

# Human Capital and Capital Markets



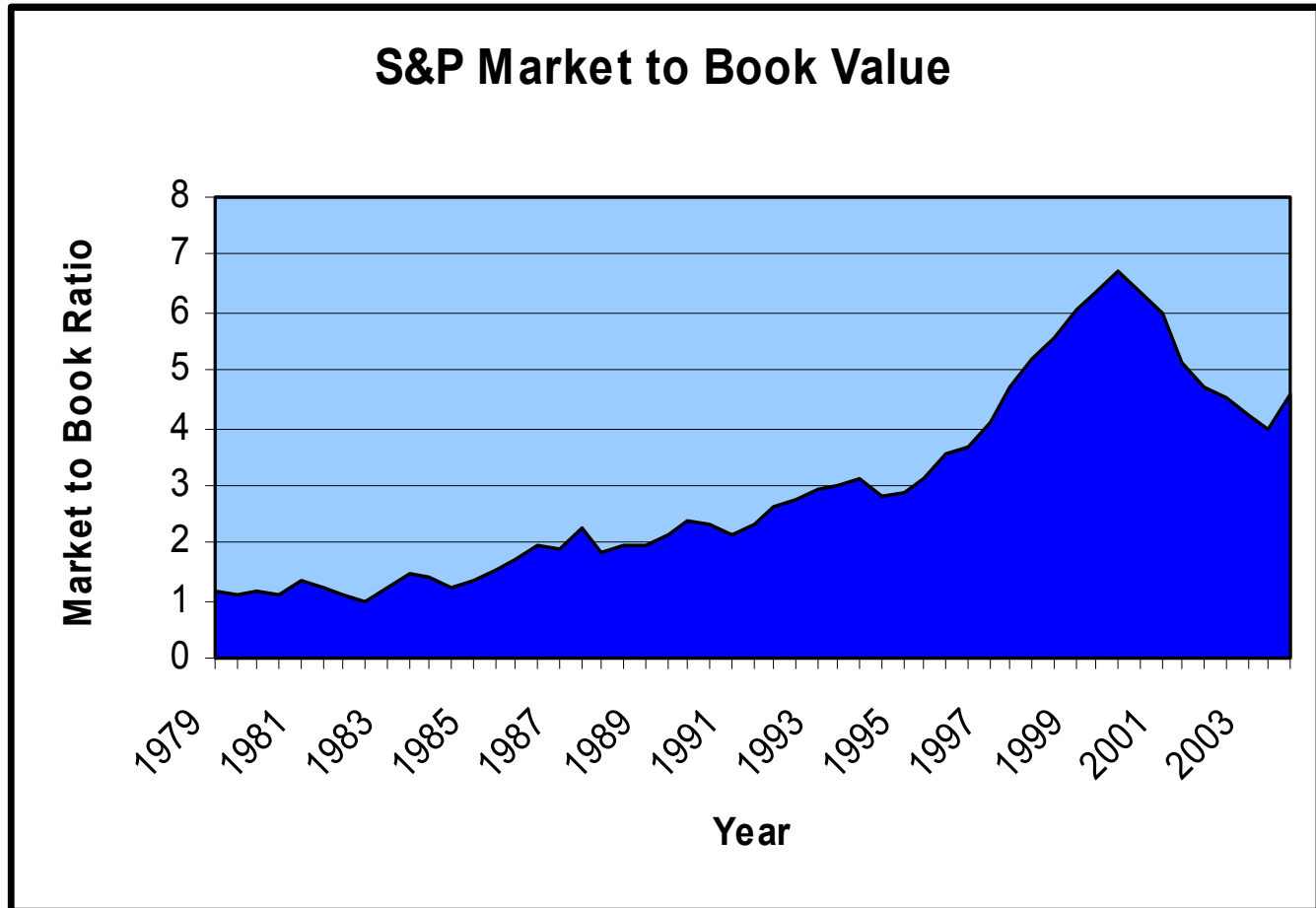
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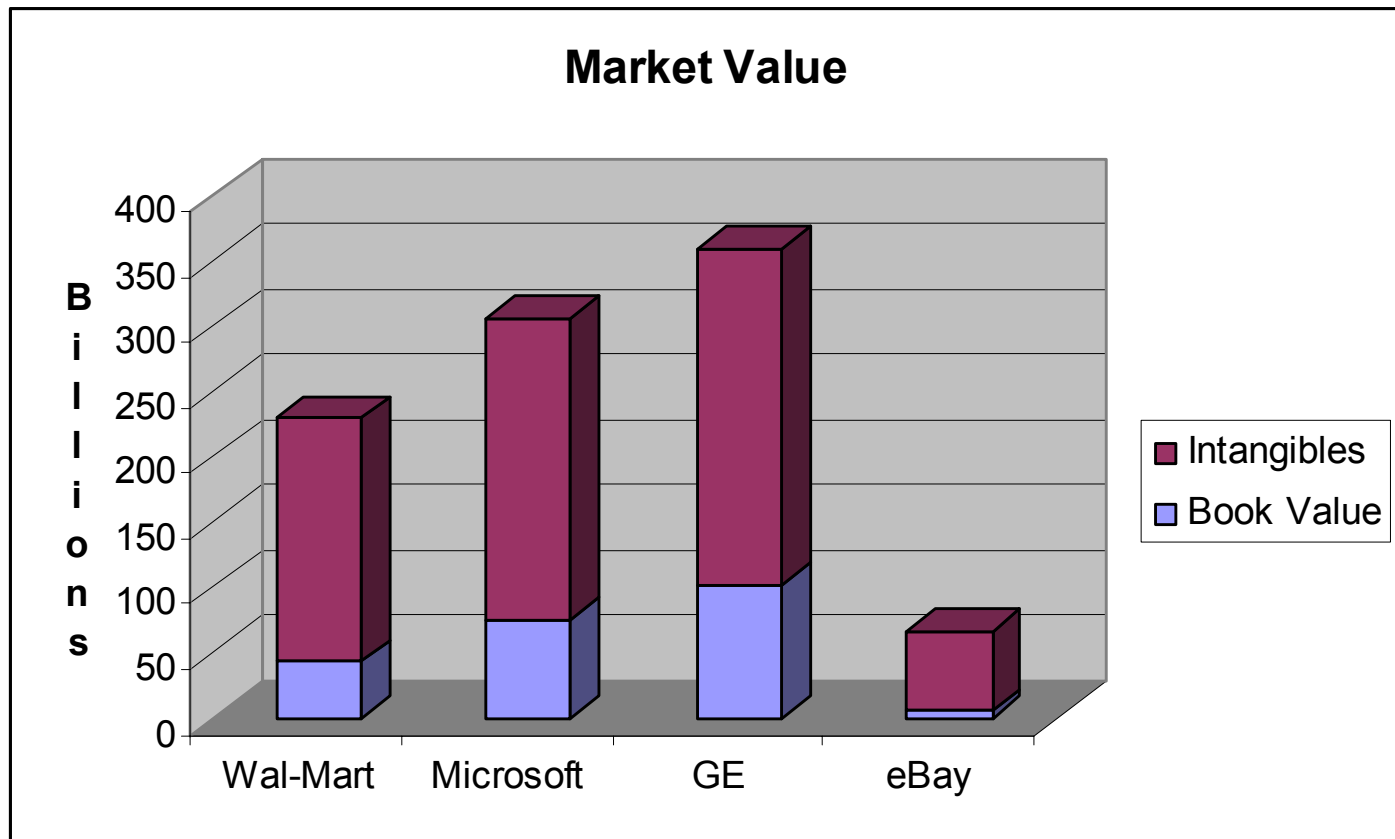
# Overview

1. Is human capital a material issue?
2. What does academic research show?
3. What are consultants selling?
4. What should you do?
5. How will this impact the future of HR?

# Is it Material?



# Book Value of Specific Firms



Data from: Forbes Nov 2, 2004

16 February 2005



# What Do Regulators Say?

- SEC- “companies should provide *more information on intangible assets.*” (May 2001, task force)
- American Institute of Chartered Accountants – “corporations should provide more forward looking information and *enhanced discussion of non-financial performance factors* that create longer term value.” (Jerkins Committee)
- Senate Committee on Banking, Housing, and Urban Affairs - five testifying experts spoke of *inadequate treatment of intangible assets* by the traditional accounting system. (2000, “Adapting a 1930s Financial Reporting Model to the 21st Century,”)

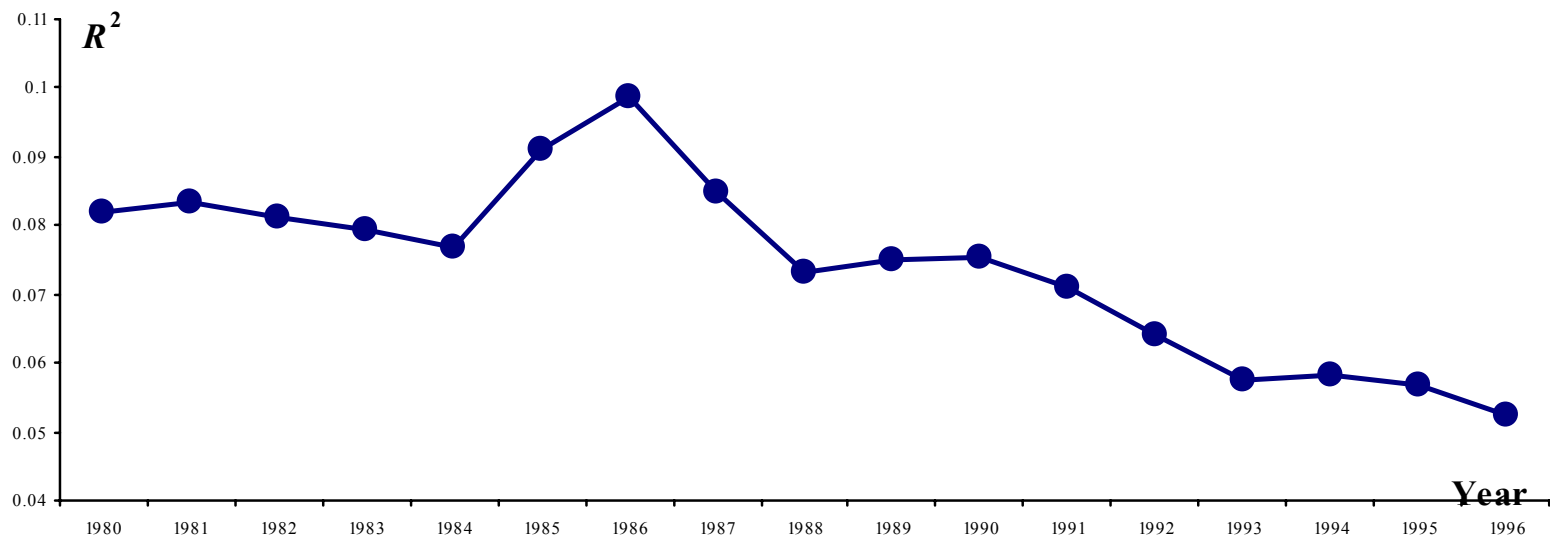


# What Do Investors Say?

- Sell-side analysts – nearly all rely on a broad range of intangibles.
- Buy-side investors – base 35% of their decisions on intangibles.

# Trend: Earnings Matter Less

Figure 4-2  
Association Between Annual Earnings and Stock Returns



From Lev, 2000



# What Can We Learn From the Research?



# Human Capital & Financial Performance

- A one standard deviation increase (i.e. upper 16% of sample) in high involvement practices
  - - 7.05% turnover
  - + \$27,044 sales/employee
  - + \$18,641 higher market value/employee
  - + \$3,814 more profits/employee
  - + \$41,000 shareholder wealth/employee
  - + **14% total market value**  
(Huselid 1995 & 1997, Wharton)



# “High Involvement” Practices

- HR is “taken seriously at top levels”
- Investment in cross-training, development
- High levels of (2-way) communication
- Innovative/Participative/“Empowerment”
- Lower status differences among levels
- More full-time, fewer temps, less turnover

Trend toward “High Engagement”

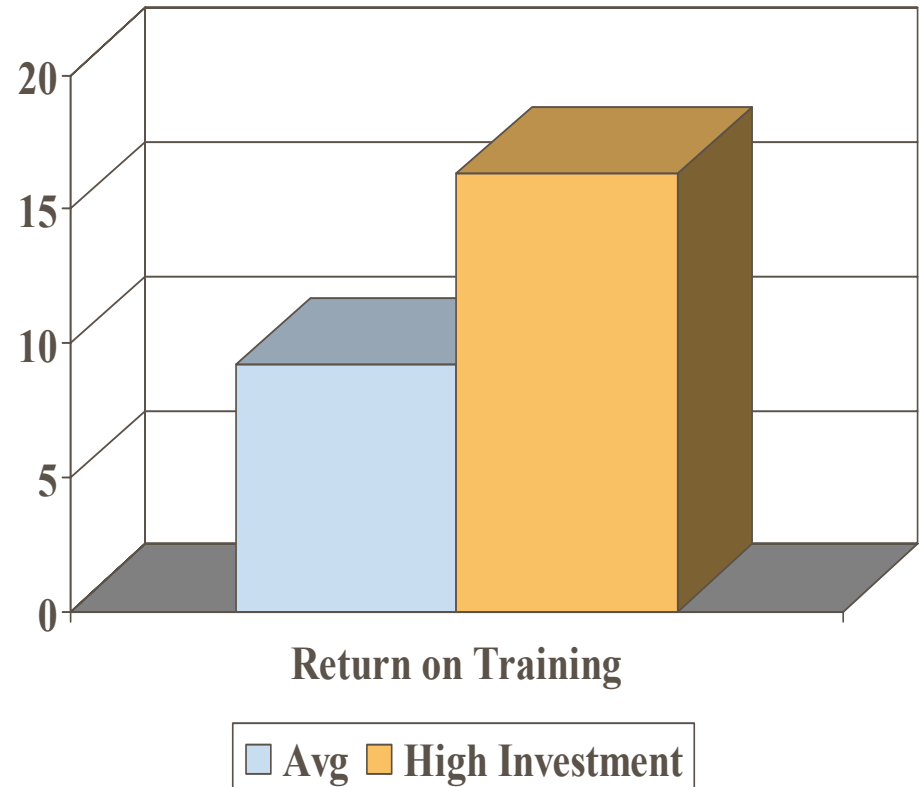


# HC & Production Uptime

- Production lines;
  - High HR - operated 98% of time;
  - Low HR - operated 87% of time.
  - Difference - at least \$4 million / year
- Study found relatively **little advantage in adopting good practices piecemeal.**) Casey Ichniowski, Columbia)

# HC, Training & Stock Price

- Companies that invested most in education and training had a return of 16.3% vs. 9.2% (Laurie Bassi, ASTD)





# HC & IPO Survival

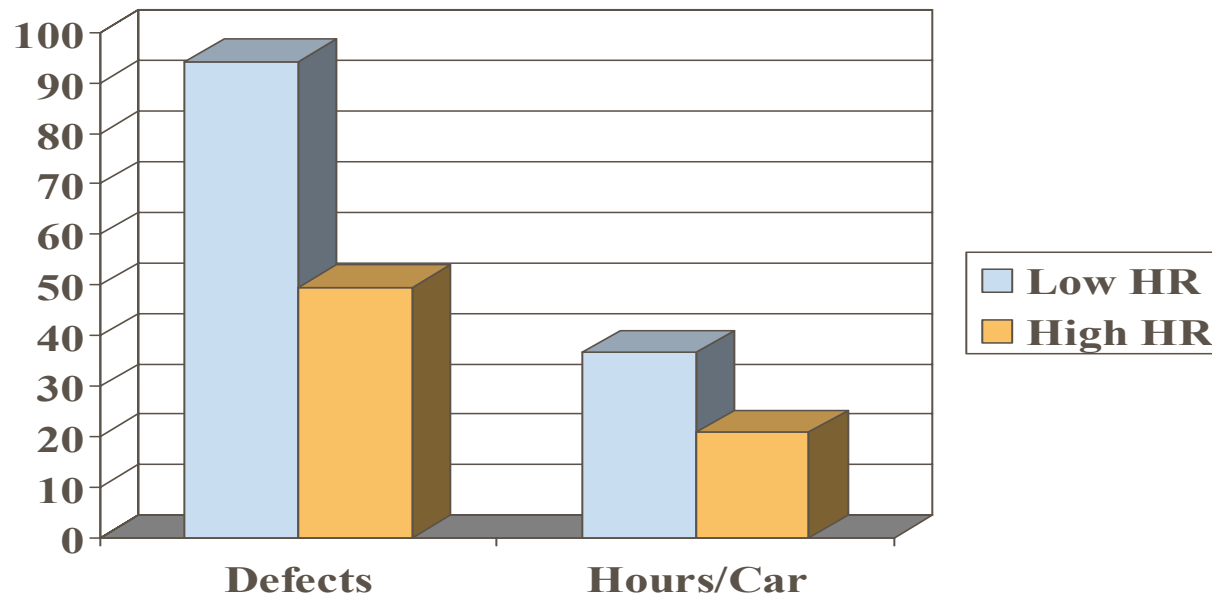
- Survival probability of IPOs over 5 years
  - High on valuing HR +20%
  - High on sharing rewards +42% (Theresa Welbourne, U. Michigan)



# HC & Manufacturing Productivity

- Automobile assembly after switch from GM to Toyota system in Fremont plant
  - 50% fewer labour hours (John Krafcik, MIT)

# HC in Automotive Mfg.



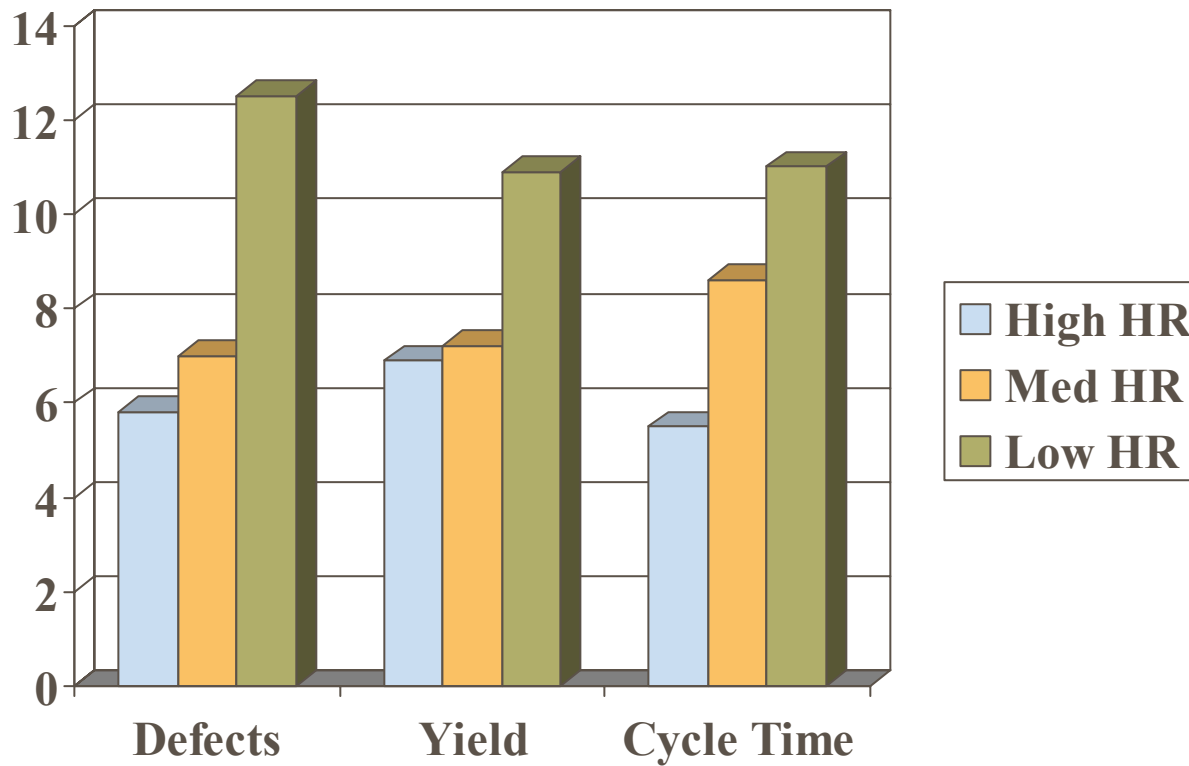
- High HR/Flex production include training, job rotation, contingent pay and limited status differences (John Paul MacDuffie, Wharton)



# HC in Steel Mini-mills

- Steel mini-mills, commitment-oriented HR practices required
  - 34% fewer labour hours
  - 63% better scrap rate. (Jeffrey B. Arthur, Virginia Tech)

# HC in Chip Fabrication



(Vinay Sohoni, Berkeley)



# HC in Oil Refineries

- What had no effect on operations
  - Refinery age
  - Refinery size
  - Processing complexity
  - Location
  - Maintenance expenditures
- What had an effect
  - HR Practices, +12% in profitability (Richard Ricketts, Solomon Assoc)



# HC and Retail Profitability

- “Employee-Customer-Profit Chain” (Sears Roebuck) -- positive correlations among:  
Employee Satisfaction - Customer Retention - Financial Results
- Causality not clear initially, but repeated use in US and Canada (by Sears & Zellers) shows results follow effective managers from store to store (Anthony J. Rucci, U. Illinois)



# Summing it Up

- “Substantial gains, on the order of 40 percent or so in most of the studies reviewed, can be obtained by implementing high performance management practices.”  
(Jeffrey Pfeffer, Stanford)



# What Can We Learn From Consultants?



# Saratoga Institute

- Long term collection of many HR measures for benchmarking
- No indication of which particularly add/detract value



# Watson Wyatt

- High index companies increased share price 64% over 5 years to 2001 vs. 21% for low performers.
- Correlation with good results *following* HR improvement =.41 versus HR improved following good results =.19... *shows causality*
- Of 43 HR practices, 37 help while 6 significantly hurt financial results over time
- A beginning point for identifying valid versus poor investments in HR programs



# Gallup

- 12 key questions in an employee attitude survey identify strong vs. weak areas in various studies
- Focus is “engagement” ...up to 80% are not
- “Actively disengaged” produce up to 28% less, “disengaged” 23% less than “engaged”
- Improvements in a unit’s engagement created 6 times revenue growth per employee vs. declines
- Improved productivity, sales, profits, reduced shrink, labour turnover



# David Maister

- 9 questions of 74 in an attitude survey distinguished high from low performing offices within a major global company
- Individual leaders created the difference
- Basic leadership elements could be trained and improved
- Different questions from Gallup, but equally potent and simple



# Summing Up

- Firms ought to report human capital practices and outcomes to the financial markets.



# What Firms Should Do



# What Investors Need to Know

- How does the firm compare to others on practices and measures that make a difference?
- Are human capital intangibles getting better or worse?



# What Firms Should Report (1)

- Big Three:
  - Engagement scores
  - Human capital practices index
  - Audit of how well HC practices are handled in practice.



# What Firms Should Report (2)

- Operational metrics such as:
  - Lost time due to injury
  - Absenteeism
  - Retention
  - Diversity
- Qualitative reports
  - HR philosophy
  - Description of practices especially on leadership
- Investment in Training



## What Firms Should Report (3)

- The report should explain the causal link from the measure or practice to firm success and any evidence on the magnitude of the impact.



# UK Task Force on HCM- Overview on Reporting

- Have a strategic focus
  - Communicate *Board's* current understanding of link from HCM to performance.
  - Follow a process susceptible to review by auditors
  - Allow comparison over time & use standards where possible
- Oct 2003



# UK Task Force on HCM- Suggested Measurables

- Size & composition of workforce
- Retention & motivation
- Skills, competencies & relevant training
- Remuneration & fair employment practices
- Leadership & succession planning



# How To Implement

- Preferably under the guidance of the Board's HR committee.
- However, there's nothing stopping HR from producing a report on its own.



# Sustaining Your Human Capital Report

- Build your own reporting of effective practices
- Monitor reporting trends
- Participate in research for truly effective measures



# What Are Firms Reporting on Now

- UPS: staff retention
- TD Bank: engagement
- First Tennessee: HR awards won and limited commentary on HR practices
- Hudson's Bay Company: disabling injury frequency
- Novo: Information on developing leaders, healthy work environment, employee involvement in community + stats on diversity, absence, turnover, training.



# What's Missing

- Human capital measures are often shown in social responsibility reports, rather than appealing to the financial markets.
- Usually the details are sketchy.
- No one talks about causality.



# What You Should Do Now

- Look for allies in your firm (e.g. CEO, CFO, Board HR committee.)
- Look for allies in other companies (e.g. people attending this talk.)
- Create a team responsible for producing a small report on human capital intangibles based on data you can get easily.
- Discuss the report with top management and improve every year.



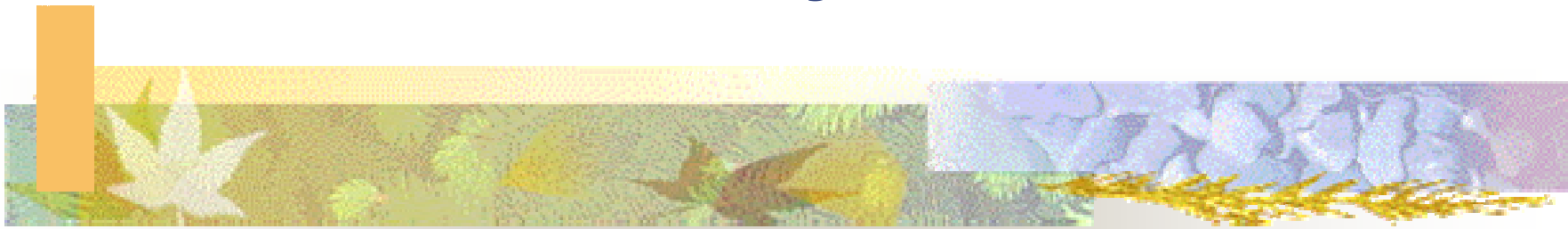
# What Does This Mean For the Future of HR?



# The Future of HR

- The financial markets will take an interest in HR practices and metrics.
- The board will take an interest.
- The CEO will take an interest.
- HR will be under enormous pressure to deliver good results.
- Good HR practices will spread.

# Thank you



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