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**AN EFFICIENT MIX BETWEEN IN-HOUSE MANAGEMENT AND ENTREPRENEURS
IN REAL ESTATE MANAGEMENT**

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AN EFFICIENT MIX BETWEEN IN-HOUSE MANAGEMENT AND ENTREPRENEURS WITHIN REAL ESTATE MANAGEMENT

ABSTRACT

A broad literature review and a focused Delphi study on Swedish real estate holding firms implies that strategic decisions concerning the real estate portfolio as well as critical contacts with the customer should be undertaken by in-house personnel. The trend for outsourcing is mainly driven by investors demand for higher returns in combination with a growing market for professional providers of real estate service who can gain from economics of scope and scale. However, there are no empirical studies from the real estate sector that gives deliberate proof for the superiority in economic terms of outsourcing. If the choice between in-house management and outsourcing is a conscious choice, then it will have a limited effect on the long run net operating income. This is a dominating opinion among Swedish real estate executives.

Keywords: Real Estate, In-house management, Outsourcing, Delphi study.

INTRODUCTION AND AIM

The choice between in-house management and entrepreneurs for different activities and service processes within real estate management should be regarded as a strategic organizational decision influenced by financial factors. The current trend with corporate merging, outsourcing and downsizing has its roots in the globalization of capital markets and increased world wide competition. Investors look for liquid assets where larger sums can be invested with a safe exit. In the race to satisfy ever demanding, and foot-lose investors, management of the firms are under pressure to show stable and growing results. This general business trend will probably have an impact on the real estate sector as well, with increased size of the real estate firm, emphasis on securitization and direct measures to increase efficiency and transparency. The goal is a growing net operating income, and as follows - increased shareholder value.

Ideas for the following discussion come from the general financial and management literature combined with specific real estate literature and a Delphi-study with executives from eleven selected Swedish real estate holding companies. The aim is to identify trends and motivations in the general business environment related to the question of in-house or external management, and to discuss these in a real estate context.

The text is organized in the following way. First a literature review is presented that cover both business in general and direct real estate related issues. Second, the basis for analyses and discussion of the choice between in-house management and outsourcing, is summarized. The third section contains a brief overview of the Swedish real estate sector as a background to the fourth section, which cover the main results from the Delphi study on real estate executives. Finally conclusions follow with a summary of the most important observations.

LITERATURE REVIEW

Most of the literature about the choice between in-house management and entrepreneurs stems from other fields than real estate. Taking differences among industries into account, ideas and solutions can be transferred to the real estate sector. A review of selected literature is structured under the following headings:

- General organizational theory
- Service management and quality
- Corporate and public real estate
- Real Estate Investment Trusts (REITs)

General organizational theory

Coase (1937) asks the fundamental question about why we have firms at all? I.e. corporations with coordinated competence that covers several steps in a production process (vertical integration). The reason can be expressed in terms of efficiency and transaction costs. All kind of goods and services that are needed for a certain production process are not available in the market at the right moment and with the right quality.

A broad literature, e.g. Fama (1980) and Jensen – Meckling (1976) is about the principal – agent relationship. A key question is how the principal can give the agent incentives to perform the task in a desired way. These discussions about the principal-agent relationship give basis for formulation of contract terms.

An emerging field of the modern economic theory is about contracts, and more specific, if the contracts should be detailed or have the function of a broad framework, Klein (1992). One conclusion is that specific contracts give high costs for negotiations, contracting and ongoing control. These costs can exceed future conflict costs. A more open contract gives more flexibility when markets are rapidly changing. However, an open contract will always give room for different interpretations in case of conflict.

Klein (1988) give an example of the automobile industry, which show that companies like GM and Ford choose to perform design and manufacturing of strategic components in-house. The motive is the high cost for interrupted supply of components and the necessity to have control of the know how built-in into all components, activities and processes. Know how cannot easily be transferred from one company to another, and the contract with the service provider is also a mirror of the degree of confidence between the parties.

Another example from the soft drink industry given by Muris - Scheffman – Spiller (1992) shows that multi-national companies like Coca-Cola and Pepsi-Cola choose to give up their contracts with independent bottlers and instead carry out the bottling in their own factories. The motive is increased competition and as follow a need for faster adaptation of the soft drink assortment to new demands. In-house bottling is in the current market situation expected to give more flexibility and less risk.

Franchising gives a special principal-agent relation. Kaufmann - Lafontaine (1996) present a broad discussion of the contracts among McDonald's and their operators. An observation is that the franchise contract gives obvious possibilities for profit to the operator. Another observation is that McDonald's over time have reduced the number of stores with in-house management and increased the number of franchise agreements, as they give a higher profit. Yet another observation is that all operators are strong carriers of the McDonald's corporate brand.

Service management and quality

Service management is a particular branch of organizational theory that has a strong position in the Nordic countries. The specific Nordic service management literature, exemplified with Gummesson (1997), Grönroos (1992), Norman (1983) give alternate concepts for production, marketing and distribution of service. A special branch of the literature is about blueprinting of service processes, Shostack (1981). A central point in blueprinting of service is the customers route through the company, and how to optimize all the activities and processes in that route. The control mechanisms of these activities and processes are quite different for outsourcing or outtasking compared with in-house management.

Walter (1998) conducts a case study on five Swedish premium hotels. The question was how they managed "food & beverage" and their attitude to outsourcing? The following factors were found important to consider before an outsourcing decision:

- There have to be a concrete reason for outsourcing. The outsourcing decision should not only be part of a corporate trend.
- The choice of outsourcing partner is crucial. Human relations are central.
- The outsourcing decision is equivalent with creation of a partnership that is built on flexibility and mutual confidence.
- Checkpoints for quality control is important.
- All economic relations have to be settled in advance.
- The hotel and the supplier should work like a team. The guests should not notice that there are several different companies involved in the service delivery.

Axelsson (1998) presents a broad discussion about the corporate choice between in-house management and outsourcing. His key point is that each company has to identify their core competence. Everything else can be outsourced. Among a broad set of factors that have to be considered in the choice between in-house management and outsourcing, the following can be mentioned:

- What is the corporate core competence and what competence is distinguishing from other companies?
- Are there competent suppliers in the service market for the service needed?
- Economics of scale and scope.
- Frequency of transactions, uncertainty and degree of specialty in the service provided.
- Effects of teamwork.
- Possibility to go back to earlier management solution.
- Staff policy.

Axelsson (ibid) also discusses different ways to buy service from the market. The classical transaction based way when there are many service providers and a more modern view where relations are more important than the price. The latter approach is built on the assumption that there are only a few suppliers that the company has a closer and flexible relationship with. The service supplier is a closely related partner.

The questions about quality is central in modern organizational theory. A special part of the literature is about quality systems and models, e.g. ISO-standards¹ and TQM – Total Quality Management. - schemes² A process for ISO-certifying is built on documentation of existing routines and processes – “everything in good order”. However, a ISO-certificate or a high scoring in any TQM-contest is not a guarantee for economic success. It should be noticed that a deliberate part of the credits in common TQM-contests is devoted to service partner relations. Partner relations are fundamental in the corporate service process.

Corporate and public real estate

Most of the real estate related literature about in-house management and outsourcing is found in the area of corporate real estate, e.g. Manning - Rodriguez - Roulac (1997), Rodriguez - Sirmans (1996), Roulac (1997), Walton (1993 a, b) and Kimbler - Rutherford (1993). One frequent topic is the question about the positive/negative financial effects of outsourcing. However, among all articles it is hard to find clear evidence that organizational matters within the real estate division have an effect on shareholder value.

Deavers (1997) single out four factors behind the outsourcing trend. All these factors have in common that they are related to the fast development of information technology:

¹ The International Organization for Standardization (ISO) is a world wide federations with its headquarters in Geneva.

² The most well known TQM standard is the Malcom Baldrige Award. A price that can be won through excellence in quality.

- A quick change of technical solutions
- Increased risk and need for flexibility
- More emphasis on core business
- Globalization of business and increased competition.

Manning - Rodriguez - Roulac (1997) give the latest summary of knowledge about pros and cons with outsourcing. The substance is that strategic real estate portfolio matters are best solved internally while day to day operations can be bought externally. The entrepreneurial fee should be based on the surplus value that is created. With a fast changing market environment it is crucial to integrate the real estate strategies with the over all strategies of the mother company.

Walton (1993 a, b) is one of several authors who claim that the corporate core business trend give an increased number of outsourcing solutions for the supporting real estate function. There is also a growing interest for facility management solution, e.i . a co-ordination of all supporting service processes to the main process. Walton argue that the following factors are important to consider in outsourcing solutions:

- The service provider should understand and accept the corporate culture and values
- Delivered service should be the entrepreneurial core business and “best in class”
- It should be a long business relation
- The entrepreneur should follow TQM-principles
- The service provided should be cost effective
- Security questions related to the buildings have a high priority
- The entrepreneur should not only be evaluated by price. Quality is also important as well as the possibility for the entrepreneur to further develop his competence.

Carn - Black - Rabiński (1995) summarize views on outsourcing from a Delphi-study with US corporate executives. Their main results are as follow:

- The profit from outsourcing is unclear in many companies
- Internal control and competence to procure can be maintained with outtasking solutions instead of outsourcing
- Strategic alliances with entrepreneurs are more and more common
- The co-ordination of the entrepreneurial service will become a function that grows in importance within the real estate organization
- Service functions which are outsourced rarely returns in-house.

A summary of the Carn – Black –Rabiński study is that there is a trend with core business and outsourcing, but there are few evidences about which solutions are profitable in the long run.

Charpentier - Samuelsson (1996) investigate the effects of outtasking in the county council of Stockholm. The cost for caretaking and maintenance of health care buildings are reduced by some 20 to 30% after two years with external entrepreneurs. Even the cost for caretaking and maintenance performed in-house has been reduced to the same degree due to competition from the entrepreneurs. Lundström - Sandgren (1992) also argue that not all real estate service should be outsourced as the real estate division within the public sector will lose the competence to procure and evaluate real estate service. A partial outsourcing (outtasking) can together with implementation of benchmarking programs and effective transfer pricing system create a “business like” climate which gives competition and cost reduction.

Real Estate Investment Trusts

There is a vast literature about Real Estate Investment Trusts (REITs). Most of the literature is oriented against financial performance and how real estate can be compared with stocks and bonds in a

portfolio context. Capozza-Lee (1995) finds that big retail REITs give a performance premium compared with small .One explanation is that big REITs have relatively low administration costs. Capozza-Seguín (1997, 1998) broadens the empirical analyses and find that smaller mortgage portfolios have a positive impact on the stock price due to less cost of administration. They also find that diversified REITs have higher return on the real estate level compared with focused companies. However, higher overhead cost and less transparency make a disadvantage that equalizes the over all return.

POINTS OF DISCUSSION AND ANALYZES

The following points of analyzes for in-house management versus entrepreneurial solutions are derived from the literature and from tentative discussions with Swedish real estate executives. Most of the factors presented are of a general nature, and not related particularly to real estate. The discussion is also on an aggregated level and not linked to specified service functions.

Economics of scale and scope

Both in-house management and entrepreneurs can benefit from a higher volume that increases the possibilities to co-ordinate resources. The marginal value of scale is at a certain level supposed to decrease by volume, depending on the costs of control and co-ordination. The optimal volume of real estate service functions can differ with the kind of service and the situation.

A service partner – internal or external – which can specialize, have the possibility to add more value to the bottom line. Entrepreneurs, with the possibility to gain experience from the whole market, have a considerable advantage compared with in-house management. When the concept of facility management grows in importance will also entrepreneurs from other fields have an opportunity to transfer knowledge to the real estate field.

Risk exposure

The choice between in-house management and outsourcing is also a choice between different kinds of risk. In-house management gives more direct control, while control in the outsourcing and outtasking alternatives is more indirect and regulated in the service contract. Risk exposure is to a great extent a question of flexibility and competence in a fast changing environment.

Service quality

With an increased emphasis on quality is it important to control all activities and processes in the service chain. Ways of co-ordination and control has to be taken under special consideration when outsourcing and outtasking becomes prevalent. Implementation and evaluation of service quality programs are in general more complicated when more actors are involved.

Frequency and complexity of contract negotiations

The cost of renegotiating comprehensive service contracts can be considerable. These costs should always be seen along with internal organizational costs related to the implementation of new work routines, further training of the labor force etc.

The real estate portfolio mix

A real estate portfolio with a few object in each location, and also a variation in uses, normally give favor to outsourcing solutions.

Degree of integration into customer business

In businesses like shopping malls and hotels an active investor/owner can gain from integration forward into customers business. Creation of a lease contract that e.g. involves clauses for marketing, service quality and development of corporate brand aims to create a common firm. This involvement in the tenants business demands a certain competence that sometimes is best performed in-house and in other cases by entrepreneurs.

Customer demand for specialized service

In certain businesses like biotechnology there is a demand for specially equipped real estate and specialized service in narrow areas of competence like clean rooms and security. If this kind of real estate is rented, it is often from firms that have specialized and have a deep in-house competence in the area.

Competition in the market for entrepreneurs

In many markets there is a limited competition between entrepreneurs. There can be few actors with a professional competence. Renegotiation of existing contracts is a special situation where the present entrepreneur is favored as he got all the information and knowledge about the real estate objects and the users. There are normally also considerable transaction costs related to contracting a new entrepreneur.

Competence for procurement and evaluation of entrepreneurs

With long time relations with the same entrepreneurs the competence to procure and evaluate new service alternatives would most probably decline over time.

Development of corporate brand and corporate culture

There is a well recognized trend with the increased importance of the corporate brand. In real estate, the corporate brand is developed in relation to present and potential customers. A real estate firm with all real estate service functions in-house can have an advantage as the firm is more visible. It can also easier communicate a corporate culture if most service functions are in-house. On the other hand it is easier to maintain the corporate culture over time if the firm is small.

Organizational learning and response to new information and situations

The real estate firm needs accurate and timely information about real estate performance. Access to such information is crucial for the organizational learning process and a basis for the possibility to take prudent decisions on both the strategic and operational level.

THE SWEDISH REAL ESTATE SECTOR

A bank and real estate crisis

The 1990s has been a dramatic decade for the Swedish real estate sector. A severe bank and real estate related crisis during 1990-1994, was the starting point for a government aided and quick restructuring of the banking sector. An important side result was the creation of a number of brand new and relatively big real estate companies, which have their origin in the bad banks created to rescue the banking system. These new companies, listed on the Stockholm stock exchange, have been active partners in a nationwide restructuring of the whole commercial real estate sector. The restructuring was facilitated by a huge amount of real estate for sale due to foreclosures in private real estate holding companies.

During the first phase of the restructuring period, 1994 and onwards, there has been less emphasis on organizational issues, and more discussion about market positioning and liquidity. However, at least four major trends can at the moment be identified within the Swedish professional real estate sector:

- Increased importance of financial aspects, exemplified with the introduction of a Swedish property index in 1997.
- An over all shift from a production orientation with focus on technical aspects to focus on customers, markets and service.
- Implementation of process orientation, quality programs and facility management approaches led by corporate real estate functions in multinational companies like Ericsson.

- Institutionalization of the outsourcing possibility through creation of a handbook for procurement of real estate related services.³

By all means the tradition among Swedish real estate owners has been to keep most real estate management functions in-house. Up to the middle of 1990s there were only a few professional external providers of broad scale real estate management service.

Eight major types of Swedish companies/real estate

From an ownership point of view the Swedish real estate sector can be divided in eight major groups with roughly estimated market values at the end of 1998 as in diagram 1.⁴

TYPE OF COMPANY/REAL ESTATE	MARKET VALUE (Billion SEK)
29 public real estate companies	170
Institutional investors	150
Private owners	300
Municipal housing companies	300
Owner-Occupiers	300
Public sector real estate	350
Tenant-owned real estate (co-operatives)	250
Detached houses and summer houses	1 600
Farm and forest real estate	600
Other real estate: Power plants etc	200
Total:	4 200

Diagram 1: The Swedish Real estate sector by company/real estate type and market value (1 USD = 8 SEK).

The 11 companies in the Delphi study presented below, are from the four first groups that operate on the open rental market. The public traded real estate holding companies (including some major construction companies), listed at the Stockholm stock exchange, holds roughly 4% of the total market value for all real estate in Sweden. However, in a European context, Sweden together with the UK, have a high number of listed companies.

A handful of Swedish institutional investors - pension funds and insurance companies - have a significant amount of real estate assets in their total portfolios. Certain institutions have up to 10% of their total assets allocated in directly owned real estate, while the average is 6%.

Private Swedish owners on average have small holdings. A limited number of large private real estate holding firms that have their roots in locally oriented construction companies.

In almost every Swedish municipality there is a 100% municipality owned housing company that dominates the local rental market. In the major Swedish cities - Stockholm, Gothenburg and Malmoe - there are seven well consolidated and municipality owned housing companies with a total market value of some 100 billion SEK. The municipality ownership of market dominating housing companies is under debate as they today are not used for any major social housing scheme.

³ The handbook is a result of a co-operation between The Swedish Association of Municipal Housing Companies and The Swedish Federation of Property Owners.

⁴ Sources: Swedish Real Estate Index (SFI), Byggstatistik AB and results from the Swedish National Assessment.

A DELPHI STUDY ON SWEDISH REAL ESTATE EXECUTIVES

To develop new tools and strategies⁵ for real estate management, 11 selected real estate companies work together with the Department of Real Estate and Construction Management at the Royal Institute of Technology (KTH), Stockholm. The companies, and their executives, are in different ways recognized as leading in development and implementation of new management ideas and techniques.

As shown in diagram two there is an overwhelming use of in-house personnel for most decisions and functions within real estate management. One of the listed companies is a clear deviant as they more or less systematically have chosen outsourcing as organizational mode. Less than 20 people in that company manage a real estate portfolio of some 10 billion SEK.

The main opinion among executives in the 11 companies about in-house management versus outsourcing can be summarized as follows.

- All strategic decisions regarding the real estate portfolio and its financing should be kept in-house as they have a direct effect on the balance sheet.
- All critical customer contacts should be kept in-house as the customer “is the most valuable asset in the firm”.
- It is important to maintain the in-house competence to purchase and evaluate real estate service.
- The corporate brand will grow in importance as the competition increases. The real estate company should be more visible on the market.
- The real estate sector has much to learn from other branches – e.g. the automobile industry - in areas such as production logistics, product differentiation and marketing.
- Service quality can be assured even when entrepreneurs are part of the service chain.

Other observations:

- Six out of 11 companies claim that their mix between in-house management and outsourcing is a strategic choice. The other five admits that the mix is a “heritage” and due to random factors.
- Nine of the companies agree that outsourcing and outsourcing is a tool for creation of competition and increased internal efficiency
- There are no empirical evidence that in-house management give higher net operating income than outsourcing or vice versa.

The massive use of in-house management is not surprising as there has been no active market for providing full scale real estate management until the middle of the 1990's. However, there are a lot of service firms in narrow sectors as plumbing, painting, HVAC, security, data support, accounting etc.

⁵ Other areas for discussion and research are real estate portfolio management, formulation of lease contracts and design of information systems.

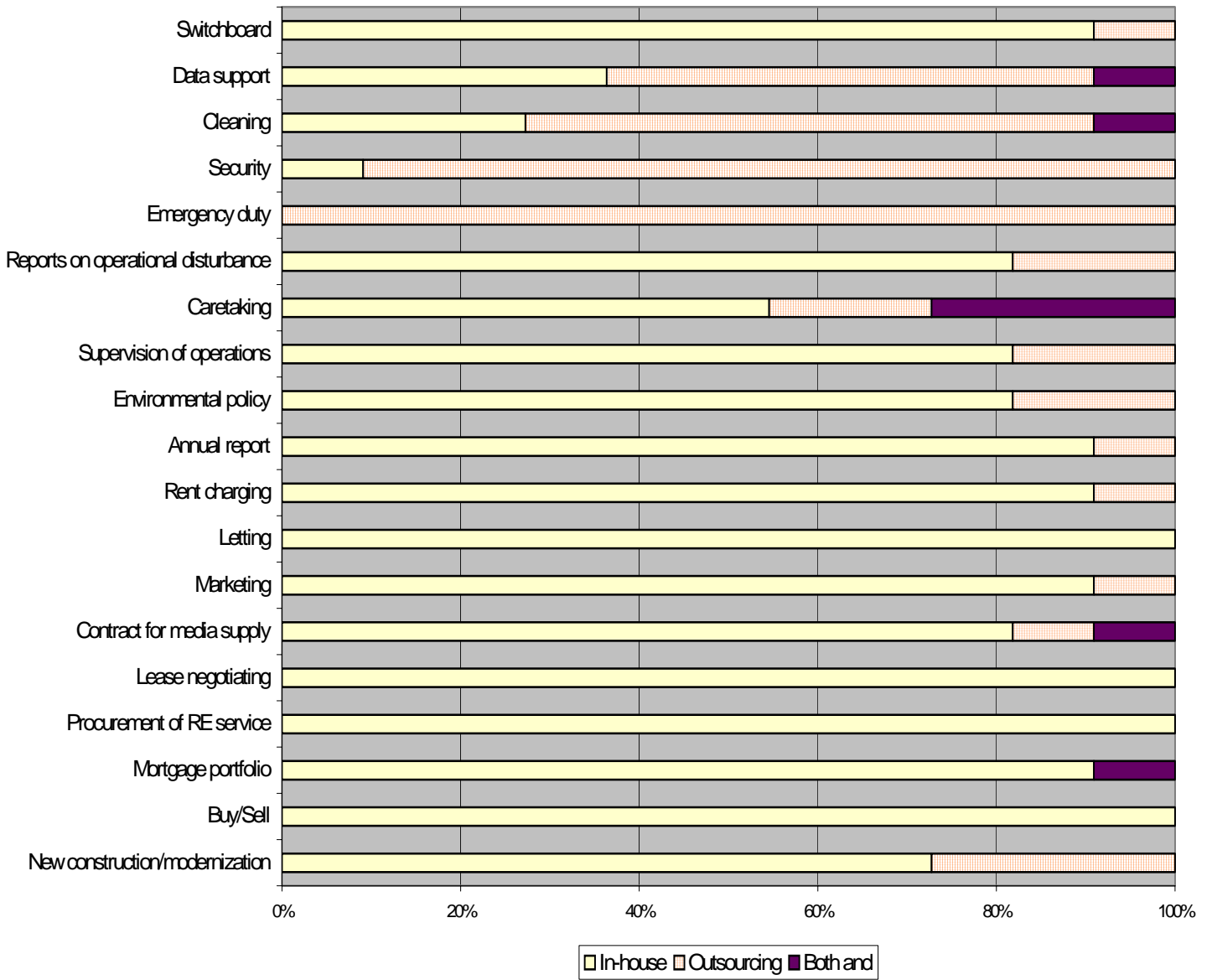


Diagram 2 The choice between in-house management and outsourcing in 11 selected companies.

CONCLUSIONS

The most important observations from the literature survey and the Delphi study with Swedish real estate executives can be summarized as follow:

- The choice between in-house management and outsourcing is a conscious choice that gives different kind of risk exposure, as well as different possibilities to take control of key activities and processes. In-house management also demand another kind of organizational competence compared with outsourcing.
- The choice is dependent on the situation. E.g. competition on the market for real estate service and the real estate portfolio with respect to geographical concentration and use.
- There is an overall trend in business to concentrate on core business. However, there are no well documented studies on real estate which unambiguously support that broad outsourcing programs give a better economic outcome than in-house management, or vice-versa.
- Both in-house management and entrepreneurs should be the subject of marked competition by customer surveys, benchmarking etc.
- The real estate firm should, with any kind of organizational solution, have direct access to critical information about target markets, customers, competing firms and the own real estate portfolio regarding market positions, technical status, operations etc.
- Decisions that have a direct effect on the balance sheet can with advantage be kept in-house. The same recommendation can be given for critical customer contacts.
- Back-office service as book keeping, billing, rent charging, data support etc can with advantage be bought from entrepreneurs.
- Outsourcing and outtasking should be regarded as partnerships built on mutual confidence and a common quality goal. Buying real estate service at the lowest cost is not always the best solution in the long run.
- The real estate firm should always keep an in-house competence to procure and evaluate strategic real estate service.
- As the corporate brand tends to be more important on the rental market will the real estate firm have to transfer its corporate culture to entrepreneurs that are in contact with customers.

The initial question about “the efficient mix” between in-house management and outsourcing can be answered with: It depends!

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