EVAluation
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Stern Stewart Research
The Americas

IT Outsourcing and Shareholder Value

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- Outsourcing non-strategic processes eliminates a distraction, enabling management to focus its distinctive capabilities on areas critical to its strategic success.

- Evidence shows that IT outsourcing has a discernible positive impact on share prices. A study of 27 companies undertaking large IT outsourcing initiatives indicates an average gain in shareholder value of 5.7% over and above the general market trend.

- Some 62% of the cases tested demonstrated positive shareholder returns; 26% were negative and the balance were approximately break-even.

- By continuing to own and manage all IT activities, many companies are sacrificing attractive opportunities to increase value.

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INTRODUCTION

Outsourcing non-strategic processes has been an important trend in the U.S. in recent years. While IT transactions began prior to 1990, outsourcing has certainly been popularized in the last decade. Part of the explanation lies in the larger trends operating on the world economy — increasing competition, rapid technological change, global integration of markets, deregulation, and privatization. On a more micro level, strategic concerns have steered management to exploit the benefits offered by focus and specialization. Outsourcing non-strategic processes eliminates a distraction, enabling management to focus its distinctive capabilities on areas critical to its strategic success. On the other side of the transaction is a profit seeking specialist. The specialist often enjoys economies of scale in providing services, has greater expertise, and can mobilize quickly the diverse capabilities needed to provide technical solutions.

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Currently, the most popular arena for outsourcing is information technology. According to IDC, IT outsourcing transactions accounted for about $20 billion[1], or 40% of U.S. outsourcing activity in 1998; the primary providers being IBM, EDS, Andersen Consulting, CSC, and AT&T Solutions. These firms have the capability to take over a company's data center, transferring its personnel onto their payroll, oversee the help desk, provide software maintenance, development and support, and much more.

One of the first companies to outsource IT was Equifax, the Atlanta-based credit reporting company. Historically, for quality control reasons, management believed it was vital to own and maintain its computers. But this was a costly strategy, involving continual capital expenditures to avoid obsolescence. In 1993, the company moved in a different direction, entering into a ten year $700 million outsourcing arrangement with IBM. As part of the agreement, Equifax sold its computer assets and contracted for the service at rates that reduced its cost by a projected 10%. The company incurred some criticism that it was outsourcing the heart of the business, but management realized that Equifax's competencies are in software, not hardware. And the software remains proprietary.

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Since the early 1990s, outsourcing has evolved from solely a cost savings initiative to one that may help a company develop capabilities necessary to execute strategy. Advances may arise from innovations promoted by the specialist or by enabling internal resources to focus on value adding applications because the vendor is managing the day-to-day IT needs. Further, close collaboration with an IT expert reduces the risk of falling behind competitors as technology changes. For these reasons we would expect that, all things being equal, outsourcing adds value.

But is this expectation borne out in the marketplace? Do investors recognize and reward companies with higher stock prices when they initiate an outsourcing strategy?

To answer this question, Stern Stewart & Company performed a study to determine whether companies that outsource information technology receive a boost from the market when this strategy becomes known. The research focuses on IT "mega-deals," ones whose benefits (if any) would likely register in the stock price around the time of announcement. Some 27 such deals were identified (see Appendix), primarily in the U.S., but also including companies from the U.K., France, Japan, New Zealand, and South Africa. The date of announcement was marked by the public press release made by the companies involved. The earliest transaction in the sample is Equifax, announced in 1993; the most recent is Nissan, announced October 29, 1999. The size of the contracts range from a low of $325 million (First National Bank, South Africa, 1997) up to $5 billion (BellSouth, 1997).[2]

[2] The size of the outsourcing deal was deemed significant for inclusion in the sample if its estimated contract value was at least equal to 2% of the company's equity capitalization (market value) prior to the press release.

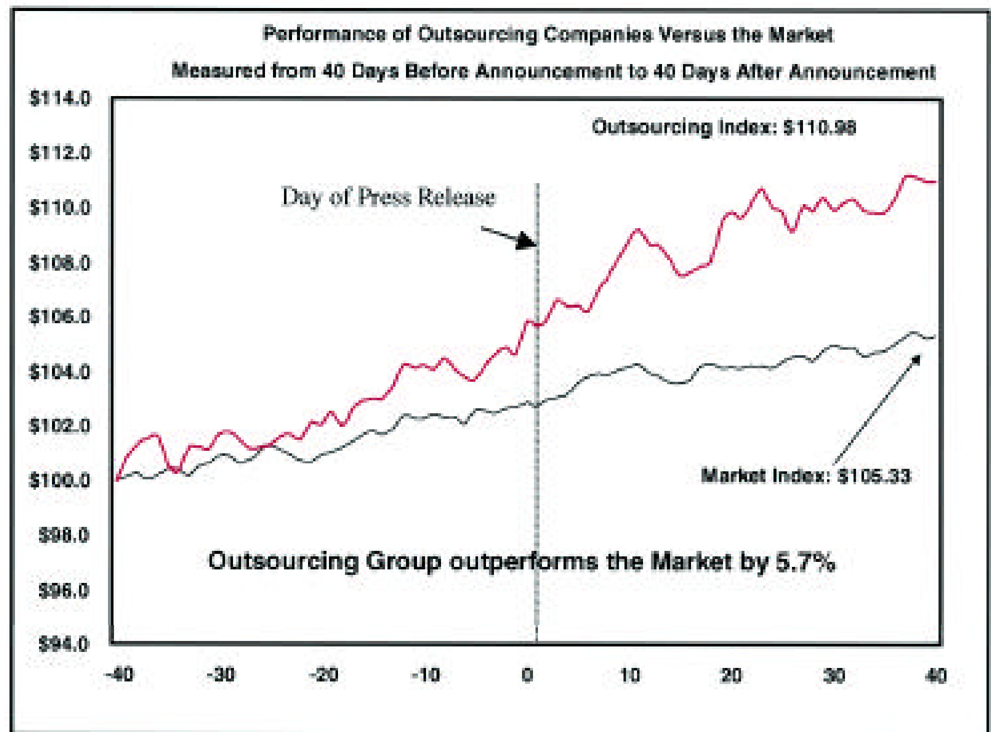
Stock price data were gathered for each company, and for the market index (the S&P500 was used for U.S. companies, and a similar representative index for companies located in other countries), from 40 days prior to and 40 days after the press release, denoted as Day "0". The 2 month interval on each side of the announcement enables the study to capture information that may filter into the market prior to Day 0, and allows the market to assimilate the impact of the initiative after the information is formally disclosed.

The difference between the stock returns for each company and the market index is deemed to be the excess return attributable to the outsourcing initiative. The data for all 27 companies is aggregated to determine the overall returns from IT outsourcing.

THE EVIDENCE

The evidence reveals a positive 5.7% impact on stock price from IT outsourcing.

The evidence reveals a positive impact on stock price from IT outsourcing. The average company in the outsourcing group outperformed the market by 5.7% from two months prior to two months after the announcement. This means that for a company with equity capitalization of $7 billion (the median for the outsourcing group) the average increase in value is $400 million. Considering that the median contract size is $1 billion, these benefits are substantial.



Of the 27 companies studied, the results for three companies were about break-even; that is, their returns relative to the market were between -1 and +1 percent. Positive returns were demonstrated by17 companies (62% of the sample) and only seven were negative (26% of the sample). The strong ratio of positives to negatives, 2.4-to-1, lifts our confidence that the overall results are not being driven by a small, unrepresentative number of individual cases.

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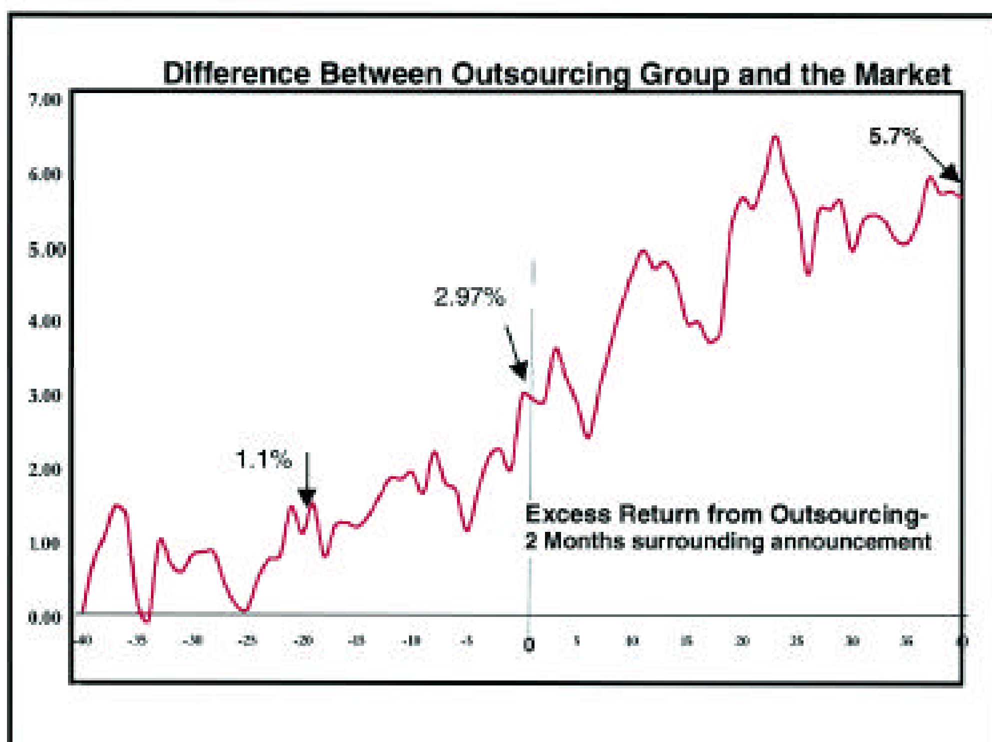
It is interesting to note that the excess stock returns begin prior to Day 0. By Day -20, approximately one month before the press release, the average company had returns of 1.1% over the market. By Day -1 the excess returns had reached 2%. Alikely explanation is that to facilitate the transition to the new service provider, company employees are informed of the initiative about one month before the public announcement. This information quickly filters into the general market. Continuing to trace the pattern of returns, another 1% gain accrues to the outsourcing group on the day of the press release, when this information is confirmed. By Day +20, the excess return accumulates to 5.6%. While we extend the data for another month (20 trading days) the excess return remains about the same. In other words, the entire return is reflected in the stock price by the end of the first month following the public announcement.

Day Relative to Press Release	Cumulative Excess Return to the Outsourcing Group
-20	1.1%
-1	2.0
0	3.0
10	4.6
20	5.6
40	5.7

The pattern of returns is seen most clearly in the graph below, illustrating the difference between the outsourcing group and market indices.



TRACKING STOCK RETURNS FROM SIX MONTHS PRIOR TO ANNOUNCEMENT

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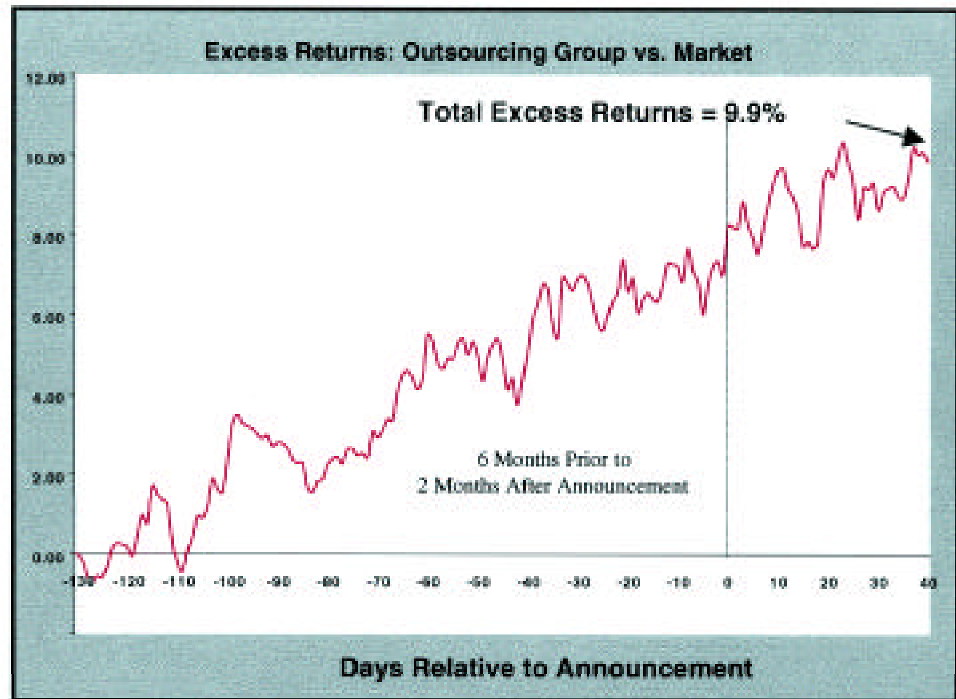
The appearance of positive returns prior to the announcement is reinforced when taking a longer look back, to six months before the press release. For the period six months to two months prior to announcement, the outsourcing group accumulates excess returns of 5.1%. And up to Day -1, the returns sum to 7%. By Day +20, the excess returns grow to 9.7% without significant growth thereafter. (The total excess return at Day 40 is 9.9%). This suggests that the majority of the benefits actually occur before the day of the press release.

One explanation is that "due diligence" is underway as much as six months before a large outsourcing transaction. Due diligence is the process of studying the outsourcing opportunity, including the current capabilities of the client, the needs and potential benefits, the roles and responsibilities of the vendor and in-house managers, the structure of the contract, and so on. With substantial activity in process over an extended period, it is certainly possible that news of a potentially significant event filters out into the market and draws a reaction from investors. The graph comparing the stock performance of the outsourcing group relative to the overall market illustrates this phenomenon very clearly.



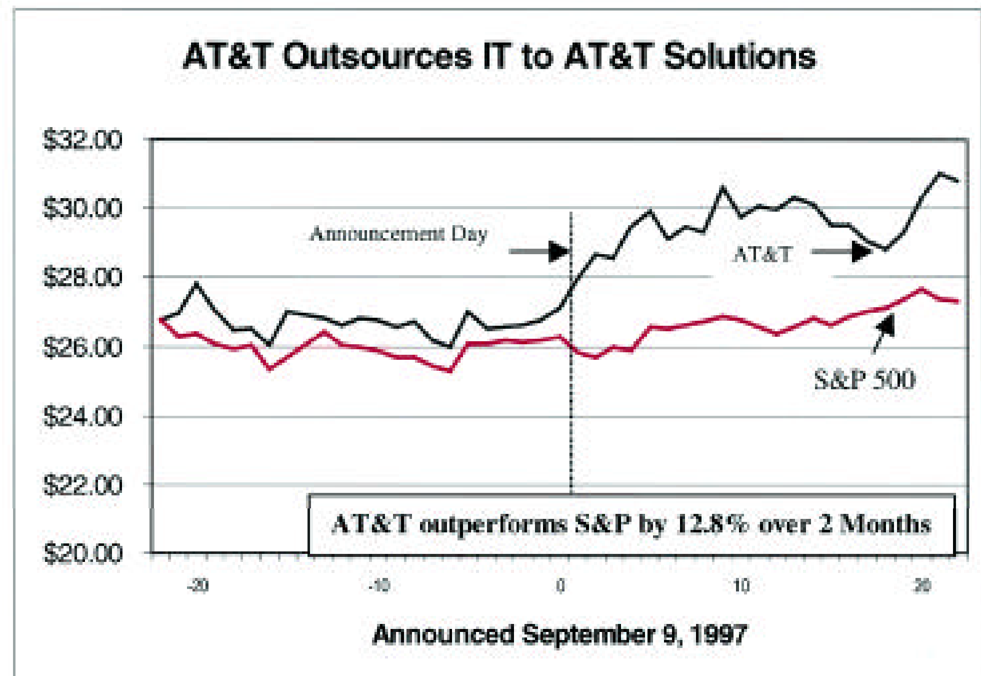
…that only 7 out of 27 deals were negative provides strong affirmation of the positive view of outsourcing in the marketplace.

There is one important caveat about the methodology. The number of companies contained in the sample is not very large, making the results less than statistically conclusive. (The sample size is limited by the requirement that transactions be large enough to have a measurable impact on the share price.) Still, that only 7 out of 27 deals were negative provides strong affirmation of the positive view of outsourcing in the marketplace.

One of the cases included in the survey is AT&T, which in 1997 transferred its in-house networking and IT group to AT&T Solutions, an outsourcing practice that designs, manages, and operates global networks for multinational companies. Essentially, AT&T engaged in an outsourcing arrangement with itself. How does this add up? The answer is in the discipline of providing a service for profit. It is the difference between carrying out a function, a series of tasks,

versus running a business. Inside AT&T, the IT group no doubt was a "cost center," with incentives to negotiate year-over-year increases in its expense budget. At AT&T Solutions, the same managers are operating under contracts for which a profit is measured, monitored, and possibly even used for incentive compensation. Efficiency gains and innovation are much more likely to emerge from this latter situation.

The President of AT&T Solutions observed, "It's a win for shareholders because it will create operating efficiencies that will lower AT&T's costs significantly." (Press Release, September 9, 1997.) The scope of the arrangement ranks it among the largest such contracts. And the "win" for shareholders is confirmed in the market: AT&T's stock price appreciated by 7% more than the market in the week following the announcement.



J.P. Morgan provides another interesting case study. Morgan formed a separate venture called Pinnacle to manage its IT needs. Pinnacle is an alliance of major service providers; as indicated by Morgan's CEO, Douglas Warner:

> *"Outsourcing will give Morgan added flexibility to tailor technology use to changing business needs, capitalizing on the Alliance's substantial processing capacity and economies of scale to make technology costs more variable...*
> *(Outsourcing) will put us at the forefront of creative, flexible management of technology — increasing our ability to exploit new technologies, manage costs, and create competitive advantage."* (Press Release, May 13, 1996.)

The contract with Pinnacle is expected to amount to about $2 billion and extends for 10 years. Management projects savings of 15%. Following the announcement, J.P. Morgan's market value increased by about $250 million, a stock price gain of 1.5% over and above the market.

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J.P. Morgan's rationale confirms that the motives for outsourcing have grown more sophisticated. It is not just about cost. Morgan's objective to make costs variable demonstrates that outsourcing is a technique that can reduce risk and increase flexibility.

CONCLUSIONS

Outsourcing IT creates value; a proposition supported both by empirical evidence and common sense. The opportunity to generate additional shareholder value should prompt CEOs and other senior executives to review internal IT activities and seek candidates for outsourcing. This does not mean that IT should be placed entirely in the hands of outsiders. But the common objection that all of IT is strategic, and must remain confidential, is equally misleading. Managing the data center, manning the help desk, and maintaining existing applications are similar tasks across many companies. Specialists that have scale can often perform these activities at lower cost.

Outsourcing non-strategic processes enables a company to allocate management attention to areas where it will have the greatest impact.

One of the scarcest resources for any company is management time and energy. Outsourcing non-strategic processes enables a company to allocate management attention to areas where it will have the greatest impact. It also provides a company with access to best practices developed and applied by a specialist, and sharpened by competition and other compelling incentives to innovate, generate efficiencies, reduce costs, and deliver creative solutions to customers. And where the underlying technology is in flux, the need for a flexible provider with diverse capabilities diminishes the risk that IT will be an impediment to executing management's strategic plan.

Outsourcing requires, however, a willingness to nurture a partnership with another company. The culture of many successful firms is to perform all functions in house: if they can do it, they believe they should. This mindset is often a roadblock to new ideas and initiatives that create shareholder value. Yet the evidence from the marketplace is that IT services can often be best obtained through contractual arrangements with industry specialists, making outsourcing an important shareholder value strategy that warrants attention of executives at the highest levels.

APPENDIX
IT Outsourcing and Shareholder Value

[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Galeries Lafayette	IBM	06Jul99	15	825	274	301.00%	16.2%	44	50.8%	139
Ryder System, Inc.	IBM/Andersen	12-Mar-97	10	1400	2429	57.63%	6.2%	150	-9.2%	-223
Equifax Inc.	IBM	26-Apr-93	10	650	1311	49.58%	-0.3%	-3	16.3%	213
McDermott International, Inc.	AT&T	31-Mar-99	10	600	1497	40.08%	18.4%	276	-30.7%	-459
General Dynamics	CSC	05-May-98	3	1667	5354	31.13%	-0.6%	-30	-6.8%	-366
Xerox	EDS	14-Jun-94	10	3200	10787	29.67%	2.8%	304	20.3%	2187
Policy Management Systems	Lockheed Martin	16-Mar-98	10	350	1357	25.79%	12.7%	173	13.8%	187
FAG Kugelfischer	IBM	01Jul99	N/A	390	1585	24.61%	-2.2%	-35	28.7%	454
Cable & Wireless	IBM	01-Sep-98	10	3000	12403	24.19%	-19.3%	-2395	28.4%	3519
Telecom New Zealand	EDS	15-Jul-99	10	1500	7325	20.48%	6.4%	467	-5.9%	-433
J.P. Morgan	Pinnacle Alliance: CSC, Andersen, Etc.	13-May-96	7	2857	16094	17.75%	0.7%	115	0.2%	40
Equifax Inc.	IBM	13-Jul-98	10	900	5269	17.08%	15.1%	794	6.6%	347
CNA Financial Corporation	CSC	18-Nov-96	10	1000	6442	15.52%	-4.9%	-315	-9.1%	-584
Textron Inc.	AT&T	09-Sep-96	10	1100	7175	15.33%	5.0%	426	-2.1%	-151
Boeing Company	IBM	30-Sep-98	5	4000	33016	12.12%	8.2%	2706	-25.3%	-8341

Summary of Outsourcing Transactions Included in the Study

Merrill Lynch & Co.	AT&T	07-May-96	5	1000	9903	10.10%	14.8%	1466	0.7%	69
BellSouth Corp.	EDS/Andersen	18-Nov-97	10	5000	53382	9.37%	23.6%	12614	22.0%	11718
First National Bank (S. Africa)	EDS	29-May-97	10	325	4176	7.78%	44.0%	1839	63.6%	2657
Du Pont	CSC/Andersen	11-Dec-96	10	4000	52199	7.66%	5.1%	2665	21.7%	11339
Nissan	IBM	28Oct99	9.5	1000	14535	6.88%	-32.4%	-4712	15.7%	2279
Mazda	IBM	07Oct99	10	450	6793	6.62%	-29.3%	-1993	-18.6%	-1263
Imperial Chemicals (Eur.)	IBM	18-Mar-99	NA	415	6968	5.96%	39.3%	2735	20.5%	1431
Dayton Hudson	IBM	29-Mar-99	5	800	30367	2.63%	-5.2%	-1577	36.1%	10974
Citigroup Inc.	AT&T	10-Mar-98	5	1500	66525	2.25%	6.6%	4361	16.0%	10637
MCI Worldcom	EDS	11Feb99	10	3300	149341	2.21%	21.0%	31371	47.9%	71471
AT&T Corp.	AT&T	09-Sep-97	NA	N/A	66129	0.00%	32.5%	21485	20.0%	13242
United Health Group	AT&T	29-Aug-98	NA	N/A	7168	0.00%	-32.7%	-2346	-55.1%	-3952
			Total	$41,229	$579,803	7.11%	5.6%	$70,581	9.9%	$127,125

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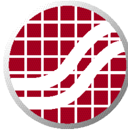

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