THE POWER OF 'TOTAL COST OF OWNERSHIP' AS A BUYING (OR SELLING) TOOL

WHITE PAPER AT A GLANCE

Total Cost of Ownership (TCO) is a powerful tool that businesses can use to try to figure out the true cost of making large-scale purchases. It is ideal for use in capital expenditure decisions, complex outsourcing decisions – or something as simple as buying a new car. TCO looks at the whole-life costs of buying and running an asset from initial evaluation stage through to disposing of the asset at the end of its life. Used by the buyer, TCO can put some rigour into the investment decision process. Used by the seller, TCO can be a very effective way of educating the customer about their true costs and enhancing understanding of what is important to the customer from a financial perspective in making an investment decision.

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BY VINCENT REYNOLDS

INTRODUCTION

Total Cost of Ownership (TCO) is a powerful tool that businesses can use to figure out the true cost of buying a large-scale system or solution. As a concept, TCO has been around a while, certainly since the early 20th century. The IT consulting organization Gartner Group popularized it in the late 1980s in relation to the purchase of large IT solutions. However, TCO can be used in a wide range of applications from large capital expenditures to outsourcing decisions to something as simple as buying a new car. TCO is as much a philosophy as a methodology. Its strengths lie in taking a holistic, life-cycle approach to calculating the cost of making an expensive purchase. TCO produces a cost figure that can be compared with other solutions (and vendors) and which can be used in conjunction with other investment appraisal techniques such as Net Present Value, Internal Rate of Return, Return on Investment and Payback.

CALCULATING TCO

There are various TCO formulae available but we will use the following one.

$$TCO = EC + AC + (UC \times t) + DC + LOC$$

Let's apply this formula to a small printing company that is considering changing to a new state-of-the-art printer, one that comes with a price tag of five million euro. At a very simplistic level, the company might simply take into account this price tag of five million euro and use that to make a buying decision. To do so however may lead to a very incomplete picture of the economic consequences of buying the new solution. TCO will give a much fuller picture of the costs as follows.

EC stands for Evaluation Cost. It is the cost of evaluating whether to pursue the proposed solution and commit resources to it. For the printing company in this example, these costs might include the cost of researching the new technology, visits to suppliers, visits to other users, consulting support and management time involved in deciding whether to go ahead to the next stage of acquiring the solution.

AC stands for Acquisition Cost. This is the easy one. It is the "sticker price" or invoice price of the asset or solution the customer is buying, in this case the five million Euro to buy the new printer. For naïve buyers, this may be the sole cost that they base their buying decision upon. This is a financial falsehood however since there are many other elements to the cost of buying a large ticket item or solution.

UC x t. When you acquire the asset, it is going to cost money to run it. This is Usage Cost x time. It is the variable cost that is tied to the volume of activity. In the printer example, UC will be things like paper, toner, services, power, etc. In other words, UC x t deals with the operating cost of using the asset during the course of its life.

DC is Disposal Cost. How much will it cost us to dispose of the asset or solution at the end of its life? For the printer, this will be the cost of decommissioning and disposing of the printer in accordance with environmental regulations. In other cases, it could be some kind of termination or exit penalties. For a chemical plant, it could be a very significant cost. In other cases, such as an articulated truck, disposal cost might be a positive figure, a financial gain, arising from trading in the truck or selling it on the second-hand market. In that case it would reduce rather than increase TCO.

LOC is the Lost Opportunity Cost. This is a more subtle cost, often not fully taken into account when evaluating which solution to choose in a big ticket item purchase. It is the cost of change or disruption as a result of moving to a new solution or model. For the printing company, they may lose time and efficiency (and even lose business or customers) while they try to master the new technology. LOC also includes the cost of management time (and the time of other key staff) spent coming up to speed with the new solution. It is a difficult cost to quantify but, with good basic assumptions, management can come up with a figure to include in TCO.

There are variations to the TCO formula in use in business today but the key thing is to think through all of the costs involved in buying and running an asset or service. That is why I say that the TCO model is as much a philosophy as a methodology. By exploring all of the costs fully, you can find a home for each of them in one of the TCO elements. Or else you can create new elements to come up with your own TCO formula that makes most sense for your business. The TCO can then be compared with the cost of continuing to use the existing operation – in the case of the printer, how they currently run their printing operation – and to compare TCO between different vendors competing to sell us the new printing technology.

HOW CAN BUYERS USE TCO?

Buyers can use TCO to help figure out the real cost of buying and deploying a complex solution. By taking a step-by-step approach, the buyer can incrementally build up the cost that will impact the company over the life of the asset or solution. The TCO figure can be compared with the benefits of ownership in the form of the savings or revenues that the solution will generate. TCO and the related benefits can then be converted into a projected stream of cash flows which can be discounted to present value using the company's cost of capital or some other 'hurdle rate'. This will tell the company whether it makes sense to make the investment from the point of view of shareholder expectations.

HOW CAN SELLERS USE TCO?

In the hands of the seller, TCO can be a powerful tool for educating the customer in the full economics involved in making a large financial decision such as decision to outsource IT or buy a new manufacturing line or computer system. Solution providers can use the tool to work with the customer to try to reduce the customer's TCO. Let's take each cost element in turn. The sales person can reduce the customer's Evaluation Cost by making information available to the customer regarding performance metrics, by putting them in touch with other customers that are using the solution, by providing them with templates they can use to navigate their way through the decision process, etc. The solution provider can help the customer to balance Acquisition Cost with Usage Cost by engineering the solution to suit the customer's preference for capital expenditure (AC) or operational expenditure (UC x t). Acquisition Cost can even become a positive number for the customer by creating a sale and leaseback transaction with the customer. With regard to Disposal Cost, arrangements can be made with the customer to reduce these or at least help the customer to quantify them. Finally, the solution provider can help the customer reduce Lost Opportunity Cost by evaluating the risks of changing to the new platform and developing with the customer a plan to capture the benefits of change as soon as possible. In short, TCO can help the solution provider to move from 'transaction selling' to true 'collaborative selling', based on relationship rather than purely on price.

CONCLUSION

TCO is a powerful business tool. I can tell you as a former finance director that a vendor bringing this type of methodology to my attention would impress me, especially if they can explain it in simple terms. The reality is that many companies (well, certainly the more progressive ones) are using a version of this approach. Thinking TCO through as a buyer can improve your chances of making good investment decisions, especially if you use TCO in conjunction with other investment appraisal tools such as Internal Rate of Return. From the perspective of the seller, thinking TCO though with a customer can have a very positive impact on your ability to successfully sell solutions to that customer.

About the Author

Vincent Reynolds is the founder of Rapport Consulting. His background is in corporate finance, having acted as Finance Director for Tellabs Inc., a NASDAQ quoted telecommunications equipment manufacturer. For the past seven years, Mr Reynolds has acted as a consultant providing financial acumen and management development programmes to global companies such as British Telecom, GlaxoSmithKline, ESB and a host of other clients.