ROI VS. TCO CALCULATIONS:

PROS, CONS, AND BEST PRACTICES

HOW TO DETERMINE WHICH METRIC TO USE BASED ON WHAT YOU SELL, THE COMPETITIVE SITUATION, AND THE BUYER'S TITLE

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INTRODUCTION

UNDERSTAND HOW TO CALCULATE ROI & TCO

Each metric - TCO and ROI - provides insight into investment from a different point of view. How do you know which one is the best?

Imagine you have millions of dollars at your disposal to spend on projects for your company. How do you determine which is the best investment? The pie is only so big, and there are more requests than money. What do you do?

Luckily about a million years ago (not really), someone came up with metrics that can be used to help you make an informed decision on how to invest your money. You may have heard of acronyms like ROI, TCO, NPV, IRR, or ROA. But which is best? Unfortunately, there is no real answer to that question. However, a better question is: What do I care about most? Value, payback period, savings, total cost, or something else? Once you have determined what you care about most, the answer to which metric is best becomes clearer.

For this paper's purpose, we're going to look at two metrics that offer very different results. TCO, or Total Cost of Ownership, and ROI, or Return on Investment. Each metric provides insight into an investment from a different point of view. Let's begin with a definition of both.

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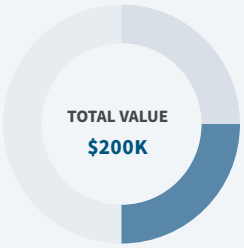
APPLICATION OF TCO WITH AN EXAMPLE



TCO OVER 3 YEARS

Either upgrading our existing on-premise systems or moving to the cloud. In our example, we will refer to the Depreciable life.

COST	ON-PREM	CLOUD
upgrade cost	$800,000	X
3 year cloud	X	$1.2Mil
3 year maintenance	$550K	X
3 year labor cost	$200K	$25K
3 year utility cost	$45K	X
TOTAL 3 YEAR COST	$1,595,000	$1,225,000

Moving our operations to the cloud enables us to eliminate many on-premise costs, including maintenance, labor to manage the software and hardware, and utility costs. Even though the initial investment is lower for on-premise, the cloud option spread over three years appears to be a better choice with the total cost over $350,000 lower than on-premise.

The best part of using a TCO calculation is that it forces you to think beyond the purchase price. Unlike ROI, TCO enables you to make a comparison between new and used, or build vs. buy. However, the biggest problem with TCO is it doesn't take into consideration the value or return on the investment. TCO only provides the user with cost information over the life of the asset.

WHAT DOES TOTAL COST OF OWNERSHIP (TCO) MEAN?

Total Cost of Ownership is the total cost of owning an asset, solution, or service over its entire life cycle. The TCO includes the acquisition cost, maintenance and repair costs, , and operating costs over its lifetime. It also includes any opportunity costs of missing capabilities. The life of the asset or service can be defined in several different ways. For example, the "depreciable life" is the number of years of depreciation on your books. The "economic life" is the number of years the asset continues to provide value. The "service life" is the number of years the asset remains in service.

ACQUISITION COST +

MAINTENANCE +

OPERATING COSTS +

REPAIR COSTS +

OPPORTUNITY COSTS OVER THE LIFE OF THE ASSET

TOTAL COST OF OWNERSHIP

LET'S LOOK AT THE ROI COMPARISON FOR THE SAME PROJECT.

WHAT IS RETURN ON INVESTMENT (ROI)

Return on Investment is a percentage that represents the net value received (benefits) from an investment over a given period of time. The ROI formula is easy to remember because it is visually literal.

CALCULATE THE RETURN ON INVESTMENT

TOTAL BENEFITS — TOTAL COSTS (RETURNS)` ÷ TOTAL COSTS

> **ROI IS FOCUSED ON THE VALUE OF THE RETURN FOR YOUR DOLLARS INVESTED.**


Website Redesign Budget Template
Fill in your projected expenses here.
(Those "100" entries are placeholders.)
Fill in your actual expenses here.
(Those "100" entries are placeholders.)
Budget
Actual
Amount Left
BASICS
SOFTWARE
CONTENT & DESIGN
TESTING
EXISTING CONTENT MIGRATION
TOTAL
Website Redesign Actual Cost by Category
11.8%
23.5%
47.1%
5.9%
Expense Summary
Website Redesign Budget vs. Actual Comparison

APPLICATION OF ROI WITH A BUSINESS USE CASE.

MOVING TO THE CLOUD

BENEFITS

In the example below, we compare the total cost of upgrading our current on-premise system to moving to a cloud solution. There are benefits to both staying the course with an on-premise solution and moving to the cloud. Let's look at both options.

SCALABILITY

Cloud benefits begin with scalability. You only pay for what you need, and as you grow, you can add additional computing power, users, storage, etc. cloud solution.

NO UPFRONT INVESTMENT

Second, there is typically no upfront investment when you move to a cloud solution. The legacy systems you have like PC's, laptops, and other devices can be used, thus extending the life of your existing infrastructure.

FEWER PERSONNEL

Finally, you should benefit from the need for fewer personnel to manage, update, and maintain the system. The vendor takes care of all the effort to maintain, manage, and repair a cloud solution.

STAYING WITH ON-PREMISE

In the example below, we compare the total cost of upgrading our current on-premise system to moving to a cloud solution. There are benefits to both staying the course with an on-premise solution and moving to the cloud. Let's look at both options.

LONG-TERM COST

Alternately, an on-premise solution has its advantages, too, beginning with long term cost. Once you pay for your on-premise solution, you own it free and clear. Only operational, maintenance, and repair costs remain. Usually, these costs are minimal compared to paying a monthly fee to a cloud provider. (A cloud solution is an OpEx expense forever.)

CUSTOMIZATION

You are in complete control over your environment. Thus, you can customize as your needs evolve. Cloud applications serve a broader audience, and customization is not always an option. Upgrades are automatic when someone else is managing your system. Whereas, when you have control, you determine when and how updates are applied.

STABILITY

While cloud solutions rely on the Internet, On-prem systems do not. With cloud solutions, you can experience downtime at any time, for reasons totally outside your control if your cloud vendors experience issues.

APPLICATION OF ROI WITH A BUSINESS USE CASE

Using our ROI formula, we compare on-premise upgrade costs and three years of benefits to a three-year investment in moving to the cloud. For the purposes of our example, the business benefits are equal. You must determine the value of the benefits you expect from each investment.

The investment to stay the course (option one) and upgrade existing systems only considers the acquisition cost and the value returned (benefits) over a three-year period. The return on investment is 250%. While Option two takes into account the investment to move to the cloud and returns (benefits) and ROI of 167%.

If ROI is the only metric you consider, the on-premise solution is the best option. However, the problem with ROI is the fact that profit (return or value) is not the same as cash. Even though you are showing returns of 250% for on-premise and 167% for a cloud solution, you're not actually getting those returns because the ROI formula does not consider other costs like operating costs and maintenance costs. ROI for the on-premise solution only looks at the value returned on your invested funds

On the other hand, TCO will take into consideration the purchase price and associated costs over the life of the investment. In this case, it was three-years.

*Note: in reality, there are likely opportunity costs in both the on-premise and cloud scenarios, which should be considered. In this example, we remove that for simplicity's sake.

COSTS:
$800,000

3-YEARS OF BENEFITS*:
$2,000,000

$2M/$800K
=2.5

2.5 * 100
= 250% ROI

ON PREMISE **= 250% ROI**

3-YR CLOUD INVESTMENT:
$1.200,000

3-YEARS OF BENEFITS*:
$2,000,000

$2M/$1.2M
=1.67

1.67* 100
= 167% ROI

ON CLOUD **= 167% ROI**

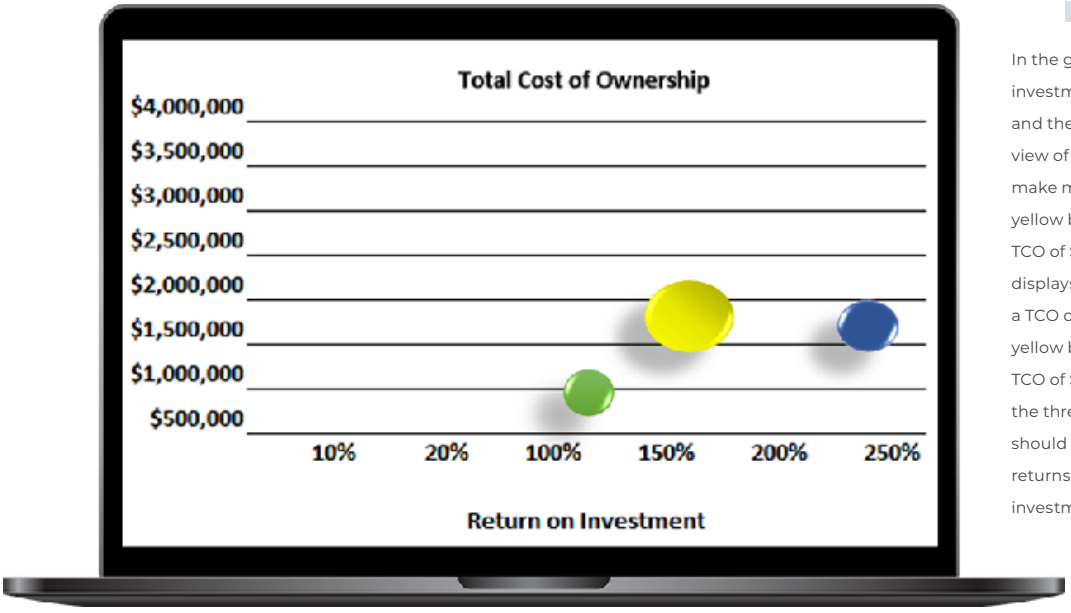
ROI V TCO - WHICH METRIC IS BETTER?

TCO is focused on the total cost over the life of the investment. ROI is focused on the value of your return for the dollars invested. While both calculations offer insight, neither on its own provides the complete picture. You need to make an informed buying decision when looking at multiple options.

When considering among multiple similar investment options or vendors,, if the value returned is estimated to be equivalent for all offers, then TCO is a better choice. Because TCO will help break down the total cost of ownership over the life of the asset/project, ignoring the value returned. If, however, the value returned is significantly different between your given choices, then ROI may be a better choice because you can compare returns based on the estimated value delivered for a fee.

The best choice is to use both TCO and ROI when evaluating multiple investment options. When you put ROI and TCO together, you can assess the amount of risk you are willing to accept based on the total cost and the expected return from multiple project choices. Below I have illustrated how you can look at multiple investments taking into consideration the amount of investment, TCO, and ROI.

When you put ROI and TCO together, you can assess the amount of risk you are willing to accept based on the total cost and the expected return from multiple project choices.



In the graphic on the left, we compare the investment (size of ball), the ROI (horizontal axis), and the TCO (vertical axis) to provide a holistic view of how to utilize ROI and TCO together to make more informed investment decisions. The yellow ball indicates a $1M investment with a TCO of $1.8M and an ROI of 160%. The blue ball displays an initial investment of $800,000 and a TCO of $1.4M, and an ROI of 249%. Finally, the yellow ball shows an investment of $300,000, a TCO of $750K, and an ROI of 135%. Looking at the three options on the chart, the blue option should be obvious as the best investment with returns at 250% and a TCO just over the initial investment.

REQUEST A DEMO

ValueCore empowers sales and marketing organizations to present compelling value propositions to prospects and customers. We make it easy for professionals to collaborate in a dynamic fashion with buyers around the value of their solutions.

In this world, the friction between buyers and sellers will be reduced as data is shared more efficiently during sales processes.

Faster buyer engagement, shorter sales cycles, higher win rates, and bigger deal values. Our customers report 40%+ higher win rates when ValueCore is included in proposals, and 30%+ reductions in losses to no-decision.

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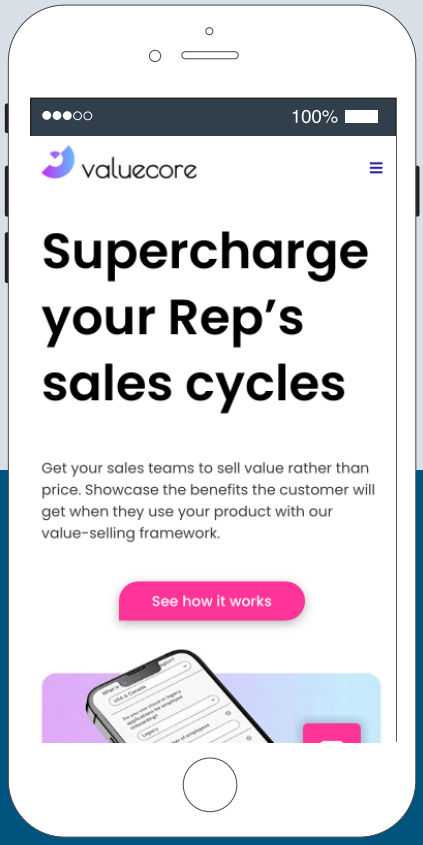

THE AUTHOR

Michael Nick is Vice President of Growth and Strategy for ValueCore. He has published several bestselling books, including ROI Selling, Why Johnny Can't Sell, and Amazon's top 10 Business book, The Key to the C-Suite.

Michael has been mentioned and published in Selling Power, The Huffington Post, Sales & Marketing Magazine, and featured in Top Sales World magazine, where he was named for four straight years in a row as one of these top 50 "Most Influential" People in Sales and Marketing in the world by TSW. In addition, Michael ranks in the top 50 Top Sales Gurus from Sales Guru.