

The Value of Outsourcing to Stakeholders- A case study

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Outsourcing non-core functions to specialized service providers has become a world trend and common strategy in the modern organization. It enables companies to stay at the forefront of business process change in order to function efficiently in a highly competitive environment. Outsourcing non-strategic processes enables management to focus on core business that is critical to its strategic success. Outsourcing has evolved from a mere cost saving activity to one, which helps the company develop capabilities required to execute strategy.

Since 2000 Outsourcing has exhibited steady growth in South Africa with the information technology outsourcing service market reaching R 4.5 billion (up 19 % year on year) in this period. Some of the main reasons for outsourcing IT has been skill shortages due to the brain drain phenomenon, the rate of technological change, the countries isolation and resultant lack of competition pre 1994, technological pressure and cost savings. As a matter of fact reasons for outsourcing has always been listed as one of four namely strategic, economies of scale, market forces, and technical considerations, thus giving no direct consideration of the creation of shareholders' value through the outsourcing activity. But as with all business strategies the ultimate judgement of management strategies is the value attrition to shareholders, for whom management acts as an agent.

Studies done at the Unisa School of Business Leadership investigated whether on the one hand (study 1) managers do consider the contribution of outsourcing to creating shareholders value when making outsourcing decisions and on the other hand (study 2) if investors reward companies with higher stock prices for initiating outsourcing strategies. The research focused on the top outsourcing contracts for 1999 -2001 determining the influences the deals had on the share price of the individual companies as share prices reflect the public value of a listed company.

Comparisons were made to determine whether companies that outsource non-core business outperformed the respective market indexes. Bench marketing against market indexes was done to establish whether major sector happenings influenced the share price of the individual companies. If the company outperformed the respective market index or there was a rise in the share price after the outsource announcement one would be able to assume that the market favoured the outsource activity. The companies targeted in the research was not intended to be comprehensive of all outsource or even all IT outsource transactions and it is acknowledged that the outsourcing announcement could not be isolated from other company and market news during the periods analysed. The conclusions derived from these studies were therefor more indicative of a trend, rather than purely scientific. These companies were monitored for a period of 40 days before and 40 days after the announcements of the outsourcing) were made in the media. The

following 3 schedules illustrate the different aspects and findings of the overlapping companies as extracted from the two referenced studies.

Schedule 1: Extract of a list of IT outsource transactions as announced in the media

Outsourcing Company	Outsource to	Value (R)	Date
ABSA	CS Holdings	20 million	Mar 2000
Gensec (Sanlam)	EDS	155 million	Oct 2000
Metropolitan Group	Debis IT Services SA	100 million	Feb 2000
Prestasi	Policy Management systems	400 million	Jan 2000
Pep Stores	USC Group	Multi million	July 2000
Sanlam	CS Holdings	15 million	Nov 1999

The share price performance were monitored and conclusions made on the evidence (Illustrated in Schedule 2)

Schedule 2: Extract of the Summary of share price reaction

Company	Share price performance over duration of 80 days	Share price performance during the announcement week
ABSA	Positive	Positive
Gensec (Sanlam)	Positive	Positive
Metropolitan Group	No correlation	No correlation
Prestasi	Positive	Positive
Pep Stores	Positive	Neutral
Sanlam	No correlation	No correlation

Eighty seven percent of the companies investigated in study 2 showed a definite correlation between the announcement of an IT outsource transaction and the share price performance.

In the week of the announcement 40 % of companies' share price performance indicated a positive correlation to the announcement whilst 53 % reacted neutrally and 7 % negatively. Over the longer period of 40 days after the announcement 47 % of the companies share price performance indicated a positive correlation to the outsourcing announcement. This lead to the conclusion those investors are slightly positive to companies that outsource, but do not adjust the value of the company solely on this information.

In order to pursue this matter further study 2 developed a high level instrument to qualitatively assess investor community awareness and perceptual value attrition towards outsourcing. One representative from each major institutional investor company (being the largest investor group on the JSE in South Africa) was identified and invited to participate in a survey. The results were as follows:

- Institutional investors believe that IT outsource only *sometimes, but not in most cases* add shareholder value to the company performing the outsourcing deal.

- ❑ Institutional investors only *sometimes but not in most cases* analyse IT outsource announcements to determine shareholder value addition.
- ❑ Institutional investors perception of the value of a company that outsource is positively influenced by the news of an outsource transaction, but this doesn't inspire any action.

Study 1 pursued outsourcing and shareholder value from a management perspective. One of the questions asked from these managers were do they consider the direct contribution of outsourcing to shareholder value in taking the outsourcing decisions (or is the effect only indirect i.e. through cost savings. Results of these are summarised in *Schedule 3*

Schedule 3: Extract of list of management's reasons for outsourcing

Company	Focus on core business	Technology expansion & expertise	Cost savings	Increase in shareholder Value	IT training for the existing staff
ABSA	X		X		X
Gensec (Sanlam)	X	X			
Metropolitan Group		X			
Prestasi	X	X	X	X	
Pep Stores			X		
Sanlam		X	X		X

From study 1 it was clear that technology expansion and expertise were the main motivators for management to perform these outsourcing deals. (86 % of the companies) Whilst cost savings as a motivator was listed as a reason by 60 % of the managers. It is interesting to note that only 13 % of the managers performed outsource deals as a direct motivation to increase shareholders value.

Evidence from the market has shown that IT services can often be best obtained through contractual arrangements with industry specialists. This creates the ideal opportunity for managers to not only use outsourcing as a method to bring about cost savings but outsourcing should also be considered as an important shareholder value creation strategy warranting attention from executives at the highest levels in the organization.