The surprising economics of a people business

By Felix Barber and Rainer Strack, Harvard Business Review, June 2005

When people are the most important resource, standard performance measures and management practices are not appropriate. Performance metrics that are as financially rigorous as say economic value added, but that highlight the productivity of people (not capital) are needed. This argument is particularly relevant to what the authors call people businesses. Such businesses are characterized by one or more of the following attributes:

- The overall employee costs are high.
- The ratio of employee to capital costs is high.
- The spending on activities such as R&D aimed at generating future revenues is low.

All service businesses are not people businesses. McDonald's is not a people business because in relative terms it spends more on branding and real estate rather than people. People businesses may not be knowledge intensive. Hotel management and Security/Facilities management are good examples. An elevator manufacturer like Otis is in a people business because its revenues mainly come from service activities that have to performed by people.

In people businesses, measures such as return on assets and return on equity can be misleading. If employee costs are 5 times assets, it takes only a 5% reduction in employee costs to increase returns on assets by 25%.

Conventional measures of employee productivity may also not apply to people businesses. Metrics like sales per employee can be easily distorted by outsourcing and capital investment.

Let Return on investment be denoted by ROI, Cost of Capital by CoC, Invested capital by IC and Earnings by E.

Economic profit= [ROI-CoC] (IC) = [E/IC-CoC] (IC) = E-(CoC) (IC)

For people businesses, we must replace E by:

Revenue – Personnel costs - Supplier costs - Depreciation

Economic Profit = R-PC-SC-D-(CoC) (IC)

= [R-PC-SC-D-(CoC) (IC)]/P X P where P is the number of people.

= [(R-SC-D-(CoC) (IC))/P-PC/P] XP

= [Employee productivity – Average cost per Person] X number of people

In this equation, employee productivity corresponds to capital productivity or return on investment. The average personnel cost per person corresponds to the cost of capital. The number of people employed corresponds to the amount of invested capital.

Consider a typical security/facilities Management Company in which operating profit is 10% of employee costs and economic profit is 8% of employee costs. A 5% improvement in employee productivity can improve operating profit by 50% and economic profit by 62.5%.

If success in a capital-intensive business comes from primarily making the right investment decisions, success in a people intensive business comes from hiring the right people and putting in place processes and structure that make them productive. In a people business, employees' interests should be aligned with the company's business objectives. Relevant performance information that will be acted upon is also essential for a people business.

People businesses are far more sensitive to pay than traditional businesses. Employees in such businesses expect to receive all the returns. (In contrast, capital is a silent spectator!) Compensation is also the primary determinant of shareholder returns. Productivity varies across employees. So, performance based variable pay is a critical success factor.

Suppose operating profits are 15% of employee costs. Consider two situations: 100% fixed pay and 85% fixed pay and 15% variable pay. If profits fall by 50%, the variable pay will reduce to 7.5%, compensating the profit fall to a large extent. If the entire pay is fixed, the profit fall will not be compensated at all.

Economies of scale in people businesses tend to be less significant compared to industrial businesses. Thus, large people businesses do not necessarily have cost advantages over smaller competitors.

Smart pricing is needed to ensure that the company can capture the value created for customers.

- In pricing by the hour, the value added by the company above that created collectively by its employees is limited.
- In a fixed price contract, by improving productivity, the company can add more value than that delivered by employees.
- Where scope lies for high value addition, a success fee or commission may offer the best returns.

- In some situations, a combination of fixed fee and performance incentive for superior outcomes is a good pricing strategy.

Truly successful people businesses create assets that make the companies much more than the sum of their employees. Indeed, the goal of many people businesses, trying to increase returns, will be to move out of that category by leveraging the value of their people oriented activities to build intellectual or brand capital or even physical capital such as data centers. Ironically enough, as people businesses start outsourcing some of their people intensive activities, they would complete a cycle that started with their being service providers for someone else.