IN SEARCH OF TRUE VALUE

CAN OUTSOURCING REALLY ADD VALUE TO THE SHARE PRICE PERFORMANCE OF A COMPANY? **BOB FAWTHROP** OF LOGICA LOOKS AT THE FACTS AND FIGURES TO FIND OUT.

There is clear evidence that outsourcing has a positive effect for shareholders – be it short term or, more importantly, long term. Morgan Chambers recently completed the most definitive recent study, where it considered the FTSE 100 and evaluated the response of the investor and analyst communities to strategic outsourcing and whether such announcements drove share value up. Morgan Chambers tracked the share price of 21 companies (or 37% of all the FTSE100 outsourced companies) over a five-year period and compared them with the market sector average and the FTSE 100 overall. US analysts Stern Stewart & Co also found that IT outsourcing had a discernible positive impact on share prices, with a gain of an average in shareholder value of 5.7% over and above the general market trend.

Interestingly, Stern Stewart & Co research showed that the company share prices rose by an average of 1.1% between 40 days and 20 days before the deal's announcement. The analyst put this down to the customer's employees being informed about the contract at an early stage, in order to facilitate the transition to the new supplier, and the news leaking out to the market. Share prices then gained an average of 1% on the day the deal was made public through a press release, before levelling out between 20 days and 40 days after the announcement. However, examples do exist where share price's may decline on an outsourcing announcement: Westpac Banking's shares fell by 46 cents to $15.43 when it announced that it may extend its current outsourcing programme to include its credit card processing and back office operations.

THE DOWNSIDE. Cost savings are still the largest overriding factor in making an outsourcing decision and the market likes to see a reducing cost base for equivalent performance. However, there are other benefits an outsourcing contract can affect the financial aspects of a firm and create a positive view among some market analysts, these include:

- re-profiling of IT costs – through amortisation and service charge scheduling;
- re-profiling capital – asset buy- and lease-back as part of service contract;
- transfer of fixed to variable costs – 'click-rate' service charging; and
- improved economic value add (EVA) through transfer of headcount to service provider.

There are also IT-related technical improvements which can be assessed to have a positive impact on an organisation:

- technology refreshed without capital expenditure – building it into the service and therefore operating cost;
- improved ability to introduce business change – greater IT scope and capacity;
- ability to introduce business continuity at reduced cost – shared service approach;
- increased capability to support new initiatives through use of service provider infrastructure.

DEFINING OUTSOURCING. There are three kinds of outsourcing:

- **Sole sourcing:** one-stop shop, with one supplier supplying everything. Often the supplier is chosen without a competitive tender process.
- **Multi-sourcing:** selective sourcing of individual service elements and functions by different suppliers (also called strategic sourcing).
- **'Best of Breed':** same model as multi-sourcing but with a focus on selecting specialist or niche suppliers.

The most commonly outsourced functions involve: IT infrastructure; disaster recovery; mainframe operations; network management; mid-range operations; PC support, desktop; helpdesk; application maintenance and development; (and today) complete business functions, such as finance, supply chain and human resources.

What is interesting is that even with all the press that outsourcing receives, some 75% of firms have not outsourced any part of their Information services, although the market is projected to increase at 14%-17% compound annual growth rate (CAGR). The business process market or BPO market, where both the IT and the associated manual functions are outsourced, is believed by most market analysts to be growing at over 22% a year, but again 95% of

companies have not yet taken the plunge into outsourcing. This explains the heady P/E multiples of 50x–60x assigned to some of the pure BPO businesses such as Capita and Serco. Of particular interest to the finance people within an organisation are the business models for outsourcing. Firms have a variety of models at their disposal when they undertake an outsourcing relationship, such as service fee; shared risk and reward; joint venture; and design, build, finance and operate (DBFO).

SERVICE FEE. The model is predicated on the principle that once staff, assets, third-party contract liabilities and software licences have been transferred to the outsourcer, the user will then purchase services from the outsourcer. Usually based on a defined scope of service and service level agreements (SLAs). The model is essentially – allowing for the value of assets to be transferred – a simple, fee-based service-purchasing agreement with an agreed duration.

SHARED RISK AND REWARD. Similar to the fixed service fee model but with variance. Typically, a combination of reduced service fee plus payment to the outsourcer will depend upon certain agreed business performance targets being met by the client. The principle of all shared risk and reward business models is to incentivise the outsourcer to help the user organisation gain market share, profitability or other business goals. This type of business model may also be represented in gain/share agreements, where the outsourcer receives agreed additional financial payment if certain targets are met, say, within a continuous improvement programme.

JOINT VENTURE. This requires the setting up of a co-owned subsidiary to provide IT services back to the user and, commercially, onward to other IT users on a revenue-earning basis. A joint venture is only to be recommended when there is true opportunity for building external revenue streams by selling on the service created by the joint venture. According to most advisers, such opportunities are rare, and depend on the existence within the user company of some unique skill, talent, software or know-how, which may of real value in the market. Even so, it may make better sense to operate a reverse gain-share relationship, in that the user allows the outsourcer to sell on that capability, while rewarding the user with a percentage, royalties or reduced outsourcing fees within a simpler service agreement-type structure.

DESIGN, BUILD, FINANCE AND OPERATE. These are typically government or commercial PFI-based initiatives, where the service provider builds or creates an asset at his cost and is then paid for the providing the service during the time that the system is operational. This payment schedule may run for up to 10 years.

In many of these models, an important ancillary aspect for the customer is: to take certain assets off-balance sheet; receive up-front cash and to regard the operational charges as an continuing service cost, rather than, say, some form of capitalised finance lease.

CAN OUTSOURCING ADVERSELY AFFECT SHAREHOLDER VALUE. There are obvious things not to do. It is important to distinguish between tactical outsourcing contracts and strategic outsourcing policy. Investors do not respond in a knee-jerk fashion to declarations of outsourcing, aware that such an announcement might be intended as a tactical distraction for poor corporate performance. In the UK, investors have mixed feelings about the significance of outsourcing to shareholder value, from hostility to indifference. Therefore, any announcement of outsourcing intent or implementation has to be handled correctly and seen to be effective since outsourcing is neither earnings positive or negative. It will be judged on its success. And just offloading expensive services is not seen by them as a positive factor. Outsourcing can be just one of a basket of actions that may be viewed positively or negatively. It should always come with 'cost savings' – cost base management and maximising efficiency alone may not be enough. Also care must be taken not to choose the 'wrong' service provider or enter into a restrictive long-term relationship that may impede future mergers and acquisitions. This could adversely affect shareholder value.

HOW TO MAXIMISE THE CREATION OF SHAREHOLDER VALUE. One of the biggest problems is how the market views the relative importance of different measures. The *ValueReporting Revolution* study by PricewaterhouseCoopers published in February 2001 shows the different rankings of the top 10 measures of company performance between the different communities, the market analysts assessing the market on behalf of private investors, and the professional investor community assessing the market on behalf of the institutional investors (see *Figure 1*). Therefore how do you map outsourcing against these differing targets to achieve increase in shareholder value, it is like firing a single arrow at three targets all at 90 degree angles and hitting all three bull's-eyes.

The best advice I can offer is to consider using outsourcing as a tool to: contain and reduce overall costs; avoid or offset unnecessary capital expenditure; reduce risk of backing a technological solution cul-de-sac; sweat existing assets; accelerate speed to market using the service provider capabilities; and focus on the business. But most of all in today's uncertain environment is to demonstrate strategic commitment to reduced risk, by passing it to service provider at reduced cost.

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FIGURE 1
STUDY OF TOP 10 COMPANY PERFORMANCE MEASURES.

As seen by:		
REPORTING FIRMS	MARKET ANALYSTS	INVESTORS
1. Strategic direction	1. Market growth	1. Earnings
2. Cashflow	2. Strategic direction	3. Cashflow
3. Market growth	3. Competitive landscape of management	3. Quality/experience
4. Gross margins	4. Quality/experience	4. Competitive landscape
5. Quality/experience of management	5. Earnings	5. Market growth
6. Market size	6. Market size	6. Strategic direction
7. Competitive landscape	7. Gross margins	7. Gross margins
8. Earnings	8. Market share	8. Market share
9. Speed to market	9. Cashflow	9. Speed to market
10. Market share	10. Speed to market	10. Market size

The measures above are those that appeared in the PwC ValueReporting Revolution *study published in February 2001 of the 'high-importance' list for three influencer groups and are listed in an ascending rank order.* www.valuereporting.com