

February 2007

Document **A11**

RESEARCH NOTE **MANAGING RISK AND FLEXIBILITY:** **A LOOK AT PAYBACK PERIOD**

THE BOTTOM LINE

The payback period of an application is an important indicator of risk. The shorter the payback the less likelihood that new technology will make your solution obsolete and the greater the flexibility your company has in adopting new technology. Going a step further, short payback periods offer the choice of deploying a short-term solution with the intention of replacing it in the near future rather than waiting for the perfect solution.

Is a software decision permanent? Given the time and effort that goes into an enterprise software decision, we'd like to believe we make that decision only once. The problem is that technology changes and new solutions quickly surpass existing ones. If you decided on a mainframe-based, dumb terminal sales information system 12 years ago, it's likely you discarded it long ago and moved to a Web-based system. Unfortunately, if the corporation didn't recover enough in benefits from that old system to cover its costs, the entire effort resulted in a negative ROI and no action may have been a better decision. Nucleus believes payback period – the point in time after deployment when benefits equal costs – is the critical measure of risk and should be the CIO's most important measure of corporate flexibility.

RISK

Payback period is simply the point in time when the total costs of a project are offset by the benefits received. It is an excellent measure of risk and should be your primary measurement, along with ROI. In evaluating risk, the longer the payback period, the greater the likelihood that you will experience one of two types of risk: technological or financial.

Technological risk is the risk that a new technology will make your existing solution obsolete. The rise of the Internet provided numerous examples of well-designed client-server applications that became obsolete almost overnight. Many companies that invested in long-term client-server projects were forced to abandon these applications, and the money invested, and turn to Web-based applications instead. Those that chose projects with a short payback period were more likely to have recovered their costs before discarding the application.

Financial risk is the risk that a non-technology factor will influence the application. Mergers, acquisitions, changes in management, and competitive pressures all influence the corporate technology infrastructure and can reduce the chance that you will recover the ROI you expect. In this case, the old adage a bird in the hand is worth two in the bush should be heeded. That project with a great ROI and a

RELATED RESEARCH

- E19 Indirect benefits -
The invisible ROI
drivers
- D26 Lies, Damn Lies, and
Average ROI
- C51 Manifesto:
Separating ROI fact
from fiction.
- C41 Quantifying
productivity returns
- A21 The strengths and
weaknesses of TCO
- A11 Payback and Risk
- A10 Maximizing ROI
- A4 Human factors and
ROI

5-year payback may be less attractive than a project with a lower ROI but a 6-month payback.

FLEXIBILITY

You may not want to move to new technology — but your competitor might. In this highly competitive business environment, choosing applications with long payback periods hampers your corporation's ability to quickly react to the opportunities brought by new technology.

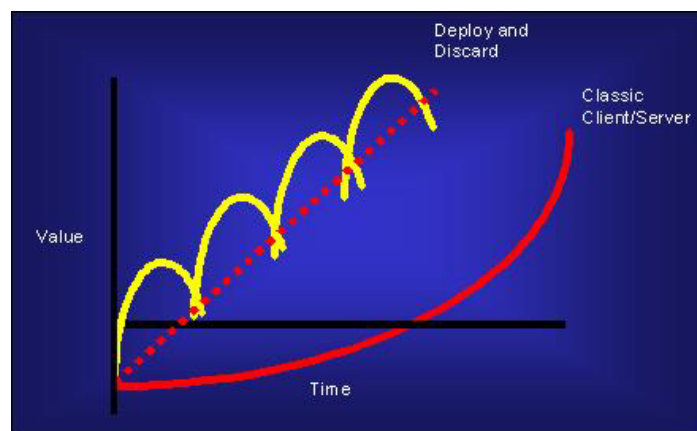
Did you beat your competitors to an E-commerce solution? Most bricks and mortar businesses didn't. They spent time integrating existing processes and legacy solutions while "virtual" Web-only companies could start almost overnight. Can your groupware system accommodate your suppliers and customers? Companies with legacy messaging systems have been slow to react to the benefits of an extranet and are losing out to more flexible upstarts. These companies are burdened with the costs of decisions made years earlier.

Choosing applications with short payback periods means you can make the case to the CFO that the application that was perfect 3 years ago, and that cost a significant amount to purchase and deploy, should be discarded in favor of the latest technology. Once you reach the payback period, continue to evaluate the benefits of all of your existing solutions and be quick to discard them once a better solution comes along.

DEPLOY AND REPLACE

The flexibility achieved by short payback periods offers an opportunity to evaluate software as short-term or disposable applications. You may decide that the perfect solution is three years away, but that a temporary solution can provide real benefits to the corporation in the interim. Calculating payback period will allow you to deploy a solution today, knowing that it is less than complete, with the intention of replacing it in the future.

FIGURE 1
DEPLOY AND REPLACE



Following a deploy-and-replace strategy may be the most effective way for the CIO to maximize the ROI for the corporation. Immediately deploying a good solution while waiting for a future better solution increases return today while offering the flexibility to change direction in the future should a new technology arise.

Managing payback period is an important tool for the CIO. Maintaining flexibility and minimizing risk are important considerations when purchasing new software. Once the payback period has been met, the CIO now gains the ability to critically re-evaluate existing solutions in light of new technology.

Nucleus Research is a global provider of investigative technology research and advisory services. Building on its unique ROI case study approach, for nearly a decade Nucleus Research has delivered insight and analysis on the true value of technology and strategies for maximizing current investments and exploiting new technology opportunities. For more information or a list of services, visit NucleusResearch.com, call +1-781-416-2900, or e-mail info@NucleusResearch.com.