the impact of human capital management on shareholder value

BY: JERRY AMERNIC

Almost every company says people are its most valuable resource, but just how important is hard to say. The rule of thumb among management experts is that 30% of market capitalisation is due to physical assets which is fine except that leaves 70% of the pie up for grabs. However, a new study should put much of the mystery—about how much people actually contribute to shareholder value—to rest. ➤

Two years ago Watson Wyatt Worldwide, a global consulting firm, released its Human Capital Index or HCI. The study, the first one that ever demonstrated the link between superior human resource practices and the creation of shareholder value, surveyed 405 public companies in North America. It identified thirty practices that were associated with explaining an increase of up to 30% of the shareholder value of a given firm. The five key areas were:

- Recruiting excellence
- Clear rewards and accountability
- Collegial flexible workplace
- Communications integrity
- Prudent use of resources

The firm developed a matrix to measure how well a company stacks up with certain indicators. Cut through the jargon and that means how well it treats its people in terms of rewards, communications, career development, culture, and staffing.

Watson Wyatt recently released results from a second HCI survey in 2002 that looked at 750 large, publicly traded companies in Europe and North America. The list includes the likes of American Express, Microsoft, Daimler Chrysler Corporation, Shell Oil and General Motors. The findings? Superior HR practices create shareholder value.

"In the first study we didn't really know that HR practices drove economic performance," says Jan Grude, National Practice Director for Watson Wyatt's Human Capital Group in Toronto, Canada. "It demonstrated that a link exists but now we know positive financial outcomes will follow effective human resource practices. This is revolutionary because it's the first time anyone has been able to demonstrate that improved human capital management drives higher shareholder returns. So it can act as a predictor."

Grude says that while 30% of market capitalisation is due to the value of physical assets, a similar percentage is due to human capital practices. What's more, this portion can be broken down into solid measurable data. Put another way, certain practices can account for a large portion of a company's market capitalisation.

For example, based on the 1999 and 2001 HCI surveys, let's look at companies that scored well in the area of clear rewards for high performers and accountability for poor performers, which is often a sticky point among employees.

Improvement in this key area may explain up to an increase of 16.5% in market value. Likewise, improvement in developing a 'collegial, flexible workplace' may explain and even lead to a 9% increase. Following down the list we have 'recruiting and retention excellence' at 7.9%, 'communications integrity' at 7.1%, and 'focused HR service technology' at 6.5%. Show improvement in all five areas and, according to the data, you may be looking at an increase in market value of up to 47%, all other things being equal. That's nothing to sneeze at.

The data can be broken down even further. The category of linking total rewards and accountability to value creation involves 16 distinct practices. Number one on the list is 'health benefits important for recruiting and retention', followed by 'high percentage of company stock owned by employees'. Other practices include things like linking a person's pay to the company's business strategy, the percentage of employees eligible for stock options, and promotion of competent employees.

According to Watson Wyatt's survey, specific HR prac-

tices that had a lot to do with creating shareholder value were flexible work arrangements and employees having easy access to basic technologies for communication. What about something like the 'prudent use of resources'? The study had some interesting things to say about that. Just look at employee training. A company that emphasises training people for their next job over learning how to succeed in their present one may actually be contributing to a 1.9% decline in market value.

Training and development generates the lowest return of all the major human capital practices, while recruiting excellence generates the highest return. This isn't to say companies should forget about it. Training and development is not a core competence for most organisations and many of them do it inefficiently. They are better to hire from outside for broad-based training, or to hire people who already possess the requisite skills.

"One of the key challenges that line executives, and certainly human resources executives face is determining a return on their human capital investments," says Bruce Pfau, Watson Wyatt's U. S. Director of Organisational Effectiveness and one of the authors of the study. "When a company is trying to generate superior returns on human capital, it makes changes to related programs. The HCI is a method for determining which are the highest return items. That makes it the best measure of ROI for human capital programs."

If you don't believe him, have a look at the five-year (1996-2001) total return to shareholders shown by companies involved in the HCI surveys. Those that scored low on their HCI index, which means the bottom 25%, had a total return of 21%. Those in the middle rung, the next 50%, had a total return of 39%. But those in the top quarter of the class had a total return of 64%—more than three times the return of the bottom group.

"Leading CEOs are keenly aware of the value of their people," says Jack Welch, the now-retired CEO of General Electric: "The day we screw up the people thing, this company is over." During Welch's tenure as boss, GE's market capitalisation rose by some $450 billion! Bill Gates of Microsoft puts it this way: "Take our 20 best people away and I can tell you that Microsoft would become an unimportant company."

One company that knows the importance of its people is Hyundai Semiconductor America (HSA), which produces memory chips for computers, printers, telephones, TVs, industrial machinery, and other applications. When S. I. Kim took over as President and CEO in 1999, he saw a problem. HSA's Korean expatriates and its American engineers weren't communicating well with each other in the company's plant in Eugene, Oregon.

Kim, a veteran of quality assurance, production and marketing in both Korea and the United States, decided to stress improvements in attitudes and behaviours over technical issues. He developed 'The People Initiative'.

The People Initiative focused on communications, rewards and recognition, performance management, training and development, and leadership. In communications, for example, a concerted effort was made to increase the frequency and accessibility of information given to employees. Systems were set up where employees could go to a computer in the bay where they worked and log on to their e-mail account. Computers were also set up in the cafeteria and electronic reader boards were introduced, all these things pointing to improved communications.

The results? In one year HSA realised an 83% increase in die output, a key measurement for a semi-➤

conductor plant. In terms of the company's HCI, the increase in shareholder value was to the tune of $600 million.

In its research, WatsonWyatt compared the HCI scores and financial data for 51 companies that participated in both the 1999 and 2001 surveys. It wanted to find the correlation between a company's HCI score from 1999 and its financial performance two years later. Analysis of the data showed that a company's HCI practices were a 'very significant' indicator of the financial numbers 41% of the time.

"The bottom line," says Watson Wyatt's Pfau, "is that effective human capital practices drive business outcomes more than business outcomes lead to good HR practices."

The Gallup Organisation has for many years researched how employee attitudes relate to the performance of an organisation. Much of its research was demonstrated in two popular management books—'First, Break All the Rules' which was published in 1998, and 'Now, Discover Your Strengths' which came out in 2000. Gallup developed a model describing the path between the individual contribution of every employee and the ultimate business outcome—an increase in company value. In a nutshell, the model says:

- You identify strengths and make the right fit with your people
- Great managers lead to engaged employees which, in turn, lead to engaged customers
- This results in sustainable growth, real profit increase, and stock increase.

So no matter how you look at it, employees who are happy in their jobs and who feel they are well compensated and appreciated perform better than those who aren't. They are more productive and ultimately generate more value for the organisation. The trick is to get everyone pulling together. DBR

This article was prepared exclusively for the Drake Business Review by Jerry Amernic, a writer and consultant with extensive experience in the HR sector.