutions Financing (BSF) despite the economic downturn and tightening credit markets. This study provides information that allows Industry participants to better take advantage of this growth opportunity along with the tools and insight to effectively balance the risk/reward trade-offs inherent in BSF.

Executive Summary

Despite the challenging global economic and credit environment, experience shows there are always areas of opportunity for the equipment finance industry. One such area is Bundled Solutions Financing. Even though technology traditionally represents one of the most penetrated areas for equipment finance, the *2008 ELFA Survey of Equipment Finance Activity* indicates the Industry is not taking full advantage of one of its fastest growing segments. As aptly put by one leasing executive, *"… the leasing industry has not yet captured the majority of the possible financing opportunity represented by Bundled Solutions Financing. . . . How do we pick up this additional volume and therefore help generate further cash flow for ourselves?"*

By detailing the strategic advantages and performance risks for all major parties to a bundled transaction this study provides tools to assist lessors in answering that question. Identification and implementation of market-tested best practices are highlighted, along with learnings from those lessors that have emerged as leaders in this product. Differences in approach are reviewed for the three major types of leasing organizations: independents, banks, and captives. The major issues faced by the Industry in expanding the use of Bundled Solutions Financing are identified and explored:

Accelerating trends in technology causing shifts in end-user buying behavior from point products to solutions, and in vendor profit migration to software and services

Bundling's future as a significant procurement option for U.S. technology buyers

Bundling's potentially game-changing - possibly revolutionary - impact on the Industry

The information in this study is intended to inform long-term strategic decisions including:

- Seeking out emerging opportunities in new technological approaches;
- Anticipating the emerging threats of managed services and on-demand outsourcing;
- Understanding risk/reward trade-offs, especially given the increasing complexity of BSF;

- Assessing strategic opportunities to partner with other transaction participants to leverage respective competitive strengths (e.g., technology, financing and vendor management);
- Planning and executing an action plan to implement and/or expand the use of BSF to meet increasing customer demand;
- Increasing confidence in the practice of bundling, especially given its long-time popularity, sophisticated evolution, and widespread use by the Industry;
- Using BSF as a competitive advantage, built upon a foundation of bringing innovation directly to the customer;
- Understanding future trends in BSF to take advantage of new opportunities - and manage their associated risks – as the product continues to adapt to market forces.

Additionally, this study encourages Industry participants to investigate the following areas for additional product development:

- Application to other market segments, such as health services, where demographics are driving increased customer demand;
- Leveraging the product in overseas markets, understanding how the product differs from implementations in the U.S. market;
- Adapting to technology's transition to an on-demand access and use model.

Overview

Definition of Bundled Solutions Financing

As used in this study, the term Bundled Solutions Financing (BSF) entails the financing of equipment along with associated soft costs (e.g., services provided by a lessor or third-party vendor), with the lessor arranging a single transaction that provides an all-encompassing business solution. In the technology marketplace specifically bundling has come to denote an offering that combines the financing of equipment - such as on-premises servers – with “soft” components including software, installation, maintenance, and managed and professional services. Other soft costs bundled more recently by financing providers include transportation, remote support, education/training, asset management and recovery, certification, insurance, and upgrades. All of this constitutes a very broad portfolio of soft cost options, which continues to expand.

Industry interest in bundling is increasing because the product can provide a competitive advantage to the financial arranger when a customer is implementing new technology. The following scenario illustrates just one aspect of the benefits of solutions financing: In addition to acquisition of the equipment itself, the arranger can help the customer acquire support to develop and test their new technology environment, add in a portfolio of services, provide improved process automation, and bolster the customer’s security – all in the same transaction! Financing of other soft costs can also be included such as training, ongoing maintenance, and extended warranties. All of these are solid sources for ongoing revenue generation. Of crucial importance, bundling can allow the customer to use the operating budget instead of navigating the capital acquisition process, which can be extremely difficult, especially in this challenging economic environment.

Untapped Domestic and Global Opportunity for Equipment Finance

While many sectors of the global economy have contracted dramatically, technology sales are flourishing. The annual rate of growth for IT financing and leasing has been expanding worldwide by at least 10% a year since 2006 according to an IDC market research estimate. More importantly, Bundled Solutions Financing is expanding at an estimated 20% annual rate, compared to a 4% rate of growth for financing hardware-only transactions.[1]

[1] IDC analyst Joseph Pucciarelli quoted in 10 June 2009 U.S. edition of *Network World* article by Jon Brodkin “IT Shops Borrow Money, Lease in Droves as Recession Strains Budgets.”

These positive trends are also true of U.S. purchases of software and IT services. In 2009 these two categories are estimated to comprise more than 72% of the total U.S. commercial spend on technology; they have grown by an estimated 5% per annum since 2006 while hardware-related purchases have shrunk by more than 2% annually over the same period. Through 2011 IDC projects purchases of software and IT services will grow by more than 11% each year, contrasted to spending on hardware, estimated to *accelerate its contraction* to a 3% annual rate for the next few years. Yet according to the *2008 ELFA Survey of Equipment Finance Activity* only 59% of computer equipment and – more surprisingly – only 32% of software used by businesses was leased or financed in 2007.

The U.S. market is not the only major source of potential Industry growth in Bundled Solutions Financing. Though the scope of this study focuses on the use of bundling in the U.S. market, some interview respondents did refer to its potential use abroad, pointing to examples of faster growing IT markets overseas. While sales of IT hardware continued to decline in North America during the first half of 2009, growth was generally positive abroad, especially in emerging markets. "The practice of bundled financing is certainly not mature in China and India, for example, but knowledge about its potential is spreading quickly," said the head of a global captive finance unit. This unit manages stand-alone operations in both the U.S. and Europe to meet demand for bundled financing arrangements. Growing mid-size enterprises in emerging markets will no doubt be looking for creative ways to finance the large upfront costs traditionally associated with large server implementations, a significant area of projected future investment.

The challenge for lessors wishing to "export" bundling abroad is to set up the appropriate infrastructure and to observe international accounting standards. For example, many technology providers must account for off-balance sheet financing through the application of mark-to-market valuations when doing business outside the U.S. There are other significant accounting differences as well. Lessors will definitely need to invest in expert knowledge to expand outside the U.S.

A Brief History of Bundling in the U.S.

Connecting the use of equipment to a lease or a license for software and associated services is a well accepted financing option in the U.S. market. Most interview respondents said they have witnessed bundling used as a financing choice for technology procurement since at least the late 1990s. This was at the height of the dot-com era when software fell into the "cash-

[2] U.S. technology spend estimates based on IDC's Worldwide Black Book database for 2Q2009

and-carry" category of technology purchasing. At that time the IT market became as focused on purchasing innovative software as it had traditionally been on hardware and IT infrastructure. "I support the view that technology - in the broadest sense of the meaning, including equipment and services - has been a major driver in the growth of bundling over at least the past 10 years," noted a long-time Industry observer. For example, even before it was purchased and later spun off from AT&T in 1997 NCR was tying a bundled financing framework to the sale of its hardware assets.

The Industry has long shown interest in the practice of bundled financing. For example, in late 2006, the Equipment Leasing and Finance Foundation published *Business Differentiation: What Makes a Select Few Leasing Companies Consistently Outperform their Peers?* This study identified differentiating attributes of higher performing U.S. equipment leasing companies. Among unique attributes highlighted, "Outperformers" placed much more emphasis on the importance of bundling of service contracts than their industry peers. (See Figure 1)

Figure 1

Most Unique Areas of Focus for Equipment Leasing Outperformers[3]

Rank	Areas of Leasing Focus
1	Securitization
2	**Bundling of service contacts**
3	Collateral offerings directed at specific fund sources
4	Utilization-based contracts
5	Providing on-line auctions to dispose of off-leased assets

Current Product Position

Nearly all the executives at major equipment finance companies who were interviewed for this study said they are financing technology-focused bundled deals to some degree. "Bundled transactions are no longer the exception for us," said an executive leading the captive finance/leasing unit of a prominent

[3] *Business Differentiation: What Makes a Few Select Companies Consistently Outperform Their Peers?"* October 2006: The Equipment Leasing and Finance Foundation.

technology vendor. “Increasingly complex deals are being arranged in response to what is happening in the market. And therefore we are providing our customers with more complex solutions and service extensions to this approach [bundling].” For some Industry participants the practice of bundling now constitutes a majority of their overall financing in technology. “When you look across the spectrum of product financing, bundling is used by us most frequently with technology – I would say about 75 percent of the time,” estimated a bank leasing executive.

Product Benefits

While the implications of Bundled Solutions Financing are different for all parties involved, its expansion and evolution in the marketplace is driven by the benefits realized by each party to the transaction:

Benefits to the Lessor/Financial Arranger

As arranger of the financing and associated bundled technology solutions, bundling provides an opportunity to deepen customer and vendor relationships while achieving an additional, longer-term source of funding, and potentially lower per-unit costs to the client in delivery of the solution.

Benefits to the Technology Vendor

As the provider of a unique technology solution, bundling allows the capture of additional cash flow and increased market share while enabling continued innovation for increasingly savvy and demanding customers.

Benefits to the Customer

With a ongoing need to acquire necessary technology despite credit and budget challenges, bundling allows the customer to smooth costs over time via the operating budget, even while continuing to invest in the latest generation of technology offerings.

Evolving Nature of Technology and Technology Procurement

Today the spectrum of products included in technology-focused financing continues to expand as the market changes. In computer leasing, for example, the warranty has become an extension of the services provision of a bundled contract. This is the simpler end of the technology solutions financing spectrum.

While the use of bundling is certainly projected to grow, at this point survey respondents felt the product is still in the process of gaining understanding and acceptance by customers. “Currently we are not actively looking for bundling opportunities,” said a finance executive who has seen a steady demand for this type of financing over the past year. “It has really arisen as a need put forth by our customer to bundle services to the equipment that is being financed by us. For us, the customer is certainly driving its use, but I would not say that it is a customer necessity quite yet.”

Top Three Product Growth Factors

Along with the accelerating complexity of technology solutions, commercial finance providers are simultaneously confronted with the end-user’s increasingly complex investment needs, which often compel the financial arranger to create an alternative form of financing to a standard equipment lease agreement. As of now, solutions financing appears to best address this widespread and growing market need. Specifically, this study has identified three main factors that are driving the continued growth of bundling in the Industry:

1. Provides Financial and Marketing Flexibility
Not even an economic disruption appears to have tempered interest in the use of bundling. Rather, it is being leveraged as a pipeline to push product sales and sustain cash flow, serving as a hedge against the ravages of the credit crisis. For example, capital providers needing to increase sales find solutions financing attracts customers looking for a one-stop procurement source. And the customer receives more value from a holistic technology solution, which extends into various services along the IT lifecycle, boosting their overall return on investment (ROI) and conserving valuable capital for other business priorities.

2. Drives Innovation and Competitive Advantage in the Industry
Despite fears to the contrary, bundling drives innovation rather than “commoditization” in the Industry. Leading with a tailored market proposition, the arranging lessor has an opportunity to provide both financing and technology innovation for the duration of a customer’s IT procurement lifecycle. By delivering a bundled solution the lessor also gains a competitive advantage for itself and the Industry. “The best advantage for the Industry is leading with an innovative approach,” said a long-time industry participant. “If we want to succeed in the long term with equipment leasing, how can we only offer the asset itself? Then it comes down to competition over pricing . . . a bundled solution provides the Industry another significant structuring tool.”

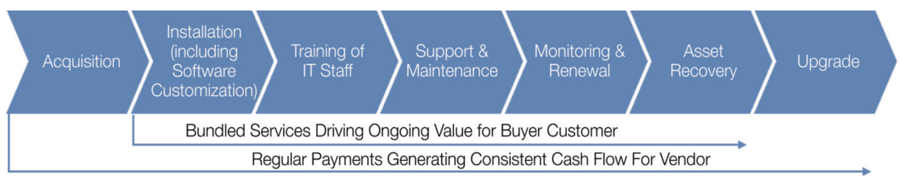
The head of a captive finance subsidiary prefers to think of his company’s approach as “delivering customer solutions rather than simply providing the financing. We develop complex, customized solutions for large enterprises. It is not just about pricing a deal for 10,000 PCs for an enterprise customer. Customers don't come to us solely for advantages in financing. They want to leverage financing plus gain a complete IT solution, ultimately decreasing the cost of their IT infrastructure. Most of my customers don't need our money."

3. Complements Increasing Complexity in the IT Market

As technology expands its role in creating competitive advantage for the world's top performing companies, the market for solutions financing continues to evolve to add value. The evolution has gone from the financing of mainframe computers decades ago to customers today routinely prioritizing technology investments in software and services over hardware. (See Figure 2)

Figure 2

Bundled Solutions Financing Along the Technology Lifecycle[4]



The terminology used today in technology finance is characteristic of its evolution and innovation. "Single-source financing for Integrated Technology Services," describes IBM Global Financing's offering, adding that its "one-stop financing is where solutions can include hardware, software, services, maintenance, transition costs, etc., from any vendor." Honeywell Global Finance refers to its approach as "Total Solution Financing," and National City Commercial Capital, now a division of PNC Financial Services Group, markets its "Managed Services Solutions." A provider of remotely managed messaging services promotes its "OneStop Managed Services" in teaming with ePlus to offer its products to organizations "looking for all-in-one pricing." GreatAmerica Leasing Corporation greets visitors to its home page with the message: "Helping you get there through Innovative and Informed Solutions." And HP offers its "Total Care portfolio of services, software and solutions for every business need."[5]

[4] Accenture research

[5] IBM Global Financing; Honeywell Global Finance; National City Commercial Capital, now a part of PNC Financial Services Group; www.nc-4.com/mgss/default.asp; ePlus: www.azaleos.com/uploads/files/Azaleos_Financing_Offer_Press_Release_FIN.pdf; GreatAmerica Leasing Corporation: www.greatamerica.com; Hewlett-Packard: http://h20271.www2.hp.com/SMB-AP/cache/561552-0-0-190-121.html

In the face of increasing demand, promotion of bundling by leading sources of technology financing should not be surprising. "Everyone wants to go to market right now with a complete solution," a bank executive said. By providing a holistic technology solution, the financing lessor places the focus of the bundled contract where it needs to be – on the long-term needs of the customer. "Bundled transactions are no longer the exception for us," said an executive at a prominent technology captive. "Increasingly complex transactions are being arranged in response to the market. And therefore we are providing our customers more complex financial solutions and service extensions as part of this approach." "We do not run a cookie cutter shop," echoed an executive at an independent leasing company that regularly arranges bundled technology solutions. "We are entirely customer-focused so it comes down to providing the appropriate solution for an agreed-upon price. It's all about solving a customer need through solutions financing."

Strategic Value to the Equipment Finance Industry

Regardless of the challenges associated with bundling, most executives interviewed agreed that it does provide a differentiating opportunity for the industry. The following quotes are typical of comments from survey respondents: "It is a differentiating product which is opening up a whole new segment of the market for us. We believe we have a completely different approach to a sale by using it," and "…bundling brings the value of equipment and services into one transaction, which is an added value that is unique to the leasing and finance industry."

The recent economic decline has demonstrated that bundling will not only survive, but can actually thrive in the best and worst of times. As the availability of credit receded, the competitive landscape shifted. Some providers, even those market leaders considered financially well heeled, had to withdraw at least temporarily from the market, accelerating consolidation. In this unprecedented market turmoil, some lessors have had to rely on bundling via third-party finance providers to maintain their level of business while simultaneously liquidating traditional lease portfolios to decrease balance sheet liabilities. These lessors are currently unable to directly finance large-ticket technology deals or seek new opportunities in the once-robust middle market. However, they consider it strategically vital to maintain a bundled financial solution for their customers.

Some lessors have actually gained market clout through leveraging the demand for bundling, even in an extremely challenging credit environment. A few bank executives interviewed, for example, have been actively lending to captive lessors, allowing the parent technology manufacturer to preserve its capital for ongoing investment in the core product line. Going forward, these capital sources believe they will find a "sweet spot" by focusing solely on a few large customers, such as large technology captives, since the market has placed a premium on lending and a higher priority on one-stop shopping.

Advantages of Bundling: Short and Long Term

Bundling positions the financial arranger as a long-term consultant to the customer, reinforcing a symbiotic relationship between the two throughout the technology procurement lifecycle. The key question for the financial source is how to leverage this relationship to earn revenue during the entire transaction term? The answer lies in helping customers lower IT infrastructure costs without sacrificing operational capability or efficiency along each stage of the lifecycle, not just during the acquisition and implementation of a solution. Captive finance units of technology manufacturers have long utilized the support and maintenance related to their own hardware to produce a steady source of revenue. More recently, lessors are adding “green solutions” to the asset recovery stage of the lifecycle, atop other related services such as inventory analysis, asset testing, transportation, hard file data cleansing, and reconfiguration. “The core element of bundling for us is to seamlessly control all developments in the customer interaction,” summarized an executive at an independent lessor.

With the lessor offering to partner with a customer along its technology lifecycle, bundling should persist as a financing option in at least the foreseeable future because it:

- Provides an additional and predictable source of revenue;
- Meshes well with highly scalable technology investments;
- Offers more pricing flexibility and wider margins;
- Protects against competitor duplication and helps mitigate cut-throat price competition;
- Places a premium on the financial arranger’s expertise;
- Helps drive new, sustainable solutions;
- Provides alternative financing to the leasing industry;
- Creates increased customer focus.

Provides an Additional and Predictable Source of Revenue

In partnering with a customer to provide a bundled solution, a lessor gains access to a few key revenue sources along the technology lifecycle, even where the transaction is highly weighted toward the provision of software and services. For example, the finance provider can also earn revenue on the performance of related services, with income being recognized as the services are performed. This allows the lessor to gain a steady revenue stream while managing the customer relationship throughout the technology lifecycle. Aspects of software bundling can also provide additional revenue opportunities, such as resale of software rights or similar arrangements.

For captives bundling can provide relatively more income stability than for other lessors, even during a market downturn. Since the captive’s parent can more closely control maintenance requirements and provision, it has a better opportunity to “lock in” a steady revenue stream on the maintenance portion of the bundled contract.

Meshes Well with Highly Scalable Technology Investments

Based on a number of interview responses for this study, technology customers are increasing their demand for funding that provides flexibility to accommodate their transformational initiatives. In response, a number of leasing companies and vendor suppliers are offering solutions financing approaches addressing more complex programs such as core banking replacements and ERP implementations.

Offers More Pricing Flexibility and Greater Margins

A study respondent remarked "there is margin in mystery" and the complexities of bundling can offer lessors a more attractive degree of pricing flexibility than traditional leasing arrangements. Bundling soft costs gives the lessor an additional opportunity to manage its margin beyond the value of the equipment underlying the contract. "Where we bundle, we always prioritize the software pricing. We consider this to be the highest value portion of the transaction from the customer's perspective," said a bank leasing executive, who also notes "We have been getting attractive margins on solutions financing relative to equipment leasing margins." From the supplier's perspective, bundled solutions often allow for higher margins because it is much harder for the end user to price shop a total solution approach, compared to buying components separately. As a result, provider margins have also benefited.

As arrangers of bundled solutions offer additional components of value, they can achieve still greater margin flexibility. To accomplish this, they need to realize that not all bundled services are equally valued by their customers, and that customers may have different sensitivities to pricing in a bundled transaction vs. an equipment-only lease. "For us, the structure of the bundled deal is ultimately important," said a finance executive. "As a leasing company, over time we have learned to appropriately price bundled transactions… what we have found is that deals are increasingly priced based on the perceived value to our customer."

Protects Against Competitor Duplication and Helps Mitigate Cut-Throat Price Competition

Due in part to the wider margins being earned with technology solutions that address increasingly specific demands of IT buyers, bundled deals tend to be more customized and less likely to be copied by competitors. As a result, solutions financing is much less likely to experience the margin deterioration, price shopping and competition of commoditization.

Places a Premium on the Financial Arranger's Expertise

A bundled solution can give a lessor the opportunity to leverage its accumulated credit and financing experience, creating a unique and valuable sales proposition for customers across a wide range of technology purchase requirements. This customized approach is particularly effective as the lessor provides guidance and support to the customer navigating through challenging accounting standards and internal capital expenditure approval thresholds.

Helps Drive New Sustainable Solutions

Driven by customer need, bundling can help the Industry create new solutions and applications for a broader market. A number of independent lessors are turning to third-party IT vendors when a customer demands a custom solution. Over time, the solution will be tested and refined, ultimately for marketing to a broader audience. A number of examples of this process of "customization to standardization" have been witnessed in the office equipment arena. One example, the development of processes and tools to remotely track the use of photocopiers, is Innovation Case Study 1 in the Appendix.

Provides Alternative Financing to the Industry

The source providing a bundled solution does not necessarily have to be the funder. For example, technology manufacturers with captive finance units are not averse to leveraging other non-vendor capital sources to finance their customer transactions, especially in the current difficult credit environment.

Creates Increased Customer Focus

Finally, by providing a bespoke solution the lessor becomes even more customer focused, increasing its unique value proposition. In many situations requiring crafting a bundled transaction the lessor's sales force can enter customer negotiations as if the deal terms were a "blank sheet." The payment components of a statement of work or master service agreement can be fixed or variable. Some contracts are based on time and materials. And though a monthly billing cycle has become the industry norm, bundled payments can be offered to coincide with IT project milestones, thus encouraging self funding within a larger buying organization.

"Today a bundled contract with three or four distinct items provides a great deal of flexibility to your sales and marketing folks. Overall it gives your company a competitive advantage in the marketplace," an industry executive said. "My customer relationship managers would never consider the approach a commodity."

The office equipment market offers a couple of examples of how this approach can be successful by enhancing a customer's ability to manage their cash flow over time: *Pay Per Use* ties a customer's payment to the actual usage of an asset (e.g., a photo copier); and *Pay Per Forecast* bases a customer payment on the expected usage or agreed-upon benefits to be derived by the customized solution.

The 3 Main BSF Delivery Models and their Implications

In delivering a bundled solution to its customers, lessors utilize three main organizational models: bundling by a single provider, bundling among multiple providers, and bundling among multiple providers via a "deal coordinator." Each model provides distinctive strategic and/or competitive advantages.

Bundling By a Single Provider

If it chooses, a large captive lessor can organize and manage a bundled arrangement on its own. It can access a breadth of hardware, software and technology solutions along with significant capital resources. "Although most finance organizations such as commercial banks, leasing companies, and vendor lessors provide some form of project financing, they lack the resources and skills needed to provide total IT solution financing, and often subcontract this aspect of their deals to third parties," per IBM Global Financing marketing materials.[6]

Obviously, the advantage of this approach is that the single provider controls the entire bundling process from offering financing to executing solutions on behalf of its customers. However, a few executives interviewed did warn that internal rivalries have been known to emerge over whether the parent's priority of pushing product out the door supersedes the captive's mission to produce an acceptable margin. These rivalries can become quite heated as both sides struggle to attain targeted performance goals.

[6] IBM Global Financing marketing brochure, June 2007

Bundling Among Multiple Providers

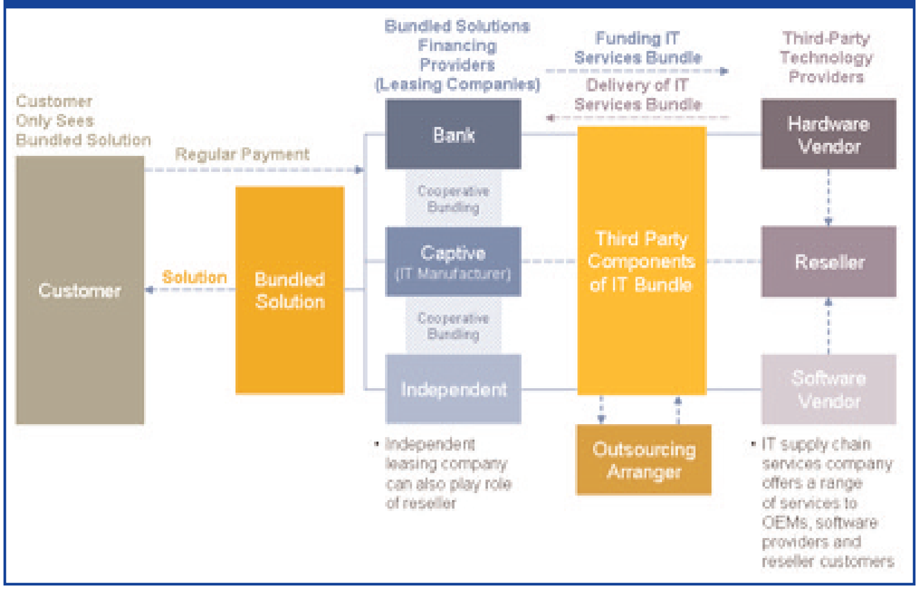
More representative of the current market structure, the financial provider can leverage a complex multi-vendor system through sourcing software, hardware, and IT services components from different companies. Often these companies are part of an established network of IT vendors or resellers. Technology customers are driving creation of these networks to facilitate the financing source bringing together the respective strengths of several organizations into a single contract. This popular approach has given rise to market opportunities in solutions financing for both independent and bank leasing companies.

Outsourcing Bundled Solutions via an "Outsourcing Arranger" (Deal Coordinator)

As the web of delivery networks continues to proliferate in the marketplace, an opportunity may exist for a facilitator to manage nearly all aspects of executing a bundled solution for the financing lessor. A few study respondents expressed interest in having their bundled solutions portfolios managed by a third-party coordinator. "The key question here is whether you can outsource the bundled approach and if so, who ultimately benefits?" a long-time industry executive observed. "Possibly the only way it would work is if you would

Figure 3

Bundled Solutions Financing Landscape[7]



[7] Accenture research

exclude any overlap in capabilities and have both parties benefiting almost independently from the transaction," said a bank leasing executive. At least in theory, an outsourced approach could free lessors to focus more intensely on selling.

Creating a Future: Evolutionary to Revolutionary Product Development

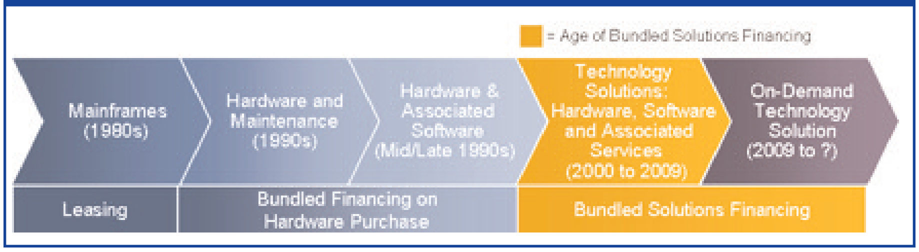
We would rather offer a revolutionary project solution than an evolutionary one, since the client economics are more compelling and because - quite frankly - our sales force naturally wants a quicker sale, especially in this difficult market.

Executive at Independent Lessor

To date, the Industry's approach to bundling technology solutions could be viewed as evolutionary: a practice that has been used widely this decade is continuing to morph into an extending web of financing and solutions-based options. (Figure 4)

Figure 4

Golden Age for Bundled Solutions Financing: Evolution to On-Demand Revolution?[8]



However, a revolution may also be unfolding, fueled by increased customer focus on *on-demand software and services* rather than traditional on-site provision (e.g., via on-premises servers) of technology. During this economic downturn, customers have been increasingly seeking on-demand software and business processes as a way to stretch thinning budgets.

The on-demand trend is behind the strong growth of "transformational technology," including virtualization, cloud computing and similar offerings. Transformational technologies allow a customer to access such traditionally

[8] Accenture research

hardware-related components as servers, storage and a network on an as-needed basis. "Virtualization" is marketed as an efficient methodology to consolidate existing server, desktop, business applications and network infrastructure. As a complementary approach, "cloud computing" refers to the Internet-based sourcing of computing capabilities – hardware, software, and business processes – somewhere "out there" in a computing "cloud" where vast resources are linked together.[9]

Using these technologies, customers only pay for what they use. Financing related to these products requires more complex variations on bundling. The important concept is that the "product" acquired by the end user comprises a broadening set of software and services almost incidentally tied to a hardware purchase.

The on-demand migration raises the specter of a future threat for the Industry –establishment of a technology "utility" solution that replaces ongoing bundled financing. One executive interviewed compares on-demand computing to a "real utility". "Like electricity, a real utility is the provision of services based on customer need at the actual moment of that need," he said. "It is not about providing services to a customer based on managing an ongoing contract. I believe this is the next challenge facing our industry." This executive views the utility approach as a market entrance opportunity for outsourcing providers who are not equipment lessors. He observes, "We understand the concept of a true outsourcing utility model; the question for the future is who will be deploying it?"

To date, major technology lessors have enjoyed a degree of success in marketing end-to-end financing solutions for advanced technology implementations. These larger vendors now offer common business applications directly from the Internet, with associated data and software stored on servers. The market is crowded with offerings such as infrastructure as a service (IaaS), platform as a service (PaaS) and software as a service (SaaS).

The question for the equipment finance industry is: What happens when a large set of top customers have direct access to a complex technology infrastructure through an on-demand solution? Will they continue to turn to a third-party source to manage periodic upgrades to the architecture and financing, or will they bypass the middleman in favor of managing on-demand use themselves or through an outsourcing vendor?

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[9] 2009 brochure on Accenture Cloud Computing Accelerator, Accenture Technology Labs: www.accenture.com/Global/Services/Accenture_Technology_Labs/R_and_I/CloudComputingAccelerator.htm

Industry Risk/Reward Trade-Offs for BSF:

Managing Associated Risks and Required Resources

As in any other type of transaction, the bottom-line challenge for the financing source is achieving the targeted return on its investment while managing to an appropriate level of risk. The scope of a bundled offering typically begins with basic maintenance tied to a traditional hardware asset, such as servers, but can expand to include software and, often, pass-through billing for software or solutions provided by third-party technology vendors. The product also provides flexible pricing options that encompass these product and solution bundles. The transaction is priced and marketed as a single solution to the customer, increasingly tied to the on-demand usage of the solution itself.

The performance risk associated with executing these arrangements accumulates along each step of the customer's technology lifecycle. At some point, the financial risk becomes less critical to manage than the exposure associated with providing a solution tailored to a specific customer.

"Funding providers are only going to offer solutions that afford them an adequate return, sufficient collateral and reasonable probability of payback," noted a bank executive. The following section elaborates upon the risks of bundling mentioned most often and passionately by interview respondents across the spectrum of Industry participants:

- Pricing and setting of appropriate upfront residual values;
- Positioning against vendor performance risk and related customer payment default;
- Managing reputation, structural and contractual risk;
- Managing the availability of required expertise;
- Managing back-office infrastructure to achieve higher efficiencies.

Pricing and Setting of Appropriate Upfront Residual Values

The cumulative experience of the lessors in this study is that one of the most crucial risks to the lessor is assessing appropriate residual values on the components of the bundled transaction. With such a broad spectrum of service-oriented financing options available in the market today, setting accurate upfront residual values is highly challenging. As the owner of the underlying bundled asset, the lessor must also annually (at the least) review its position and assume any necessary write-downs. If it incorrectly forecasts the residual value at deal inception, millions of dollars in write- downs and substantial reputation deterioration could ultimately occur.

Study participant suggestions for setting appropriate residual positions, especially for the "soft" components of the bundled framework include: 1) referring to other bundled contracts that established predictable cash flows; 2) clearly identifying risks to be considered in the establishment of a valuation; and 3) managing for worst-case scenarios.

Positioning Against Vendor Performance Risk and Related Customer Payment Default

The art of determining appropriate residual values becomes particularly important if customers perceive inadequacies in delivery of the services included in a bundled deal. A customer threatening to take its case to court may demand unbundling of the pricing and residual values prescribed to the various transaction components.

In a poignant sign of the times, a few lessors interviewed have been sorting out customer bankruptcies involving bundled transactions. The good news is that the financing provider does possess recourse against the value of the IT hardware included in the original bundled contract. However, the lessor may be unable to recover any of the remaining value of the "soft" services, which increasingly make up more than half of the original contract.

"When you get right down to it, what we are financing are the soft costs," said an Industry executive recently impacted by a bankruptcy involving bundling. The soft portion of the contract constitutes a sizeable unsecured claim for the finance source, and it shows that bundling of "soft services" can at times be a riskier proposition than traditional equipment leasing, which nearly always entails a secured asset. In a bankruptcy, the lessor is focused on the financial value it could realize in the secondary marketplace – essentially limited to the hardware - rather than the ongoing value of the customer's solution. One leasing executive said his company is most comfortable in managing bundled transactions where the services portion of the contract is 25% or less of the total value.

For some study respondents, residual positions are solely based on equipment and are not impacted by vendor performance because the service and supply charges are simply being billed, collected and remitted to a third-party vendor each month as a pass through. These dollars are not funded up-front, nor are they paid unless they are collected. Because these contracts are still upgraded or terminated just like a traditional equipment leasing agreement, residual timing is not normally impacted. As a plus, any aspect of a bundled contract that allows the finance arranger to revisit the customer arrangement during the term can serve as a hedge against a decline in the residual position.

A possible hedge where services comprise at least 50 percent of the contract value is to have an agreement in place where, if the customer defaults due to vendor performance issues, the vendor agrees to replace the original service revenue stream with a new contract with a different client. Of course, this only works if the lessor is comfortable the vendor could actually perform. Additionally, this tactic can be interpreted as a lack of faith in the customer's stability, thus negatively impacting the customer relationship even though the concern is certainly realistic in this economy.

For an executive at one lessor impacted by lessee bankruptcy, lessons learned in a difficult market climate may force a return to industry basics. "If we have a few more customer defaults on bundled transactions, we will likely have to go back to traditional leasing," a bank executive said. This reaction may be one reason another long-time Industry participant said he has seen the use of bundling "go in waves" over the past 25 years.

Managing Reputation, Structural and Contractual Risk

With bundling, it is not sufficient for the lessor to ensure a customer is satisfied with the IT equipment leased. The lessor must also manage for the possible negative outcomes associated with provision of software and services. Even though the financial arranger works closely with technology vendors to extend the solutions spectrum on behalf of the customer, the customer will nearly always look to the financial provider to ensure fulfillment. As an interview respondent emphasized, "Ideally, customers want one neck to choke - yours… this is a major advantage of bundling to customers…they do not have to work with multiple vendors, but rather one lessor that will fit together the puzzle pieces of a complex technology solution."

Reputation Risk and the Hell or High Water Legal Provision

Study respondents frequently noted their concerns about the interrelated areas of reputation risk, enforceability of the hell or high water legal provision, and level of deal transparency associated with bundled transactions.

The bad taste left by a few high-profile legal cases, particularly the infamous NorVergence case, lingers for some potential users of bundled financing as well as for financing sources (See Appendix: Managing the Underlying Risk: Hell or High Water in Bundling Post NorVergence for more details on the legal issues surrounding NorVergence.) In these cases, customers have been disappointed by the actual or perceived lack of performance of associated services attached to a hardware purchase. As a consequence of the high visibility of customer dissatisfaction and frustration in the NorVergence case, a number of industry executives have also expressed fear about the negative publicity that can come with customer disappointment regarding the services portion of a bundled transaction. They believe this fallout could potentially harm their long-term reputation in the market and, ultimately diminish the value of their brand.

"How can a lessor separate reputation risk from a bundled transaction?" asked an Industry executive. "Contractual rights do not always mean much when it comes to reputation risk." Ultimately the lessor will still have to assume the risk associated with these bundled structures because, as noted earlier, even if the framework is outsourced to a third party, it is still tied back to the leased equipment.

It has long been a maxim in the marketplace that the hell or high water legal provision places the onus on the customer to pay for a bundled solution even if some services portion is unfulfilled. Nevertheless, the customer will still feel they have the moral high ground in such instances regardless of the facts. "Just because a customer has signed the provision and you are exempt from liability, it does not do your organization much good from a customer management standpoint, especially if word of these disagreements gets around," said a bank executive. And, as demonstrated in the NorVergence judgments, a court may side with the customer regardless of the documented safeguards.

Acknowledging that he usually faces some "front-and-center" risk, an executive at an independent lessor said that at any moment a small percentage of his portfolio is delinquent. This is not the result of a customer's inability to pay, but stems more often from the customer's dissatisfaction with the vendor. "Even though you have hedged against the legal aspects of this risk through the drafting of specific documentation, it still involves risk by association," he notes.

"Cleaner" options for the lessor in more complicated deals may be to document directly with the customer, or take direct assignment from the vendor only on the equipment. Then the lessor can still obtain the desired hell or high water contract protection on the equipment. A risk still exists, however, that the equipment could become unwanted should the delivery of services fall through. These approaches may also dilute some of the "single solution" aspect of the transaction.

For many independent and bank lessors interviewed for this study, and even some captives, one of the main drivers of their success with bundling is the expertise and agility they possess in working with a number of third-party vendors to deliver value to the end user. If managed diligently, partnering with quality third-party vendors can provide an arranger a differentiating competitive advantage. Therefore, "know thy vendor" should be a top priority for the leasing arranger, particularly given the tenuous enforceability of the hell or high water clause in bundled transactions. Respondents also noted that one of the best preventative measures is to avoid working with third-party vendors that provide a solution that may not be available from any other vendor.

Contractual Risk: The Importance of Deal Transparency

In properly managing customer expectations the importance of revealing the underlying realities of a bundled transaction cannot be underestimated. As a risk management tool a number of interview respondents agreed the bundled contract should provide all involved parties as much transparency as is practical. On the other hand, an inevitable (and traditional) tension exists between sales and marketing and the need to provide greater transparency to the customer. A few Industry respondents emphasized that they have seen a heightened "surveillance" of bundled contracts by customers demanding increased transparency.

Arrangers of solutions financing are encouraged to offer more detail in their contract documentation, pricing and underlying values. "It is very important for the lessor to specify who is owed what right up front," a long-time lawyer to the Industry said. "When it comes to providing transparency in pricing, for example, it is ideal to offer a separate line item in the contract for each part of the transaction, with a full and clear disclaimer for each item. Of course, providing this level of detail is certainly the ideal and is not always practical."

The recommended level of transparency may well sound naïve, but disclosing transparency in pricing can be advantageous to the finance arranger – at least over the long term. An executive at an independent lessor, for example, said his company "… provides complete transparency of its pricing to customers 99% of the time. This allows our customers to gain complete visibility to our actual costs. In the short term, we have no doubt lost some business by doing this, but we also believe that we are able to keep our customer relationships strong in the long term." He said his company keeps the levels and sources of revenue generation transparent as well. "They do not really change over the course of the deal," he added.

Many industry respondents indicated that arrangers of bundling contracts should, at the very least, offer a clear distinction between what comprises the key "soft" and "hard" components. Despite the value of offering further transparency to a customer, what is actually practiced in the market is quite diverse. In a complex bundled deal, there are a number of transaction possibilities that can occur, especially with substantial soft costs. “There is a spectrum of possibilities here – one where the deal is iron clad and all the products and services are spelled out completely and then there is the other side, where the deal is done on one page. I have seen both used,” said a longtime Industry veteran.

Structural Risk: Accounting Issues and Transaction Structure

Increased accounting risk to the financial arranger also builds as layers of services are added to what would have been considered at one time a simple equipment leasing transaction. “If an agreement contains too much in the way of services or software, it may not be proper to characterize it as a lease, since its substance is closer to that of a service contract or master service agreement,” Shawn Halladay wrote in 2008. “Although its economics may be the same as for a bundled lease, a master service agreement has different accounting characteristics for the lessor than does a lease, as well as varying income tax and legal consequences.”[10]

From an accounting standpoint, revenue is recognized as the service is performed, even if cash is provided at the beginning of the deal. Therefore, a critical challenge for finance providers is to determine how and when to recognize the revenue originating from each component offered in a bundled transaction. As the complexity of bundling evolves, financial arrangers must manage through a maze of revenue recognition standards that were largely created prior to the rise of the solutions financing approach.

In response, an ever-increasing number of usage-based billing and management reporting approaches have been introduced. In all of these cases, the financing provider should keep in mind that it is essentially financing layers of soft costs that can result in a number of revenue recognition possibilities. Differences in revenue recognition can result, for example, between a bundled transaction based on software licensing and one that hinges on use of the software, with billing based on its use.

Managing the Availability of Required BSF Expertise

Nearly all respondents interviewed internally house most of the capabilities required to manage solutions financing. In addition to captive lessors delivering technology solutions as their core business, banks and independent

[10] “Financial Reporting Aspects of Bundled Transactions,” Halladay, Shawn D. The Journal of Equipment Lease Financing, published by the Equipment Leasing & Finance Foundation, Fall 2008

lessors are ramping up their hiring of professionals with technology expertise. "In the near future we expect to expand or open new sales locations in targeted market areas where we can find qualified personnel," said an executive at an independent lessor. As an alternative, in order to take advantage of this opportunity many providers will not hesitate to turn to outside experts, such as accountants and lawyers, to provide advice regarding the specific risks associated with bundling.

Managing Back-Office Infrastructure to Achieve Operational Efficiencies

To ensure that the life of a bundled transaction is managed properly, the lessor must organize and run its back-office and processing operations proactively. "For us, effectively providing a bundled technology solution is all about operationalizing the services financing aspects," said an executive at a captive lessor. Major back-office functions such as accounting, legal, risk management, and billing require continuous attention by finance arrangers to correctly incorporate the nuances of services financing vs. equipment financing.

From an administrative standpoint achieving higher operational efficiency should be the objective. Some study respondents said they have recently invested in automation and technology as a way to bring efficiencies and scalability to the administration of bundling. Organizations not yet actively involved in solutions financing need to consider whether increasing its use would require them to transform their operational infrastructure. The answer will revolve around effectively adapting their company's particular business capabilities to the specific bundling opportunities targeted. "From an operational standpoint, we have been focused on building up our legal and accounting capabilities," noted one lessor. "But we don't have a need to make any significant change with our processing or back-office approach. We don't do enough deals yet." As noted earlier in this study, one captive provider realizes operational efficiencies by managing separate facilities in the U.S. and Europe devoted to executing a large number of bundled deals end to end.

The Big Picture: Leveraging an Embedded Risk Sensitive Culture

While many specific issues are noted in this study, it is clear that solutions financing is currently in a state of flux. Specific issues and solutions can quickly change in one or more important aspects. In terms of safeguarding the successful outcomes of bundled transactions in any environment, a number of interviewed organizations utilize tried and true risk management processes that are completely integrated into their transaction processing policies and procedures. These lessors regularly provide training to employees who are focused on executing bundled transactions. This represents a systemic approach to risk management that is entrenched across their organizations and addresses all aspects of risk. This approach is optimal for all lessors regardless of the financial product under consideration.

Strategic Implications of BSF

To Customers

Regardless of which financing source a customer chooses, the basic value proposition of BSF to the customer is the same: The ability to work within budget parameters and still gain access to needed technology. By contrast, although each of the Industry's major lessor categories are actively offering Bundled Solutions Financing in the market, the respective advantages and challenges they must manage are quite varied. As shown later in this section, the implications of using solutions financing for an independent or bank-owned lessor can be substantially different from those encountered by a captive finance arm of a technology vendor.

As acknowledged throughout this study, technology customers are finding it more difficult to make necessary expenditures in the face of aging IT systems and dramatic budget cutbacks. Many IT departments are under the most stringent capital expenditure, hiring restrictions, and employee cutbacks in their experience. The irony is that, regardless of the financial and credit challenges facing a technology buyer, ongoing investment is necessary to run a viable IT infrastructure that provides continued long-term competitive advantage. "Our customers are under a lot of pressure to cut back IT purchases, but they still need to acquire new technology to continue to run their infrastructure as cost effectively as possible. In the longer term they must be competitively positioned once the economy improves," an executive at a captive lessor observed.

As a result, "… customers are seeking increasingly efficient ways to leverage a vast IT infrastructure," notes the head of a major captive lessor. Bundled financing extends a welcome bridge across the gap between performance demands and financing restrictions by providing highly flexible customer-centric contracts and financing terms to meet increasingly complex procurement pressures. "I believe the packaged/bundled product brings a lot of comfort to the customer, enabling better long term strategic decisions," an executive at an independent lessor commented.

Among other distinct advantages, bundling helps the customer:

- Reduce time and resource costs;
- Lower the total cost of ownership;
- Transfer risk outside of the buyer organization;
- Overcome capital expenditure limitations;

- Gain strategic alignment with internal tax and accounting preferences;
- Speed IT implementation;
- Improve operational flexibility;
- Realize pricing scalability;
- Establish a deeper long-term partnership with the vendor and/or financial arranger.

Reduce Time and Resource Costs

As an essentially outsourced solution, bundling can drive cost reductions in procurement of equipment and services, overhead, and costly technical support.

Lower the Total Cost of Ownership

Lowering of the total cost of technology ownership is a major incentive for investment. The customer can also achieve greater efficiencies in managing maintenance and technology upgrades throughout the IT procurement life-cycle via a bundled transaction.

Transfer Risk Outside of the Buyer Organization

This is an advantage unless the customer perceives that the third-party technology vendor does not fulfill the agreed-upon bundled solution.

Overcome Capital Expenditure Limitations

Unforeseen CapEx requests can derail even the most foresighted budget. Bundling allows customers faced with capital spending limitations to more easily migrate to managed services, since the monthly subscription payment does not qualify as a capital expenditure, but is included in operating expenses. “The uptake in this approach comes from customers not wanting to make a large initial capital outlay,” said a banker. Bundling provides a financing tool that smoothes the impact of potentially high upfront technology investments, especially those weighted toward the procurement of software and services.

Gain Strategic Alignment with Internal Tax and Accounting Preferences

If structured appropriately on behalf of a customer, the solutions financing framework helps alleviate the complexity associated with multiple accounting interpretations related to large IT implementations, especially those spanning a number of product categories and geographic locations.

Speed IT Implementation

With more than half of a typical company's IT infrastructure devoted to development and testing, technologists need to quickly gain access to the newest software, technology or services. Bundling can speed the approval and procurement process for CIOs, better matching costs with benefits, nimbly (compared to other forms of financing) dialing up or down project requirements.

Improve Operational Flexibility

Bundling provides large customer companies further operational flexibility by simplifying the management of complex IT infrastructures.

Realize Pricing Scalability

A number of study respondents said customers of all sizes are willing to pay more for a total solution rather than use limited internal resources to purchase and integrate separate components. Also, processing a single invoice each month is something that most savvy customers recognize as a cost savings to their organization.

Establish a Deeper Long-Term Partnership with the Vendor and/or Financial Arranger

Solutions financing helps deepen the relationship between financing arranger, vendor and customer by providing long-term benefits to the buyer, including servicing and reliability.

Strategic Implications of BSF

To Technology Vendors and their Financing Partners

Value to Venders

As the world's top technology vendors maneuver through unchartered credit and economic waters, they face a daunting array of market and competitive forces. These challenges include shorter product cycles due to rapid technology changes, long and complex supply chains, disruptive competition from technology and value-chain innovators, demanding cross-border international and multinational customers who leverage sophisticated global procurement strategies, and shrinking margins on their core line of hardware products.

More than a decade of evolution of the Internet as an IT platform, the emergence of transformational technology, and the wider acceptance of open source software have created an increasing customer demand that this complexity be tied together in a single, holistic solution. However, many of the executives interviewed for this study emphasized that customers are much less patient when coordinating multiple vendors for their equipment, software and services, even with a holistic approach.

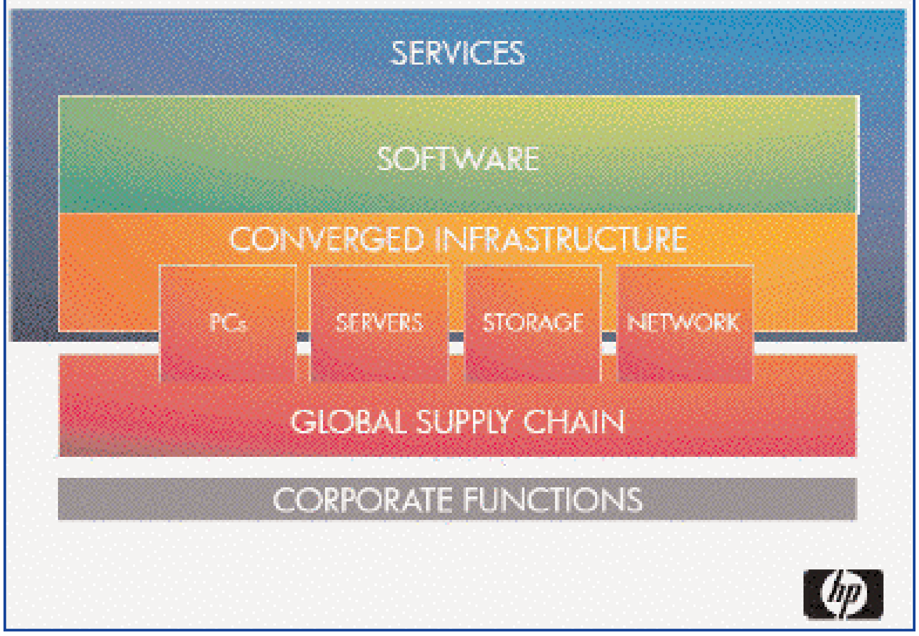
In response, a number of large technology vendors are merging with vendors offering complementary product and service portfolios, marketing integrated solutions as a capability that can lead to further competitive differentiation, and turning to third-party sources of finance to partner with them in creating a solution. As illustration, two major vendors, HP and EDS, have merged with the goal of becoming one of a handful of full-service IT solution providers capable of delivering a broad range of customer offerings on a global basis.

As a strategic centerpiece for these vendors, bundled combinations of hardware, software and value-added services are being developed and introduced at a startling pace, possibly even accelerating during this economic downturn. This, in turn, allows innovative vendors an improved ability to remain above the rising watermark of asset commoditization and intense price-based competition. HP, for example, utilizes a global operating model that wraps its integrated offering with "customer-driven global services to optimize supply chain and corporate overhead to maximize cost advantage, leverage a broad portfolio based on industry standards to capitalize on technology convergence, and differentiate with a value-added software layer." (See Figure 5)[11]

[11] HP investor presentation "Uniquely Positioned to Win," by HP CEO Mark Hurd, 24 September 2009

Figure 5

HP's Global Operating Model



Based on recent interviews and industry commentary, economic realities – not just customer demand – are increasingly incenting technology vendors to leverage bundling. As credit markets worsened, approval rates for vendor financing programs declined. At the same time, vendors experienced dramatic price increases and service cuts. This pushed vendors to look for funding alternatives, including bundling. The advantage vendors realize with bundling goes beyond the ability to offer a greater breadth of services. It also allows the vendor to generate much needed cash flow, particularly in the early stages of the technology sales cycle, while preserving increasingly scarce internal capital for future investments in R&D.

Technology vendors are turning to financing sources not only to capture this additional cash flow, but also to preserve profit margins and returns in the face of declining equipment costs relative to soft costs. "We understand that our vendor customers have a need to generate cash and book sales," said a bank respondent. "It is all about the end result." Relying on its own financial resources, the resulting combination of a direct debt obligation and long-term customer credit risk could adversely impact a vendor's financial performance. "Beginning about a year ago, I have seen a lot more vendors who are asking how to bundle more services into a lease," said a bank leasing executive. "Bundling provides a vendor incentive through both improved cash flow and the ability to recognize a sale."

Even in a normal economic climate, vendors could introduce new generation offerings to the market on their own, but working with a lessor facilitates marketing their wares to a different, and potentially larger, audience. "Obviously, the solutions financing concept would not be successful if only a few end-user customers realized the value of purchasing a complete solution," said an industry executive.

Some lessors work closely with their vendors by outlining "a business road map" to identify sales opportunities along the IT services sales cycle. "Fundamentally, we help the vendor chase down business during the sales cycle by assisting with their accounting and documentation," per an executive at an independent lessor. The leasing company also organizes other managed services during a vendor's sales cycle, which results in a consistent revenue stream, especially in the early stages of the cycle. This arranger believes it is well ahead of many its competitors in managing this aspect of vendor relationships.

Bundling helps ensure the vendor's assets are deployed more efficiently and profitably over their lifecycles. In a bundled transaction, a vendor is better able to measure the usage of a technology solution in the marketplace. In essence, this offers a vendor the opportunity to "road test" its latest portfolio of technology products and services, increasing the value of its offering while managing against commoditization. In certain cases, it facilitates vendor creation or adoption of new services solutions or products to help increase market differentiation, as described in Innovation Case Study 2 in the Appendix. Bottom line, a reliable innovative vendor and the right financing partner can ensure the proper execution and resulting increased adoption of a bundled solution. "In my opinion both the solutions provider (the financing lessor) and the technology vendor are driving this approach, since it offers both of them unique benefits," said a finance executive.

Financing Partners: Managing Associated Vendor Risks

To assess the viability of partnering with a particular vendor, lessors should, at the least, consider the size and reputation of the vendor, its product mix, the competitiveness of its products, and the investments it is making to upgrade its technology. A financing provider can also gain insights into a vendor's long-term viability by observing its commitment to such solutions components as maintenance and servicing, and its consistency of execution on all aspects of bundled transactions.

If the lessor has chosen to utilize a three-party agreement, it should be well aware of potential agency risks should the deal fall apart. In particular, the non-vendor financier is vulnerable to some loss of direct management control over the service provision of a bundled contract. "The number one criticism against solutions financing is the fear of loss of control," said a bank executive. "The fear is that your position as an equipment lessor is not the top priority in the contract, therefore you lose the servicing capability and are not in a position to get the best price for your core asset."

For the lessor, at least two highly negative bundling scenarios underscore the challenges of vendor accountability and potential for longer-term harm to the lessor's reputation: 1) if the customer believes the vendor is not delivering the agreed upon bundle of software and services; or 2) if the vendor defaults. "The key question is who is going to be the vendor's replacement and who is going to pay the new vendor to provide the originally agreed upon services," an Industry attorney said.

Nothing will harm the trust underlying a bundled contract more than the customer's perception – accurate or not -- of shortcomings in the services provided, especially since judicial decisions in the NorVergence case showed that a court could rule there is no difference between the finance and service providers, causing both to lose. "Our legal department would like us never to 'bury' a vendor maintenance payment in our transactions, potentially blurring the lines between lessor passive finance and vendor performance and payment issues," noted an Industry participant.

In addition to the various service provider performance risk mitigations mentioned earlier in the study, other risk management tools can be deployed by the funding source, such as:

Seeking Vendor Indemnification or Buyback. When contracting a vendor arrangement, the agreement should be clear regarding clawbacks between the vendor and the funding source for unperformed services in the event of a default, and vendor's indemnification for non-payment due to customer perception that the vendor has not satisfactorily performed on the services provision. "In the case of early termination of the services portion of the contract for non-performance, if you have a viable vendor you could have recourse to make them buy back the services," suggested an attorney active in the Industry. "You could also build up a reserve for the indemnification."

Applying Definition of Accounts Receivable. If appropriate, the arranger should look for opportunities to apply a definition of accounts receivable to some of the services components in the contract. To the extent that the portion of the contract including services is defined as accounts receivable, the law will offer some protection.

Investigating Applicable Insurance Coverage. Based on Industry demand, a few insurers are offering some form of protection to help lessors guard against vendor default or early termination of promised services.

The good news is that a number of executives interviewed emphasized that the execution of a satisfactory bundled arrangement with a vendor is normally straightforward as regards not only indemnities, but also typical responsibilities such as collection and remittance of maintenance payments back to the vendor partner. However, since a bundled contract is not simply an equipment lease, the lessor should be aware of the most likely areas where operational challenges may arise:

- Administration of pass-through payments;

- Administration of variable payments;

- Provision of vendor reporting to allow the vendor to manage its payment reconciliations in a more accurate and user friendly manner;

- Active management of short payments and delinquencies with the vendor partner;

- Quick and accurate resolution of customer questions when there are changing payment terms during the life of the financing.

The lessor needs to be confident that it can adequately manage these aspects of a bundled transaction. For example, if variable costs are included in the vendor contract the lessor should be aware that many lease invoicing systems do not handle variable billing efficiently. Because of recent downsizing, which constrains internal resources and systems (i.e., hinders the lessor’s ability to manually process these transactions) these administrative challenges become especially relevant.

The lessor should also determine upfront who is responsible for the sales and property taxes incurred in the bundled deal. A bank executive underscored how taxes can increase the challenges of accounting for a bundled deal. “A transaction is made much more complicated when you account for sales and property taxes in a single payment,” he said. “It does raise the central issue of who is responsible for the sales tax and property tax in the transaction.” Additionally, tax treatment of a bundled transaction is determined pursuant to each state's applicable statutes, which adds another layer of difficulty.

Strategic Implications of BSF

To Captives

A number of large captive subsidiaries are financing a significant portion of customer purchases through bundled arrangements. They have the margin flexibility to drive their parent's sales and earn an additional revenue stream. Solutions financing also allows them to closely manage customer relationships over time to better ensure future sales.

An executive at an independent lessor believes captives possess a major advantage from a risk exposure standpoint since they also have more flexibility in assuming the underlying risk in these deals. Captive finance sources typically have more control and influence over many aspects of the bundling contract beyond margins, including services offered, levels of servicing, and pricing. Additionally, they are able to efficiently create and manage a portfolio of bundled solutions, spreading the risk. "Captives are doing a lot more bundling now than before," this same respondent said.

As illustrated by the earlier HP-EDS example, large captive lessors are aggressively pushing their services agenda in the technology arena, even to the point of emphasizing software and services over traditional hardware assets. They have come to appreciate the value of capturing additional services-based revenue on top of what can be earned on ever-lowering equipment margins. Some providers have even undergone internal reorganizations to facilitate software and solutions businesses playing a much larger role in their company's future strategies.

Bundling is an attractive value proposition for customers of captive lessors. By leveraging strong residual value positions on its hardware, the captive can offer the customer a lower cumulative hardware cost, enhancing the customer's ROI and Net Present Value savings compared to outright asset purchase. As an example, captive lessors have been promoting solutions financing to help larger technology buyers consolidate their data centers, creating economies of scale, reduction in annual energy consumption, and increased overall processing power. One captive respondent to this study is offering new assets and services for the process of data consolidation and is adjusting its bundled pricing upward as the pricing for the underlying hardware assets remains flat or declines.

Bundling provides captive lessors an opportunity to gain in-depth market knowledge to make strategic adjustments to their product based on ever-changing customer requirements. In an example noted earlier, greater focus on environmental issues has prompted providers to add financing options that give end users green alternatives for asset recovery and disposal.

Captives: Managing Associated Risks

Despite the many advantages inherent in providing bundled solutions to its customers, a captive finance unit does face financial vulnerability. Although better customer information enhances the captive's ability to manage the credit and residual value risk normally associated with solutions financing, its products and programs may impact the parent's revenue recognition and – at times – overall financial performance since, as discussed earlier, revenues earned from services provided are deferred and recognized over the period during which the services are to be performed.

The challenge of parent revenue recognition, in turn, requires the captive to maintain a certain level of debt to support its investment in these contracts. A number of captive lessors record the equipment's fair value as a sale at the beginning of the contract and the remaining "soft" components of the customer's monthly payments as revenue after the sale. In transactions that do not qualify as sales-type leases, increasing as a result of the growth in services-led strategies, revenue is recognized as "post sale revenue" over the term of the contract, whether rental or operating lease. In applying their accounting methodology, captives can allocate the fixed monthly payments made by customers to the relative fair value elements of the contract. To hedge risk, some captives have also designated their contracts as non-cancelable and have included cancellation penalties approximately equal to the full value of the lease receivables.

More details on other challenges captives face in managing solutions financing for the parent manufacturing company, such as internal conflicts over price or margin, accuracy in residual assessments, and the degree of end-user transparency provided have been covered earlier in this study.

Strategic Implications of BSF

To Independent Lessors

Customers are driving solutions financing demand for independents. “We are not actively looking for bundling opportunities,” said one of the independent executives interviewed, “It has really arisen as a need put forth by our customer to bundle services with the equipment we are financing. We see ourselves as the banker for a unique customer solution.”

Bundled financing allows an independent lessor to move away from price-only competition where they might often lose against their captive and bank counterparts. Instead, focus shifts to the quality and innovation of the solution the customer receives. Whether an independent lessor’s role is limited to financing a bundled transaction or involves originating the transaction as a form of product differentiation, independents are particularly reliant on their third-party technology vendors for delivery of a bundled solution. The vendor partners selected, the quality of the lessor/vendor relationships, and the qualities of services provided are key to a deal’s success.

As the financial originator, the independent lessor offers credit and financing expertise and the vendor delivers and manages the value-added solution requested by the customer. Both parties are more effectively bringing their unique strengths to the marketplace. “In this difficult economic environment, organizations are increasingly focused on their core services and products,” said the head of an independent lessor. “Bundling offers us an opportunity to bring together the respective strengths of our organizations in a type of joint venture.”

In selecting appropriate vendor partners, another challenge for an independent lessor could be having to coax technology vendors away from their traditional banking relationships. As an incentive, the independent leasing company must convince the technology vendor that it will benefit from partnering together to build a unique, high-value solution that could be marketed to a potentially broader customer base than the vendor might otherwise access. The lessor can also offer smaller vendor partners use of resources they might not possess or afford on their own, such as certain software licenses.

Some independent lessors champion a proactive approach to bundling technology solutions as a form of product differentiation. “In most of the markets where we offer bundling, we find this capability helps our vendor offer a more complete solution to their end-user customers,” said an executive who has developed a bundled solution in the copier market. His on-demand program gives copier dealers the ability to offer their customers one monthly invoice including equipment, all of the supplies, and the maintenance needed to produce a certain number of pages per month. “We earn money through financing the affiliated asset - in this case via a cost-per-page program,” he said, adding that some funding sources also charge a fee or higher rate to cover the additional administrative costs of this type of program. “We try to use advanced automation and technology as a way to bring efficiencies to the additional administrative effort.” This approach also helps the copier dealers differentiate themselves from their competitors.

Independent lessors may look to minimize their cost of sales by participating in reseller programs provided by technology manufacturers. These programs are governed by the degree of reseller authorization the lessor has negotiated with the manufacturer. The authorization level dictates the types of products the lessor can resell and at what prices, as well as the funding received for marketing the original equipment manufacturer’s (OEM’s) product mix, including special promotions. The lessor meets vendor expectations mainly through sales volume, which is largely driven by the sophistication of its sales force and in-house engineers. Not surprisingly, the business of managing reseller authorization levels can prove to be rather expensive for lessors given the natural fluidity in ever-evolving technology products.

For those independent lessors more interested in earning the margins associated with bundled technology solutions, without actively helping to develop them, a partnership with a third-party expert (the “outsourcing arranger” discussed in the study section “Value to the Industry”.) might make sense. Relying on an outsourcing arranger to develop solutions on its behalf could help a smaller independent focus on maximizing its sales margins.

Independent Lessors: Managing Associated Risks

While independent lessors can benefit from the margins associated with bundled financing, the product increases their vulnerability to their customers’ perception of the value of the technology solution itself. One major downside is that a dissatisfied customer may go elsewhere for the service underlying the bundled deal. Therefore, it is in the lessor’s best interest to establish appropriate exit structures and strategies for the services provided. As discussed earlier in the risk mitigation section of this study, these lessors should also focus on bundled services solutions that can be replaced by competing vendors, rather than too often relying on vendors who develop and deliver proprietary solutions.

“Know thy vendor” applies here as well. Independents must balance how much responsibility they are willing to share with a third-party technology vendor on a particular bundled transaction. Decisions include which elements to include in the contract, which to exclude and what services elements the integrator must manage and be ultimately responsible for to the end-user.

“A high percentage of our bundled transactions come in the form of private-label structures,” noted an executive from an independent lessor. “In these private-label arrangements, we have strong assignment language with the vendor regarding our company enjoying the benefits but not the obligations.” If his company encounters a problem with a vendor, it will sever the private-label arrangement and work closely with the end-user to find another vendor that meets their requirements. This lessor prefers to leverage technology solutions it knows can be reproduced by other vendors and will try to avoid proprietary products.

The lessor in the preceding paragraph will make exceptions with a proprietary arrangement “where both we and the customer see significant long-term value in the deal.” However, in a lesson learned from the NorVergence case, this independent provider will not fund the vendor upfront. It will only finance expenses based on the actual use of the equipment assigned to the bundled contract.

In all scenarios, the vast majority of independent leasing executives interviewed for this study emphasized that only by running a dedicated bundled financing program can they make the appropriate choices. When it comes to succeeding with Bundled Solutions Financing, they feel strongly that experience is tantamount.

Strategic Implications of BSF

To Bank Lessors

At a time when capital comes at a considerable premium, banks have naturally emerged as one of the leading financing sources and are increasingly asked to offer Bundled Solutions Financing. "In today's market, conditions have clearly placed the funding provider in the driver's seat," said a banking executive. Validating this, a captive leasing executive conceded that banks are able to offer more attractive pricing to their customers, especially in a tighter credit climate. "They still have the financial wherewithal to provide their priority customers more competitive pricing than captives," he said. "We are not even in a position to offer price as a differentiator." And, an executive at an independent lessor believes customer demand for banks to provide solutions financing is being driven by availability of credit. "It all comes down to a question of credit – who can provide it and to what degree," he said, adding that pricing is always subordinate to whether the customer can access credit.

Bank leasing executives appreciate the value in financing bundled technology solutions for their customers, and not just as an alternative to fill in financing gaps created by the current economy. One banking executive, for example, has seen bundled transactions earn higher margins for his bank. "I am very pleased to see the pendulum is finally swinging back in terms of the grudging willingness of lessees to accept higher margins," he said, adding that in the past the high level of industry concentration and competition drove lower margins. However all good things must end, and he sees a window of one to two years of continued margin flexibility in the market.

In addition to access to financing, bank lessors possess some inherent advantages in managing a bundled solution. They have the resources and experience to offer combined tax, accounting and legal expertise to support solutions financing. Typically, they can also manage UCC assignments, filings, extensions, terminations, and provide the appropriate reporting. It is common for banks to hire executives, even those with a sales focus, which have formal legal and tax training. Certainly, as compared to their captive counterparts, banks present greater neutrality regarding their use of capital, particularly as it relates to the assessment and management of residual values and credit exposure. Over time, the bundled approach also allows a bank to gain a more comprehensive view of the customer's capital structure, further improving their financial product offering.

Even though they are not directly involved in the manufacturing or reselling of technology, bank leasing units are building up their market expertise, especially by partnering with captive lessors and other IT vendors. It is not unusual to find even a mid-size bank managing a technology finance unit focused on providing bundled solutions to customers such as professional services firms, health care providers and education entities, for example. “As credit becomes more rationalized, how do you differentiate yourself strictly through financing?” asked an executive at a mid-sized bank. “We see ourselves more and more as a solutions-oriented business. By leveraging bundled contracts, we have more to offer as a bank.”

In partnering with third-party technology vendors, some banks are offering financial solutions tailored specifically for the managed services and outsourcing market. The bank offers vendor customers access to debt on a non-recourse basis and the opportunity to receive up-front revenue recognition on the equipment component of the solution, based on the vendor’s credit standing. This can be a powerful combination in attracting a desired vendor partner.

Bank Lessors: Managing Associated Risks

The downside for a bank offering solutions financing is the assumption of some level of vendor performance risk. As noted previously, a bundled contract can put the financial provider’s reputation at risk if the end-user has issues with vendor performance, real or perceived. “The key question for us is whether we can be roped into product and performance issues,” said a bank leasing executive. “How does a lessor separate reputation risk from a bundled transaction? Reputation risk is stopping me from offering this type of financing.”

A bank’s uneasiness can also center on more traditional issues such as the creditworthiness of the parties involved in the arrangement. “It is really more of a credit decision on our part,” said a bank executive. “Many times we are involved in transactions where soft costs comprise at least half the transaction. The underlying risk is lending against an unsecured product and/or solution that includes a lot of costs which have absolutely no resale value. Even a captive lessor, which can control most aspects of delivering a solution, would be vulnerable in trying to recover the value attributed to soft costs when a customer defaults on a bundled contract.”

Conclusion

Bundled Solutions Financing represents an under-exploited opportunity for the Industry. Traditionally, the Industry has had its best penetration in growing markets. The classic example has been the technology hardware market, where leasing has always had the largest single share of the financing opportunity. While the cost and importance of hardware is diminishing in the technology market and there are many equipment segments where BSF could be applicable, this study proposes that the largest immediate opportunity remains in the technology sector.

While this is good news for the Industry, the current evolution of technology requires modifications to the traditional equipment finance product set if the opportunity is to be realized. As noted somewhat ironically in the study title, end-users are moving from purchasing technology equipment and software to a services model, where equipment takes second place to software and other soft costs. Leading-edge technology providers are moving even further along this spectrum to an on-demand model that closely mirrors public utilities in terms of how the customer acquires needed technology capacity and capability. For this utility-like structure, hardware is not a transaction component that is visible to the lessee. Instead, the lessee purchases a capability, like electricity, that is simply there when needed. And, this capability is delivered via the Internet with no “box” required.

Both economic and technological realities are accelerating the rates of adoption and evolution of solutions financing among technology providers, especially in terms of removing equipment as an identifiable component of the financing. This study postulates that the increasing rate of change is most accurately described as revolutionary –technology providers and users must move ever faster simply to maintain their respective competitive advantages.

The message to lessors is that they must change their traditional equipment-centric financing product to take advantage of this opportunity, which is the fastest growing area of technology. Lessors will struggle if they attempt to use the traditional paradigm of an equipment-based leased, where the lessor can obtain a security interest in the equipment and the hell or high water clause has a history of judicial enforcement.

Therefore, Bundled Solutions Financing requires lessors to accurately determine the true risk components of the transaction, identify their risk appetite for the product, and create realistic mitigation plans. Only after the risks are clearly understood and dealt with can each lessor create the strategies that will allow it to identify those segments where it will be competitive in vying for opportunities.

This study provides Industry leadership with a better understanding of this innovative financing approach. It should be used as a reference source on the strategic implications, risk/reward trade-offs, advantages, and disadvantages of bundling. It is our sincere desire that the information and insights provided will result in the development of value-adding competitive products to ensure the Industry will continue its preeminent role as financier in the technology sector. Additionally, we believe this study can help lead the way for lessors to use their learnings from the technology sector to expand the leading-edge financial offerings the Industry provides to other market segments.

Appendix: Managing the Underlying Risk:

Hell or High Water in Bundling Post NorVergence

At first glance, legal precedent in the United States appears to side with the arranger of bundled transactions in receiving protection from the perceived default or inability of a vendor to deliver a bundled solution to a customer. A recent article in the Journal of Equipment Lease Finance explained: "…When the purchaser buys a properly structured equipment lease transaction, constituting a "finance lease" under Section 103(1) of Article 2A of the Uniform Commercial Code (UCC), the purchaser can be confident that the rental payments under the equipment lease are irrevocable and Independent obligations that will be paid notwithstanding any defenses the lessee may have against the vendor, the equipment lessor or any other party, and regardless of whether the equipment performs or any services or supplies are provided. The hell or high water nature of the lessee's obligation to pay rent under an Article 2A finance lease (that is not a consumer lease) is virtually always set forth in the equipment lease and is further enshrined in Section 407 of Article 2A.3."[12]

However, including bundled services in the leasing contract does appear to complicate matters for the financing provider, who could still be left vulnerable due to the non-delivery of services to the customer. "Since bundled transactions may mix equipment acquisition financing with future procurement of goods or services, bundled transactions interject the possibility that a portion of the payment streams purchased will not be of the type originally intended to receive hell or high water treatment," added the Journal article.[13]

In some cases, including NorVergence, court rulings have indeed shown that the hell or high water provision will not offer blanket protection for the lessor. As bundled transactions become more prevalent and complicated - with the inclusion of substantial on-going services and multiple vendors - the ability for the financing provider to obtain standard hell or high water language for a complex bundled solution appears to be dissipating, much less the ability to enforce the provision. Often, customers are not willing to sign a hell or high water obligation where there are significant future services to be provided. Rather, the customer may insist on strong 'out' language to end a contract should the servicing not meet its needs and expectations. This scenario, of course, has negative implications for an equipment investor.

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[12] A"The Impact of Bundling on Equipment Lease Syndications from the Purchaser's Perspective," Rosenblatt, Philip R.; Patterson, Stephen J.; Rosenstein, Richard S. The Journal of Equipment Lease Financing, published by the Equipment Leasing & Finance Foundation, Fall 2008

[13] See note 12 above.

“Most cases will go into a summary judgment which the customer will see as being less than equitable,” noted an Industry attorney. “Over the years, I have seen that judges will occasionally try to get the financing provider to pay for something they are not able to recover for – this is a worst case scenario as the financial provider will not be able to collect their money and will be responsible for providing the service.”

An attorney interviewed for this study said he also has seen an erosion of the hell or high water standards recently, especially at the state level. “I have seen the vulnerability of the Industry emerge on the state level due to case law and the investigations of state attorneys general,” he said. “The theory is that they have seen the practice of bundling as being unfair and even unconscionable. States have mini FTCs which have been known to exact difficult regulations when it comes to these contracts.”

Perhaps surprisingly, a number of executives interviewed for this study did feel reasonably protected by the hell or high water obligation in a commercial bundled contract. “With an automobile, if you have an accident because of a defect in the equipment, you blame the manufacturer and not the company financing that car loan,” an industry executive said. On the other hand, in a concern voiced throughout this study, a few study respondents emphasized that the hell or high water provisions are not helpful in protecting them from reputation risk if an assigned vendor is unable to fulfill an intended bundled service prescribed in the transaction.

The NorVergence case dramatically demonstrates the exposure that Industry participants can face in working with third-party vendors, especially those that develop and market highly proprietary technology solutions. NorVergence sold proprietary bundled telecommunication services to small businesses, nonprofit organizations and municipalities. The New Jersey-based provider allegedly did not deliver on promised services and filed for bankruptcy in July 2004. The finance companies that funded its contracts were not paid upon the bankruptcy filing.

Many of NorVergence’s customers were promised savings – from 30% up to 60% – on their telephone, cell phone and Internet bills if they rented "revolutionary" technology called a Matrix box, which NorVergence distributed. Ultimately the case attracted the attention of the Federal Trade Commission, among other consumer protection representatives. The FTC accused the Newark-based company of defrauding customers by charging inflated rents for the boxes – $400 to $5,700 a month. NorVergence then sold the leases through syndication to a number of equipment finance companies in order to generate much-needed cash flow. Ultimately a number of the finance firms that handled NorVergence's rental agreements agreed to forgive most of the debt owed under a settlement reached with attorneys general in more than 18 states.[14]

Although the NorVergence case has apparently not diminished interest among the lessor community in offering solutions-based financing, interview respondents did indicate an aversion to engaging in a secondary market to generate additional revenue in the process. No doubt this aversion stems, at least in part, from the NorVergence fallout. "I see no potential for large-scale syndication and bundling, especially in this post-Enron era," said a captive executive, "Deeply subordinated risk is definitely off the table at this time."

An executive at an independent leasing company has seen post-NorVergence syndication of bundled contracts on only a couple of occasions. "To do so is a much bigger challenge than managing a regular bundled transaction," he said. "I think it is much more difficult to gain agreement from a lease syndicate when it comes to the bundling process."

The silver lining for the Industry is the generally positive perception of Bundled Solutions Financing. "Over the years, I have I seen a few instances where a traditional funding source refused to be involved in a bundled transaction," noted a long-time Industry observer. "Of course, the NorVergence case has increased the scrutiny these transactions receive. There is heightened caution in the underwriting process, which now requires a much higher level of detail so that risk departments can better understand the product's application in a specific lessee situation. There has also been a stronger desire for transparency, which has broadened product acceptance in the Industry."

[14] *The Washington Post:* 20 June 2005, "Promised Savings," by Dina ElBoghdad.

Appendix: Innovation Case Studies

A number of study respondents emphasized that they are attracted to Bundled Solutions Financing because it provides them an opportunity to showcase their differentiating innovation with their valued customers. The following case studies provide 2 real-life examples.

Innovation Case Study 1: Boosting Profitability for an Energy Distributor

In this case, an independent lessor structured a bundled contract with an electricity distribution company to boost profitability with commercial energy customers. The distributor wanted to better determine its customers' energy usage, especially during periods of high demand. Together, the distributor and the independent lessor successfully sought out a third-party vendor to design technology to remotely track usage. Using the improved information provided via this new technology, the energy distributor lowered rates on kilowatt usage during peak periods while still increasing its profitability. "The power company needed to show a positive return on this technology investment. The success of this bundled solution was based on the perceived product value," said an executive at the independent financing company. "We provided a financial solution that delivered the economics the customer needed to implement the monitoring technology."

Innovation Case Study 2: Competitive Differentiation through Bundling

For over three years, one independent leasing company has aggressively partnered with third-party technology vendors to provide solutions for a diverse array of customer segments including office equipment, health care, and telecommunications. The lessor believes it has developed a distinct competitive advantage with these segments by developing end-to-end bundled solutions that would be difficult to replicate solely through the application of technology. About 10% of its staff is dedicated to developing and maintaining these holistic bundled solutions. "We believe this is a point of sustainable differentiation for us," said an executive at the independent provider. "In all our major markets we have developed so many points of differentiation we believe it would be hard for our competitors to catch up."

As an example, the lessor supplies copier and printer dealers with readers that provide remote measurement of customer usage of equipment and supplies. "We are achieving more seamless integration with our vendors by providing remote meter reading tools within the customer environment," noted the executive. "Bundling has driven the development and active use of this system." The lessor consolidates data from the remote locations and reports actual usage to the vendor. The vendor then transfers invoicing data back to the lessor, who provides complete billing support. For end-users, the executive notes that a single monthly invoice is a big driver in the success of this particular bundled product. "We use bundled billing as a strong point of differentiation," he said. "We control the entire billing and collections process, which also saves dealer resources."

The executive added that his company would not consider outsourcing the bundled process for two major reasons: 1) the advantage gained in dealer relationship management, and 2) the possibility of service gaps that would be unacceptable to his customers. He cited a situation where, for a time, a competitor outsourced similar processes to India but the approach "ultimately turned out to be less efficient to the provider and much less satisfactory from a customer management standpoint."

"Though we still have some manual processes, the need to efficiently add a very large number of printer/copiers to the end-user base drove the creation of automated meters for data collection," the executive said. The remote meter has become so well accepted in the market that it is now considered best in class. The technology created to facilitate bundling has given the lessor an additional source of income since its electronic meter reading units can now be purchased separately from its financial services.

Appendix: Bundling Across the Equipment Spectrum

In addition to the information technology sector, Bundled Solutions Financing is offered in various forms across a large number of industries; notably communications, the auto and truck fleet business, and aircraft leasing. "We see bundling across a broad spectrum of equipment where at the very least maintenance and servicing is typically included," said a bank executive.

"I have seen bundling used extensively in the fleet leasing business, which involves all possible customer lifecycle issues including fleet maintenance," said a leasing executive. "Trucks in particular need turnkey maintenance." Bundling has also been applied to the leasing of aircraft, where not only the aircraft is leased, but also the crew, fuel, maintenance, and other services necessary to operate the flight.

Bundling has long been regarded as the basic product model for retail and commercial customers in the communications industry. Additional impetus for its use continues as major sectors of the communications industry converge, driven largely by the bundling of telephony, video and Internet services for consumers. This convergence, however, has led to a greater threat of commoditization as competitors market virtually indistinguishable bundled service packages. There is one major challenge to be resolved for the bundling product in this market: "Complex issues around consumer taxes and tariffs are forcing parties to consider who should do the invoicing - the lessor or the vendor," an Industry executive said.

As illustrated elsewhere in this study, office equipment is another area where the bundling approach can be effectively leveraged. One finance provider is marketing a bundled approach to equipment dealers by demonstrating they can lock in customers more readily, and compete more effectively on service than price against a broad variety of competitors including IT VARs, print resellers, and large national suppliers. Symbolic of the competition that has emerged in this arena, HP has offered to make up the difference if projected savings from its "Managed Print Services" offering are not realized within a year of implementation. HP is looking to better penetrate a global printing market that is estimated at $172 billion.[15]

A number of interview respondents indicated they see considerable opportunity for bundling in the health services arena, especially as the population ages. In a variation on the "razor/razor blade" analogy, the solutions financ-

[15] HP press release, 13 July 2009: www.hp.com/hpinfo/newsroom/press/2009/090713b.html

ing approach of "Cost per Test" or "Cost per Procedure" is already utilized across a variety of medical and laboratory equipment. In this approach, the up-front equipment cost is minimal, with the balance recovered in the cost of materials used for each test or procedure.

Bundling could also be considered appropriate for large public finance projects. Though a few study respondents did not yet see bundling being applied to specific infrastructure projects funded under by the Obama Administration, long-term potential might reside with the vendors approved for these projects. "What will be the intersection between infrastructure financing and the new administration's emerging approach?" asked a long-time Industry veteran. "This could incent an increased use of bundling as well." According to recent estimates, U.S. government stimulus spending will add $40 billion to $60 billion per year to the overall U.S. IT industry over the next few years.[16]

One Industry leader believes bundling can be leveraged as a differentiator across all equipment product categories, though its comparative advantage can depend on market differences and demand in a challenging economic climate.

Regardless of which equipment sector discussed, bundling has three major variations; focus on price, product, or solutions.

- With **Price Bundling** the arranger brings together separate products and sells them as a package at a discounted price. A number of disadvantages are associated with this approach, including the possibility of further price competition and its negative impact on margins. This approach is seen in the communications industry.

- With **Product Bundling** the arranger integrates two or more complementary products and services and, in doing so, creates some pricing flexibility. The benefits accruing from this approach, however, are often short lived and apply to more mature product offerings.

- The subject of this study, and the most sophisticated – in most cases the most effective – form of bundling is the **Solutions-Driven Approach**, which addresses customer needs by combining diverse products and services. Its many advantages include difficulty in imitation, the opportunity to utilize the product in new markets, and the ability to generate wider

[16] Estimates by Pierre Audoin Consultants (PAC) based on passage of the American Recovery & Reinvestment Act (ARRA), 1 April 2009

Study Definitions

Bundled Solutions Financing:
As used in this study, the term Bundled Solutions Financing entails the financing of equipment along with associated soft costs (e.g., services provided by a lessor or third-party vendor), with the lessor arranging a single transaction that provides an all-encompassing business solution. In the technology marketplace specifically bundling has come to denote an offering that combines the financing of equipment - such as on-premises servers – with "soft" components including software, installation, maintenance, and managed and professional services. Other soft costs bundled more recently by financing providers include transportation, remote support, education/training, asset management and recovery, certification, insurance, and upgrades. All of this constitutes a very broad portfolio of soft cost options, which continues to expand.

Bank Lessor: The lease and asset finance units of U.S.-based banks.

Captive Lessor: A wholly owned financing subsidiary of a large technology manufacturer.

Cloud Computing: Refers to the sourcing of computing capabilities – hardware, software, business processes – somewhere "out there," in a computing "cloud" created wherever vast resources are linked together.

Independent Lessor: A leasing company that is not tied to any single manufacturer and purchases equipment from various unrelated manufacturers. The equipment then is leased to the end-user or lessee. This type of lessor also is referred to as a third-party lessor.

The Industry: The Equipment Leasing and Finance Industry, as represented by the Equipment Leasing and Finance Association and the Equipment Leasing and Finance Foundation, the sponsor of this study.

Lessor: The source which arranges the financing in addition to the delivery of software and services tied to a technology solution on behalf of a customer.

Original Equipment Manufacturer (or OEM): Manufacturer of technology products or components that are purchased for retail sale by a second company (the VAR, distributor or dealer). In the leasing industry an independent leasing company could be an OEM.

Outsourcing Arranger ("Deal Coordinator"): Facilitator that manages nearly all aspects of executing a bundled solution for the financing lessor.

Technology Vendor: The original manufacturer of hardware, software or a technology solution which constitutes a major portion of a bundled solution.

Transformational Technology: Transformational technology allows a customer to access such traditionally hardware-related components as servers, storage and a network on an as-needed basis. Using this technology, customers only pay for what they use. The important concept is that the "product" acquired by the end user comprises a broadening set of software and services almost incidentally tied to a hardware purchase.

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