Opportunities for Action in Consumer Markets

New Rules for People Businesses

THE BOSTON CONSULTING GROUP

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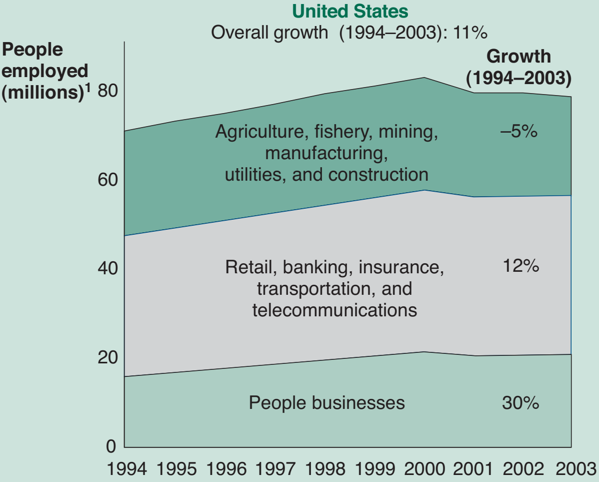
"People businesses" have become big business. They account for about 25 percent of private-sector employment and well over half of employment growth in advanced economies. (See Exhibit 1.) People businesses—companies with high employee costs as a percentage of sales and low investment in capital or R&D—have different business economics, respond to different strategies, and need to be managed by different rules than traditional businesses. When employees make the difference, metrics, operations, compensation, and strategies need to be focused less on returns from capital investment and more on returns from people.

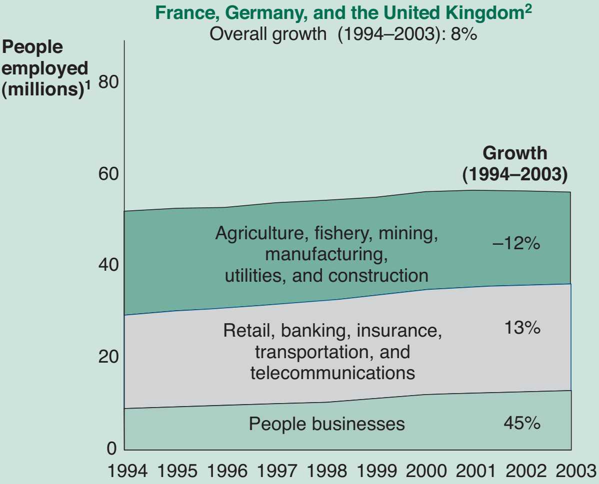
Performance Measures for Employees

Traditional capital-oriented measures tell us very little about employees' performance. In fact, they can be misleading. An IT services company, for example, could appear healthy in terms of return on capital, even though the firm may have lost half of its top engineers. Since employees are critically important to the success of a people business—and they are a large and stable denominator for performance measures—it makes sense to work with employee-oriented rather than capital-oriented measures.

Fortunately, measuring the performance of people businesses is relatively straightforward because employees represent most of the cost and create most of the value. Most companies already have some measures of employee productivity, such as sales per employee and profit per employee, but they aren't comparable across different businesses or consistent for one business over time. For example, sales per

Exhibit 1. People Businesses Have Recently Grown Faster Than Other Service Businesses





SOURCES: National labor surveys; Nomenclature Générale des Activités Economiques dans l'Union Européenne (NACE); North American Industry Classification System (NAICS); French, German, and U.K. national statistics offices; BCG analysis.

[1]Excludes public-sector and not-for-profit companies.

[2]The United Kingdom excludes Northern Ireland.

employee—still the most common measure of employee productivity—is strongly affected by the level of outsourcing and capital investment in the business.

Our approach, which we call *workonomics,* eliminates these distortions and represents the true value of employee productivity.[1] Common measures of shareholder value creation in a traditional capital-oriented performance-management system, such as economic value added (EVA) or cash value added (CVA), are variations on the same theme. They all measure shareholder value creation in terms of economic profit: the dollar amount by which a company's actual return on invested capital exceeds the return that investors require.

Economic profit is likewise the key measure in the workonomics system, but we define it from an employee-oriented instead of a capital-oriented perspective. Workonomics defines an employee's productivity as the amount a company could, in principle, afford to pay for an average employee and still achieve the required return on investment for shareholders. From a capital-oriented perspective, value creation is the amount of capital invested multiplied by the difference between the actual return and the required return on capital. From an employee-oriented perspective, value creation is the number of employees multiplied by the difference between employee productivity and cost per employee. From either perspective, the measure of shareholder value—economic profit—is the same, but the performance drivers con-

1. The Boston Consulting Group has been using workonomics successfully with clients since 1998. The approach was pioneered by consultants in the firm's Swiss and German offices. For their practical application of work linking human and customer capital to shareholder value, Rainer Strack, a vice president and director in BCG's Düsseldorf office, and Ulrich Villis, a manager in the firm's Munich office, won Germany's Erich-Gutenberg Award.

sidered are quite different. Management's task is to make employees more productive than they would be on their own so that the company can earn more for its work than it needs to pay its employees. Workonomics turns the spotlight on the employee's contribution to value creation and suggests employee-oriented levers to improve it. (See Exhibit 2.)

Obviously, engaged employees are critical for people businesses. Therefore, it makes sense to ask employees not only how well they believe the company is meeting their own needs but also whether it has established the performance disciplines that can help them meet the company's objectives. Those disciplines are

- clear, commonly shared goals
- structure and accountability
- a process to manage performance and incentives
- platforms for collaboration
- a competent work force capable of achieving the company's objectives

It takes courage on the part of management to ask employees if it is doing a good job at organizing and running the company. But when a company clearly understands the performance disciplines it needs, it can assess whether those requirements are being met in a way that also meets employees' personal needs and motivates them to excel.

People and Operations Management Systems

Because people businesses require fewer assets than traditional businesses, their returns are extremely sensitive to small changes in operational performance. Consider the fact that, on average, an improvement of 5 percent in employee productivity—or a similar reduction in employee costs—increases profits for people businesses by 15 percent of assets (because employee costs are typically three times the value of assets) and increases economic profit by 50 percent (because economic profit is typically 10 percent of employee costs).

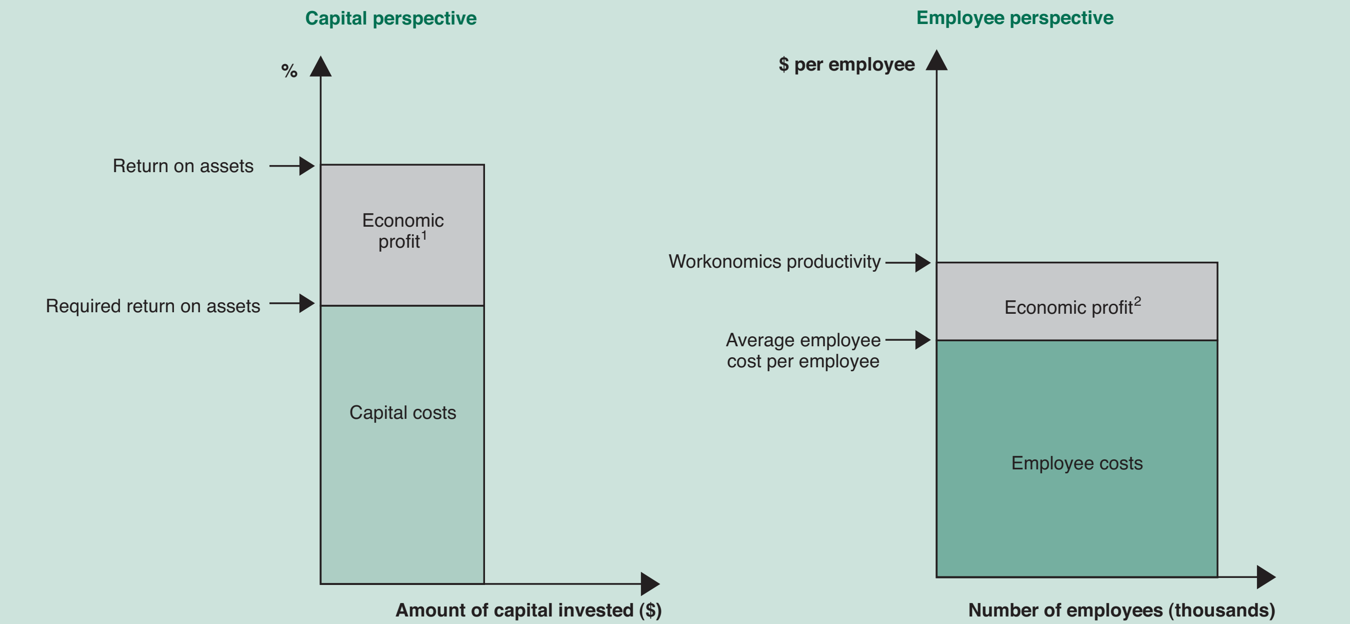
Leading people businesses understand these ratios and focus on developing a strong and fine-tuned people-and-operations management system. Such a system encompasses three levels: information (employee metrics, customer metrics, and benchmarks); understanding (employee competencies and engagement, outstanding performance, and customer satisfaction); and action (HR processes, organizational context, and business focus). All three levels are institutionalized and linked to create a fast and effective feedback loop.

Information is critical to establishing hard links between financial accounts and employee metrics such as productivity, utilization, and attrition; number of employees; and cost per employee. This approach is much more useful than a conventional balanced-scorecard approach, which offers only a soft link between financial accounts and employees' performance. Hard links are particularly helpful in consumer or small-business services that use direct marketing, because they permit a company to track the lifetime value of a customer, customer attrition, and the costs of gaining a new customer. If employee activities are customer facing, measuring the value of employees by the value they create for individual customers will establish an important link between employee and customer perspectives.

Understanding concentrates less on tracking accounting numbers and more on analyzing how well a people business is motivating, training, and focusing employees. A precise measure of employee competencies may be an elusive ideal, but companies *can* accurately measure whether they are succeeding in recruiting and retaining the employees they want and whether they are outplacing or improving the skills of poor performers. Tracking employees who score significantly higher than others can also uncover the drivers of productive behavior. Top-performing teams and employees tend to do the right things the right way.

Action must result from information and understanding. The corporate center needs to decide how to leverage insights and understanding across the network. HR processes represent one powerful set of performance improvement levers in people businesses. But others may be equally or more important. Depending on what is appropriate for the business, the corporate center can, for example, introduce standardized best-practice processes and constantly improve them with new information, or it can estab-

Exhibit 2. For People Businesses, an Employee-Oriented Perspective on Shareholder Value Makes More Sense Than a Capital-Oriented Perspective



SOURCE: BCG analysis.

[1]Usually calculated on a posttax basis to be comparable with (posttax) capital costs.

[2]Usually calculated on a pretax basis to be comparable with (pretax) employee costs.

lish knowledge networks so that business unit heads, branch or office managers, and other employees can learn from one another without the need for standardized processes.

The Compensation Challenge

Compensation raises big issues in all businesses, but the impact of those issues is greatest in people businesses. Compensation is also the largest factor affecting shareholder risks and returns. Therefore, people businesses need to decide how explicit and direct they want the link between variable compensation and profits to be. Of course, differences in compensation can easily lead to friction among employees—particularly when roles within the company are diverse, when the company has grown by acquiring other organizations with different pay schemes, and when the variable component of compensation is high. But even large differences in compensation need not pose a problem if they can be justified by clear logic based on business economics and the company's strategy. The following are some questions to ask:

- Are there substantial variations in productivity (independent of asset investment, market, or competitive environment) among employees or teams doing similar jobs?

- Are these productivity differences measurable in the short and long terms?

- Are these productivity differences measurable at the individual and team levels?

- What would such measures of productivity differences be? How could we put them in place?

- Have we clearly separated rewards for past achievement from rewards for current performance?

The Ladder of Strategic Advantage

Most people businesses with superior returns have found a way to create substantial value over and above the value of their employees (and the added costs required to create that value). At its most basic, a people business is a subcontractor looking for opportunities to "shop bodies" at an hourly rate to companies that want to manage capacity flexibly. The subcontractor takes a first step toward adding more value when it focuses on a particular activity to accumulate experience and know-how. Greater experience makes it possible to do the work better or cheaper than a less experienced outsourcing company or individual service provider. Greater depth of process experience usually leads to higher returns because, with the right management, experience improves the speed, quality, and cost with which the service can be performed.

Nevertheless, economies of scale and experience tend to be less dramatic in people businesses than in industrial businesses, where processes are embedded and learning is institutionalized in machinery or software. So sometimes the best way to go beyond good operational performance and build true strategic advantage may actually be to limit engagement in the more people-intensive aspects of the value chain.

Cendant Corporation is an interesting company to look at in this light. It is the world's leading franchiser of hotel brands that include Ramada, Howard Johnson, and Travelodge. Cendant doesn't own or manage any hotels, but it supports each of its brands with advertising, marketing, and loyalty programs. It also provides links with travel Web sites and ensures that all franchisees meet standards for quality. In addition, Cendant is the world's largest franchiser of residential real estate, franchising such powerful and well-known brands as Century 21 and Coldwell Banker. The pattern of deconstructing the service value chain into separate businesses representing distinct competencies—property ownership, scale-intensive activities (such as branding, purchasing, and business process design), and people—is prevalent in many consumer services. Although most brand owners retain some participation in the people-intensive aspects of the business—and may even manage some hotels—many other hotel and service brands operate like Cendant.

Rules of the Game for People Businesses

People businesses offer enormous opportunities and unprecedented value if they are managed according to the right rules.

- First, introduce new employee-oriented metrics linked to financial accounts in order to assess and manage your most important asset: employees.

- Second, develop a sharp, fine-tuned people-and-operations management system that encompasses information, understanding, and action.

- Third, use compensation, particularly performance-related compensation, as a versatile lever for managing people and profits.

- Fourth, continuously renew strategic advantage by building differentiated skills and by adding defensible brands and intellectual property to people-intensive operations.

As the world economy shifts from manufacturing to service- and knowledge-based industries, capital itself is becoming relatively less important. By just about any measure, people are increasingly central to business performance. For people businesses in particular, the challenge is not asset productivity but employee productivity.

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For further reading, see "The Surprising Economics of a 'People Business,'" by Felix Barber and Rainer Strack—the lead article in the June 2005 issue of *Harvard Business Review*. Also see the BCG report *Rules of the Game for People Businesses: Succeeding in the Economy's Highest-Growth Segment* (April 2005) for a more extensive discussion of people businesses.

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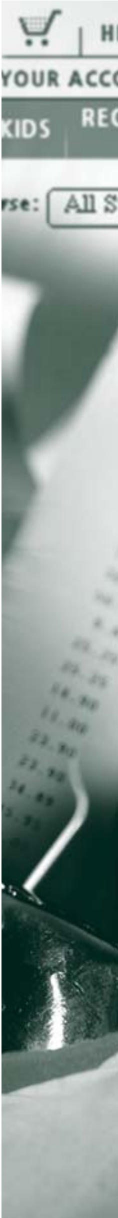

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