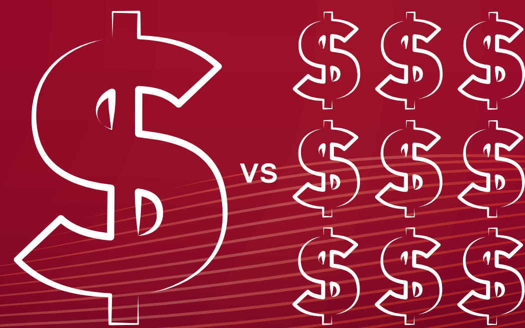
BROCADE

A Capex to Opex Shift in Network Infrastructure

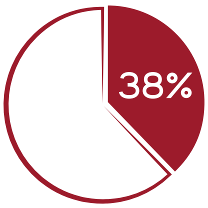


EXECUTIVE SUMMARY

The global financial crisis of 2008 and 2009 forced many companies to reevaluate how they acquire information technology networking infrastructure. Financial stresses created an environment where capital expense budgets were extremely limited. Chief financial officers and treasurers, along with chief information officers and IT executives with budgeting authority, found themselves unable to invest in infrastructure that could maximize income for their company at a critical period. Neither could companies scale back to cut expenses, because the fixed depreciation costs incurred by capex purchases made it nearly impossible.

The lessons taught by the recession are well-remembered by the senior finance executives who survived this period. Conserving cash. De-risking major investments. Forecasting conservatively. And above all, maintaining flexibility to grow or shrink a business as needed.

Brocade Network Subscription was developed to serve a need for companies acquiring IT networking infrastructure. As a subscription service, Brocade decouples usage from ownership. Similar to As-a-Service models, customers have virtual ownership, offering them the flexibility to scale up or down as well as upgrade on demand. And as technology advances and companies replace and update their infrastructure, finance and IT executives aren't hamstrung by capex budget forecasts or multi-year forecasts.



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— 2014 CFO Research survey

The Role of the CFO in IT Purchasing

The CFO has been considered the top IT decision-maker for companies for several years now. A 2010 Gartner Inc. survey found more IT departments reporting to a CFO than any other type of executive and the CFO playing a vital role in determining IT investment at 75 percent of the companies surveyed.

IT systems and IT infrastructure are key spending categories. In a 2014 CFO Research survey of 507 senior finance executives, 38 percent reported plans to spend more on enterprise-level IT systems in the coming year—more than any other category of spending. Computer hardware, a category that includes IT infrastructure, had the second-highest percentage of planned spending, at 34 percent.

With the introduction of cloud computing concepts and technological advances, IT networking has gone through a significant transformation. As CFOs and CIOs evaluate their company’s needs, this transformation has introduced uncertainty into their budgeting and technology acquisition planning. Even anticipating a company’s technology needs and opportunities in one year or six months can be challenging. Because technology considerations are becoming more and more fundamental to company’s growth plans, CFOs are finding it vitally important to lean on the CIO’s knowledge in planning. As more technology decisions are made at the business unit manager level, it’s also becoming more imperative that CFOs develop a culture of knowledge coordination between those managers and IT managers. The marriage of finance and IT considerations in technology decisions helps ensure that the right decisions are made initially, and that the proper course corrections follow with subsequent decisions.

“A key problem was lengthy delays in deciding to move forward with IT projects, trying to make sure a solution was “perfect” before moving forward with it. When IT networking infrastructure is acquired through capital expenditure, the fear of making the wrong choice, and locking the company into that choice for several years, can paralyze decision-making.”

Smarter Decisions: Finance and IT Partner for Growth

A 2013 study by CFO Research found that most senior finance executives surveyed (57 percent) believed that their company did only a fair or poor job at ensuring that IT projects aimed at improving their businesses yielded their expected returns. Many of those executives said that a key problem was lengthy delays in deciding to move forward with IT projects, trying to make sure a solution was “perfect” before moving forward with it. When IT networking infrastructure is acquired through capital expenditure, the fear of making the wrong choice, and locking the company into that choice for several years, can paralyze decision-making.

From a finance executive’s perspective, the primary goal is to provide the company with the best networking infrastructure so that the company can maximize income. Managing the company’s financial model, as well as managing operating results and net income, is also critical. Maintaining financial flexibility by minimizing costs and preserving cash and debt capacity are also important.

For the IT executive, procuring up-to-date technologies that maximize productivity is imperative. However, CIOs are searching for strategies to avoid making risky investments on IT that may become outdated or inadequate in the near future. Creating new revenue streams was the top opportunity for improving return on investment from IT infrastructure, according to a 2014 IBM survey of senior IT executives. That same survey found that the IT executives believe that less than 10 percent of their companies have IT infrastructure that is fully prepared for the demands of mobile technology, social media, big data, and cloud computing—an indicator that many companies will be looking to make significant IT infrastructure investments.

Both finance and IT strive to enable company growth despite changes in technology, company strategies, mergers and acquisitions, and risk. In this environment, CFOs find themselves in an optimal position to work with CIOs, utilizing their expertise, to chart the best path forward through technology developments and opportunities.

Flexibility in a Just-in-Time Environment

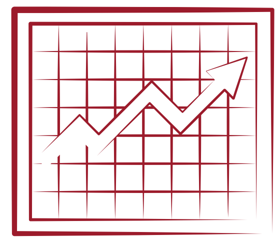
Before the introduction of Brocade Network Subscription, companies acquired IT networking infrastructure through two models: cash purchase and term lease. The customer assumes several layers of risk with both of these traditional models; for example, the risk that the technology will become outdated before the end of the lease term, or that the customer will be committed for several years to a vendor that provides unsatisfactory services. Acquisitions through capital expenditures (capex) also introduce an element of risk because of the depreciation that results, as a fixed cost, without the flexibility of downward adjustments, if needed.

With a cash/capex purchase, the buyer owns the equipment with the fixed charges for typically three to five years—without the flexibility to migrate to new technologies as they are developed.

Brocade Network Subscription allows customers to expand or decrease their IT networking infrastructure flexibly, on an as-needed basis. Financially, Brocade Network Subscription allows a company to align its infrastructure with its costs—if it scales back its network by 20 percent, then its cost decreases by 20 percent—immediately.

Using Brocade Network Subscription for networking infrastructure also enables a company to preserve cash and debt capacity for other uses. For a company engaged in a merger or acquisition, the subscription model provides flexibility for adjusting asset and infrastructure costs. If a company is forced to outsource its networking to a cloud arrangement but it still wants to maintain control of its assets, Brocade Network Subscription provides the flexibility to make changes.

By shifting from capex to operating expense funding for networking infrastructure, a company is capable of managing its network as a just-in-time environment.



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Case Study: An IT Capex to Opex Conversion

PhoenixNAP is an IT services company that serves companies with IT departments of up to 100 employees. The company provides a broad portfolio of services, providing co-located data centers and dedicated servers, infrastructure as a service, backup and disaster recovery services, and private, public, and hybrid cloud services.

As a data center operator and owner, phoenixNAP faced significant costs when it expanded those data centers—purchasing a generator for $600,000, for example, or new chiller plants, plus the installation costs, explained Ian McClarty, phoenixNAP's president.

FINANCE TAKEAWAYS FROM PHOENIXNAP STORY

- CFOs are taking on more and more responsibilities within their companies and should be playing a more prominent role in IT acquisition decisions.
- CFOs and CIOs are in the best position to chart their company's path to growth, and they ought to coordinate closely when making IT-equipment acquisition decisions.
- Evaluate how to best match your company's operational expenses with revenues.
- When considering large IT-equipment outlays, CFOs must take into account how much capital expense budget space should be preserved.
- Freeing up capital and financing can give your company the advantage to focus on its core missions and revenue generators.

"You don't want to be holding the bag on equipment that could become obsolete very quickly."

— Ian McClarty, President, phoenixNAP

PhoenixNAP needed to preserve capital expense budget space for purchases of servers and other IT equipment needed for its data center customers, said William Bell, phoenixNAP's vice president, product development. With Brocade Network Subscription, phoenixNAP changed from a 100 percent Cisco shop to a 100 percent Brocade customer.

As existing network gear reached the end of its useful life, the company was looking at replacement costs of $300,000 to $600,000 for the next generation of routers and went with Brocade Network Subscription. The switch to Brocade was made easier by the fact that employees who were trained on Cisco equipment could pivot easily to Brocade equipment, according to McClarty.

In the past, adding the network gear needed for a data center expansion could be a $750,000 capex event for the company, Bell explained. "We try to match our operational expenses with revenue generation, and this was an easy way for us to do that," he said.

While most of phoenixNAP 's capital outlay for adding a new customer typically comes though IT equipment purchases like new servers, the company can use the same Brocade Network Subscription terms with its customers to serve their network IT requirements.

With phoenixNAP's customers, usually standing right behind the IT decision-maker is the CFO with concerns about acquiring IT assets, such as networking switches, that will have no value within five years, Bell pointed out. CFOs are increasingly injecting themselves in the IT capex-to-opex conversion

For phoenixNAP, one of the biggest advantages with Brocade Network Subscription is the ability to change out switching technology, if needed, rather than be anchored to switching gear with a large capex investment.

From a capital outlay perspective, Brocade Network Subscription allows phoenixNAP to use capital and financing that would be tied up in setting up network gear that would serve one or two clients per year, and instead use it to serve 10 to 15 clients per year, McClarty said. It also allows the company to maintain a hyper-focus on its data center growth.

Another consideration that often isn't emphasized enough is the state of IT networking infrastructure technology, McClarty said. Because networking technology is expected to advance to a "disruptive" level within the next few years, and because the form of that technology has not yet been settled, there's a real risk that networking gear in use now could become outdated overnight.

"You don't want to be holding the bag on equipment that could become obsolete very quickly," he said.

The Brocade Story

Brocade launched the Brocade Network Subscription offering in August 2011, initially as a direct-to-customer model. In January 2013, it also launched a two-tier distribution model that allowed Brocade's customers to sign on as partners and extend the subscription service to its customers. Later in 2013, the company launched the service for use by federal agencies.

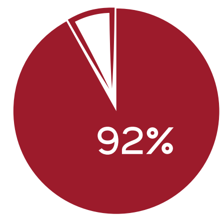
Because the financial risk of returned IT networking equipment or canceled contracts in the Brocade Network Subscription arrangement is borne by Brocade, and because its own capital outlays for new equipment aren't covered by initial revenue streams, the company had to gradually ramp up the new subscription service through an initial period of negative cash flow. By the third year, as Brocade Network Subscription expanded to more customers and as customers demonstrated their faith in Brocade's technology by acquiring more infrastructure through Brocade Network Subscription, the service had become profitable for the company.

Initially, the company focused on Brocade Network Subscription for new customers—92 percent of the company's Brocade Network Subscription customers had previously had no Brocade IT network infrastructure. Because of the minimal risk with the subscription service and seamless integration of Brocade's equipment with other vendors, it was easy for customers to add Brocade as a second vendor without disturbing their financial and technology commitments to the first vendor. If the customer wanted to cancel the arrangement for any reason, there were none of the financial obligations that come with IT infrastructure acquired through the traditional capex or leasing models.

Of the customers that signed network subscription contracts with Brocade, more than 83 percent returned to the company within three to six months for additional equipment. Equipment returns have been extremely low, which makes Brocade Network Subscription profitable for Brocade.

Brocade's network subscription customers tend to be larger, financially stable companies with more cash than average, but not much budget room. With hosting companies and other managed service providers, the Brocade Network Subscription arrangement resonates well because it aligns their costs with revenues, and the same benefits are passed on to their customers.

Brocade Network Subscription has also been well received in the data center enterprise space, such as with large manufacturing companies. With medical companies, including hospitals, Brocade Network Subscription is attractive because it allows them to view the IT infrastructure as an operating expense and there is no need to go through a public bid process. For higher education institutions, especially large universities engaged in multi-school research, Brocade Network Subscription has allowed them to ramp up to 100 gigabit technology sooner. For K-12 schools, Brocade Network Subscription has enabled them to upgrade their network infrastructure to meet Common Core requirements.



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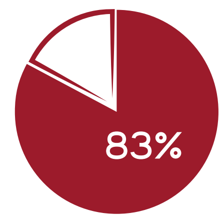

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Over the next 12 to 24 months, one of the largest growth opportunities for Brocade Network Subscription is with federal government agencies, especially as Tony Scott, the federal Chief Information Officer, launches the First Annual IT Solutions Challenge; developing solutions and exploring ideas to transform IT and IT acquisition.

Just as it does in the private sector, Brocade Network Subscription gives federal agencies the flexibility of using operating expense to refresh and update technology when the network needs it, and without having to outsource the technology into a third-party provider cloud environment. And studies show that the updated technology is desperately needed, with about 73 percent of federal spending on IT going to maintenance contracts for outdated infrastructure.

Brocade Network Subscription also allows agencies to get into predictable technology refresh cycles that they haven't been able to because of uncertain capital procurement budgets. Because operating and maintenance funding tends to be more stable, Brocade Network Subscription allows federal agencies to use that source to update aging infrastructure rather than simply maintaining outdated legacy equipment. It also helps removes uncertainty about funding technology upgrades when the government eventually executes a multi-year IT consolidation plan.

Conclusion

Brocade Network Subscription addresses concerns that both CFOs and CIOs have voiced since the financial crisis of 2008 and 2009. According to Gartner analysts, by 2015, 50 percent of the acquisitions in the IT network infrastructure space will come through subscription models. From the finance perspective, Brocade Network Subscription frees up capex budgets, and cash and financing capacity, for other purposes. It avoids depreciation for equipment that is likely to be quickly out of date. It also allows companies to utilize their opex budgets more effectively and to retain other elements of financial flexibility. From a technology perspective, Brocade Network Subscription allows companies to maintain up-to-date IT networking technology, to ramp up or scale back network infrastructure at any point for any reason. And it takes the IT executive out of the network technology forecasting business, which will be especially difficult in the next few years as a wave of "disruptive" technologies take hold. Instead, the CFO can use the CIO's help in focusing on the larger goal of maximizing the company's growth and returns on investment from IT.

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Developed in conjunction with CFO Publishing. The views expressed were gathered from interviews with Brocade and PhoenixNAP, and not those of the editors of *CFO* or of CFO Publishing.

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