

Business impact of outsourcing: a fact-based analysis



Contents

- 2 Introduction
- 2 The case for measuring the business impact of outsourcing
- 3 Study findings: outsourcing clients outperform on key business metrics
- 3 Research analysis and methodology
- 5 Outsourcing in action: individual cases of successful business impact
- 6 Outsourcing's role in building a smarter planet
- 7 Conclusion

Introduction

IT and business process sophistication are well recognized indicators of a company's competitiveness and potential for superior performance when compared with industry peers. However, maintaining a state-of-the-art IT infrastructure is an expensive proposition that triggers many corporations to outsource their information systems. According to recent AMR research, over half of large enterprises "are considering outsourcing as a vehicle for reengineering their business process. Many firms have used the recession as an opportunity to focus heavily on eliminating waste and streamlining poor process flows."¹ In addition, enterprises are often able to use outsourcing initiatives to free up resources to focus on core business value drivers, gain from economies of scale, liberate cash to be used for additional investments, and mitigate business and IT risk.

Although the benefits of outsourcing have been outlined theoretically and supported by a number of empirical studies understanding the business impact of outsourcing in financial terms that both CIOs and CFOs appreciate can be a challenging task. This motivated scientists at the IBM T. J. Watson Research Center to investigate the

long-term impact of IT, application and business process outsourcing on companies' financial performance. Using a rigorous statistical approach, the IBM Research team analyzed the financials of 244 publicly traded companies that entered into a large-scale outsourcing program between 2001 and 2006. That analysis revealed a correlation between outsourcing and significant improvement in business performance. The results of the IBM Research study demonstrate that outsourcing clients consistently outperform their peers on key financial metrics, including *Selling, General and Administrative* (SG&A) expenses, *Earnings Before Taxes* (EBT), *Operating Income and Return on Assets* (ROA). The results also demonstrate that companies that choose to outsource experience significant improvements in their financial performance compared to their performance levels prior to outsourcing.

This new analysis is an extension of the 2005 IBM Research study on the business impact of outsourcing.² The differences in scope and methodology between the two studies limit one's ability to compare the results directly, but the consistency in findings indicate with high statistical confidence that outsourcing is part of a broader management strategy leading to stronger financial performance and market leadership.

The case for measuring the business impact of outsourcing

The financial impact of outsourcing projects is typically assessed using commonly accepted performance indicators, financial/budget planning activities and the analysis of project costs. While necessary and useful, this type of operational analysis may not always inform the CFO and leadership teams how the outsourcing project is affecting their companies' bottom-line financial performance. Despite being a valuable benchmark, the aggregate performance of companies that outsourced IT and/or business processes is generally unavailable. Therefore, making this data and analysis available may aid c-level executives in comparing their own understanding of their company's financial performance with others in their industry, as well as with other companies that have embraced

outsourcing as a part of their business strategy. Furthermore, senior executives are keenly interested in identifying additional levers of business performance, especially those behind profitability and other drivers of shareholder value. Gaining better visibility into the long-term, strategic benefits of outsourcing has the potential to elevate the outsourcing conversation to a higher level within the organization beyond the operational leadership, and contribute new insights to develop business cases for future outsourcing initiatives.

Study findings: outsourcing clients outperform on key business metrics

The IBM Research team focused its investigation on SG&A, EBT, Operating Income and ROA. Two analyses were completed—the first compared the performance of outsourcing clients against their industry sectors, while the second analysis compared individual company performance before and after outsourcing. The results were impressive.

Analysis 1: Average company financial performance metrics compared to the average of sector peers

When compared to industry sector peers, outsourcing clients outperformed on every financial metric. Table 1 summarizes these results.

Metric	Change In Growth	Performance Highlights
SG&A	-2.9 points	Lower growth in SG&A One year following the start of the engagement, companies that outsourced had 2.9 points lower SG&A growth than their sector peers.
EBT	+4.3 points	Higher earnings growth Two years following the start of the engagement, companies that outsourced had 4.3 points higher earnings growth than their sector peers.
Operating Income	+3.2 points	Higher income growth Two years following the start of the engagement, companies that outsourced had 3.2 points higher operating income growth than their sector peers.
ROA	+0.13 points	Better growth in ROA Two years following the start of the engagement, outsourcing clients grew their ROA 0.13 points better than their sector peers.

Results are statistically significant with 95% confidence interval.

Table 1. Financial performance metrics of outsourcing clients versus sector peers.

Analysis 2: Average company's financial performance pre- and postoutsourcing

Across all metrics analyzed, outsourcing clients have demonstrated significant improvements compared to their performance in the preoutsourcing period. Of the four metrics analyzed, two produced statistically significant findings, as shown in Table 2.

Metric	Change In Growth	Performance Highlights
SG&A	-3.5 points	Lower growth in SG&A Companies that outsourced were able to reduce the rate of their annual SG&A growth by 3.5 points in the first year of the engagement.
EBT	+4.5 points	Higher earnings growth Companies that outsourced were able to increase the rate of their annual earnings growth by 4.5 points in the second year of the engagement.

Results are statistically significant with 95% confidence interval.

Table 2. Financial performance metrics pre- and postoutsourcing.

Research analysis and methodology

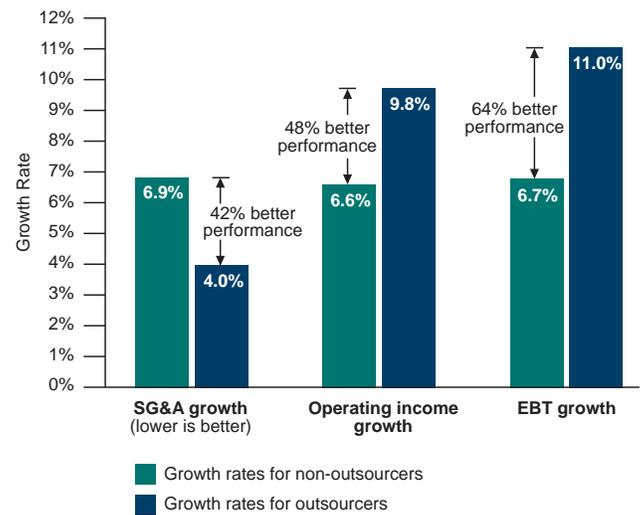
Scientists in the Business Analytics and Mathematical Sciences Department at the IBM T. J. Watson Research Center conducted the study. They analyzed each company's financial performance in the five quarters prior to outsourcing and then measured results up to 12 quarters after outsourcing began. Following the analysis of theoretical and empirical evidence on outsourcing benefits, the IBM Research team focused its investigation on SG&A, EBT, Operating Income, and ROA. The financial data was obtained from Capital IQ, a division of Standard & Poor's.

The IBM team used the Datamonitor ComputerWire database of historical services contract signings to identify companies to include in the study. On November 11, 2008, the

database listed over 13,000 services engagements. To eliminate the selection bias, an automatic filter was implemented to search the database and used the following set of qualifying criteria:

- Company is listed on one of the U.S. stock exchanges.
- Announced total contract value is higher than US\$20 million (according to Datamonitor), to a single provider or vendor in a single outsourcing contract.
- Start date of the outsourcing agreement was between January 1, 2001, and June 30, 2006. Selecting only the companies that outsourced in this period allowed the researchers to focus on the current outsourcing market. The end date of June 2006 was chosen to allow for a sufficient amount of after-contract commencement to record and measure financial performance metrics. As a result, the timeframe for the analysis spanned October 1999 to June 2008.
- The outsourcing engagement included at least one of the following types of outsourced services:
 - Application development, application management and application selective outsourcing
 - Business process outsourcing (BPO), BPO customer relationship management, BPO finance and accounting, BPO financial process management, BPO human resources and BPO procurement
 - Processing services, data center outsourcing, desktop management, help desk management, infrastructure management, server management, storage services and off-shore contracting.
- The engagement is the company's first outsourcing contract in the five-year period, unless all of the outsourcing agreements in the previous five years were significantly smaller than (less than one-fifth the size of) the agreement in consideration.
- Relevant company financial data is available from Capital IQ for the time period prior to and following the commencement of the outsourcing contract.

Business Impact of Outsourcing



Source: 2009 Business impact of outsourcing: a fact-based analysis, IBM

Figure 1. Correlation between outsourcing and financial performance.

The IBM Research team conducted two analyses. It:

1. Compared the performance of outsourcing companies to their respective industry sector averages. Capital IQ definitions were used for industry. The analysis was conducted via statistical hypothesis testing with a 95 percent confidence interval. The data was sector adjusted, i.e., following the data analysis steps, the average growth value for a company's sector was subtracted from a company's growth, to obtain the *sector-adjusted growth number*. IBM Researchers evaluated 10 sectors provided by Capital IQ: *Consumer Discretionary*, *Consumer Staples*, *Energy*, *Financials*, *Healthcare*, *Industrials*, *Information Technology*, *Materials*, *Telecommunication Services*, and *Utilities*. The 10 sectors are based on Standard and Poor's Global Industry Classification Standards (GICS).
2. Compared the performance of outsourcing companies before and after the start of the engagement. The analysis was conducted via statistical hypothesis testing with a 95 percent confidence interval.

Both analyses demonstrate the strong correlation between the decision to outsource and the financial performance of client companies, as shown in Figure 1. It is important to note, however, that the analysis does not establish causality or imply that outsourcing was the sole driver behind this improvement. To further establish confidence in the results, the IBM Research team ran a Monte Carlo simulation computing the probability of observing the same result in a random population of companies. The team ran the analysis 1,000,000 times, with 244 companies selected randomly at each run, while preserving the same industry distribution. Financial improvements consistent with those reported in the study occurred in less than 5 percent of the samples, thereby confirming the 95 percent confidence level of the results.

Outsourcing in action: individual cases of successful business impact

Outsourcing is a unique experience, and individual companies find its impact to come in different shapes and sizes. Listed below are the stories of the business impact of outsourcing for a major, multinational insurance company and a global engineering and construction firm.

The business impact of outsourcing for major insurer Manulife

With a vision to be the “most professional life insurance company in the world,³ global insurance company Manulife must be responsive, service oriented, and customer focused for the millions of clients it serves in 22 countries around the world.” Over the past decade, Manulife has quadrupled in size to C\$437 billion of funds under management (as of 30 September, 2009), while seeing its employee population double in that timeframe to 59,000. Growth has been something to celebrate for Manulife⁴ since going public in 1999.

Outsourcing is one tool of many that Manulife uses to fulfill its growth, business, and operational strategies. Its first large-scale outsourcing program began over seven years ago and would grow to encompass approximately 80 percent of its entire IT infrastructure. As with most programs, outsourcing has grown in use, efficiency and value as the program matured over the years for both infrastructure and applications.

The value Manulife has realized from outsourcing has come in many different ways. Perhaps the largest benefit is that the outsourcing relationship has helped to fund the company’s growth. With an approximate five percent efficiency gain each year, Manulife has been able to self-fund volume growth in its infrastructure and operations—even when there have been dramatic needs, such as storage requirements increasing nearly triple-digit percent over the last several years.

Outsourcing enables Manulife to modernize its infrastructure frequently, accommodate growth, and deploy new capabilities without making large capital expenditures. Through this, Manulife is able to transform operations while minimizing risk. This point resonates with the C-suite, who knows that high service levels are critical to a customer-focused mission and appreciate that capital can be preserved for other initiatives or acquisitions.

Outsourcing provides Manulife access to thought leadership, innovation and best practices through strategic suppliers that it may not get otherwise. Manulife also delegates the skills and competency worries to its vendors, who manage the refresh of talent on an ongoing basis.

Harry Pickett, Manulife's Chief Technology Officer, attributes much of the success of the program to strong governance and enforceable, comprehensive service level agreements (SLAs) that guarantee performance. "Even though we outsource, it is still our IT department that is accountable to the company for quality service and great performance. It's real dollars out the door if you don't perform," says Pickett. "The SLAs allow us to track performance, and our outsourcing governance helps drive the right behavior to achieve high customer satisfaction. Managing the program is done by people, and the better equipped they are to govern their outsourcing program, the more value they are able to achieve."

The business impact of outsourcing for global construction company Fluor

With more than 40,000 employees and more than \$20B in annual revenue, Fluor is a global leader in executing difficult engineering construction projects across the globe in some of the most challenging locales. Business success for Fluor is ultimately driven by a complex array of factors, but most importantly the company must succeed: in closing the right deals at the right price with the right schedule; in executing construction projects on time and on budget; and in being flexible and responsive to its government and corporate clients.

Outsourcing has been one tactic within a comprehensive strategy that has helped support these objectives, and while outsourcing itself isn't viewed as directly affecting sales or profitability, its impact has helped Fluor optimize its business model while enabling Fluor's leaders to focus their skills and talents on their core strengths.

In 2003, Fluor launched an IT outsourcing program in order to transform its cost equation and improve the company's ability to deliver IT services to project sites. While the first years presented some unexpected challenges, the early efforts resulted in immediate cost savings. The company was also able to tailor its IT capabilities based on the most current priorities without being hindered by some of the historic bloat its legacy IT department had acquired through the years.

As the program matured, Fluor found that outsourcing provided them with much needed flexibility in a volatile market. The construction industry is cyclical, and when construction demand surges or falls, the need for IT services follows suit. Outsourcing enabled Fluor to reduce its IT services footprint on down cycles, and quickly ramp up during growth times. In 2006 - 2007, Fluor's revenue tripled, and IT outsourcing enabled decision makers to quickly grow their IT service delivery to meet the new demand.

"Without the flexibility of being able to ramp up and ramp down, we would have had a hard time providing consistent, high-quality IT services to our rapidly growing number of project sites," says Robert Taylor, Vice President of Information Technology at Fluor. "Project engineering and construction is a dynamic business, and we need to be dynamic to succeed in it."

Outsourcing's role in building a smarter planet

In a world economy, financial performance can depend on a company's ability to exploit its global potential for integration and collaboration. Its people are driven to seize opportunities from wherever they originate to improve operational efficiency, leverage untapped talent and extract new value from

information—all for the purpose of doing things better than their competitors. Financial returns aside, such activities inevitably drive the kinds of advances needed to make communities, cities, societies—and the planet—smarter, and outsourcing is a critical part of the evolution of business change.

Successful businesses have proven that the ability to adapt and take advantage of change is critical to continued prosperity. They need to be agile and respond to new and emerging markets while exiting those that are no longer viable. Outsourcing can provide this kind of agility, enabling the business to implement new models that place focus on those areas that differentiate them in the market, and outsource the high-cost, low-value processes to external players that can manage them more efficiently and cost-effectively.

Outsourcing is more than a vehicle for workload efficiency or cost containment. Outsourcing opens the enterprise to new ideas, capabilities and expertise beyond its own walls, but more importantly, it provides a platform for innovation and insight that can transform how things are done. Consider the impact of cloud computing, which can be thought of as the newest incarnation of outsourcing. For example, cloud is changing how developers build and test new applications by enabling them to self provision computing resources in a matter of minutes and hours, not days and weeks. By enabling companies to dynamically request IT and business services from a virtualized pool and pay only for what they use, cloud is forever changing how capacity planning is done, not to mention our expectations for service delivery.

Outsourcing in all its forms enables the kind of changes that can help sustain business. By bringing organizations together to solve problems and improve operations, outsourcing can be a natural springboard for innovation and business model change. It can elevate how services are delivered, improve how companies are managed, and optimize how business processes are developed and knowledge is conveyed. Towards that end, it can be a powerful contributor to building a smarter planet.

Conclusion

As companies search for ways to cut costs and optimize revenue, a key strategic business decision they should explore is the role of outsourcing for IT infrastructure, applications, and business processes. Outsourcing decisions are often made in conjunction with other management actions to create an optimal mix of strategies and programs that will ultimately drive financial performance. A new view into the correlation between financial performance and outsourcing, as illuminated by IBM Research scientists, provides decision makers with an improved basis on which to form their viewpoints.

With new information comes new confidence. Armed with new facts, the outsourcing decision process can be elevated to include a broader audience of leaders as well as strategic topics that extend beyond managing costs or infrastructure such as how the company will refocus its energies on core competencies, how outsourcing can be a critical growth enabler, or how outsourcing can provide the flexibility for companies to outperform and differentiate themselves competitively. These benefits, and the demonstrated financial performance of the companies included in this study, reveal the real business impact of outsourcing and are important indicators for those companies considering an outsourcing strategy.

For more information

To learn more about how IT, application, and business process outsourcing can help your company dramatically improve its bottom line, please contact your IBM marketing representative or IBM Business Partner, or visit the following Web site: ibm.com/services/outsourcing



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¹ Phil Fersht and Dana Stiffler, “State of the Outsourcing Industry in Mid-2009: Activity To Resume With a More Cautious and GlobalFocus,” AMR Research, July 23, 2009.

² “*Business impact of outsourcing—a fact-based analysis.*” IBM White paper. http://www-935.ibm.com/services/it/gbs/pdf/business_impact_of_outsourcing.pdf.

³ Manulife homepage, <http://www.manulife.com/public/about/index/0,,lang=en&navId=610000,00.html>.

⁴ Manulife Financial Fact Sheet, “Manulife Financial Looks to a Bright Future as it Celebrates its Tenth Year as a Public Company,” September 25, 2009.



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