INSIGHT

Brocade Network Subscription Breaks the Traditional IT Acquisition Model Mold

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IDC OPINION

For organizations worldwide, modest economic expansion and continued financial volatility will likely remain on the menu for the next several years. These factors combined are pressing business and IT executives to meet increasing investor, customer, and constituent expectations. In one critical IT segment, these demands have become especially urgent: network infrastructure. Traditionally, network managers have relied upon capacity forecasts and look-ahead provisioning to adequately resource network infrastructure ahead of requirements. However, in the current capital-constrained environment, this has proved problematic. As a result, many IT executives have pressed network suppliers to expand acquisition options with more flexible and granular alternatives. Brocade recently announced a new equipment acquisition option called Brocade Network Subscription — a program that enables IT buyers to add network equipment capacity through a monthly, fee-based pay-as-you-go option. Unusually, this new program enables buyers to add equipment with 30 days' notice and to return it, without additional payments or penalties, upon 60 days' notice. While this may sound like a traditional, short-term, open-ended rental program, Brocade reports that pricing is much closer to traditional three-year lease pricing (e.g., prices are closer to 3% [of equipment purchase price] per month versus the 8% that is typical of rental programs). Following are key IDC findings and insights:

- While capital-constrained IT budgets linger from the recession, IT executives continue to ask IT equipment providers for more flexible, open-ended acquisition options for virtually every type of server, storage, and network infrastructure.

- IDC has noted that a number of IT buyers report willingness from some IT providers to include additional contract flexibility in certain large, highly structured contracts. Brocade Network Subscription is the first regular offering from a major provider ($1+ billion in annual revenue and publicly traded) to offer this degree of flexibility.

- IDC believes the future of IT acquisition options will be one that includes new options with much more flexibility. This original product from Brocade is the first of what will likely be a range of new options that attempt to balance the shifting requirements of buyers and sellers in an intensely volatile market.

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IN THIS INSIGHT

This IDC Insight discusses Brocade's August 30, 2011, announcement of the availability of a new acquisition option for IT buyers seeking to add network capacity through a monthly, fee-based service option dubbed Brocade Network Subscription. The new offering, unlike virtually every other acquisition option available from manufacturers, service providers, or resellers, allows IT buyers to essentially "rent" the company's equipment products without requiring multiyear commitments or the payment of fees when the equipment is returned (equipment can be added with 30 days' notice or returned upon 60 days' notice — no additional fees or penalties are involved). The program requires IT buyers acquire support and maintenance services.

SITUATION OVERVIEW

Existing Acquisition Options for IT Buyers

When describing acquisition options, market hype sometimes confuses the net business transaction, especially when terms such as "flexibility" are used. To accurately characterize Brocade Network Subscription, it is important to review alternatives. A summary of traditional IT equipment acquisition options is as follows:

- **Purchasing.** Purchasing is simple and straightforward. The seller provides the equipment, and the buyer typically has 10–30 days to pay. From a manufacturer or a reseller perspective, these transactions generally provide clear sales treatment (to the buyer), allowing the seller to record revenue upon shipment or product acceptance, depending on the contract.

- **Financing.** Financing is a purchase, but the buyer pays the seller over an extended period of time and is usually charged interest. The financing may be provided by the seller, a subsidiary of the seller, or a third-party such as a bank or an independent financing company. The underlying financial instrument is a loan, and the buyer is required to essentially commit to a contract with a so-called "hell or high water" clause. This means that the buyer has taken legal ownership of the equipment; the buyer "owns" it and has entered into a financing contract to pay for the equipment — whether it works or not. In other words, the buyer is legally bound to pay the equipment financing loan come "hell or high water." If a buyer defaults on payments, the financier may have the option to file a lien on the equipment, which gives the financier the right to repossess and resell the equipment to another party to mitigate the loss. For most commercial contracts, the financier typically has the right to sue the buyer for defaulting and will seek to recover all losses including any additional expenses incurred not covered by the sale proceeds from the repossessed equipment. Typically, buyers have no return options for the product and virtually no option to terminate a financing instrument. From a manufacturer or a reseller perspective, these transactions generally provide a clear sales treatment (to the leasing company), allowing the manufacturer or the reseller to record revenue upon shipment or product acceptance, depending on the contract.

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- **Extended payment options.** As a way of inducing additional sales, sellers may offer to extend the traditional 10- to 30-day window for cash payment, extending the payment date by 90 days, 6 months, or even a year into the future. For IT buyers, this has become a popular option. Sellers can present the offer to a potential buyer by arguing that these extended payment terms demonstrate the seller's confidence the product will meet the buyer's requirements. However, in most situations, despite how the contracts are presented to buyers, they are merely a financing contract with the interest paid for by the seller. The buyer typically takes title at the moment of delivery and has a "hell or high water" payment liability despite the soft commentary about "proving" a product's value. Of course, a seller can always make commercial concessions that are not in a contract, but for the purposes of this discussion, we are focusing on the substance of most contracts. Like with purchasing or financing, these transactions generally provide the manufacturer or the reseller with clear sales treatment (to the financing company), allowing the manufacturer or the reseller to record revenue upon shipment or product acceptance, depending on the contract.

- **Leasing.** Leases in the IT realm are typically a three-year extended rental instrument at the conclusion of which the IT buyer has the three options: return the equipment to the leasing company (which might be a subsidiary of the manufacturer, a bank, or an independent leasing company), purchase the equipment for "fair market value" as determined by the buyer and seller, or negotiate a lease extension and continue to pay for use of the equipment on a month-to-month basis. IT buyers seeking to return equipment prior to the scheduled conclusion of a lease will typically pay substantial penalties. Legally, the equipment is actually sold to the leasing company, which then provides it to the IT buyer under the terms of the lease. In these transactions, the original seller has virtually no contingent risk in the transaction; the leasing company faces the risks of selling the equipment at the end of the lease to cover its equity position in the asset and credit default if the IT buyer fails to pay. From a manufacturer or a reseller perspective, these transactions generally provide a clear sales treatment (to the leasing company), allowing the manufacturer or the reseller to record revenue upon shipment or product acceptance (depending on the contract).

- **Managed services.** Many IT buyers secure the use of IT equipment through managed services contracts. Typically, these instruments combine a suite of services with the equipment and are billed on a monthly basis. These contracts typically have a multiyear term, with cancellation penalties for all types of early termination other than failure to execute. From the provider's perspective, the equipment component of these contracts is often relatively small; the principal driver is the large services component. From a manufacturer's perspective, these transactions can be more problematic in terms of securing clear sales treatment and often require careful structuring. Depending upon the actual structure and who is the equipment provider versus service provider, revenue is typically recognized on a pro rata basis over the term of the contract.

- **Outsourcing.** To summarize a complex range of service offerings, an outsourcing contract is a managed services contract that has been highly customized for a particular IT buyer. The economics are fundamentally the same, but the IT buyer

secures the use of IT resources through a monthly payment made as part of a multiyear contract that typically includes a comprehensive suite of services. These contracts are typically governed by service-level agreements (SLAs) and are thought of by IT buyers as acquiring "services" or deliverables versus discrete IT resources such as individual pieces of equipment. Again, other than failure to execute, IT buyers generally have a limited ability to terminate these contracts early without substantive early termination fees. Again, from a manufacturer's perspective, these transactions can be more problematic in terms of securing clear sales treatment and often require careful structuring. Depending upon the actual structure and who is the equipment provider versus service provider, revenue is typically recognized on a pro rata basis over the term of the contract.

Revenue Recognition

The critical characteristic of these generally available acquisition options is that the equipment manufacturer can typically record the sale of the equipment, usually upon shipment or acceptance; if a service provider is involved with a managed service contract or when outsourcing, its revenue is recognized on a prorated basis. For leasing or financing companies, even those owned by a manufacturer, although they recognize the financing revenue on a prorated basis, the revenue associated with the equipment is typically recognized immediately. Contingent financial liability is held by a financing subsidiary or an independent leasing/financing company. For the leasing/financing providers, their risk is typically limited to a credit default or, in the case of leasing, the additional risk of realizing their equity position (or residual value) at the end of the typically three-year lease (which generally amounts to 10–15% of the equipment purchase price).

This entire range of sales, leasing/financing, and servicing options has evolved to fuel the need of equipment manufacturers to secure revenue recognition upon shipment/acceptance.

For IT buyers, despite years of sales pitches extolling the flexibility of acquisition options, the harsh reality is that leases and service contracts often involve significant penalties if they try and change a contract during the initial period of an agreement (typically three-year term).

Shifting IT Buyer Requirements

A confluence of economic and technical factors are raising new issues for IT buyers, causing them to seek new IT acquisition options that provide more flexibility than the existing mainstream options.

IT has become a daily staple of virtually every organization, whether commercial or governmental, and the failure or the incapacitation of their IT infrastructure is a contingency to be avoided. Therefore, business leaders charge their IT executives with maintaining and operating a reliable and, to the extent possible, low-cost IT infrastructure. For these IT executives responsible for providing network connectivity, this has become increasingly difficult. Predicting network capacity requirements has become increasingly problematic because many companies have moved to single instances of their worldwide enterprise applications (driving up network loads), many companies have virtualized their server and storage resources — meaning that every

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new virtual instance has the potential to overload finite network resources, and an external customer or market event, be it a social networking promotion or a financial markets "flash" selling crisis, has the potential to irrationally spike network capacity demand. Coping with increasing IT capacity requirements, *managing volatility in an increasing volatile world,* has become the new IT management challenge.

These internal drivers for additional IT capacity flexibility have come at the same time external dialogue has focused the IT industry on the newly available public IT cloud services that burst onto the scene, promising new acquisition flexibility via a largely open-ended, pay-per-use "services" pricing model. This technology alternative, public IT cloud services, combined with the constrained macroeconomic climate and increased internal capacity volatility, has many IT organizations scrambling to cover with tight budgets and new demands driven by business innovation and response to the changed economic outlook.

IT Buyers Call for More Flexibility; a Tight Market Answers

Beginning in 2010 in IDC's many direct conversations with IT buyers, our analysts have noticed a significant increase in IT organizations seeking acquisition contracts with more, much more, flexibility than has been traditionally available. Whether it be large, enterprise-class organizations seeking more flexibility in their storage provisioning contracts, government agencies seeking to acquire IT capacity without budget (while at the same time unable to enter into traditional leasing contracts), or large financial services companies seeking to expand the flexibility of their managed print services contracts, the near-universal request has been for more flexibility. IT managers and CIOs have moved in this direction also as a result of their learnings on the merits and pitfalls of cloud computing and services — the new paradigm that is transforming the IT landscape.

In lean economic times, power within the acquisition negotiation inevitably shifts from providers to buyers, and requests that previously might have been dismissed out of hand are being considered. For IT manufacturers, a sale that created revenue recognition issues was often dismissed out of hand as "not possible."

Notwithstanding manufacturers' strong desire to continue to structure sales such that clean revenue recognition was the norm, IDC is aware of a number of large IT acquisition negotiations where IT buyers have asked for and received special contract concessions that enable them to return equipment or terminate contracts with more flexibility than traditional structures. To be clear, these instances of optional contract flexibility have been related to a range of IT contracts including outsourcing, managed services, time and material contracts, and leasing/financing agreements. In traditional multiyear IT acquisition agreements, the IT buyer bears the risk of over-provisioning or changes that create a need to shift a contract (i.e., sale of a division, reorganization or business changes). For many years, IT providers included no- or low-penalty restructuring clauses when the provider failed to execute. The trend for the past 18 months has been for IT buyers, especially in large, competitively bid contracts, to push providers to begin shouldering additional "provisioning" risk. In other words, the IT buyer would have additional flexibility to restructure contracts up to and including returning equipment or deferring services without penalty. As far as revenue recognition is concerned, when IDC has asked manufacturers about how some of

these special contracts affect it, we were told that information is a private commercial matter.

IDC believes that, for IT providers, these contracts may create two significant issues: First is the economic risk associated with taking back equipment or deferring "committed" services. Second, and perhaps more importantly, contingent contract "outs" create a situation where it is unclear whether or not the provider was entitled to record a sale. In accounting parlance, the issue is one of being able to record revenue upon shipment/acceptance.

For IT buyers, the situations IDC has seen where additional contractual flexibility has been provided were short, single-line clauses inside of large, complex contracts — IDC has not seen any situations where no- or low-penalty return options were available as part of standard business agreement. The feedback from IT buyers to IDC has been that contractual "outs," while not a "must have," are a feature they highly value. In a close competitive battle, these features would often tip the scale to the provider that offered more flexibility.

It is into this roiling and rapidly shifting situation of evolving contract structures Brocade has launched its new acquisition model, Brocade Network Subscription.

Brocade Network Subscription

In IDC's view, Brocade Network Subscription can be described as an open-ended equipment pay-as-you-go option, but one with fees that are much closer to long-term leasing costs (typically 3% of purchase price per month for a three-year agreement versus 8–12% for a month-to-month rental contract).

With Brocade Network Subscription, IT buyers can add onsite equipment capacity with 30 days' notice and reduce it upon 60 days' notice. No other payments or fees are required. IT buyers do not need to pay for a large portfolio of managed services (although they are available); however, the buyer is required to keep the equipment under a manufacturer maintenance plan. Rather than call it a rental, the company has opted to liken it to a subscription — albeit one that can be changed with the requisite notice.

In addition, IDC has noted that Brocade has responded to IT buyer requests for a "blended" version of the offering, at a lower price, that provides for one segment of the portfolio to be returned upon 60 days' notice, with the balance being subject to traditional long-term contractual commitments.

Brocade Network Subscription is available through the company's authorized resellers for both commercial and governmental entities. At this time, it is available in the United States, Canada, Germany, the United Kingdom, France, the Netherlands, Switzerland, Sweden, and Hong Kong. IDC believes that additional geographic expansion will occur based on evolving IT buyer demand and preferences.

Optimizing the IT Portfolio

For most IT organizations, it is a not a question of which acquisition method is "best" — it is a matter of the optimum blend of the three principal models to deliver an adequate level of flexibility at an optimum cost. IDC believes that a combination of

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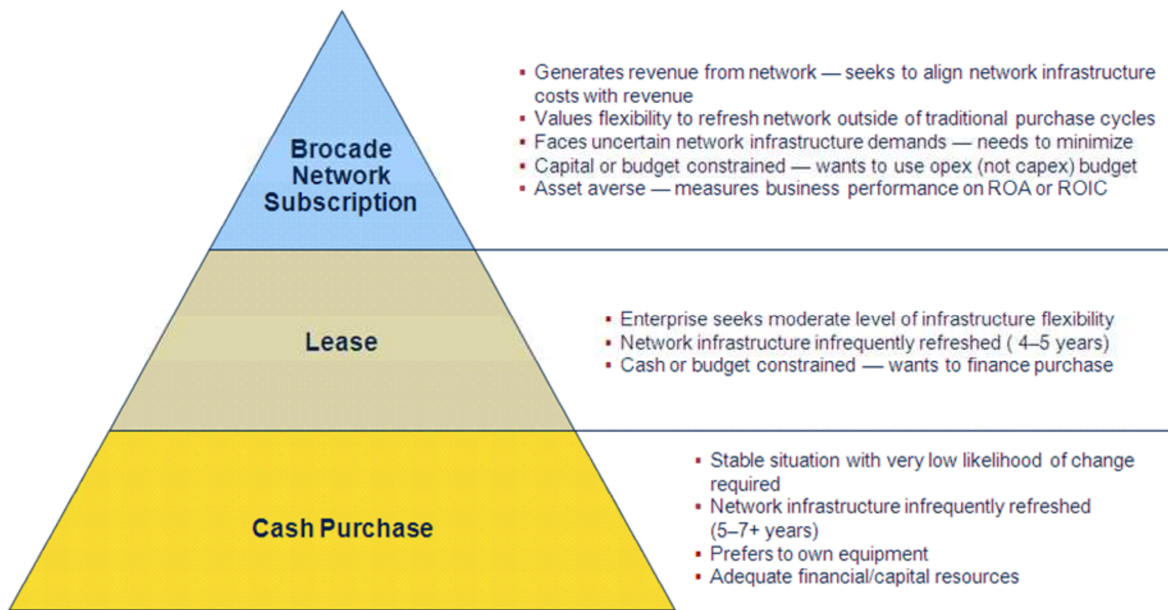
owned, leased, and "short-term" asset acquisition models will provide the most advantageous outcome for most IT organizations. The art of best-in-class IT portfolio management is having resources on different terms/prices and then optimizing the relative mix based on internal and external requirements.

To this end, IDC believes that Brocade Network Subscription provides a meaningful and new acquisition option for many IT organization network equipment portfolios. Figure 1 illustrates how Brocade Network Subscription might fit into a typical network equipment portfolio.

FIGURE 1

A Typical Network Equipment Portfolio Acquisition Strategy Mix



Source: IDC, 2011

FUTURE OUTLOOK

Brocade Network Subscription is a significant development within the IT industry. For IT buyers, it represents the first standard offering that provides an option to acquire resources on a short- or medium-term basis with no turn-back penalties. In IDC's view, this creates significantly more flexibility to tailor an optimum network portfolio.

For IT executives seeking to optimize their network infrastructure, the operative strategy has been to acquire equipment (capacity) based on forecast load. The issue of course is that both external and internal issues are conspiring to make it increasingly difficult to accurately forecast network capacity growth. At the same time,

IT executives are being challenged by a constrained economy and pressing internal requirements to aggressively strive for maximum portfolio utilization.

IDC research has found that optimum IT equipment portfolio management involves structuring tranches of equipment with different terms for the optimum mix of cost and flexibility. For most organizations, this involves acquiring some portion of their equipment with relatively flexible terms. Prior to Brocade Network Subscription, this was only available for very large companies engaged in enterprise contract negotiation typically for very large equipment buys.

At the time of this writing, other network equipment providers [to IDC's knowledge] do not offer a true "pay as you go" standard product without penalty-laden return options or the requirement to lease the equipment for three years or more.

Based on the mediocre short- and medium-term economic outlook, it seems likely that buyers will continue to have the upper hand in acquisition negotiations. And whether it is network equipment, storage, servers, or software, IDC expects IT buyers will continue to press aggressively for more flexible acquisition options.

Brocade Network Subscription poses a real challenge compared with traditional, less-flexible acquisition norms; however, IDC expects that large IT providers will continue to approach these new options carefully and on an exception basis. For the next 24 months, IDC expects this type of variable acquisition option will only be available from innovators such as Brocade or to those buyers with the patience and fortitude to negotiate custom contracts.

This option from Brocade addresses a recurring requirement from IT buyers: more flexible acquisition options. The degree to which the industry has embraced cloud — the ultimate "pay as you go" option — underscores this point.

IDC believes the future of IT acquisition options will be one that includes new options with much more flexibility. This new product from Brocade is the first of what will likely be a range of new options that attempt to balance the shifting requirements of buyers and sellers in an intensely volatile market.

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