The value of Intangibles to overcome the systemic crisis

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5.13 Overcoming the Crisis: Rewarding Human Capital Development for Sustainable Business Performance
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The analysis of the European Central Bank (ECB) about the lessons that can be drawn from the crisis that over the last 30 months continues to occupy bankers and other decision makers on both sides of the Atlantic is rightly shared at large, although opinions sometime differ on the scope of the cure.

The fragility of the international financial system, that has impacted almost all market segments or category of players, the limit of short term macro-economic policies, and the inadequate appraisal of systemic risks accompanying the wider transmission of financial instability throughout our economies, require reinforced -and often concerted- actions for improving the future functioning of financial systems and restore trust within the markets and among policy makers and public opinion at large. As often reminded by the leaders of the European Union institutions, these actions should focus on global governance, and on financial and structural reforms. In each of these areas, from enhanced transparency and supervision of financial products to greater alignment of incentives to long-term value creation for market participants, to national labour markets reforms, to mention just a few of the remedies under review, human capital leadership, management and development remain essential pre-conditions to “exit” the crisis and “enter” into a new path of growth. This is well summarised in a recent statement of Jean-Claude Trichet, the president of the ECB, when he underline that the “main asset for growth and development in our societies is human capital”*. Along these lines is the objective set by José Manuel Barroso, president of the European Commission, in the “Europe 2020” strategy, proposing an EU policy agenda that aims to a “smart, sustainable and inclusive economy delivering high levels of employment, productivity and social cohesion”**.

The take-up by the EU member States of the new agenda and the political will of the Commission to carry out an active follow-up of its implementation remain to be seen. Hopefully their individual and joint commitments will be more effective than what happened in the past decade for the “sister” plan known as the Lisbon Agenda. But, as the European Commission itself acknowledges in its strategy paper, economic realities are moving faster that political realities. Many corporations, often affected by the gap between the speed of the market and the delay and inadequacy of policy response, have been already adapting or transforming their business and management models to face the adverse market conditions while coping with longer-term challenges. These spans from globalisation to the pressure on the availability and use of resources, from ageing of the work force to the shortage of talents. Hewitt Associates, that provides leading organizations around the world with expert human resources consulting and outsourcing solutions to help them anticipate and solve their most complex benefits, talent, and related financial challenges. With a history of exceptional client service since 1940, Hewitt works with companies to design, implement, communicate, and administer a wide range of human resources, retirement, investment management, health care, compensation, and talent management strategies. With a history of exceptional client service since 1940, Hewitt has offices in more than 30 countries and employs approximately 23,000 associates who are helping make the world a better place to work. Hewitt Associates is a company listed on the New York Stock Exchange (NYSE:HEW). For more information on Hewitt studies and services, e-mail: humancapitalconsulting@hewitt.com or consult our website at: www.hewitt.com

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* Speech of Jean-Claude Trichet, at the annual conference organised by the Asociación de Mercados Financieros, Madrid, 23 November 2009.
* Hewitt Associates (NYSE:HEW), has offices in more than 30 countries and employs approximately 23,000 associates. For more information visit: www.hewitt.com
out for the European Club for human resources (ECHR) by Hewitt Associates, corporate growth plans are focusing more on selected human capital development measures - including the prospect of newly created qualified jobs- and on the opportunity to measure and leverage HR's value to the business more effectively. On the downside however, concerns remain regarding productivity gaps, workforce adequacy, and rigorouness in people management policy implementation. This study involving seventy European HR leaders from sixteen nationalities shows that 2010 is emerging as a true year of transition during which companies are looking to improve their competitiveness and prepare for a post-crisis environment. This is leading to a greater balance between more "defensive" measures --such as those aiming to reduce production, workforce costs and capacity-- and "growth" initiatives aiming to upgrade productivity, talent and leadership capabilities, or to explore new opportunities for mergers and acquisitions.

The top three priorities on the HR agenda for the period 2010 to 2012 remain stable with an even greater emphasis on core human capital issues, namely: leadership development (mentioned by 46%), employee engagement (39%) and talent retention (32%). As a fourth priority, the focus will be on improving the assessment of what HR does and how it adds value to the business. This is also the area where HR leaders seem to be most keen to have further support and fill their current gap in terms of delivery capacity.

When judging its own performance against business expectations, HR recognises that there is large scope for improvement in HR strategy and execution, and in all other 26 different people-related activities under analysis. In sixteen of these activities --they were eleven in last year's survey-- the majority of respondents admit to performing below business expectations. The most frequently mentioned areas of excellence continue to be those related to statutory compliance issues, such as health and safety at work, employee data-privacy, industrial relations and non-discrimination. But also in these best performing fields, in particular in relation to non-discriminatory practices, the proportion of companies acknowledging the gap has increased from 15% last year to 36% this year.

The weakest fields where HR assesses itself as delivering below target are in relation to: HR metrics (77%), work/life balance programmes (75%), management of intergenerational diversity (62%), consistency of HR policies across countries (62%), and employee communication (59%). All areas that require well defined valuation tools, a forward looking mindset combined with new capabilities for a thorough appraisal of the business context and of its implication from an HR perspective.

The traditional range of people and internal "customer" tools are generally preferred by HR to measure the impact of their activities on business results. Employee engagement surveys emerge this year as the most commonly used tool. However, the proportion of companies that due to lack of resources do not use HR metrics at all has increased from 8% last year to 18% this year. Meanwhile, there are 35% of respondents that are still looking for relevant quantitative tools. The solution to this problem may well reside in a more open and co-operative approach that involves in house and external HR advisors and third qualified parties from research institutes, management schools, and business analysts.

One of the most compelling case of possible enhancement or deterioration of business value linked to human capital assets is evident in the context of corporate transactions. The recent Hewitt's quarterly M&A pulse survey of 278 organizations around the world shows that 72% expect to increase their deal activity over the next two years. Although corporate transaction activity is expected to increase in 2010, yet many acquiring companies around the world say they fall short in meeting their deal objectives. Almost half (47%) said their past transactions did not achieve their intended financial and strategic objectives. Further, while almost two-thirds (65%) of companies indicate that leadership and key talent retention are critical to the success of a deal, nearly half (49%) of these organizations report they have lost critical employees at the same rate or at an even higher rate than non-critical employees.

Hewitt analysis shows that the loss of critical employees can have a devastating impact on corporate transactions. Based on a sample of 96 companies representing more than $568 billion (USD) in total deal value over a two-year period, Hewitt's analysis found that
more than $54 billion (USD) – or 10% – of a deal’s value depends on the rate at which critical employees separate during or immediately after corporate transactions. To explore this point further, Hewitt compared the survey responses of companies that exceeded deal objectives (Overachievers) versus those organizations that did not achieve their deal objectives (Underachievers). In its analysis, Hewitt found a clear link between deal success and investment in leadership and key talent issues. “Overachievers” and “Underachievers” both say leadership and talent strategies are important to the success of a deal (69% versus 62%, respectively). However, less than a third of “Underachievers” report their leadership and key talent strategy in transactions as being effective, compared with 70% of “Overachievers”. The latter are also twice as likely to effectively identify and retain leaders (81% versus 42%) and assess critical talent (73% 35%). In conclusion, Hewitt research and daily practices consistently demonstrate a direct link between leadership, talent management and business performance. A greater focus on operational performance and on relevant and reliable metrics to assess it are always more essential. However, a rigorous and timely execution of HR policies is not enough to guarantee long term sustainable performance. The competitive advantage of an organisation will also depend on its ability to articulate innovative people management policies in anticipation of emerging business paradigms that affect the world of work and change the way business operate.

5.14 Executive compensation and intangible assets

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In the design of an executive compensation policy the choice of the performance measures plays a critical role. As it has been noted “Measures give relevance to rewards; rewards give meaning to measures”. In fact “While organizations develop a variety of measures, they tend to fall into the areas of finance, internal business, innovation and learning, and customer satisfaction”. More specifically, on the basis of the Kaplan and Norton Model of the “Balanced Scorecard” the performance measure could be structured taking into account the following criteria (see Table 1).

1. Resource focused - These are measures that imply the use of the benefits received from the resources of the organization.
2. Process focused - These are measures that relate more directly to how things are done in the organization.
3. External – driven - These are measures that reflect the market place in which the organization operates.
4. Internal – driven - These are the measures that are more likely in the control of the organization.

On the basis of these criteria 4 categories of performance measures have been identified:

1. Financial Metrics, subdivided into Value Creation and Stakeholder Return.
3. Operational Metrics, subdivided into Operational Efficiency and Resource Utilization.
4. Capabilities Metrics, subdivided into Human Resource Capabilities and Internal Effectiveness.

Unfortunately in many companies several of the specific measures included in these 4 categories have been totally ignored and, in any case, the top management has been traditionally rewarded only on the basis of the Financial Metrics. As a recent survey shows over 90% of the performance measures of stock option and long term incentive plans are based on Financial Metrics (mainly Total Shareholder Return and Earnings per Share). Even in the annual bonus plans about 2/3 of the performance measures are based on Financial Metrics (mainly Annual Profit). (see Tables 2 and 3).

What is the reason of the focus on only one of the 4 quadrants of the Kaplan and Norton Model? In our opinion the focus on Financial Metrics is connected with