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Are You A Candidate For Software Leasing?

It's Not For All, But It Offers Cash Flow Benefits To Smaller Companies

Microsoft Windows XP is just one of many software packages that can be licensed rather than purchased.

Anyone who has ever looked at the economics of leasing a car or a piece of business machinery knows the basic logic behind it. In return for a higher overall cost of ownership, a business can reduce its initial investment and move the cost from a capital item that requires it to be depreciated to a normal expense that can be taken directly against revenue.

Software leasing, otherwise known as subscription pricing, may be less well known, but it is another option for smaller businesses. "Subscription-based [software] has been around for a long time," says Julie Giera, a vice president at Forrester Research. "It goes back probably 30 years or so with IBM and their kind of rental model."

Giera explains the fundamentals of the process this way. "Generally, the way this works is customers will pay a leasing fee for the software. They will have usage rights to that software for as long as they are paying the subscription fee. The term can be one year or it can be multiyear, as in the case of Microsoft. Microsoft has a three-year subscription program. At the end of that term, customers really have to either renew the subscription or remove the software. There are some companies that offer buy-out clauses at the end of the subscription."

◼ Leasing Offers Flexibility

One benefit of leasing is the ability to spread payments out over the term of the lease rather than have a large up-front cost to purchase outright. Giera says that it also makes sense for companies that may not need the software in the long term. For example, a company that may be acquired in the next year or two may decide to lease rather than purchase its software.

Another feature is the ability to upgrade to newer versions of the software during the lease period, but Giera cautions that this may or may not be included. "Again, let me use Microsoft as an example: Microsoft's subscription program contains software assurance—their maintenance. And so a company signing up for that would have rights to any updates that are released during the

period of time." But some companies require a maintenance fee in addition to the subscription.

She points out another factor that may tilt the balance toward subscription. "How likely is it that you will be making a transition from that software suite to something else? So a very small company that was maybe looking at open source perhaps would want to lease from Microsoft for a period of time and then make [the] transition. But you really have to consider how long will that transition really take because during the transition, you still [need] usage rights to the software."

■ Not For Everyone

Leasing does have a downside, however. The major one is cost. "It's more expensive for you to lease the software than it is to make the up-front purchase and depreciate that purchase over the leasing period of time. Microsoft, for example, gives a 15% discount on an annual basis for leasing the software so that the pricing of that is 15% less than actually buying," says Giera. In other words, if you buy a $200 copy of WinXP, you pay it once, and you're done. If you enter a three-year subscription program, you're going to pay $170 a year for three years, or $510 total.

"It's going to fit for certain customers in certain situations," says Giera. "If that same small business has to lay out $30,000 in that first year to buy software, that's a big expenditure for a lot of companies. And so, the other thing is from a financial perspective, leases can be treated as expenses."

She continues, "That's why very large companies with relatively stable and consistent technology plans, who know where they're going to go and have a large installed base of that product, are more than likely to purchase as opposed to lease through subscription. The economics just kind of work in their favor, but that's really it. The only other thing is once you enter into that lease and you're using those software products, at the end of that term, if you want to continue using the software, you've got to re-up the lease."

According to Giera, most large companies, such as Oracle and PeopleSoft, offer a subscription option for their products. In general, she says that companies that target the SME market are more likely to offer it than companies aiming for the enterprise market. ■

by James Turner

View the chart that accompanies this article.
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