

Assessing the key economic drivers for change in the current business climate

Outsourcing: Delivering value and Maintaining
Competitive Advantage

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Agenda

- ❑ Introduction
- ❑ Background
- ❑ Factors driving outsourcing
- ❑ Factors offering new outsourcing opportunities
- ❑ Economic outlook

Introduction

□ Outsourcing – focus of considerable attention

- Number of responses with Google search:
 - Outsourcing: about 5,500,000
 - Shareholder value: about 1,210,000
- Number of books on Amazon
 - Outsourcing; 5,283
 - Shareholder value: 14,796

Introduction

- ❑ **Politics of outsourcing have become very sensitive**
 - Due to recent developments in outsourcing services abroad (offshoring)

Background

- ❑ Outsourcing not a new issue
- ❑ At core: what should be done within a firm and what should be contracted out
- ❑ Ronald Coase, economics Nobel prize winner 1991
 - *The Nature of the Firm*
 - why do firms exist and what are their boundaries
 - why does a large proportion of the total use of resources take place within firm, i.e., is coordinated administratively rather than by the market place
 - transaction and contract costs

Fundamental Factors driving outsourcing

- ❑ Technological change – ITC costs
- ❑ Increased competition in low-inflation environment
- ❑ Financial markets

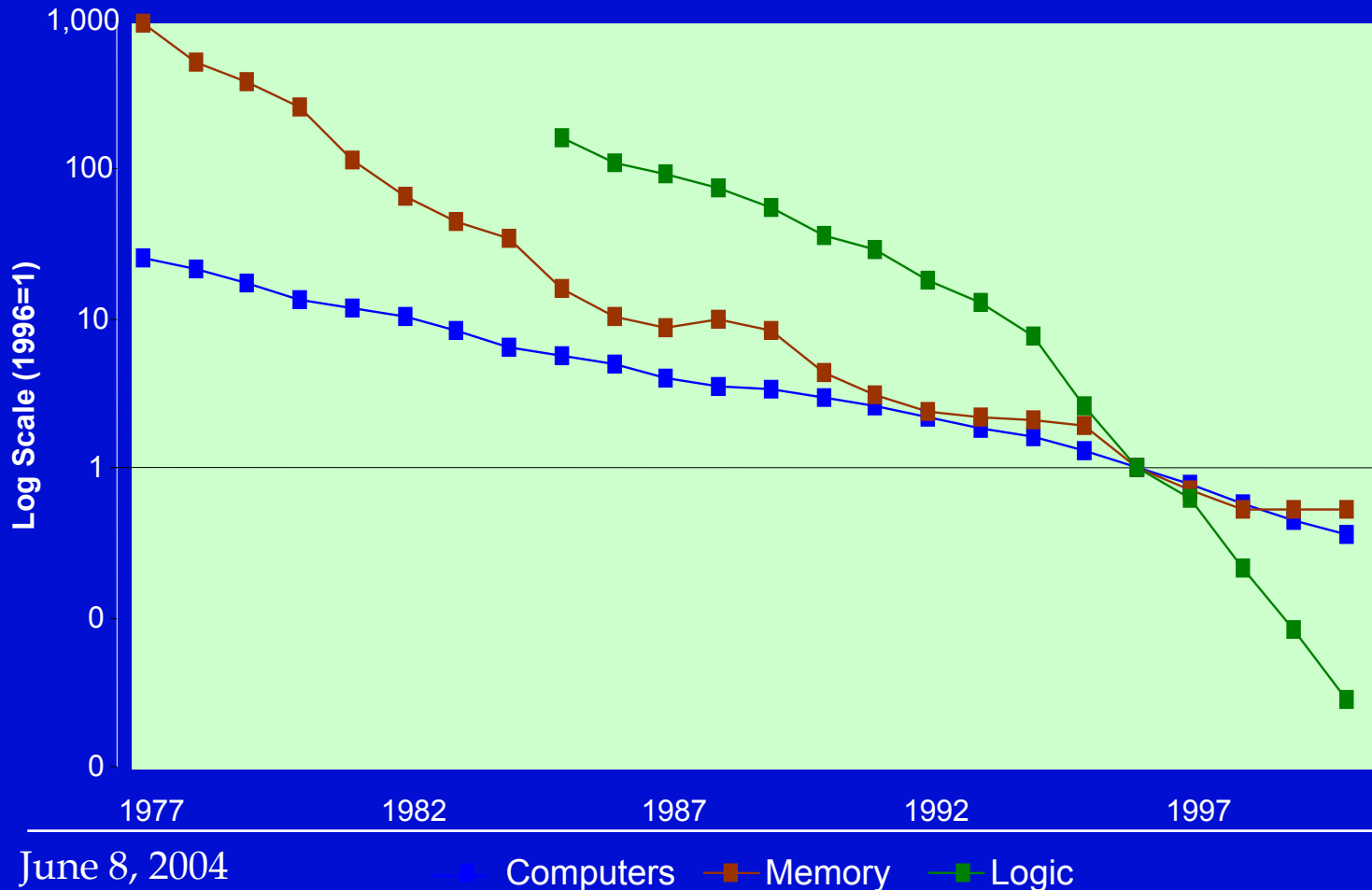
Fundamental factors driving outsourcing

- ❑ 1. Technological change – change in the cost trade-off between in-house/outside
 - Most efficient way to organise production has changed radically
 - Just in time delivery
 - Virtual manufacturing
 - 24-hour trading books of global banks
 - Backroom offices delocalisation
 - Precise form of technological change underpinning opening of new outsourcing opportunities varies – but all in one shape or another depend in ITC
 - Costs of ITC have fallen sharply

Fundamental factors driving outsourcing

Relative Prices of Computers and Semiconductors, 1977-2000

All price indexes are divided by the output price index



Fundamental factors driving outsourcing

❑ Implications of lower ITC costs - enormous

- Example:
 - Cost of telephony: OECD average one minute international call 74% lower in 2003 than in 1993

❑ Future:

- Downward trend in ITC costs will continue
 - Internet telephony
 - Others

Factors driving outsourcing

- ❑ 2. Increased competition in low inflation environment
 - Domestic competition (deregulation, reduction in protected sector)
 - International competition (industrial countries for high value added products and services, emerging economies for less sophisticated goods and services – but border tends to blur)

Fundamental factors driving outsourcing

- Low inflation no longer allows errors to be hidden away by general price appreciation

□ Future:

- Strong competitive pressures to remain
- Low inflation environment to remain
 - Oil prices a concern but should change current monetary policy in industrial countries

Fundamental factors driving outsourcing

- ❑ 3. Increased focus on shareholder value and financial bottom line
 - More firms exposed to pressures from capital markets
 - Short-termism response
- ❑ Future:
 - Some delisting of firms
 - Increased recognition that not enough to focus on next quarter's results and that longer-term perspective is required
 - But, pressure for high performance bottom line will remain

Top 10 reasons companies outsource

1. Reduce and control operating costs
2. Improve company focus
3. Gain access to world-class capabilities
4. Free internal resources for other purposes
5. Resources are not available internally
6. Accelerate reengineering benefits
7. Function difficult to manage/out of control
8. Make capital funds available
9. Share risks
10. Cash infusion

Source: Survey of Current and Potential Outsourcing End-Users
The Outsourcing Institute

Factors offering new outsourcing opportunities

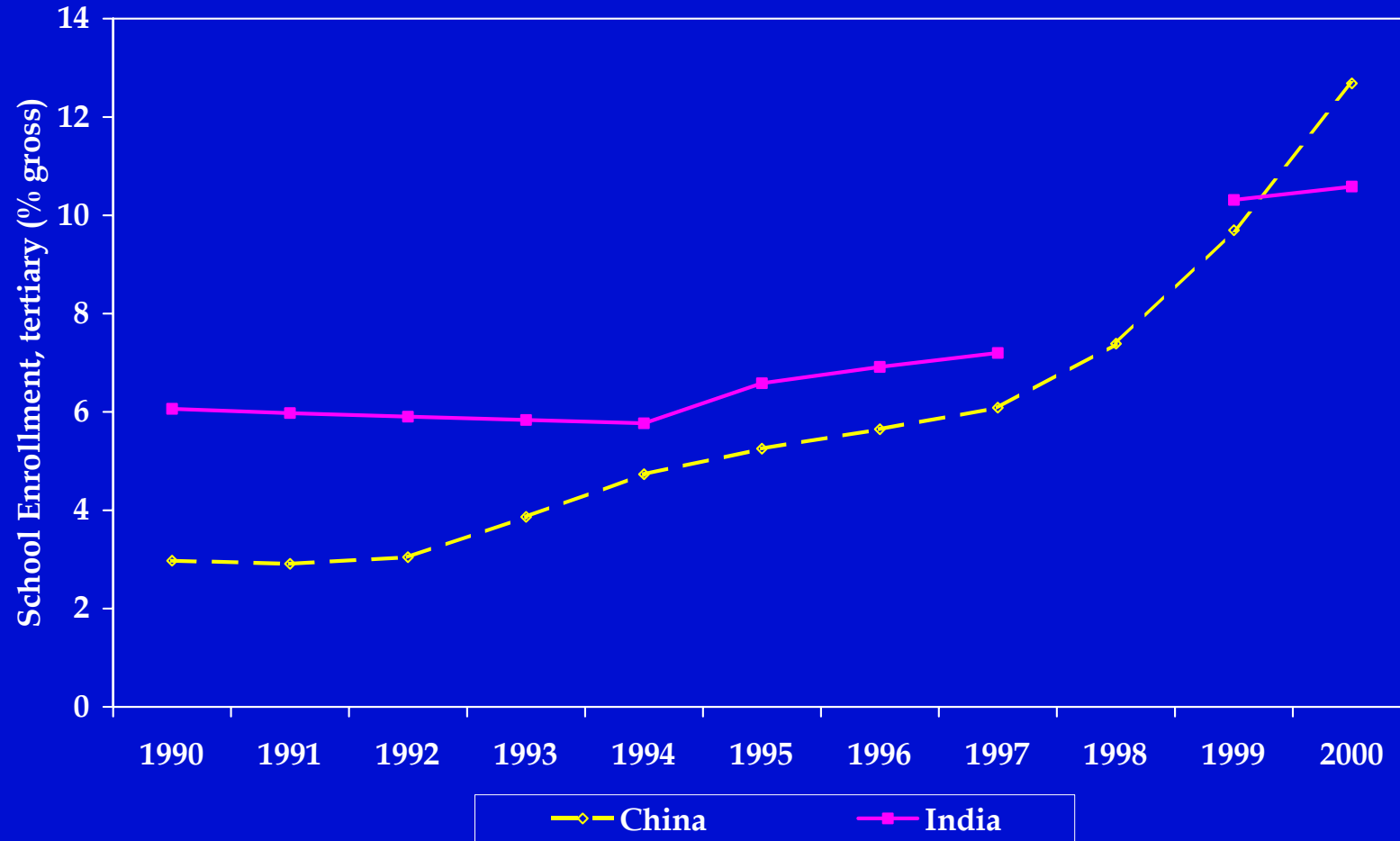
□ Globalisation

- Integration of large number of relatively low costs production centers into international trading system (WTO, etc)
- Structural reduction in transportation costs (air, sea until recently) (deregulation, ITCC, etc)

Factors offering new outsourcing opportunities

- ❑ Emergence of new economic powers with large number of skilled workers
 - Rapid growth of labour force with tertiary education

Factors offering new outsourcing opportunities



Economic Outlook

- ❑ **Most recent outlook produced by an international organisation is that of the OECD**
- ❑ **Key observations**
 - World economy is experiencing strong and sustainable recovery
 - Asia buoyant
 - China overheating
 - In the USA, economy grows faster than potential output
 - Anglo-Saxon countries are cruising ahead
 - But, recovery has still to a large extent by-passed Continental Europe

Economic Outlook

- ❑ Looking ahead, OECD believes that “there are good reasons to expect a more evenly shared recovery”
 - World recovery will pull European economies from their domestic anaemia
 - USA and China should moderate somewhat in response to monetary policy

- ❑ Risks: oil price (-), continued polarisation of recovery (-), inappropriate macro policies in USA (too loose), and in Europe (too tight)

Economic Outlook

Real GDP Growth			
	2003	2004	2005
USA	3.1	4.7	3.7
Japan	2.7	3.0	2.8
Euro area	0.5	1.6	2.4
Total OECD	2.2	3.4	3.3
Source: OECD Economic Outlook Preliminary Edition May 2004			

Economic Outlook

Inflation			
	2003	2004	2005
USA	1.7	1.7	1.6
Japan	-2.5	-1.8	-1.1
Euro area	2.0	1.7	1.7
Total OECD	1.9	1.7	1.6
Source: OECD Economic Outlook Preliminary Edition May 2004			

Economic Outlook

CHINA				
	2002	2003	2004	2005
Real GDP growth	8.0	9.1	8.3	7.8
Inflation (CPI)	-0.8	1.2	3.0	2.0
Source: OECD Economic Outlook Preliminary Edition May 2004				

Conclusions

- ❑ World recovery proceeding well but outlook increasingly clouded by oil price risk
- ❑ Pressure on outsourcing will remain:
 - Potential will grow: ICT, offshoring, etc
 - Pressures on financial bottom line will remain strong
- ❑ Great future for European Outsourcing Association