

Human Capital Index®: Human Capital As a Lead Indicator of Shareholder Value

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(<http://www.watsonwyatt.com/research/resrender.asp?id=W-488&page=1>)

Introduction

Can the way a company manages its human capital significantly affect its financial performance?

Two years ago our Human Capital Index (HCI) study confirmed that the two are clearly linked. We developed a simple set of measures quantifying exactly which HR practices and policies have the greatest correlation to shareholder value. Using those to assign a single HCI “score” to each surveyed company allowed us to deliver conclusive, groundbreaking results: Where there are superior HR practices, there is higher shareholder value.

Yet a crucial question remained: Do better people management strategies actually create higher market value? Or do financially successful companies simply have more resources to allocate to human capital initiatives?

We now have powerful insight into the answer. Our second Human Capital Index study allowed us to compare one set of companies at two points in time to analyze the correlation. The results are in and they are dramatic. Superior human capital practices are not only correlated with financial returns they are, in fact, a leading indicator of increased shareholder value. Further, we found that superior HR management leads financial performance to a much greater extent than financial outcomes lead good HR. We were also able to identify certain HR practices as value drivers and throw a cautionary flag in front of some conventional practices actually associated with a decrease in financial performance.

The results of this study are more meaningful now than ever before. While the state of the economy is largely uncertain, demographic trends are not. There is no doubt that the labor shortage will continue well into the next decade and that superior HR practices are a key to attraction, retention and more and more, business outcomes. It is also a certainty that executives will now, more than ever, look to HR to justify expenditures and demonstrate the economic value of an organization’s people practices.

The overriding message: If a company’s goal is to improve shareholder value, a key priority must be its approach to human capital.

About the Survey

In the first HCI study, conducted in 1999, Watson Wyatt surveyed more than 400 U.S. and Canada-based companies that were publicly traded, had at least three years of

shareholder returns, and a minimum of \$100 million in revenue or market value. We asked a wide range of questions about how the organizations carried out their human resources practices, including pay, people development, communications and staffing.

Responses were matched to objective financial measures, including market value, three- and five-year total returns to shareholders (TRS), and Tobin's Q, an economist's ratio that measures an organization's ability to create value beyond its physical assets. Publicly available data from Standard and Poor's Compustat database were used to access the financial information needed.

To investigate the relationship between human capital practices and value creation, a series of multiple regression analyses were conducted, identifying a clear relationship between the effectiveness of a company's human capital practices and shareholder value creation. Thirty key HR practices were associated with a 30 percent increase in market value. Summary HCI scores were created for individual organizations so that results could be expressed on a scale of 0 to 100. An HCI score of 0 represents the poorest human capital management, while a score of 100 is ideal.

In 2000, a European HCI survey was conducted to gain a more global perspective on these issues. More than 250 responses from 16 countries were received. The survey included 200 questions in six languages and covered companies of all sizes and from all sectors of the economy — more than a third of participants were in the Euro 500 and more than a quarter were in the Global 500. The findings from the European study were similar to the North American results, with improvements in 19 key HR practices associated with a 26 percent increase in market value.

In early 2001, the HCI research was conducted again, this time including responses from more than 500 North American companies. In this most recent research, the participants reflected a broader view of business and included some larger, more prominent firms — with average annual sales of \$4.68 billion, \$8.45 billion in market value and 18,697 employees on average. Fifty-one of these companies participated in both the 1999 and 2001 surveys.

The European and new North American data were then merged. The result is a complete respondent base of more than 750 companies in the United States, Canada and Europe with at least three years of shareholder returns, 1,000 or more employees and a minimum of \$100 million in revenues or market value.

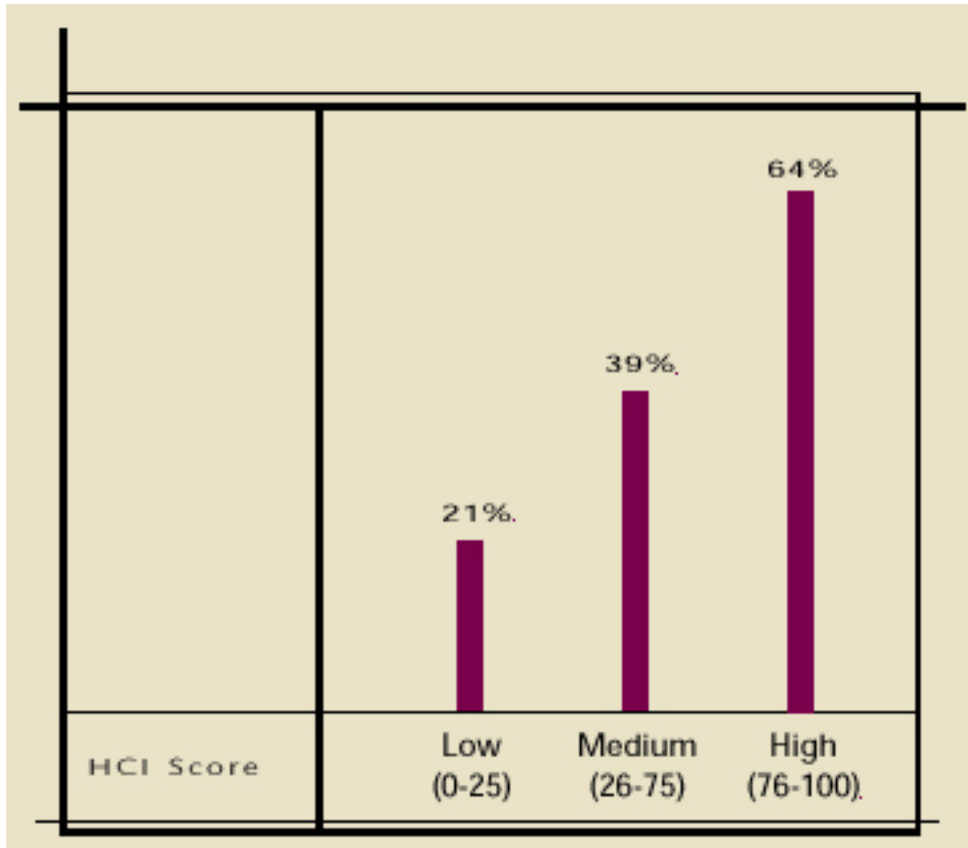
Survey Highlights

Results Link Superior Human Capital Practices to Higher Shareholder Return

The results from the 2001 HCI study are just as definitive as those from 1999: The higher a company's HCI score, the higher its shareholder value. In other words, the better an organization is doing in managing its human capital, the better its returns for shareholders. We broke the companies into three groups based on their summary HCI

scores. Those in the low group averaged a 21 percent five-year return. The medium group averaged 39 percent. Those with high HCI scores returned 64 percent over five years (Figure 1).

Figure 1: Five-Year Total Returns to Shareholders
(April 1996 - April 2001)



In addition to providing dramatic evidence that good human capital management matters, the HCI study shows precisely which HR practices — amid the ever-increasing portfolio of options — have an impact on the bottom line. This year's study identifies the 49 specific HR practices that play the greatest role in creating shareholder value. We have divided those practices into six dimensions (Figure 2). The research quantifies exactly how much an improvement in each practice could be expected to increase a company's market value. For example, a company that makes a significant improvement * in all of the practices categorized under "Total Rewards and Accountability" should see its value improve by 16.5 percent (Figure 2). And a significant improvement in 43 key HR practices is associated with an increase of 47 percent in market value. Additionally, one dimension, "Prudent Use of Resources" identifies six practices that diminish shareholder value.

Figure 2: Key Links Between Human Capital and Shareholder Value Creation

Practice	Impact on Market Value
Total rewards and accountability	16.5%
Collegial, flexible workplace	9.0%
Recruiting and retention excellence	7.9%
Communications integrity	7.1%
Focused HR service technologies	6.5%
Prudent use of resources	-33.9%

Expected change in market value associated with a significant one standard deviation (1 SD) improvement in HCI dimension.

* What constitutes a “significant improvement”? A one standard deviation increases. Most answers to HCI questions are on a 1 – 5 scale, so a significant change is a one-scale-point movement from a 1 to a 2, a 2 to a 3, and so on.

Data Over Time Show Human Capital Practices Lead Value Creation

The first HCI study confirmed that there was a positive relationship between the quality of a company’s HR practices and its economic results. But it did not offer resolution to the debate that has raged for years: Do effective HR practices drive positive financial results or do positive financial results lead to better HR practices?

Two years ago, we noted that the best performing companies did not simply have better-funded programs, they had entirely different programs than the poorly performing companies. The high performers employed certain programs (e.g., broad-based stock options) that low performers did not. They stayed away from certain programs (e.g., training employees for future jobs) that low performers embraced. If it were true that good financial performance simply afforded rich companies the ability to implement elaborate HR programs, one would expect to see the same types of programs across the board. We did not. Yet it was still not proof that superior HR management was causing high market value. The best we could offer at the time was that the relationship probably moved both ways.

But our latest study yields the missing crucial data. Fifty-one companies participated in both the original and the follow-up HCI studies. We have HCI scores and financial performance information for 1999 and 2001.

To see which way the relationship truly runs, we simply compared two different correlations:

- Correlation A represents the relationship between the 1999 HCI score and 2001 financial performance.
- Correlation B represents the relationship between 1999 financial performance and 2001 HCI scores.

If better financial performance is what creates superior HR practices, Correlation B should be larger. If, in fact, the way companies manage their human capital is what drives financial success, Correlation A should be larger.

Our results were dramatic. Correlation A, .41, is statistically significantly larger than Correlation B, .19. The cross-lag panel analysis demonstrates HR practices are not only associated with business outcomes, but also create them. Moreover, a careful inspection of all the data shows that for every available correlation calculated over time, the relationship between past HR practices and future financial performance is stronger than the relationship between past financial outcomes and future HR practices. We will be following this data prospectively in longitudinal studies, but for now the weight of the evidence clearly favors human capital practices as a leading — rather than a lagging — indicator of business success.

Figure 3: Correlation Analysis

Correlation A	1999 HCI Score x 2001 Financial Performance	.41
Correlation B	1999 Financial Performance x 2001 HCI Score	.19

Conclusion

There's no question that it pays to manage people right.

Organizations have long focused resources on other aspects of their companies, including infrastructure, R&D, sales and advertising, just to name a few. These things can increase shareholder value creation in measurable ways. Some — but certainly not all — tried to

use their human capital to increase returns to shareholders. But even these companies were taking a shot in the dark, because no one could quantify which human capital programs were linked to good outcomes.

The business case has been building and Watson Wyatt's Human Capital Index research makes it airtight. The linkage between superior human capital management and superior shareholder returns has been proven. Moreover, proof that superior HR practices drive financial results more than superior financial results drive HR practices supports our theory: If you hire the right people, create an environment that supports creative thinking and increased productivity, leveraged by technology, you'll reap the rewards.