

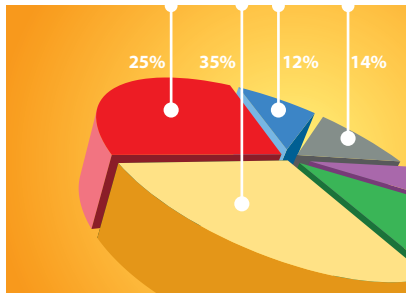
TRESTLE GROUP

Winter 2005

Executive Briefing

Shareholder Value and Outsourcing

A Trestle Group Research Publication



Providing the bridge between companies and outsourcing providers around the world.

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Introduction

Trestle Group Research is committed to developing thought provoking studies for executives across industries. The Trestle Group Research Executive Briefing series provides an introduction to themes that top executive agendas; combining research with expert opinions from the market.

This edition focuses on illustrating the link between shareholder value and outsourcing. Many companies are outsourcing today to achieve various goals — examples include reduction of costs, increased efficiencies and increased flexibility. As companies outsource, executives should continuously evaluate the link between shareholder value and the outsourcing initiative using measurable indicators — will today's outsourcing initiative increase or erode shareholder value?

This document addresses the following topics:

- Defining shareholder value
- Understanding outsourcing
- Connecting shareholder value and outsourcing
- The science of management

To prepare this document, Trestle Group Research has teamed with Mark Sickles, a renowned expert on this topic.

About Mark Sickles

Mark W. Sickles is author of Shareholder Value Assurance — The Cure for Enronitis, plus numerous articles on achieving long-term shareholder value, including Tool Kit for the Post-Enron Board, published by the National Association of Corporate Directors (NACD). Mark has been a featured guest on television and radio talk shows as well as keynote and featured speaker for business and professional organizations. His role as strategic consultant to American Standard resulted in a cover story on driving increased shareholder value entitled, Setting the Standard.

The founding principal of SVA Technologies, Mark is also President of the NJ Chapter of NACD. He serves on the Editorial Advisory Board of HR Innovator Magazine and Rutgers University's State Advisory Council, and is a past board member of Abington Health Care Corporation.

For over fifteen years, Mark has created sources of competitive advantage and long-term shareholder value for firms as both senior executive and advisor to boards, CEOs, and other "C" suit executives.

About Trestle Group Research

Trestle Group Research is committed to providing thought-provoking research and practical insights into such topics as corporate strategies, regulatory issues and global trends in outsourcing. This research enables organizations to maximize benefits from outsourcing initiatives.

Trestle Group Research is part of Trestle Group, an international management consultancy firm specialized in outsourcing. Trestle Group works with companies to help develop outsourcing strategies, locate the right location/service provider and support the implementation of the appropriate outsourcing model. Trestle Group is partnered with 70+ service providers around the world offering their clients a significant portfolio of capabilities and choice.

Defining Shareholder Value

Defining shareholder value is best done by first defining separately "shareholder" and "value". For the purpose of this article, shareholder means share owner: either an institution or individual who purchased stock as a long term investment. This definition excludes share trader, whose goals and practices tend to adversely impact long-term shareholder value.

Value has always meant, "getting more than you're giving". Still does. Boards and management either destroy or create shareholder value. There is absolute value creation when operating income is more than the annual cost of the shareholder's money invested in the stock. There is relative value creation when operating income is more than that income produced by other companies of similar risk. Which do shareholders expect? They expect both.

Because shareholders expect long-term value, the resources used to produce superior levels of operating income must be sustainable. Known as strategic assets, these resources are difficult to imitate and costly to duplicate. The competition can't afford them, can't copy them, and therefore, the value these assets produce — superior returns — is long term.

Finally, long-term shareholder value requires the ability to grow profitably. Very few firms can do this. It's said that six out of seven mergers and acquisitions destroy long-term shareholder value.

To assess the ability to grow profitably, two interdependent measures are needed:

1. The percentage of a firm's capital budget spent on growth projects compared to maintenance projects
2. The level of operating income left over after these investments for growth

When both are more than competitors', the firm is well positioned to deliver long-term shareholder value.

To summarize, shareholder value is present when:

- Operating income exceeds the cost of capital
- Operating income is greater than that produced by alternative investments of comparable risk
- The mix of capital spending is skewed towards growth more so than the mix of capital spending by competitors
- The sources of these superior rates of profitable growth are sustainable

Understanding Outsourcing

Outsourcing is often defined as the transfer of activities or processes to a third party for some type of benefit including cost reductions, increased efficiencies, access to flexible labor pools and ability to focus on core competencies.

Offshore outsourcing is the transfer of activities or processes to a lower cost country — further increasing cost savings as well as flexibility.

If outsourcing engagements are conducted properly, shareholder value will increase. If done improperly, adverse effects to shareholder value are likely to incur. As executives evaluate outsourcing initiatives, the following questions should be addressed:

- Throughout my organization, have I properly identified core versus non-activities?
- Can I realize the cost savings projected in the business plan and are these savings sustainable?
- How does this outsourcing initiative affect my core employees?
- Will my customers be affected by this initiative thus affecting sales?
- Will the quality of my product or service be compromised?
- How do I measure the impact on shareholder value created through an outsourcing initiative?

Outsourcing has existed for thousands of years in one form or another. For example, people have outsourced their money management to banks for centuries, companies have relied on governments to manage city infrastructures for thousands of years and very few people today supply their own energy.

The question is not whether or not I should outsource, the question is — How can I outsource to increase shareholder value?

Connecting Shareholder Value and Outsourcing

There are 9 basic ingredients in the recipe for shareholder value.

These basic ingredients fall into three categories:

- Income:** Revenues, Margins, and Expenses
- Cash Flow:** Inventory Turns, Age of Receivables, Age of Payables
- Return on Assets (ROA):** Inventory Levels, Levels of Receivables — Payables, PP&E (Plant Property & Equipment)

To create shareholder value, all these measures need to go in the right direction. For some, that's up, for others, down. In other words, outsourcers seeking to reduce expenses must do so in a way that, at worst, does not adversely impact the other 8 measures and, at best, has a positive impact on the other measures. When done right, outsourcing is an excellent means for reducing expenses in ways that increase income, cash flow and ROA.

So the question with outsourcing is not "Should we do it?" but instead, "When, where, and how?" To answer this question correctly, we need to break work down into four basic categories.

These four categories are:

1. Work that is a source of competitive disadvantage and below average returns
2. Work that is a source of competitive parity and average returns
3. Work that is a source of temporary advantage and above average returns
4. Work that creates a sustainable advantage and also above average returns

1. The first category of work is the wrong thing to do, whether you do it well or not. This work should be continuously identified and eliminated. If you do not regularly "weed the garden", then by doing this work you are destroying shareholder value in the process.

2. The second category of work is the work you outsource. If it's not done well, it can become a disadvantage, causing below average returns. This work should be done as efficiently as possible, at the lowest possible cost. Outsourcing this work reduces expenses while freeing up management to focus on the next two categories of work.

The following two categories are similar to each other in that both are sources of competitive advantage and above average returns. They differ in that one is a temporary advantage (category 3) while the other is sustainable (category 4).

3. Management should exploit the temporary competitive advantage with a great sense of urgency for as long as the advantage lasts, while trying to find ways to make the advantage last longer. Outsourcing should only be considered as the advantage approaches its end, changing this category of work into a source of parity and average returns.

4. The last category of work should never be outsourced. This work and the resources used to do it, are strategic assets, also known as core competencies. They are the sustainable competitive advantages that differentiate your firm from the competition, enabling you to deliver long-term value to your shareholders. This work should be kept close to the vest, if not under the covers. There is nothing to discuss about this work with outsourcing vendors because the work doesn't exist. Right? Right! Like the chess master who touches his pieces on the left side of the board to hide the fact that his attack will be from the right, smart managers know to mention other things when asked to explain their success.

The Science of Management

For whatever reason, business management has not been considered a science to the same degree as biology, mathematics, or physics. As a result, we tolerate inexperienced business managers making the same mistakes made by those who came before them. *"Next time, he'll handle that better."* Why tolerate inexperienced managers destroying shareholder value as they learn from their own mistakes on company time?

The natural phenomena that occur in business are as much science as the phenomena that occur in biology and physics. SVA Technologies has developed a scientific system of management principles proven to influence the underlying elements of shareholder value - price, cost, and capital requirements — thereby enabling long-term success under many different business conditions. Perhaps one client said it best: "SVA takes away all opportunity to fail".

The fundamental flow of this system can be captured in this 12-step process:

1. Establish the right financial goals
2. Determine relative strength of driving forces affecting underlying elements of shareholder value
3. Identify and evaluate key competitors
4. Determine the strategic imperatives essential for first coping with these external driving forces, and then changing those forces to your advantage and your competitors' disadvantage
5. Identify the resources and capabilities needed to achieve the strategic imperatives (Critical Success Factors — CSF)
6. Determine if any of these CSF meet the criteria for strategic assets and sources of competitive advantage
7. Perform a gap analysis to compare the firm's current resources and capabilities to the list of CSFs
8. Determine what actions need to be taken to achieve a standard of excellence with CSF's
9. Based on Steps 1-8, develop Hi-Impact Improvement Opportunities and list of related critical issues
10. Develop a set of interdependent objectives
11. Develop detailed actions plans
12. Work the system to achieve the goal

Like your personal computer, this system is simple in the foreground, but highly complex in the background. A partial list of this system's raw materials includes the Principle of Coordination, Systems Theory, Theory of Profound Knowledge, Theory of Constraints, Six Sigma, Balanced Scorecard, Activity-Based Management, Zero-based Budgeting, Free Cash Flow, Industrial Organization Planning, Resource-based Planning, Competitive Force Framework, High Performance Work Systems, Principle of Gravity, and the Principle of Supply and Demand.

Ongoing use of this system will cause workforces to act themselves into a better way of thinking. This is much more effective than trying to think themselves into a better way of acting. Once the SVA system is in their thoughts, producing actions leading to long-term shareholder value, you'll be able to accelerate this positive momentum by adding technology into the equation.

Unique business excellence software delivers the science of management in a way that enables users to practice the art. The net result is a principle-based capability to formulate a strategy for shareholder value, and then implement that strategy to actually deliver shareholder value. In doing so, management will fulfill its responsibility to shareholders by functioning as strategic assets and sources of competitive advantage.

Conclusion

Outsourcing can either strengthen or destroy shareholder value depending on how it is managed throughout the organizations. As executives consider various outsourcing initiatives, they should ask themselves how this project would affect shareholder value. Knowing "what" to do is necessary, but not sufficient. You must also know "why" and "how".

When evaluating opportunities, executives should remember the four types of work:

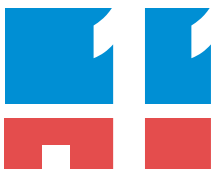
1. Work that is a source of competitive disadvantage and below average returns
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Actively identify and eliminate 1. Always consider outsourcing 2. Guard and exploit types 3 and 4.

The twelve-step methodology will help organizations perfect the science of managing shareholder value into an art. Investment in human resources and ongoing continuation of the methodology will continue to increase shareholder value and produce above average returns.

Top executives should make outsourcing decisions based on concrete valuations including shareholder value, not on trends or pressure to jump on the bandwagon. Competitive advantage is maintained by those organizations that are hawkish about continually measuring their competitive advantage.

Outsourcing is not new - outsourcing is a paradigm in successful business. Combining outsourcing with the science of managing shareholder value will provide a competitive advantage that will extend far beyond a short-term focus on stock price.





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To learn more how **Trestle Group** can assist you with your outsourcing initiatives, email solutions@trestlegroup.com or contact a **Trestle Group** professional at one of our offices.

Switzerland

The World Trade Center
Leutschenbachstrasse 95
8050 Zurich

Tel: + 41 1 308 39 72
Fax: + 41 1 308 35 00

Germany

Frankfurter Welle
An der Welle 4
60422 Frankfurt

Tel: +49 69 7593 8461
Fax: +49 69 7593 8200

United Kingdom

Ropemaker Street
EC2Y 9HT London

Tel: +44 207 153 1006
Fax: +44 207 153 1111

United States

245 Park Avenue
10167 New York

Tel: +1 212 672 1740
Fax: +1 212 792 4001

Middle East

Hayek Building
1st Circle Road
Amman, Jordan

Tel: +962 79 666 6014
Fax: +962 6 462 4959