Impact of Vendor Selection on Firms’ IT Outsourcing: The Korea Experience

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ABSTRACT

Information technology (IT) outsourcing is often used as a cost-saving strategy for firms. In IT outsourcing, the choice of vendor is a key factor determining success. This study examines the impact that the choice of IT vendor has on firms’ IT outsourcing in Korea. The authors empirically analyzed the impact of certain characteristics of IT vendors on the market value of client firms in Korea using the event study methodology. First, the authors found that IT outsourcing announcements significantly increased the market value of firms. The authors also found that the market response to high asset-specific services of the IT vendor was significantly greater than the response to low asset-specific services. The authors’ results also showed that the effect of Korean vendors was greater than that of foreign vendors. However, the difference between IT outsourcing to large vendors and small vendors in Korea was not significant, in contrast to the US. The information provided in this study can be used by client firms to select better IT vendors and by IT vendors to develop strategies to survive the rapidly changing IT outsourcing market in Korea.

Keywords: Client Firms, Event Study, IT Outsourcing, IT Vendors, Transaction Cost Theory

INTRODUCTION

In Korea, as in many other countries, information technology (IT) has been an engine of growth during the past two decades. IT in general, and information systems (IS) in particular, are considered to be core resources for helping firms deal with rapidly changing environments (Barney, 1991). With the arrival of the information age, IT investments are becoming increasingly important to the survival and growth of firms (Bharadwaj, 2000). Many firms have also realized that IT is an effective means to attain their strategic goals as well as to improve operational efficiency (Jeong & Stylianou, 2010).

However, some firms have encountered difficulties in spending a lot of money on IT or IS due to the uncertainty of real world markets. Firms have considered turning over all or a portion of their IT functions to professional IT vendors since Kodak decided to outsource its IT functions. Lacity and Hirschhein (1993) argued that the primary reason for the IT outsourcing trend is cost efficiency. Currently, firms regard outsourcing not only as a way to reduce costs,
but also as a management change tool to drive enterprise level transformations to shift a firm’s competitive position or increase its market share (Craumer, 2002; Han et al., 2008; Shin et al., 2007; Thouin et al., 2009).

IDC (http://www.idc.com/, http://www.idckorea.com/) estimated that the worldwide IT outsourcing market would grow from US$ 340 billion in 2007 to US$ 509 billion in 2012 at an annual growth rate of 8.4%, while the Korean market is expected to grow from US$ 2.1 billion in 2008 to US$ 2.8 billion in 2012 at an annual growth rate of 6.5%. Other statistics provided by the Korean Information Technology Service Association (ITSA, http://www.itsa.or.kr/) indicate that IT outsourcing has grown by more than 20 percent per year since 2005, because IT outsourcing reduces costs and improves business processes.

Although Korea is one of the leading countries in terms of its IT growth rate and IT development stage, the IT outsourcing market in Korea has several characteristics that differ from those of other countries. In the US and other developed countries, firms are typically outsourcing to specialized, independent IT vendors to achieve organizational downsizing that solves the problems caused by the absence of skilled IT human resources (Lee et al., 2004). In contrast, Korea’s IT outsourcing market was created under the leadership of conglomerate groups. The Korean conglomerate groups established subsidiary IT vendors to integrate the groups’ information systems into the firms and to manage a wide variety of IT functions (Lee & Kim, 1997). Firms within these Korean conglomerate groups tend to outsource all their IT projects from their affiliated IT vendors (Lee et al., 2004). Korean firms prefer subsidiary IT vendors over specialized independent IT vendors because of the cultural similarity and security of the subsidiary vendors (Kim, 1997; Lee & Kim, 1997). Some Korean financial institutions, including Woori Bank and Kookmin Bank, have established IT vendors by joint-venture and outsource their IT functions to these vendors.

Another notable difference between the Korean IT outsourcing industry and those of other countries is that when Korean firms do not have access to subsidiary IT vendors, they typically prefer to use domestic vendors rather than foreign vendors. For example, in March 2004, the Korea Securities Finance Corporation chose SK C&C over IBM to outsource their application, database, security, and network management at a cost of $9 million. The Korean Racing Authority also signed an outsourcing contract with LG CNS instead of HP for a union information system in March 2004. It is widely believed in Korea that domestic vendors possess the know-how to satisfy Korean firms with services that are suitable for the Korean business environment. This belief stems from the fact that Koreans tend to place a high value on long-term relationships based on the prevalence of family-based, alumni-based, and region-based economic ties (Lee et al., 2004). These economic and socio-cultural characteristics not only influence the existing market ecosystem of IT outsourcing in Korea, but also play an important role in Korea’s indigenous market ecosystem. Therefore, the process for selecting IT vendors in Korea is likely to be quite different from that in other countries.

Researchers have recently begun to analyze the quantitative impact of IT outsourcing. A few studies have utilized event study methodology and examined the stock market’s reaction to IT outsourcing announcements. Loh and Venkatraman (1992b) investigated relations between IT outsourcing decisions and business cost structure (or business performance) in the US. Hayes et al. (2000) studied the impact of IS outsourcing by contract-granting firms and examined how the capital market reacted to firms’ plans for implementing ERP systems. Farag and Krishnan (2003) analyzed the impact of IT outsourcing investment announcements based on the project type and firm type. Agrawal et al. (2006) studied e-business outsourcing during 1999-2002. Koh et al. (2007) evaluated how IT outsourcing actually creates value for firms. Beasley et al. (2009) analyzed whether the market reaction is associated with management’s
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