By Mark Ubelhart

People make the difference. We've been hearing it forever. Now it's time to start quantifying the value of human capital in a company's value-creation proposition. The good news: Ways to measure companies' most vital asset are emerging, providing a road map for optimizing the human contribution to value and giving investors another important tool in understanding future performance. In this first of a two-part series, Mark Ubelhart of Hewitt Associates brings us up-to-date on the work being done. Furthermore, he shows how to translate People Value into our beloved financial metrics, such as Return on Investment.

Measuring the Immeasurable

About the Writer

Mark C. Ubelhart is the Value-Based Management (VBM) Practice Leader for Hewitt Associates LLC. With 30 years of consulting experience in corporate finance and executive compensation, Ubelhart served as vice president and division administrator of corporate financial consulting for a major money center bank before joining Hewitt. He holds a B.A. in economics from Dartmouth College, where he earned Phi Beta Kappa honors, and an MBA in finance from the University of Chicago. Previous articles include "Business Strategy, Performance Measurement, and Compensation" and "Case Studies of Shareholder Value Incentives."

For more than two decades, corporate managers have employed value-based management (VBM) disciplines as a way to drive shareholder value creation. Net present value of cash flows, economic value added, and cash flow return on investment (CFROI®[1]) are metric methodologies that facilitate decision-making and resource allocation to create value.

In recent years, these applications have encompassed human resource management. Not only is the scarcity of talent often more constraining than that of financial capital, but talented employees are, in part, acquired and retained by using stock as a currency. Employees are two-dimensional investors: They invest their human capital, expecting adequate return and growth, and frequently they also have a financial ownership interest as well.

The boxed inserts in Exhibit 1 entitled "Economists' Views" and "Real Options" put a theoretical corporate finance slant on the theme of this two-part series — that is, human resources investments, disclosure practices, and measurement have all evolved and will continue to evolve in ways that demonstrate alignment with long-term value creation. Examples of where this has already occurred will be cited and research results described. Concepts being explored on this frontier also will be discussed.

Many companies are exploring in one way or another value-based human resources concepts. Set forth below are ones that have gained momentum.

Revising the Economists' Views of the "Firm"

- Liberation from physical assets with growth options up for grabs and no longer belonging to asset owners.
- Falling communications and interaction costs and the digitalization of geographic and other barriers.
- Competitive advantage sustained through innovation and quality improvement.
- Use of equity capital to create alliances, alignment, and excitement for employees and partners — some with "cooperative"-like characteristics.
- Fragmentation of power due to centrifugal forces of disintegration along with lower communication costs that redistribute wealth based on what was once labeled intangibles.

New Foundations by Professor Luigi Zingales.

Lessons From "Real Options" Applications

- Learning and broad platform investments like R&D are particularly valuable in circumstances of uncertainty, uncovering follow-on investment opportunities.
- The value of flexibility, including preserving abandonment options, can be great.
- Organizations that take more risks, start a lot of projects, and kill a lot of them can thrive.
- Flexible contracts, licensing, modular investments, and risk/return sharing partnerships add value.
- Like traditional options, real options can limit losses, while the upside is magnified.
- In many cases, people and investments in them epitomize real options.

Exhibit 1: Economists' Views and Real Options.

Investment in Acquiring and Training Talent

Exhibit 2 depicts the costs associated with acquiring talent, followed by investment in training and the benefits in terms of cash inflows over the employment duration. It highlights the return on investment (ROI) concepts so often applied to other investments, such as new equipment or acquisitions. This example was developed by Capital One for call center employees.

It revealed that the extra investment to acquire more-talented employees and to train them paid off in terms of extra productivity and for a longer period of time.

Just like any traditional capital budgeting

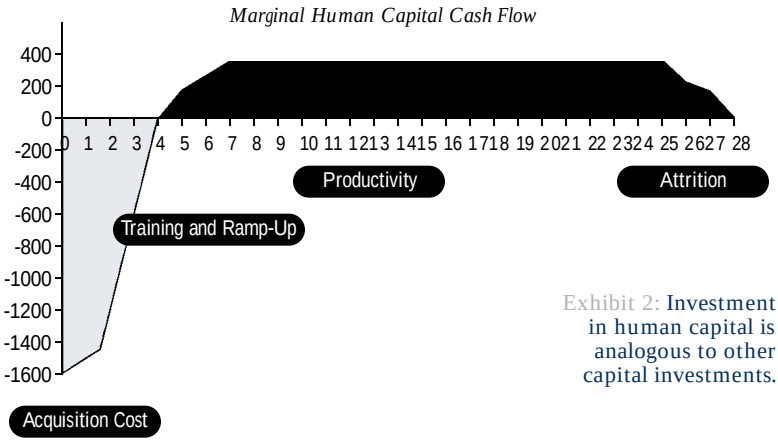


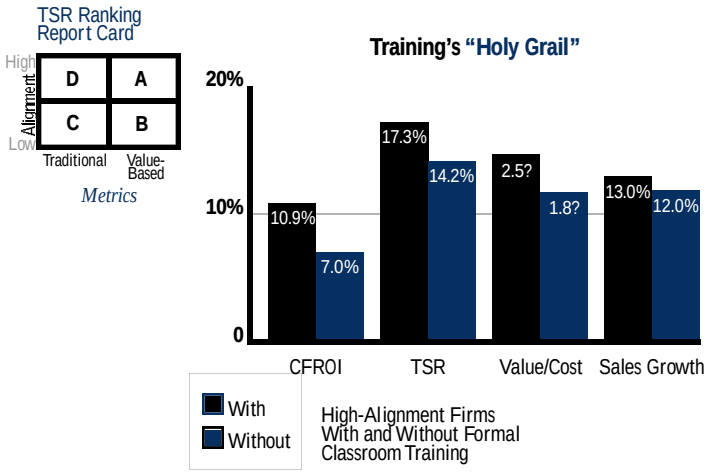
Exhibit 2: Investment in human capital is analogous to other capital investments.

[1]Registered trademark of HOLT Value Associates LP.

analysis, Exhibit 2's validity depends upon the reliability of the assumptions. In the human resource arena, some of the assumptions may be more tenuous than in more common financial analysis. However, over time, experience will improve them. In the meantime, the obvious link to value creation puts human resources investment on a par with any other.

Not so obvious are other connections to the capital markets available through training and communications. Exhibit 3 is from a CFO survey conducted by Hewitt Associates LLC and The Boston Consulting Group. Referred to as the "Holy Grail" of training is the impact that broad-based formal classroom training has on business results. Specifically, CFROI, TSR (total shareholder return), and market value/cost were dramatically higher for firms that conducted training on shareholder value concepts. Considering the enormous commitment of time required for broad-based formal classroom training, the payoff is even more staggering in magnitude. Especially noteworthy is the small difference in sales growth, implying that without training companies still grow, but not nearly as profitably.

Exhibit 3: Center for Performance Measurement CFO survey.



This four-quadrant matrix reveals, not surprisingly, that companies which employ value-based metrics have much higher total shareholder return (A is double D). Aligned firms are those that responded to the survey by indicating that the business performance metrics chosen as the best proxies for shareholder value were used in corporate incentive design, business unit performance measurement, and training. Unaligned firms were not consistent in these applications. It is noteworthy that it is better to be not aligned and emphasizing value-based metrics than it is to be aligned and using traditional ones.

Training usually incorporates bottom-up value-driver mapping — once participants understand how their company creates value. Here the individual specifies his or her own behaviors and their impact on value creation, once how shareholder value is created is understood. This approach can have high impact without elaborate model-building.

Value-Based Engagement

Of course, there is intuitive support for the notion that engaged employees are more likely to enhance value creation as reflected in the capital markets. "Best employer" lists often correlate with best financial results — that is, return and growth, as well as TSR and market value/book value multiples. However, this level of "proof" may not be sufficient to command the attention of the CEO or CFO anxious to signal to the investment community the favorable prospects of the business. Furthermore, some of the "investments" in human resources needed to increase engagement may not garner internal priority unless the cost/benefit analysis is complete.

Exhibit 4 portrays the seven levers of engagement, while Exhibit 5 provides an example of converting this to business results.

The value-based engagement example is from an analysis done with Wachovia Corporation.

The engagement work revealed a shortfall that would require a significant financial investment to address. The chart shows human resources needed to determine the

Exhibit 4: Overview of engagement — the Seven Levers.

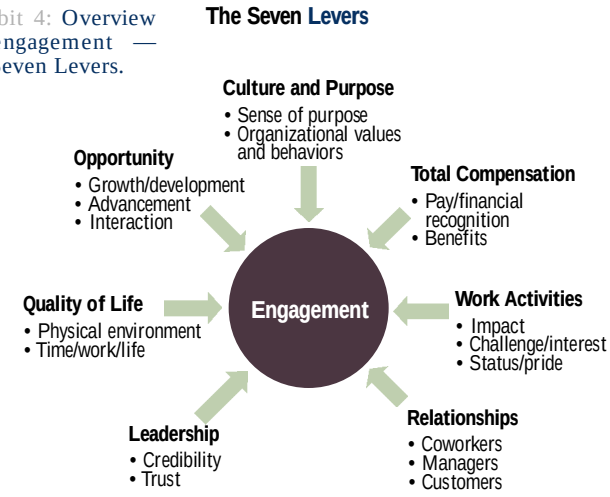


Exhibit 5: A link between engagement and business results

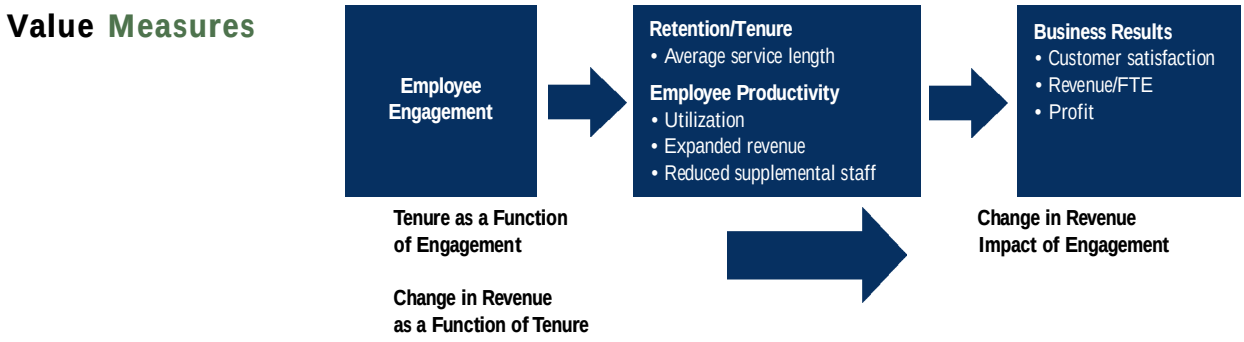
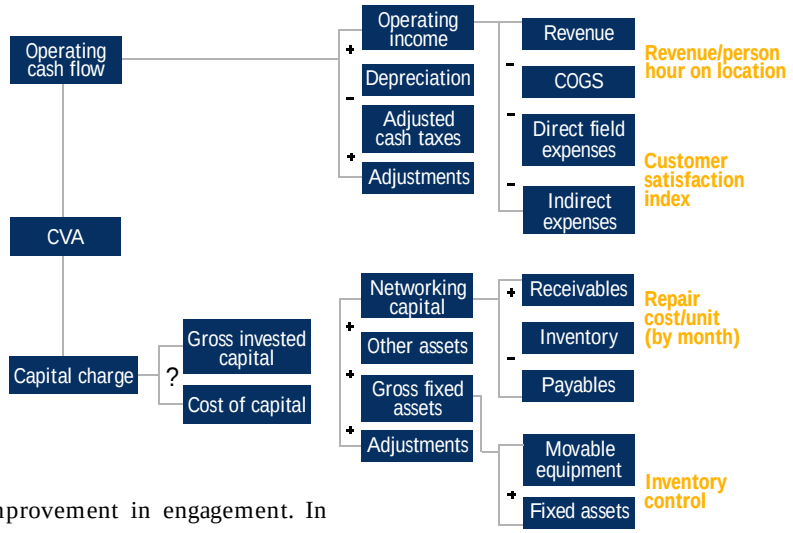


Exhibit 6: Financial relationship mapping.



business impact of the improvement in engagement. In this instance, it was established that tenure would be used as a proxy for engagement — tellers who stayed were more engaged than those who did not. Therefore, if a quantifiable link could be made between tenure and business results — in this case, revenue from loans and deposits per employee per month — the impact could be measured.

As in other studies of this type, it is essential to protect the confidentiality of employee responses, yet have data that can be compared — in this case, branch versus branch. Confidential but not anonymous response or organizational grouping must be available from the engagement surveys. As it turned out, the investment required to "fix" engagement was dwarfed by the estimated business results.

This is a form of value-driver mapping that involves statistical sampling. While there are always inherent limitations that need highlighting, the most important factor is the connection made between financial results and human resources investments. The human resources staff was delighted that it could present its resource request in a manner comparable to any classic investment decision.

As a broad concept, the value-driver linkage used to connect engagement with financial results can be structured in a return and growth framework. Subordinate categories that may be employed for this purpose include productivity, customer service, innovation, and quality — tailored, of course, to the information available and context.

The capital market perspective can be condensed to a very simple one — in the long run, value is created when ROI exceeds the cost of capital and, in such circumstances, is combined with growth. In other words, the "first-order" drivers of shareholder value are return and growth, and these two components can be collapsed into a single-dollar figure usually labeled economic or cash value added (CVA).

The VBM Perspective

There are many ways of value-driver mapping. The one shown in Exhibit 6 can be characterized as financial relationship mapping. Alternatively, process- or activity-based mapping could be done; key initiatives could be quantified in this manner or a grand economic model could be developed. All approaches, regardless of scale, aim toward

Exhibit 7:
Focus — productivity and retention.

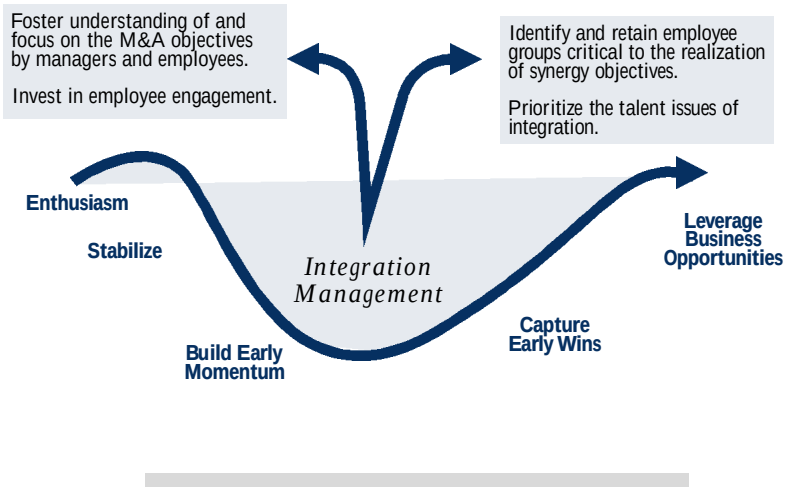


Exhibit 8:
Compensation.)

		Composition of Pay		
Degree of Attention	Total Compensation Dollars	Short-Term Versus Long-Term	Fixed Versus Variable	Incentive Design Linkage to Financial Results
Considerable	22%	42%	37%	60%
Significant	59%	42%	46%	32%
Minimal	14%	11%	11%	5%
Ignore	5%	5%	6%	3%
	100%	100%	100%	100%

linking line-of-sight subordinate dimensions with the first-order value drivers on up to shareholder value creation.

Business Acquisition and Integration

Mergers and acquisitions provide a unique opportunity to gain insight on the nature and magnitude of value inherent in HR. In most cases, the acquiring company must assess the premium it is willing to pay over and above the stand-alone value of the target company. The synergy framework requires identification of the sources of synergy, such as improved market access, consolidation of functions, shared resources and know-how, coordinated strategies, and so forth. Today, we often hear that a firm was acquired simply to obtain a specific group of engineers or software specialists.

The synergetic values can often be traced to specific people integration expectations. In capital market terms, achieving these expectations ultimately will be reflected in increased return and growth represented by the productivity and retention curve in Exhibit 7. Integration management aims at minimizing the productivity dip.

The distinguishing factor here is that there has already been an analysis and estimate of the synergy value as reflected in the acquisition terms. It is available to be compared with the integration and implementation costs — most of which are human resources–related. In an ideal analysis, of course, these would be understood and quantified as part of the deal pricing. Thus, this is merely another example of the investment perspective set forth earlier, but one in which the scale is no doubt magnified and where there is more information available regarding the value creation expectations.

Compensation Design

Incentive compensation provides a powerful signaling device, and the capital markets pay attention to it. Exhibit 8 is the result of a portfolio manager survey conducted by HOLT Value Associates and Hewitt Associates. It is apparent that while portfolio managers do consider the level of compensation, they are much more intrigued by the mix of pay (short-term vs. long-term; fixed vs. variable) and the linkage to financial results.

This illustrates a means for human resources to "design in" their contribution to value creation by making certain that the mix and metrics of pay are in sync with the business strategies. Empirical methods are available to weigh return and growth dimensions to provide instructional value — that is, where and when to emphasize growth or return. While the first-order value-driver metrics may be in the financial domain, their adaptation for ease of communication and use in incentives is human resources' responsibility.

Next time, we will show how the frontiers of measuring human value are being crossed in financial metrics similar to those used in the everyday investment process.