



Can You Believe in ROI?

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Executive Summary

In today's IT environment, the question that most IT professionals are facing more than ever before is: "What's the return on investment (ROI) of that IT project you're asking me to support?" This puts IT professionals in a unique position to either gain or lose credibility with their business counterparts. Some IT professionals may be caught off guard with this financial question, which has nothing to do with the merits of the technology. When someone asks about ROI, he or she is really asking, "When do I get back the money (return) you are asking me to spend (investment), and is the investment really worth it?" These are basic questions any buyer would ask, so let's understand how ROI really works.

Imagine what would happen if you could walk into a meeting with the new top-level management team and present a solid business case that shows the tangible value and solid ROI that your smart decision making has delivered to your organization. Imagine if you could work with your vendor to create a financial justification for a solution, not only before it was purchased, but also after the implementation. With the right approach to analysis and the tools to support it, you can do just that.

Demonstrating ROI is particularly important because most IT organizations are focusing their attention on becoming a source of business value, equal to other revenue-generating departments in the company. This approach requires a heightened focus on the value of every dollar IT spends, and the ability to describe value in terms that business leaders can understand.

There are many ways to measure this value, such as return on assets, return on equity, return on invested capital, and so on. This paper, however, is focused on assessing return on investment, a standard financial metric accepted across the industries. Does this approach to analyzing IT investments mean that tomorrow's IT leaders need to become financial analysts? No. However, it does mean that they need to understand the characteristics of a properly developed financial justification for IT investments.

This paper reviews a framework to help you establish whether your ROI analysis is effective by determining whether it adheres to four key criteria: credible, conservative, customer focused, and comprehensive.

Why ROI?

Generally, ROI is a measure of the profitability of an investment. Simply put, it measures the percentage of how much value you realize (the benefits) relative to your investment (the cost). This is normally done before the investment, when considering and comparing different projects, but it should be repeated after the solution is deployed to measure the actual, achieved results. ROI is used across different industries because it is a versatile and simple approach. ROI is an integral part of building a business case to enable IT management to assess the value they expect to deliver to the organization.

Based on a survey of 146 BMC sales employees, BMC has determined that 94% of these customer-facing employees use ROI information or tools regularly, supporting the idea of high demand for such information.

The Good, the Bad, and the Ugly

You may have been involved in reviewing or preparing ROI analyses in your career. As such, you have probably seen your share of good and bad ROI examples. So how do you distinguish the good from the bad?

The popularity of ROI can be attributed to the simplicity of the calculation. ROI, for any industry, is the same mathematically: the present value of your investment (benefits) is divided by the cost (again expressed in present-value terms).

The combination of simplicity and a high degree of flexibility makes ROI an attractive tool for IT to evaluate investment decisions, as the model can be adjusted to reflect different investments and value. This allows you to customize the analysis based on what your company considers to be the most appropriate metrics. For example, when deciding what benefits to include, you can include IT cost improvements, such as reduced mean time to repair (MTTR) and improved level of resolution of calls coming to the help desk (Level 1 call resolution), as well as business metrics, such as increased revenue, optimized labor resources, risk avoidance, the quantified value of customer retention, and more. Including a complete list of benefits will help you build an ROI case that fits the definition of “the Good,” as we’ll explain shortly.

While simplicity and flexibility are generally advantages, they can also be disadvantages. It is extremely important to set clear guidelines and parameters regarding costs and benefits. Otherwise, if you just look at a comparison of ROI percentages, you can end up comparing unrelated information. A classic example of a poor ROI analysis is the comparison of ROI percentages between projects with polar risk/return profiles. For example, investing \$50,000 and returning

100 percent should not be compared to a multimillion dollar project with modest, double-digit returns.

Some examples of ROI analyses that fall into “the Bad” category include:

1. Those that do not take into account your cost of capital, using “an average number for the industry,” yielding results hardly useful to your organization; and
2. Benefits not discounted to today’s dollars, because this approach overstates the benefits today. The ROI percentage and the projected benefits may have looked great at first glance, but you would be extremely disappointed with a return that does not meet the estimate years down the road.

Examples of “the Ugly” include a case study that lists the ROI estimate in dollars (\$15,000,000), rather than as a percentage. Until that study comes across an analyst’s desk, no one will really notice that the metric is wrong. In another example, the ROI is estimated to be 1,000 percent. Upon seeing that figure, and realizing it must have been inaccurate, the head of IT may become immediately skeptical.

4C Framework

So how can you identify ROI analyses that fall into “the Good” category? How can you determine that they are sound and trustworthy? You should employ the following simple 4C methodology:

- > Is it Credible?
- > Is it Conservative?
- > Is it Customer Focused?
- > Is it Comprehensive?

Credible

Whether completing an ROI analysis yourself, or trusting the job to a consultant or vendor, consider where the data is coming from and how industry and IT savvy the person performing the analysis might be. How relevant is his or her experience to the decision you are trying to make? While an internal analyst most likely will do an excellent job (since he or she knows your company well), consider also including the input from outside consultants or vendors who work with third-party research and analyst firms. These outside resources may have knowledge of industry best practices or have experience from other customers. If nothing else, they can help to validate the assumptions and industry data your internal resources are using. This exercise proves especially effective if you would like to compare and benchmark your company against those in the same industry, where you may not have access to information about your peers and competitors.

How can you make sure the model you are using is truly credible? Ask these key questions:

- > How recently was the model developed?
- > Was it certified by a third-party research or analyst firm?
- > Has the model been benchmarked, tested, and used with other customers in your industry?
- > Has the model been calibrated by post-deployment ROI studies of actual customer results?

With the fast pace of technology change, it makes sense for ROI models to be updated and re-validated at least every 18 to 24 months. While customer success stories supplied by a vendor are useful and help the decision-making process, a true post-deployment ROI case study with hard numbers will allow you to see real returns against the cost of the investment.

Now that you have determined whether the analysis is credible, watch out for the next pitfall: sky-high estimated returns.

Conservative

In your experience, you have probably seen four-digit, or even five-digit, ROI percentages that sounded great, but tended to quickly pale under the scrutiny of the finance organization. At what percentage is an ROI no longer credible? What makes an ROI analysis believable?

Through extensive, hands-on interactions with hundreds of organizations, BMC has found that conservative ROI models always hold up to scrutiny. It is very unlikely that

you or any other IT decision maker is going to believe an overly optimistic return. For example, would you find a promise to reduce your IT operating costs by 95 percent, while still retaining the same functions and processes, to be believable? Most likely not.

You should expect any ROI analysis to be conservative. Yet what does that mean in the context of ROI? Ask yourself the following questions:

- > Are the cost reductions or performance improvement numbers backed up by actual documented research or industry standards?
- > Are the savings based on realistic costs for your industry and geography?
- > Are the benefits phased in over time, or are you being asked to accept that they will all occur immediately?
- > Has project risk been taken into consideration?

As shown in Figure 1, some online ROI tools help organizations create a conservative analysis by asking to provide information about their industry and IT maturity level, as well as their IT metrics. The benefits then are shown as being realized over time, and the ROI results are presented as a range. As a result, the ROI model does not “over promise” future results based on the limited data that is captured up front, and hence, adheres to the conservative approach described.

Conservatism does not mean simply cutting all the benefits and expected improvements in half — it means the analysis

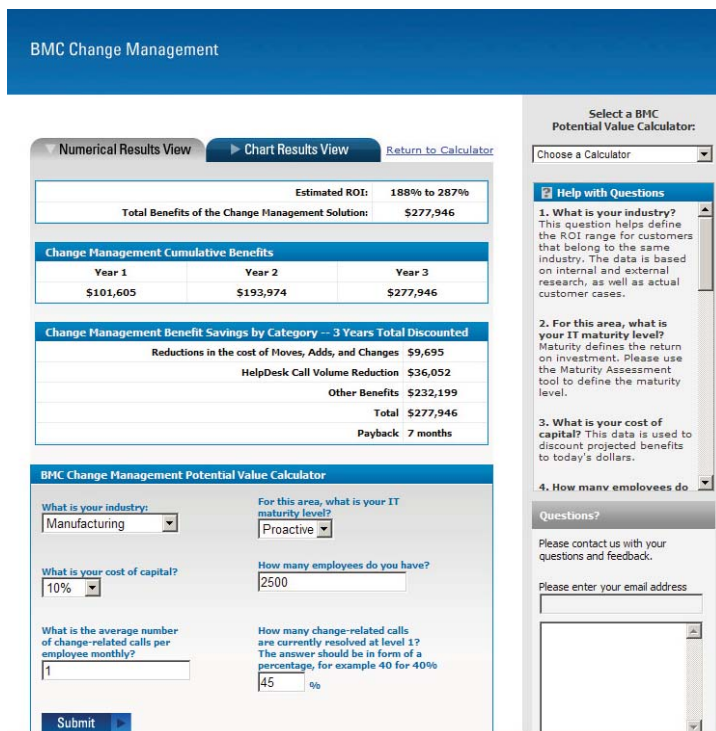


Figure 1. A conservative approach to a simple ROI

has taken a thoughtful approach has considered and realistic costs and benefits. After all, if after the project is implemented the measured ROI is greater than your initial projection indicated, you are going to be in a far better position with your management than if the situation were reversed.

Customer Focused

The next thing to check is whether the analysis was prepared based on your unique situation as a company.

- > Did you receive input from actual IT end users over one or more iterations of the analysis?
- > Or did you instead use analysis prepared from “industry averages” of companies like yours?

Often, industry averages are just that: averages. However, no two companies are alike; therefore, it is critical to use data that is as specific to your organization as possible to ensure the results are closest to the reality. The more detailed questions you are being asked, the better the results will reflect your specific situation.

For example, was the analysis based on your business-critical applications and the actual business impact of downtime from each application, or was it based on an industry average for downtime? Does the analysis take into consideration your current maturity level relative to the area where you are making the investment decision? It is very unlikely that you are starting from scratch, as you often will have at least some capabilities in the area already. So, the analysis should take into consideration the incremental value that will be delivered above what you are already receiving today. This will allow you to see the realistic improvement you can achieve given the technology or processes that are already in place.

Yet another example is the ability to understand when you will start realizing the benefits. As mentioned previously, it is highly unlikely, though theoretically possible, that your organization will realize 100 percent of the expected benefits in the first year. Make sure that the model with which you are working allows you to adjust the benefits realization over time. If you are considering multiple investments at the same

time, make sure you can develop different scenarios, and see which benefits will be realized first. This may actually help you better sequence the phases of the project, based on a strategy of realizing the greatest benefits first.

Figure 2 is an example of a customer-specific financial projection that takes into account the current IT maturity of the customer, which has been identified as 35 percent at the beginning of the project and 85 percent once the solution is fully implemented. The potential benefits are also projected to be realized over time, with only 25 percent of potential benefits to be delivered in the first year the solution goes live.

Your organization will need a customer-focused approach to accounting for costs, as well. For example, assume that your company employs the Activity-Based Costing model. In this case, internal costs, such as the number of “person-hours” required to deploy a solution and train employees — and maybe even electricity costs and the building lease fees — will need to be accounted for, along with the cost of software licensing and maintenance.

The bottom line is that the more the model reflects your particular situation, the closer the projected benefits will be to the actual results, which makes for a much more trustworthy ROI analysis.

Comprehensive

The following questions will help you determine whether an analysis is comprehensive.

- > What does the ROI model cover?
- > Is it based on third-party research?
- > Has it evolved over the years?
- > Were new IT and business benefits explored as the solution was evolving and as IT and business goals changed?
- > Does your model include both cost savings and business benefits?
- > How can you make sure that your ROI model is all encompassing and truly reflects the benefits that the investment will bring to the entire organization?

	Full Annual Benefits	Current Achieved	Target Level	Revised Annual Benefits	Note: Adjust to reflect client’s implementation schedule					
					Year 1	Year 2	Year 3	Year 4	Year 5	Total
Problem Management										
Call Volume Reduction	\$51,408	35%	85%	\$25,704	25%	50%	75%	100%	100%	\$89,964
System Downtime Reduction	\$150,646	35%	85%	\$75,323	25%	50%	75%	100%	100%	\$263,631

Figure 2. Customer-specific financial projections

All of these questions are geared toward understanding the comprehensiveness of your model. A critical success factor in performing financial justification analysis is to account for all of the possible costs and benefits. Frequently, IT decisions are made based on the expected benefits to IT, such as reduced labor effort in a particular area. Your analysis should reach beyond IT benefits to include expected business benefits from the investment.

In fact, by closely collaborating with the business, IT now can become an agent of change, as well as a trusted advisor to the business. BMC has investigated cases where IT proactively sought solutions to satisfy potential business needs, or cooperated with the business in solving existing business-critical issues, yielding excellent companywide results and tangible business impact. This includes increased gross profit, higher customer satisfaction ratings with IT services, and IT management becoming an equal partner with the business management.

For an example of business benefits, consider risk mitigation. A comprehensive financial justification model should reflect the value of reduced risk to the business, as well as the cost of risk if the project costs increase or the benefits decrease because of economic or company-related issues. In addition, it should ensure that the costs include all major purchase components (software licenses, required hardware, maintenance costs, training, consulting), as well as internal costs.

A good guideline to follow is to ensure that the costs and benefits are mutually exclusive and collectively exhaustive. In other words, ask yourself if you have considered all the potential costs and benefits, and whether you have included

them in the analysis in such a way that you are not double-counting or overlapping any items. Answering these questions will help ensure that your ROI analysis meets the definition of comprehensive.

Figure 3 is an example of how an ROI model can demonstrate a comprehensive approach to benefits. Multiple benefits are listed and the amount of the benefit achieved varies greatly.

Conclusion

In summary, you can and should believe in ROI. However, you must be sure that the ROI in which you are being asked to believe can stand up to several key tests. Is it credible? Is it conservative? Is it customer focused? Is it comprehensive? If you can answer “yes” to all four of these tests, then you can believe the analysis is sound and trustworthy.

At BMC, we believe in an open and honest dialogue with our customers about ROI, and view financial justification as a joint effort in the IT decision-making process. Over the years, we have created robust models for calculating the ROI of IT investments, and have based them on both BMC and third-party research. We have also obtained third-party certifications for the tools we use. Most importantly, these models and tools have been tested and validated with hundreds of customer organizations so that we can stand behind the results and say they are credible, conservative, customer focused, and comprehensive.

For more information about tools for calculating ROI of IT investments, please e-mail us at roi@bmc.com.

Configuration Management Five-Year Savings

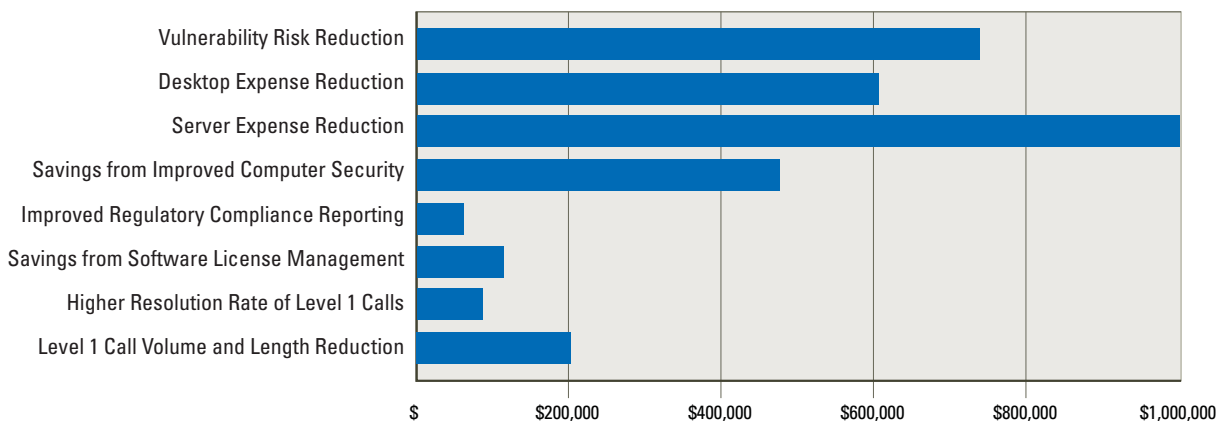


Figure 3. A comprehensive approach to ROI



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