ABSTRACT  As the reach of outsourcing extends to include strategic business functions, a central question for outsourcing managers is whether outsourcing creates value. In contrast with transactional outsourcing, strategic outsourcing is characterised by higher levels of business uncertainty and complex co-ordination requirements. Consequently, strategic outsourcing involves greater contractual risks and requires greater investment in collaboration with the vendor. Based on the conjecture that clients may be unprepared for these management challenges, we test the hypothesis that there may be negative abnormal returns to strategic outsourcing decisions. Data on the 100 largest outsourcing deals inked between 1996 and 2005 show that while transactional deals experienced positive long-term abnormal returns, complex arrangements witnessed significant long-term value destruction. The negative outcomes are exacerbated by low degrees of outsourcing experience and a lack of familiarity with the vendor. The results suggest that clients are unprepared for the management challenges of strategic outsourcing. The results have implications for asset managers in extracting value from their own strategic outsourcing decisions, and also for seeking investment opportunities in firms that manage the externalisation of their value chains effectively.

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by Anitesh Barua, Deepa Mani and Andrew Whinston

Introduction

Over the past decade, outsourcing has emerged as a strategic necessity for competitive success in modern businesses. Organisations are no longer ‘outsourcing the chores to focus on the core’; core functions, such as product development, marketing or supply chain management that directly impact the competitiveness of the firm, are increasingly being externalised to realise diverse strategic objectives, ranging from revenue increases, to innovation, to business transformation.

Asset management firms are no exception to this shift in outsourcing from the periphery towards the core of the business. The original motivations for outsourcing in the asset management industry were related to the costs of ownership of the outsourced function. However, as firms ceded control of non-core back office services, such as reference data management or fund accounting and ownership of the technology underlying these services, they grew comfortable externalising more strategic activities, such as customer support, equity execution, and fund administration and investment operations. For instance, ABN AMRO Asset Management outsourced its fund administration and investment operation for assets in the UK, Netherlands, Luxembourg and Sweden (valued at $89 billion) to State Street. The objective of the deal was to increase the efficiency of ABN’s core operations and improve management’s focus on the investment process. The outsourcing of these functions is driven more by strategic considerations, such as access to specialised investment skills, faster deployment of new products or entry into new markets. In turn, such strategic outsourcing allows asset managers to redraw firm boundaries to focus management’s time on the core activities that drive performance.

Strategic outsourcing initiatives involve a set of unique costs, risks and management challenges that are different from those posed by the outsourcing of routine, non-core activities. The latter set of services often follow a well-defined process that changes little across clients or over the lifecycle of the outsourcing relationship, and hence, requires less adaptation between the client and the vendor. As a consequence, the control and ownership of these services can be transferred to the vendor with relative ease. Risk management in these more transactional outsourcing engagements is often restricted to determining the appropriate pricing mechanism for the outsourced services and establishing relevant performance benchmarks in the contract for output quality, such as error rates, response times, or customer data security and privacy.

On the other hand, the requirements of more strategic functions, such as customer support, desk-side support for investment managers, or marketing and sales, are often unique to a particular client. In this case, the vendor must work closely with the client to understand the client’s business environment, its drivers and culture, to achieve outsourcing objectives. For instance, marketing teams must be cognisant of the asset manager’s idiosyncratic products and conditions, and engage in relevant due diligence when they interact with their clients. Further, the execution of some of these outsourced tasks often involves interactions with several departments in the client organisation. Customer support representatives must often access information from a variety of departments in the firm to address difficult questions pertaining to creditworthiness or account changes. Given the greater complexity, interdependencies and specificity of the underlying task, risk management in these strategic outsourcing initiatives is a more complex task. Firms must put processes and collaboration practices in place that communicate business needs and task knowledge to the vendor and manage interdependencies between the outsourced task and the rest of the organisation over the lifecycle of the contract.

In light of greater strategic intent behind outsourcing initiatives and the differences between strategic and non-strategic initiatives, certain questions assume significance for asset managers and others considering outsourcing:

- Do strategic outsourcing initiatives experience different performance outcomes than more transactional outsourcing initiatives?
- If yes, what is the difference in performance? What outsourcing costs and risks explain this difference?
- What are the implications of these differences in costs, risks and performance for managerial action?
- What are the implications for asset managers, in terms of managing their own outsourcing initiatives and investment opportunities, based on how target firms manage or mismanage outsourcing initiatives?

To answer these questions, we analyse the operational performance and shareholder value impact of the top 100 outsourcing initiatives implemented by US firms between 1996 and 2005. Information on risks, costs and management practices, although critical to the performance of the outsourcing initiative, may not be obvious to investors at the time of the announcement of the initiative. This information is costly to acquire and requires expertise to interpret. Thus, financial markets will be slow to incorporate this information into the price of the outsourcing firm, resulting in long-term abnormal returns following the implementation of the outsourcing contract.

We find that strategic outsourcing initiatives earned buy-and-hold abnormal returns of -21.2% over a three-year period relative to an industry, size and book-to-market matched sample of control firms. The equivalent estimate for outsourcing firms
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engaged in simpler outsourcing engagements was 17.5%. Greater levels of uncertainty in the business environment and co-ordination requirements of the outsourced task played a significant role in destroying value in strategic outsourcing initiatives. We theorise that these attributes of the outsourced task environment render it difficult to anticipate and plan for contingencies in the relationship. This, in turn, increases the likelihood of misalignment between the nature of the outsourced task and the contract, and relationship management practices chosen to manage the outsourcing relationship. The loss of value in strategic outsourcing initiatives is compounded in cases where the client has limited prior outsourcing experience, or where the client and vendor do not share a prior association.

These results suggest that, despite the potential of strategic outsourcing initiatives, firms remain unprepared for the transformation that these initiatives bring. The negative shareholder impact of business uncertainty and co-ordination requirements of the outsourced task, underscores the caution that firms must exercise before they undertake complex outsourcing initiatives. Especially firms with little experience and unfamiliarity with the vendor should especially restrict themselves to projects with low complexity and business uncertainty.

In what follows, we first present the differences in risks and ensuing management challenges, between strategic outsourcing driven by value considerations, and transactional outsourcing driven by cost considerations. We then present evidence of how these risks and challenges in strategic outsourcing affect shareholder value and operational performance of the outsourcing firm. Finally, we consider the implications of our findings for asset managers.

**Risks and management challenges in strategic outsourcing**

According to a survey by the Outsourcing Center (Goolsby, 2004), failures in outsourcing can be attributed to a myriad of causes, including unclear expectations at the beginning of the project, misalignment of interests over time, poor governance of the relationship, inequity of benefits and poor communication (figure 1). We argue that most of these factors that impact adaptation of the client and the vendor to changes in the task environment reflect two important risks - *contractual risks* and *procedural risks*.

**Contractual risks**

The outsourcing contract: specifies the mutual exchange of rights between the client and the vendor; defines foreseeable contingencies, actions and responsibilities in the outsourcing relationship and task environment; and describes processes for the resolution of unforeseeable contingencies. In this way, the contract aligns incentives to enable co-operation between the client and the vendor. It also facilitates efficient adaptation to disturbances in the relationship by rendering the information exchange process between firms more predictable and allowing for decision-making by rules rather than by exceptions.

In order to recognise contractual risks in outsourcing, we must understand the dominant forms of pricing of outsourced services. Outsourcing contracts are typically one of fixed-price contracts (involving payment of a fixed sum per billing cycle, or per unit of process output) or variable-price contracts (involving payment based on variable factors, such as the resources expended by the vendor in executing the outsourced task during the billing cycle, or the savings generated by the vendor).

As compensation in fixed price contracts is rarely subject to negotiations or revisions based on factors such as the vendor’s cost experience, changes in service requirements or quality preferences, the client must invest significant time and effort at the outset to anticipate contingencies in the task and relationship, and define service limits and performance guarantees. The greater the complexity of the outsourced process, the greater the magnitude of the effort and costs of designing more complete fixed-price contracts. On the other hand, since variable-price contracts compensate the vendor for costs of adaptation, the client does not need to invest significant time and effort in designing these contracts as ‘iron clad’. For complex, dynamic tasks in strategic outsourcing, variable-price contracts provide the benefits of flexibility to respond to unanticipated contingencies and lower costs of contract design.

The first contractual risk in strategic outsourcing involves inappropriate choice of the outsourcing contracts. Why would clients make such an inappropriate choice? Both the business press and academic literature (for example, Lacity and Willcocks, 1998) have recommended iron-clad, exhaustive contracts to protect against opportunisti
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For instance, consider the outsourcing of customer relationship management (CRM) services that requires significant adaptation to the client’s business environment. This involves not just a one-time effort in the early phases of the engagement to customise and integrate the service with the client’s internal applications and work routines, but rather continual adaptation throughout the life of the contract to incorporate changes demanded by the dynamics of the client’s business environment.

In this case, a fixed-price contract may result in inflexibility, whereby the provider refuses to tailor a stream of services that were not initially foreseen, or engages in a costly bargaining exercise with the client. Further, the CRM application may have two distinct, but complementary, dimensions involving automation and business analytics (Susarla et al., 2007). Automation tasks may include automated e-mail response, campaign management and lead generation; business analytics, however, may require an in-depth understanding of the client’s business setting, and integration with internal applications and processes. The automation tasks can be measured through SLAs on verifiable dimensions of effort, including network availability and application response (ITAA, 2003; Recktenwald, 2000). Susarla et al. (2007) show that, in such a setting, choosing a fixed-price contract will result in the vendor allocating its effort to the automation dimension (which is easily verifiable), to the detriment of the analytics dimension (which is difficult to verify), thereby lowering the value delivered to the client.

The above example illustrates the pitfalls of inappropriate contract choice. However, while variable price contracts may provide more flexibility and incentives to adapt to changes in the outsourced task environment, lower controls and safeguards in these contracts result in greater risks of opportunistic behaviour by the vendor and costs of ownership of the outsourced process. For instance, if the vendor is compensated for the time and effort expended in task execution, the client bears the major share of cost overruns in task execution (Banerjee and Duffo, 2000). Cost overruns are often an outcome of asymmetry in understanding between the firms of task workflows, performance standards or mutual interdependencies that result from the complexity of the outsourced task and the ensuing inability to precisely specify task requirements. They also result from variance in task inputs and the diversity of work processes required for task execution. Given the asymmetry between the client and the vendor on the true costs of executing the complex outsourced task, time and materials contracts entail risks to the client of dissipation of gains through inflation of true costs and privately favourable distribution of profits or costly bargaining. In fixed-price contracts, the payment to the vendor is not revised based on the latter’s cost experience and, hence, the vendor bears the risk of cost overruns.

In strategic outsourcing relationships, where it is costly to implement more complete fixed-price contracts or more controls and safeguards, the contract is limited in its ability to protect the client from risks of cost and demand overruns. In this case, it is necessary that the client invest in appropriate relationship management procedures and processes that reduce information asymmetries between the firms to address overruns in cost and demand, and improve performance outcomes.

**Procedural risks**

It is important to note from the above discussion that strategic outsourcing initiatives involve high levels of complexity and collaboration requirements, necessitating choice of variable-price contracts. We also noted that while fixed-price contracts are relatively easy to manage through suitable service level agreements (SLA), variable-price contracts may pose significant management challenges that result from asymmetry in understanding of the outsourced task and/or the costs of executing the task.

The literature on contractual co-ordination that is focused on the *alignment of incentives and relational risks* offers few prescriptions to resolve these asymmetries between the client and the vendor. On the other hand, the literature on procedural co-ordination focuses on the *alignment of decisions and actions* between the client and the vendor (for example, Sobrero and Schrader, 1998, Gulati et al., 2005). This school of research points to cognitive limits of both firms and the challenges that they pose to firms’ assessments of how their choices and actions impact others in a setting characterised by interdependence. Thus, inter-firm relationships must provide for procedural co-ordination, or for norms and procedures that implement the contract to reduce asymmetries in understanding and promote co-operative behaviour. Extending this concept to the context of outsourcing relationships, Mani et al. (2009) posit that strategic outsourcing should involve high levels of information exchange norms and processes that address cognitive limitations of the client and vendor to promote a shared understanding of the task environment and mutual adjustment in behaviour.

Organisational theorists (March and Simon, 1958; Thompson, 1967; Galbraith, 1973) suggest that the information exchange requirements in organisations depend on the nature of the task at hand. More specifically, the uncertainty in the task determines the amount and type of information to be shared within the organisation. Extending this viewpoint to the outsourcing context, Mani et al. (2006) suggest that procedural co-ordination between the user firm and the vendor is a function of the uncertainty and complexity of the outsourced task. Task allocation decisions have to be visited frequently in uncertain environments, and unspecified contingencies that arise due to complexity of the task must be addressed using judgment and experience, rather than contractual rules or computational routines (Perrow, 1967). Procedural co-ordination between firms is essential to managing the information churn in the outsourced task environment that results from dynamic business requirements and complexity of the outsourced task. Mani et al. (2009a) propose and test a fit, or
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match, between the outsourced task and the governance mechanism, and demonstrate, through empirical analysis, that organisations outsourcing strategic processes may under-invest in communication, co-ordination and collaboration processes and technologies, which may result in a loss of satisfaction and operational efficiency:

"We suggest that insufficient attention to BPO governance is the main reason BPO relationships fail to deliver value…. three key requirements of the outsourced process – its interdependence with other processes, its complexity, and its strategic importance to the enterprise – should determine three key BPO governance capabilities – the outsourcing contract, relationship management, and technical capabilities."

As an illustration of uncertainty and co-ordination requirements, consider the outsourcing of the payroll process. Unless there is a change in labour laws, or renegotiation with labour unions, there is little need to communicate and co-ordinate actions frequently between the client and the provider organisations. In contrast, a mobile service provider which has outsourced its billing function and which introduces new services frequently to remain competitive, must co-ordinate closely with the service provider to update and enhance the billing capabilities. Outsourcing supply chain services is more dynamic and complex than billing by more than an order of magnitude, and may require close collaboration between multiple process owners in the client organisation and the service provider on a regular basis.

A study of the financial value of outsourcing by European asset managers (Oxford Metrica, 2005) found that outsourcing added 10% value in one year. The study notes that "it seems that the more successful outsourcing arrangements are those where the asset manager has had a clear idea of its business model and a sound control of its cost-base". This observation indicates that well-defined processes were outsourced, and led to positive outcomes. It is not clear if outsourcing complex operations will create value unless the client allocates additional resources to design and implement appropriate governance mechanisms.

Learning effects of prior outsourcing experience and prior association with the vendor

The deconstruction of the strategic elements of the value chain is a new experience for many firms that have largely handled simple, transactional outsourcing governed by fixed-price contracts or by arms-length relationships with clearly defined SLAs and performance metrics. As noted above, managing strategic outsourcing presents a different set of challenges, and it is not clear if clients, who have only dealt with simple arrangements, are ready to get the most out of dynamic settings that demand frequent changes and adjustment in the provisioning of services. It may be natural for the outsourcing firm with little or no experience to assume that management approaches, such as arms-length relationships with vendors that prove to be effective for transactional deals, may apply equally well to strategic initiatives. Yet, as demonstrated by Mani et al (2009b), what works for transactional outsourcing are inadequate to guarantee success in more complex arrangements.

Successful firms, however, learn the art of effective outsourcing management over time. Lacity and Willcocks (1998) note that firms accumulate experience with their outsourcing deals that is "fed back into further outsourcing". Experience in dealing with complex outsourcing relationships may enable firms to implement appropriate co-ordination processes and systems. Further, as the client and vendor gain mutual experience and confidence in doing business, fears of opportunism may, at least partially, be allayed. Thus, the importance of contractual safeguards may be lessened (Santoro and McGill, 2005) over time. In fact, once the client and the vendor start to consider each other as business partners engaged in a long-term relationship, co-operative behaviour is likely to emerge, which may mitigate the need for variable-price contracts.

It should be evident from the above discussions that a firm’s choice of procedural co-ordination mechanisms may have an impact on the outcomes of strategic outsourcing. But can we expect any long-term abnormal returns from such initiatives? The efficient markets hypothesis (EMH) would suggest that, as soon as an outsourcing deal is announced, the market will adjust the value of the client firm based on its assessment of the outcomes of such a decision. This point of view assumes that the market has perfect information about every parameter that influences the outcomes of outsourcing. The reality, however, is that when a firm announces an outsourcing deal, very little information about either the nature of the contract, or the co-ordination mechanisms, are made public. It is also possible that the firm itself may not recognise the criticality of co-ordination processes and technologies for strategic engagements, and may only discover such need over time. Even if the market had all the necessary information, it may not be able to evaluate such information and incorporate it in its pricing decisions due to cognitive limits. Following Daniel and Titman (2003), we argue that outsourcing arrangements may represent intangible information regarding future cash flows, and result in a lagged market reaction and long-term abnormal stock returns. Based on the above discussions, we expect the following conjectures to hold in the data:

- outsourcing engagements characterised by higher levels of process uncertainty and complexity of co-ordination requirements are more likely to be governed by variable-price contracts than by fixed-price arrangements;
- higher levels of experience with outsourcing, and prior association with the vendor, are likely to be associated with fixed-price contracts;
- firms remain unprepared for the management of strategic outsourcing relationships – hence, strategic outsourcing initiatives, characterised by uncertainty in the business environment and coordination complexity, will experience negative abnormal returns, and since variable-price contracts are likely to be deployed in
such settings, an association between variable-price contracts and negative abnormal returns is likely to be observed;
- experience with outsourcing management and prior association with service providers will be associated with positive abnormal returns.

Evidence on the returns and risks to strategic outsourcing

Data
In this section, we present empirical evidence of the impact of strategic outsourcing on the shareholder value of the client. We analysed the 100 largest outsourcing initiatives implemented between 1996 and 2006. This allows us to estimate the long-term shareholder returns from the outsourcing deals. Nearly half the outsourcing deals in our sample are inked by firms in the financial services industry. The average contract value in our sample is $922m, and the aggregate contract value of $83 billion represents 18% of the total outsourcing contract value for the period. Our reasons for including large outsourcing contracts in our analysis are twofold: large outsourcing contracts are more likely to have a more significant economic impact on the client, and they reduce the likelihood of confounding events since firms are less likely to sign equally large contracts in the same time period.

Information on the 100 largest outsourcing initiatives and their governing contracts is obtained from IDC’s services contracts database. We also use Lexis-Nexis and the Dow Jones News Retrieval Service to verify and supplement IDC information concerning announcement and signing dates. We use the Center for Research on Security Prices (CRSP) files to compute abnormal stock returns, and the Compustat Basic and Research files to assess firm characteristics and develop operating performance measures. Our sample outsourcing contracts satisfy two requirements: the firm is publicly traded on at least one of the major US stock exchanges; information about the contract used to govern the outsourcing initiative is available.

The outsourcing contracts are classified as one of fixed price, time and materials, or transactional, combination or incentive. The outsourcing initiatives in our sample are classified as Information Systems (IS) Outsourcing, Business Process Outsourcing (BPO) and Processing Services, and Application, Network and Desktop Management. IS outsourcing services involve a long-term, contractual arrangement in which the service provider takes ownership of, and responsibility for, managing all or large part of a client’s IS infrastructure and operations, often involving customised, one-to-one engagements. Applications outsourcing is a service wherein responsibility for the deployment, management and enhancement of a packaged or customised software application is externalised to the service provider. Applications outsourcers also include application service providers (ASPs). ASPs deploy, host, manage and rent access to an application from a centrally managed facility. Network management services involve the outsourcing of the operations of a specific segment or entire network communication system of a company. The network operations provided as part of a larger IS outsourcing contract are not captured in this category. Desktop management encompasses contracts for which several desktop services are outsourced to the same supplier. Processing services involve outsourcing business activities with performance metrics tied to the efficiency of high-volume service capabilities. BPO involves outsourcing business processes or functional areas (such as logistics or HR), with performance metrics tied to the strategic business value of services provided, and to customer satisfaction. Business value is recognised through results such as new business opportunities, revenue generation and business transformation. The client and vendor share a tight partnership, with services often customised to fit the client’s particular needs.

IS outsourcing contracts constitute 53% of the sample and, on average, are valued at $1.1 billion. BPO and processing services comprise 27% and, on average, are valued at $703m. Application, network and desktop management contracts comprise the remaining 20% of the sample and, on average, are valued at $747m. The relatively higher number of IS outsourcing contracts is consistent with the greater maturity of this segment of the outsourcing market.

Figure 2 describes the number and value of the sample outsourcing contracts over time. More than 40% of the outsourcing contracts in our sample were signed in the period 2001-2003. Total contract value for the period 2001-2005 accounted for more than 50% of the aggregate contract value for the sample period. Figure 3 describes the relative proportion of fixed-price and variable-price contracts over time. Fixed-price contracts constitute 30% of our sample.
Methodology and empirical analysis
We calculate abnormal returns to the outsourcing clients over a three-year period following the implementation of the outsourcing contract, and then regress these returns on attributes such as co-ordination complexity, uncertainty in the business environment, prior association with the provider and outsourcing experience. These variables estimate the contractual and procedural risks in outsourcing. Thus, their impact on abnormal returns tells us whether clients are effectively managing risks in strategic outsourcing and reveals the impact of such mismanagement on the potential value of outsourcing. To further understand the magnitude of outsourcing risks, we compare abnormal returns between the lowest and highest 30% of firms ordered by these variables.

Measurement of abnormal stock returns
We estimate three-year buy-and-hold abnormal returns for the outsourcing firm following the implementation of the outsourcing contract, as a measure of the value created by outsourcing. Mitchell and Stafford (2000) describe event-time, buy-and-hold abnormal returns (BHAR) as “the average multi-year return from a strategy of investing in all firms that complete an event and selling at the end of a pre-specified holding period versus a comparable strategy using otherwise similar non-event firms”. Thus, the BHAR for stock i over holding period T is:

\[ BHAR_{i,T} = BHAR_{i,T} - BHAR_{m,T} \]  

where \( BHAR_{i,T} \) is the buy-and-hold return of the sample firm and \( BHAR_{m,T} \) is the buy-and-hold return of the matching control firm over the same period. Here, the buy-and-hold return for holding period T beginning time a through time b is:

\[ BHAR_{i,T} = \left( \prod_{t=a}^{b} \left(1 + r_{it} \right) \right) - 1 \]  

where \( r_{it} \) is the return for firm i in month t; in this study, period a is the month after the contract effective month and period b is the earlier of the firm’s delisting date, the end of the three-year period following the contract effective date, or 31 December 2006.

We consider an industry-, size- and book-to-market matched sample as a benchmark of returns post implementation of the outsourcing contract. We begin with a group of firms in the same two-digit SIC code as the sample that does not engage in a strategically significant outsourcing initiative as of the beginning of the contract-effective year. From this initial screen, a matched firm is defined as the firm that has the lowest absolute value of the joint difference in size (equity capitalisation) and book-to-market ratio (equity capitalisation divided by book value of equity).

Analysis and results
Table 1 reports results for the regression of choice of outsourcing contract on the firm, relational and task attributes that determine contractual and procedural risks in outsourcing. These results suggest that clients typically choose the appropriate contract to govern their strategic outsourcing initiatives. Greater uncertainty in the business environment, and tighter co-ordination requirements of the outsourced task, are positively associated with the choice of a variable-price contract. The latter offers the right incentives and flexibility required to govern strategic outsourcing initiatives. Greater outsourcing experience and prior association with the provider are associated with the choice of fixed-price contracts. This is because, as firms learn about the process of outsourcing or about the provider, they are better able to predict contingencies in the task and relational environment and, consequently, define these contingencies and incorporate responses to them in the outsourcing contract.

Table 2 reports results for the regression of BHAR on the firm, relational and task attributes that determine contractual and procedural risks in outsourcing. Model I reports results across the entire sample of outsourcing contracts, while Models II and III estimate the impact of these risks on transactional and strategic outsourcing separately. The specification in Model II is a switching regression that allows for the probability that unobserved firm characteristics that influence contract choice may also influence abnormal returns. Model III is a random-effects specification.
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Table 1. Model of choice of contractual structure. Model I shows the results of a Probit estimation of contract choice with clustered standard errors. Model II uses a Heckman Probit estimation to correct for the fact that unobserved factors that influence the decision to outsource also influence contract choice. ‘Business uncertainty’, ‘anticipated co-ordination requirements’ and ‘book-to-market ratio’ are positively related to the choice of a variable-price contract. ‘Prior co-operative association’ and ‘outsourcing experience’ are positively related to the choice of a fixed-price contract.

Table 2. Model of buy-and-hold abnormal returns (BHAR). Model I includes the drivers of contract choice that are estimated to be equivalent across both contract types. Model II uses a switching regression analysis to assess the impact of different task, firm and relational contractual determinants on BHAR in each of the two contracts. Firm and time effects are allowed for in all models. Robust standard errors clustered by firm are reported in parentheses. Model III uses a random-effects specification.

The results confirm that the uncertainty in the client’s business environment and the complexity of co-ordination requirements have a significant negative impact on abnormal returns in strategic outsourcing initiatives. Thus, although clients choose the appropriate contract to govern their strategic outsourced tasks, it seems that they do not invest in the right processes and procedures to manage the contractual and procedural risks that stem from the inherent complexity and dynamism of these tasks.

Outsourcing experience and prior association with the vendor are significantly associated with long-term positive abnormal returns to strategic outsourcing. Thus, learning effects, with respect to the outsourcing process and the vendor, help the client to better define the interface with the vendor and manage contractual and procedural risks in the outsourcing relationship.

Table 3 shows the difference in BHAR between the lowest and highest 30% of firms ordered by uncertainty in the business environment, co-ordination requirements, outsourcing experience and prior association. The differences are large and significant, emphasising the impact of contractual and procedural risks in strategic outsourcing. For example, the firms in the lowest and highest quartiles of business uncertainty and co-ordination complexity had a difference in three-year BHAR of 90%. The equivalent differences for prior association and experience are -38% and -37% respectively.

The study of financial value from outsourcing (Oxford Metrica, 2005) notes that “it appears that to date the outsourcing by European asset managers has sent all the right signals to the market. Evidently, the scale of the value enhancement is well be-
Beyond the expected present value of the direct cost saving. The extra value reflects an improved expectation of the manager’s performance as a business as a result of the process.” Our results regarding simple outsourcing deals are in agreement with the findings of the Oxford Metrica study. It is evident that the types of outsourcing arrangements in the case of European asset managers involved structured tasks: “Asset managers view outsourcing not as a tool to help address their key business issues directly but more as potentially helpful in addressing issues of lower priority. This makes sense and supports the value of outsourcing as a potential solution for managing efficiently noncore investment operations.” Our study and its results add a note of caution regarding the potential for value destruction through outsourcing of complex, strategic processes. While we are not suggesting that firms should not outsource such tasks, our findings underscore the need for both experience and expertise to successfully create value from such initiatives.

Implications for asset managers

Our data comprised diverse business functions outsourced by firms across several industries. Yet, the implications of our results are salient to asset managers for two reasons: nearly half of the outsourcing deals in our sample belong to the financial services industry; and the functions outsourced, such as technology management, back office accounting functions, or financial planning and control, involve similar challenges and risks as outsourced asset management functions. In particular, the implications of our results for asset managers are twofold: management of outsourced operations in asset management firms, and detection of investment opportunities by studying outsourcing management in target firms.

Over the last few years, there has been a growing trend among asset managers in the US and Europe to outsource their middle and back office activities. While such outsourcing appears to have generated some financial value for asset management firms, the path forward is not as clear. A study of value creation in asset management firms, and focus carefully on understanding of the quality of management decisions that impact firms’ competitiveness and strategic value.

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Oxford Metrica (July 2005), ‘Delivering value from outsourcing by European asset managers’.

by the market as being indicative of a long-term weakness of the firm involved.

Our results also have implications for investment opportunities and the pitfalls to avoid in the core function of asset management. Managers can study the competence and experience of firms in managing their outsourcing deals, and focus carefully on the nature of their outsourced processes and technologies. Our empirical results indicate that large and complex outsourcing engagements initiated by firms with little or no experience, are likely to lead to poor performance, while transactional outsourcing is likely to create long-term value. Traditional asset pricing models such as the Capital Asset Pricing Model or the Fama and French three-factor model, have assumed that efficiency of capital markets and have largely focused on the management of beta (market risk) in portfolios. However, our results underscore the inefficiency of markets in pricing certain managerial decisions that reflect intangible information on future cash flows. This, in turn, points to the opportunity in shifting the focus of asset management from beta to alpha (risk-adjusted abnormal returns), including a greater understanding of the quality of management decisions that impact firms’ competitiveness and strategic value.
