

## Do You Outsource?

In our March Sigma Summaries we articulated our stock selection process that starts with the identification of major economic themes. Last month, we discussed one of these themes, the **Consumer Emphasis on Value**. This month, we are tackling another: **Outsourcing**.

Few companies today can compete effectively without outsourcing. Competition, and the necessity of continuously improving productivity, has forced companies around the world to focus their attention on their core competitive strengths. It has also precipitated the move to externally contract their non-core functions to specialists that utilize state-of-the-art technology and economies of scale to offer superior services at lower costs.

Even though outsourcing in payroll processing and information technology has been around for many years, a cadre of new, highly specialized companies dealing with issues from complex insurance data processing to simple corporate identity uniforms have been established to deliver value, enhancing services at cost levels that are pleasing to corporate managements and shareholders.

The business models of outsourcing companies are attractive to investors because they show the ability to leverage technology and infrastructure to produce strong recurring revenues that lead to consistent earnings, cash flow and operating margins.

The universe of companies utilizing outsourcing solutions covers the gamut from large to small. Large companies are certainly recognizing the need to streamline their operations as much as possible to compete effectively in the global marketplace, especially since their ability to raise prices is persistently difficult. On the other end of the spectrum, small companies often do not have the financial resources or capability to utilize new technology, innovation or services. They look to outsourcing specialists that use state-of-the-art technology to enhance a product offering or to cut expenses. One very good example of providing a value enhancing service is the movement by small banks to offer comprehensive transactional Internet banking services. Unknown to the customer, these services are often provided by The **Bisys Group** and **Automatic Data**

**Processing** as it would be cost prohibitive for the banks to develop them in-house.

Another important area of outsourcing that we also find attractive is loosely defined as "transaction processors." Transaction processors typically operate in five separate but converging segments including payments, bank, brokerage, payroll and insurance. These processors are appealing because of their recurring revenues and high operating margins.

Chief among the attributes that we find most alluring about our investments in this sector (**Automatic Data Processing, The Bisys Group** and **Concord EFS**) is the experienced management teams with long operating histories that have dealt with both buoyant and difficult environments with considerable success. Managements that have the ability to stay focused in industry niches will reap long-term rewards as those industries grow and utilize more outsourcing solutions. Also, with very little debt on the balance sheet and a strong recurring revenue base, transaction processors generate large sums of free cash flow and strong returns on invested

capital. Moreover, as these companies become the vendor of choice and are embedded in the enterprise of a client business, the barrier to competition becomes quite large and the ability to cross sell ancillary services becomes much greater.

The trend towards the increasing use of electronic payment mechanisms is a strong long-term catalyst for payment processors. Consumers are shifting from paper-based (cash and checks) means to electronic payment forms (debit and credit card transactions). According to The 2001 Nilson Report, paper-based payments constituted roughly \$3.2 trillion, or 66% of total U.S. payments in 1999. However, the most important aspect of the report was the projection that electronic forms of payment would grow 14% annually over the next four years.

Non-paper-based payment transactions are expected to represent approximately 50% of all transactions by 2005, up from 31% in 1999. The fastest growing segment of electronic payments is online, (personal identification number, or PIN-based) debit transactions, which are growing at 30% per year. **Concord EFS** is the dominant provider in online debit transaction processing with over 50% market share. **Concord** has intelligently marketed its services to supermarkets, gas stations, convenience stores and fast food restaurants that have a

high percentage of non-discretionary purchases.

Bank and brokerage processors benefit from a variety of trends that are driving financial services firms to offer new products and adopt new technologies. **Bisys** and **Automatic Data** are beneficiaries of the convergence in financial services including the passage of the Graham-Leach-Bliley Act, a rapidly changing regulatory environment, increasing transaction volumes in financial services and the pressure to reduce costs while better serving customers. These two companies have several attractive characteristics including the diversity of their businesses and customers and the defensive quality of strong recurring revenue (with roughly 90% client retention and long-term contracts that generally range from three-to-five years).

The biggest opportunity for growth of these processors is in the insurance industry. For reasons unknown, the insurance industry has been the slowest financial segment to automate and migrate to new distribution channels. Still, insurance companies are not immune to the pressures that are pushing other companies to become more efficient. **Bisys** has brought substantial benefit to the industry by creating, through technology, a means for agents to access more products and subsequently, more revenue opportunities. **Bisys** is the largest insurance

distributor in the U.S., serving more than 100,000 agents and more than 200 carriers.

Looking beyond transaction processors, outsourcing is clearly playing a major role in a number of other diverse businesses. Uniform rental programs allow companies to outsource administrative and maintenance functions, taking themselves out of the uniform business while remaining confident that the image they convey is professional. **Cintas** designs, manufactures and implements corporate identity programs. Uniforms and related accessories are the resulting "product" and the company rents or sells these to customers throughout the United States and Canada. In 2001, Fortune Magazine's survey on America's Most Admired Companies ranked **Cintas** No. 1 among outsourcing service companies based on best-in-class scores on the quality of management, products and services, innovation, investment value and financial soundness.

Global regulation, as it relates to employment, is improving. In France, Japan, Germany and Greece, new employment regulations should precipitate the increasing use of temporary employees over the next several years. As a result, this is an additional area where long-term secular trends are very compelling. Companies all over the globe are striving to manage their costs more efficiently and

employment costs are a major part of that equation. Flexible staffing is a major productivity-enhancing tool that allows companies to acquire highly skilled workers during transitional periods of economic cycles. **Manpower Inc.** is the leading company in the industry with over 3,900 offices in 61 countries. The company is benefiting from widespread deregulation in labor markets around the globe and the consolidation in the flexible staffing sector. **Manpower's** scale and brand name allow it to leverage its infrastructure to position itself to better maximize earnings and margins in an improving economic environment. Technology is an important driver for improving future operating performance. **Manpower's** new technology system, UltraSource, should enable the company to maintain leadership in this competitive segment. Equally important, global diversification helps temporary staffing companies manage their operations more effectively with stronger regions, such as Japan, offsetting weaker areas.

Continuing with the theme that outsourcing is happening in many profitable and creative ways, **USA Education Inc.**, known as Sallie Mae in its previous life, has developed into a very profitable financial services outsourcer. It is using its strong relationship with colleges and banks to provide a wide

range of financial services, processing capabilities and information technology to meet the needs of educational institutions, lenders, students, and guarantee agencies. Once again, technology is the platform to provide a competitive advantage. In concert with its focus to drive loan volumes up through financial aid offices, **USA Education** launched Laureate, its Internet-based student loan delivery system. This delivery system provides real-time data linkage among schools, borrowers, lenders and guarantors. With the addition of electronic signatures for applications and promissory notes via the Internet, **USA Education** has delivered a fully paperless application process for student loans.

**Pitney Bowes** is another great example of a company that is leveraging its impenetrable position in mailing meters and related equipment to provide additional specialized solutions to its customer base. The company has transformed itself from the mail center to a "desktop and enterprise-wide" document management company. They focus on: 1) product and service solutions to support basic and critical business processes, 2) funds management, credit and payment solutions (to help customers to manage cash flow and acquire equipment), and 3) information management solutions to capture data created by a business

exchange or event and allow customers to use it strategically. "**Pitney** is an integral part of our internal systems," says James Kurpius, Vice President of Operations at WSGR (a leading law firm specializing in technology). "In terms of their vision, they have gone from laying bricks to building a cathedral. They have managed every learning curve to enhance our ability to satisfy our internal customers and our external clients." This statement illustrates how you can take a vendor-customer relationship and turn it into a real partnership.

While we have discussed many new areas where outsourcing is flourishing, we believe large traditional IT (Information Technology) outsourcers like **IBM** and **Computer Sciences** also have a lot of opportunity for growth. A recent study conducted by JP Morgan with McKinsey and Co. indicates that we are currently in the midst of a sea change in the way that the Internet is being used. New architectures are emerging, new applications are being developed, and new business processes are flourishing in response to the complex communications environment. The complexity associated with this structural change is a key driver for IT services. Service providers with large and diverse global customer bases, strong brand equity, broad and deep service offerings, and the ability to deliver a scalable solution

globally, will be the key beneficiaries. **IBM and Computer Sciences** recognize the importance of web and application hosting as a growth opportunity beyond their existing core businesses. Their worldwide presence, ability to scale resources quickly, and their access to vendors and other service providers are attractive to large enterprises looking for comprehensive support. Also, their stronger financial positions grant them staying power and the

currency to make accretive acquisitions.

One final area where traditional IT outsourcers have an embedded advantage is in the U.S. Defense Department and other federal government agencies. The expected appropriations toward better security systems and information sharing should be an attractive area of growth for many years. And while it is true that historically it has been difficult

for IT service specialists to make respectable returns from government contracts, evidence suggests that contract terms are improving.

In conclusion, outsourcing is everywhere. Opportunities for outsourcing exist in many new and creative forms. It is a major secular theme that we have identified as a favorable long-term trend.

*Written by: Roger N. Steed*

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