Why should investors care about Human Capital?

Topic of the month October 2014

Introduction

Over the past few years a lot of attention has been drawn to environmental topics. This is not that surprising taking into account the challenges the world is facing, such as climate change, biodiversity loss, electronic waste etc. However, we should not forget about the social issues and especially not underestimate them. In this thematic piece we will focus on one particular social aspect and that is Human Capital.

The financial crisis has taught us there are no certainties. For the first time in over a century there is a real risk that the next generation of adults ends up worse off than today's generation. "Worldwide, young people are three times more likely than their parents to be out of work. In Greece, Spain, and South Africa, more than half of young people are unemployed" *[Source: McKinsey & Company, Education to Employment: Designing a System that Works]*. Young people who are neither in employment nor in education and training (the "NEET" population) are at risk of becoming socially excluded.

Differences across countries are large: in Luxembourg and the Netherlands less than 9% of young people in the age group 20-24 belonged to the NEET population. The ratio is substantially higher in Ireland, Israel, Italy, Mexico and Spain, where this figure exceeded 25%, and in Turkey, where it reached almost 40%, see figure below. The economic costs related to this are huge. The European Foundation for Improvement of Living and Working Conditions issued a report in 2012 that estimates the cost of supporting the NEET population in Europe to be EUR 153 billion.

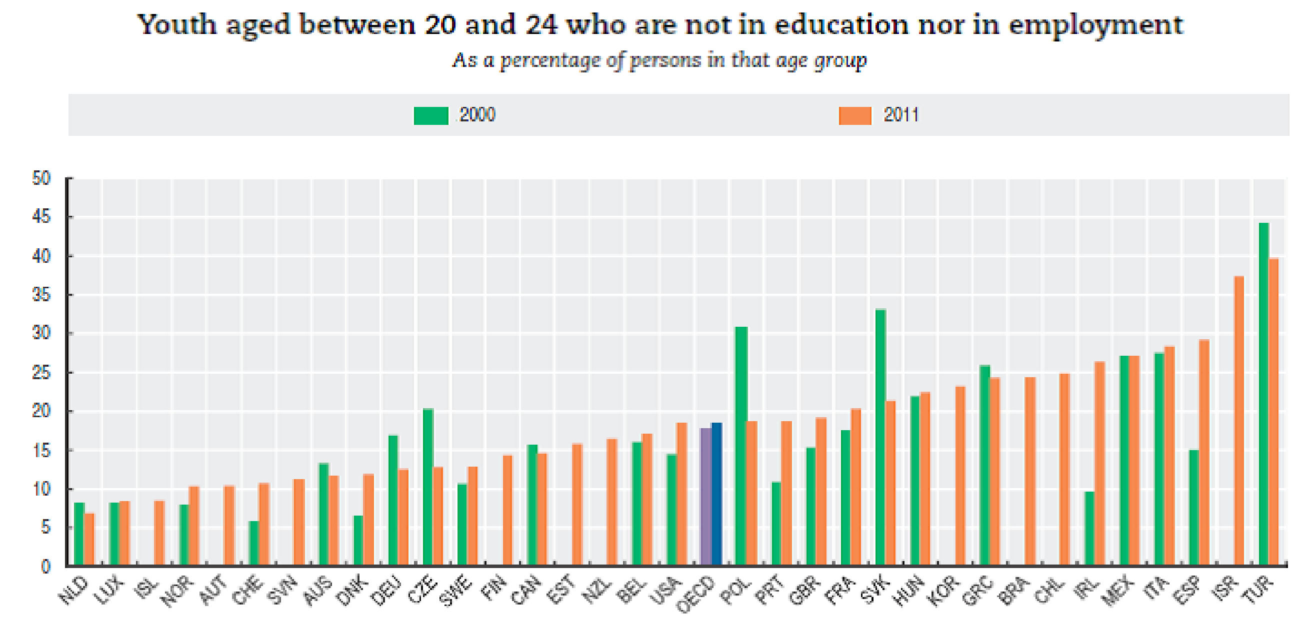

Figure 1, Economic, Environmental and Social Statistics (Source: OECD Factbook 2014)

At the same time, there is a critical shortage of skills. PwC CEO survey 2014[1] clearly shows that the availability of skills is one of the main worries that keeps CEOs awake at night. 63% of the surveyed CEOs named it as a serious concern this year, an increase of 5% from last year's survey. There are some regional differences: in Western Europe it seems to be a less pressing issue (50% overall named it a concern) while in Africa it seems to be very critical (91% of CEOs are concerned). Also on sector level, there are some variances with CEOs of engineering and technology companies being most worried. Both problems need to be tackled as they might lead to social unrest and individual despair.
In this article we will explain the importance of Human Capital, the latest developments in this area and how we as responsible investor take this aspect into account in our investment process.

Human Capital matters: the importance of intangibles

Within the last quarter of the century, the market value of the S&P 500 companies has deviated greatly from their book value (currently the deviation is around 80%). This "value gap" indicates that physical and financial accountable assets reflected on a company's balance sheet comprises less than 20% of the true value of the average firm, according to research from Ocean Tomo. The remaining 80% of the value lays in the intangible assets.

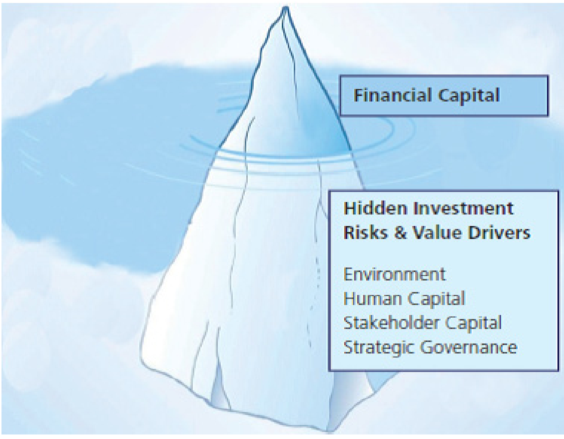

Figure 2, Kiernan's Iceberg (Source: ING IM)

Traditional accounting based financial analysis focuses only on the "top of the iceberg" and is on its own inadequate to cope with the changed competitive and investment environment companies operate in.

ING IM's approach combines financial analysis with a rigorous analysis of the hidden investment risks and value drivers that determine which companies will be long-term winners. These value drivers are strongly related to better control of future costs, advanced branding and revenue opportunities and a lower likelihood of significant reputation damage.

Academic studies have argued that the main reason why intangibles are not incorporated is because market lacks information on their value. This has, generally speaking, indeed been the case in the past. However, more and more data regarding intangibles is available, but the market takes a very long time to incorporate intangibles into the stock price. *Edmans [2011]* showed that full incorporation takes 4-5 years.

Human Capital refers to intangible collective resources possessed by individuals and groups within a given population. These resources include all the knowledge, talents, skills, abilities, experience, intelligence, training, judgment, and wisdom possessed individually and collectively, the cumulative total of which represents a form of wealth available to nations and organizations to accomplish their goals. Human capital is available to generate material wealth for an economy or a company. It is probably an organisation's most valuable intangible asset. The way in which it is developed and managed may be one of the most important determinants of economic and organizational performance.

Happy employees are more engaged and loyal. Low turnover means that good employees stay and are more productive. This has, generally speaking, a positive impact on company's performance long term as it leads to higher

expected future cash flows and lower risk. Most companies are well aware of this, but motivating employees is not an easy task. Financial reward is not the only motivator as can be seen in the chart on the next page. Intrinsic factors such as recognition, development opportunities and positive atmosphere matter just as much or even more. A flexible work environment is a factor which is becoming more and more important. Additionally, employees (especially young generations) are increasingly looking for "meaningful work". They want to work for companies which can demonstrate they benefit the broader society.

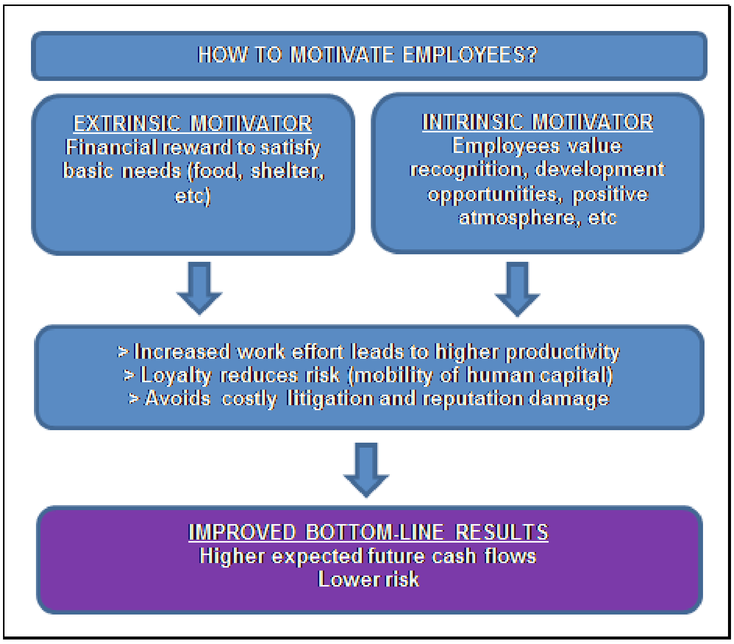

Figure 3, How to motivate employees? Source: ECCE, ING IM)

CFO asks CEO: "What happens if we invest in developing our people and then they leave us?"
CEO: "What happens if we don't and they stay?"

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"Train people well enough so they can leave, treat them well enough so they don't want to."

Richard Branson

Though many companies know that investing in their workforce is very important for their company's long-term profit generation, they sometimes decide to under-invest in their workforce to save money in the short run. A good example of this is Tesco.

Case Study: Tesco

Tesco is one of the world's largest food retailers, employing more than 500,000 people. The company was well managed from the early '90s through to mid-2000s, resulting in increased earnings and substantial stock price performance. During the global financial crisis, Tesco management decided to stop reinvesting in their stores and start cutting costs. This resulted in longer queues, staff helpfulness deteriorated and the general shopping experience went down. As a consequence the supermarket suffered from a drastic loss of customers in the UK, which led to a profit warning in early 2012 and a significant share price drop.

Mr Clarke, the CEO of Tesco, said then that the defection of customers was mostly due to a smaller number of staff in supermarkets, which analysts said had caused poor customer service and gaps on shelves. He said: „We just took a little bit more out of the stores than we put back in. So, we are putting more love back into the stores. That‘s our plan to make Tesco better in the UK.“

To help achieve this Tesco invested £200M to have the equivalent of 8,000 more colleagues in-store and also provided customer service and specialist training for nearly 250,000 team members to help them serve customers better. On the back of this, their customer ratings of service and staff helpfulness have improved and customer complaint numbers have fallen sharply. This is in line with the NCSI-UK findings regarding customer satisfaction, see table below.

	2008	2009	2010	2011	2012	2013
Waitrose	82	85	85	84	83	85
ASDA	72	70	78	80	79	80
Morrisons	74	77	77	78	78	76
Sainsbury's	71	73	73	75	75	76
Tesco	71	72	72	70	71	74
The Co-operative	x	63	70	68	73	71

Figure 2, an independent national benchmark of customer satisfaction (Source: NCSI-UK)

The increase in staff hours is one of many initiatives Tesco has implemented to address its trading weakness, so it is not possible to disaggregate the precise effect of the headcount increase. However, the company is still struggling. The question is how Tesco is going to cope with the structural shift in the industry (to online and discounters). They made a price investment of £200M but admitted this isn’t enough and that there will be a little more.

The world of multichannel retail is increasingly people-focused and demands new technical and social skills. In the context of rising online competition, in-store service levels are likely to be an increasingly differentiating factor. Tesco will need to do more on engaging their employees and retaining talent.

Challenges and next steps

The 21st-century is characterised by fast technological developments, for example cloud computing, mobile technology and data analytics. These developments are changing the skills that employers need: physical roles are increasingly replaced with knowledge-based roles. The workforce is global, highly connected, technology-savvy, youthful, ambitious, filled with passion and purpose, but also demanding.

Critical new skills are scarce and their uneven distribution around the world is forcing companies to develop innovative new ways to attract and retain talent. Another challenge is that CEOs and HR need to plan for a world that remains largely unknown. There is no room for complacency, companies need continuous improvement.

What should companies focus on?

- Training and development: train individuals for the role they will likely take in the future instead of role they are currently in
- Build passion and purpose (young people are increasingly looking for “meaningful work”, work that also benefits the broader society)
- Take work to where the talent is instead of the other way around
- From diversity to inclusion: move from compliance to diversity as a business strategy
- HR has the opportunity to add significant value in predicting the skills that will be needed in the future and feeding the results into the formation of future strategy.
- Work together with governments and universities to tackle the skills gap and reduce the proportion of young adults who are neither in school nor in work. The vicious circle of “no job-no experience, no experience-no job” needs to be broken down.

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Footnote and References:

1) *In total, PwC conducted 1,344 interviews with CEOs in 68 countries between September and December 2013. More details about our survey methodology and findings by region and by industry can be found at www.pwc.com/ceosurvey.*