Review of Financial Economics 19 (2010) 179–191

Contents lists available at ScienceDirect

Review of Financial Economics

journal homepage: www.elsevier.com/locate/rfe

Does offshoring create value for shareholders?

Alexandros P. Prezas [a], Karen Simonyan [a], Gopala Vasudevan [b,*]

[a] Suffolk University, Boston, MA 02108, United States

[b] University of Massachusetts Dartmouth, North Dartmouth, MA 02747, United States

ARTICLE INFO

Article history:
Received 11 November 2008
Received in revised form 13 May 2010
Accepted 15 May 2010
Available online 11 June 2010

JEL classification:
G34

Keywords:
Offshoring
Announcement effect
Operating performance
Stock return performance

ABSTRACT

We study the wealth effect of offshoring by analyzing the announcement-period returns as well as the long-run operating and stock return performance of firms that offshored their activities in the period 2000–2005. Announcement-period stock returns are positive for firms that offshore activities primarily to reduce costs but are negative for firms that offshore activities for other reasons. Also, announcement-period stock returns are higher for firms with a larger size, better operating performance, lower growth potential, and a higher cost of goods sold in the year prior to the offshoring announcement. Firms that offshore activities primarily to reduce costs enjoy improved operating and stock return performance in the years following the offshoring. Overall, our findings indicate that not all firms enjoy the benefits of offshoring; rather, only those that offshore primarily to reduce costs do.

1. Introduction

Moving part of a firm's activity to another country is known as offshoring. Firms offshore their activities for a variety of reasons. The reduction of operating costs is often cited as the main reason for offshoring; however, firms offshore their activities for other reasons as well, such as improving company focus, entering new markets, tapping talent that is unavailable domestically, freeing internal resources for other purposes, sharing risks, overcoming regulations that prevent certain activities domestically, etc. Despite intense debate that has been going on for several years in the public arena, there is little empirical evidence on whether offshoring is truly beneficial and adds to firm value. We seek to examine the impact of this practice.

Those opposed to offshoring see it as management enrichment at the expense of firm employees. Offshoring was one of the contentious issues during the 2004 presidential campaign. In 2004, John Kerry, the Democratic candidate, said: “We will repeal the tax loopholes and benefits that reward Benedict Arnold CEOs and companies for shipping American jobs overseas. Instead, we will provide new incentives for good companies that create and keep good jobs in America.”[1]

Supporters of offshoring see it as essential to ensure that U.S. corporations stay competitive in an increasingly global world. Gregory Mankiw, Chairman of President George Bush's Council of Economic Advisors, said: “I think outsourcing is a growing phenomenon, but it's something that we should realize is probably a plus for the economy in the long-run.”[2] However, several reports in the financial press in recent years indicate that offshoring is not always beneficial. For example, an article in the July 3, 2007 issue of the *Wall Street Journal* reports that some companies in Silicon Valley are shifting technology jobs previously outsourced to India back to the U.S. because of wage inflation and a lack of information technology infrastructure in India. Another article in the July 7, 2008 issue of the *Wall Street Journal* reports that sending customer service abroad lowers customer satisfaction, which leads to a roughly 1 to 5% reduction in market capitalization among firms that adopt such practices. The general consensus in the financial press seems to be that offshoring is beneficial only for some firms that do it effectively and for the right reasons.

The objective of this paper is two-fold. Our first objective is to examine the general effects of offshoring, as this practice has become widespread in recent years. We examine the value of offshoring by analyzing shareholder wealth effects associated with offshoring announcements and by studying the operating and stock return performance of offshoring firms before and after offshoring. We also examine the impact of offshoring on efficiency measures such as the cost of goods sold, capital expenditures, and the number of employees.

However, because various reports in the financial press have indicated that many firms were forced to reverse their offshoring decisions and move their operations back to the U.S., our second

* Corresponding author. Tel.: +1 508 999 8426; fax: +1 508 999 8646.
E-mail addresses: aprezas@suffolk.edu (A.P. Prezas), ksimonya@suffolk.edu (K. Simonyan), gvasudevan@umassd.edu (G. Vasudevan).

[1] Wisconsin primary-night remarks by Senator John Kerry, February 17, 2004. Benedict Arnold was an American general in the U.S. revolutionary war who became a traitor.

[2] “Bush adviser backs off pro-outsourcing comment,” CNN.com, February 12, 2004.

1058-3300/$ – see front matter © 2010 Elsevier Inc. All rights reserved.
doi:10.1016/j.rfe.2010.05.001

objective is to study which firms benefit from their decision to offshore. We accomplish this by partitioning our sample into two groups according to the reasons given for offshoring: "cost reduction" and "other reasons." Our findings indicate that, in general, the benefits of offshoring accrue to firms that offshore primarily to reduce costs, whereas firms that offshore their activities for other reasons do not appear to realize any benefits from such practices.

Firms that offshore their activities with the primary purpose of cost reduction realize positive announcement-period abnormal stock returns and have better long-run operating as well as stock return performance (relative to the benchmark of matching non-offshoring firms) in the years following the offshoring announcement. In contrast, firms that offshore their activities for other reasons realize negative announcement-period abnormal stock returns and exhibit the same post-offshoring long-run operating and stock return performance as matching non-offshoring firms, indicating no benefits from offshoring. Our findings also indicate that in the years after offshoring firms that offshore activities primarily to reduce costs have levels of cost of goods sold lower than those of matching non-offshoring firms, whereas firms that offshore activities for other reasons have levels of cost of goods sold similar to those of matching non-offshoring firms.

Further, firms that offshore to reduce costs have higher levels of capital expenditures than matching non-offshoring firms prior to offshoring but the same levels in the years after offshoring and have more employees than their matching non-offshoring firms before and after offshoring (the matched-firm-adjusted number of employees for these firms is relatively larger in the years after offshoring and smaller in the years before offshoring). Although firms that offshore for other reasons experience similar variations in these efficiency variables, the differences in these efficiency variables with respect to matching non-offshoring firms are smaller for such firms. Therefore, the evidence suggests that firms that offshore activities to reduce costs are perhaps successful in keeping down their cost of goods sold after offshoring by replacing capital-intensive activities with cheaper labor-intensive activities overseas.

We find that the decision to offshore activities may be in response to poor stock return performance. The mean matched-firm-adjusted stock return is −50.45% over the three-year period and is −16.73% over the six-month period prior to the offshoring announcement. Firms that offshore activities primarily to reduce costs experience larger declines in their stock returns prior to the offshoring announcement and realize significant improvements afterwards.

Finally, our cross-sectional regressions of announcement-period stock returns against firm variables show larger returns for firms that offshore primarily to reduce costs and firms with a larger size, better operating performance, lower growth potential, and a higher cost of goods sold in the year prior to the offshoring announcement. We also find that firms that are larger, have better operating performance and lower growth, and which invest less in capital expenditures, are more likely to offshore their activities. These findings suggest that larger firms with better operating performance are possibly more established and possess the resources as well as expertise necessary to initiate and successfully complete offshoring activities.

In what follows, Section 2 discusses the literature, Section 3 describes our data, Section 4 presents our methodology and empirical results, and Section 5 concludes.

2. Background

Offshoring has gained momentum in recent years for several reasons. First, the enhanced political stability in the world enables the free flow of capital and technology across countries. Second, strong education systems in countries such as India and China have produced highly educated workforces available to work at a fraction of the cost of U.S. workers. Finally, increasingly inexpensive high-bandwidth communications make it possible to access a large workforce anywhere in the world.[3]

Offshoring can be viewed as a form of corporate restructuring, which can involve changes in the number of a firm's divisions or subsidiaries, focus-increasing activities, the relocation of activities, or staff layoffs. The existing literature provides empirical evidence associated with different forms of restructuring.

Brickley and Van Drunen (1990), for example, examine the value effects associated with internal restructuring practices that alter the number of a firm's divisions or subsidiaries. They find that restructuring takes place primarily for two reasons. First, firms restructure in response to changes in the level of investment (e.g., they create new units to establish new product lines and enter new markets). Second, they restructure in an attempt to reduce costs and improve efficiency. Brickley and Van Drunen (1990) find that, on average, the market reacts positively to such restructuring announcements as unit mergers or new unit formations, especially when these restructuring activities are aimed at expansion and increasing efficiency or cutting costs. However, the market reacts negatively to the announcements of unit liquidations.

John, Lang, and Netter (1992) examine voluntary restructuring in response to poor product market performance and find that internal restructuring activities enable firms to enhance their focus. These firms significantly reduce their labor costs, the cost of goods sold, research and development expenses, and they increase their investment during the restructuring period.

Chan, Gau, and Wang (1995) explore the stock price reaction to business relocations within the U.S. They find that the market reaction to such announcements depends on the motives for relocation (such as cost savings or business expansions), the growth prospects of the firm, and the type of relocated facility. Announcement-period stock returns are positive for firms that relocate for business expansion or cost savings, and they are negative for firms that relocate to reduce capacity or consolidate facilities.

Palmon, Sun, and Tang (1997) examine the information conveyed by layoff announcements. They find that investors consider layoffs to be signals of future firm performance. The market reacts negatively to layoff announcements that are due to deterioration in product market conditions, such as a declining market share or increased input costs. However, the market reacts positively to layoff announcements motivated by efficiency improvements.

There are several surveys by consulting firms on offshoring. Perhaps the most cited study on this topic is by McKinsey and Company: "Offshoring: Is it a Win–Win Game?" (*McKinsey Global Institute*, August 2003). Using the U.S. and India as examples, McKinsey estimates that offshoring creates value for both the job transferor economy (the U.S.) and the job transferee economy (India).

Our paper extends the existing literature by focusing on offshoring, a form of corporate restructuring, which has received little attention in the extant empirical work. As in the aforementioned studies, we first examine the value of offshoring by analyzing the announcement-period returns. We further examine the relationship between these returns and firm variables in our cross-sectional regressions. Similar to John et al. (1992) as well as Brickley and Van Drunen (1990), we also examine whether offshoring leads to any improvements in performance or the increased efficiency of the sample firms.

3. Data selection

We develop a sample of U.S. firms that offshored their activities over 2000–2005. The initial sample of 251 firms was obtained from Techsunite.org, a website affiliated with the AFL-CIO. This website listed all incidences of offshoring reported to it by the respective unions of such offshoring firms. For each offshoring firm, we verified the

[3] See, e.g., "The Jobs Problem… or Is It?" *Washington Times*, January 18, 2004.