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by Felix Barber and Rainer Strack

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It's no secret that business success today revolves largely around people, not capital. Many traditional manufacturers are now essentially service businesses. In most industries, people costs are much higher than capital costs. Even when a company isn't people intensive overall, a people-based business embedded in the company often drives corporate performance.

Yet for the most part, today's business performance measures and management practices don't reflect the particular economics of people-driven businesses. Most managers fail to see that, economically speaking, IBM more closely resembles, say, advertising giant Omnicom or oil-field services firm Schlumberger than it does an industry neighbor like Intel. That is, even though cooperative and competitive relationships with Intel are important to IBM's strategy, the company's operational performance will be driven mainly by the things it has in common with seemingly dissimilar people-oriented businesses.

Indeed, when people are your most important resource, some standard performance measures and management practices become ill suited to their tasks. Consider, for example, the concept of economic profit, whose widespread adoption as a performance metric represented a major breakthrough in measuring business performance. Economic profit, measured using such methods as Economic Value Added (EVA) and Cash Value Added (CVA), takes into account something ignored by the traditional profit-and-loss statement—the full cost of capital, both debt and equity. But there's a problem with such measures for companies with relatively high people costs and low capital costs: The metrics, at least as conventionally calculated, offer little information about the real drivers of business performance. In order to identify where and how value is being created—or squandered—people-intensive businesses need performance metrics that are as financially rigorous as economic profit but that highlight the productivity of people rather than of capital.

The distinct but generally unappreciated economics of people-intensive businesses call not only for different metrics but also for different management practices. For instance, because even slight changes in employee productivity have a significant impact on shareholder returns, "human resource management" is no longer a support function but a core process for line managers.

While many of these metrics and practices apply to any business whose people costs are greater than its capital costs, they are most relevant for what we call *people businesses*. Strictly defined, these are operations—whether entire companies or business units—with 1) high overall employee costs, 2) a high ratio of employee costs to capital costs, and 3) limited spending on activities, such as R&D, aimed at generating future revenue. (For a look at the cost structures of a variety of people, and other, businesses, see the exhibit "Where Does the Money Go?") Understanding the special qualities of a people business is particularly important when it is embedded in an otherwise capital-intensive company and risks being damaged, if not destroyed, through the application of traditional performance metrics and management practices.

Why the Old Rules Don't Apply

People businesses don't fit neatly into the familiar categories that have emerged over the past several decades. Yes, many people businesses are "service businesses." But some large service-oriented companies, such as McDonald's, aren't people businesses because they have substantial assets (brand and real estate, in the case of the fast-food giant) and relatively low people costs (the restaurant chain's people costs are borne, for the most part, by McDonald's franchisees rather than by the company itself). Yes, numerous people businesses are indeed "knowledge businesses." But many others are low-valued-added operations—for example, hotel management companies—where employees' intellectual contribution isn't paramount. And some people businesses are in traditional industrial sectors: Think of elevator makers like Otis and Schindler, whose revenues come primarily from service activities. In fact, people businesses—with their distinctive cost structure—span industries ranging from IT consulting to facilities management, from insurance brokering to telecommunications services.

People businesses play a significant role in developed economies. They account for around 25% of private sector employment in North America and Western Europe and well over half of employment growth during the past decade. Because of consolidation in traditionally fragmented industries—such as advertising, contract catering, and financial advice—people businesses today are often large, publicly quoted companies. (See the exhibit "The People Business 40.")

People costs exceed capital costs in an array of other businesses, as well. For example, at an airline, employee costs are typically about one-and-a-half times the amount of capital costs, despite airlines' giant equipment purchases. (Although fuel is a major cost for airlines, fuel expenditure isn't a good lever for improving performance because, as a commodity, fuel is sold at roughly the same, though often volatile, price to all players in the industry.) Even at a heavy-industry company like an automaker, employee costs usually exceed capital costs. At a minimum, most diversified companies have large units engaged in employee-intensive activities—for instance, sales and customer service—that give those units many of the economic characteristics of a people business.

These characteristics are often ignored or unappreciated by top managers. Companies mistakenly focus on capital productivity rather than employee productivity and rely on capital-oriented metrics, such as return on assets and return on equity. These aren't much help in assessing a people business, as they tend to mask weak performance or indicate volatility where it doesn't exist. A struggling advertising agency or software company may show what seems like a satisfactory return on assets largely because it has so few of them. Similarly, even modest capital investments or productivity improvements may cause big swings in ROA for a company whose asset base is relatively small. For example, if employee costs are five times assets—not uncommon in a people business—then it takes only a 5% increase in employee productivity or a 5% reduction in employee costs to increase profits by 25% of assets.

Return on equity is often an even more questionable benchmark of operational performance. For example, because they have so few other assets, many people businesses that have grown by acquisition find that goodwill, for

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which accounting conventions vary considerably, accounts for a substantial share of their total capital. Indeed, after subtracting goodwill, many of these companies are left with negative equity. Given this and other difficulties, interpreting the return on equity of people businesses becomes an arcane science.

Just as problematic are the conventional metrics designed to measure employee productivity. While more suited to people businesses, they usually don't carry much weight with top management. That's because the most common ones, such as sales per employee and profit per employee, are easily distorted. Sales per employee, for instance, is strongly influenced both by outsourcing and by the level of capital investment. If a company outsources activities performed by half its employees and the cost of outsourcing is the same as keeping those activities in-house, sales per employee doubles but productivity doesn't budge. Similarly, if a company makes a capital investment and replaces employees with machinery whose capital costs exceed the costs of the employees replaced, an increase in sales per employee may be accompanied by a fall in productivity.

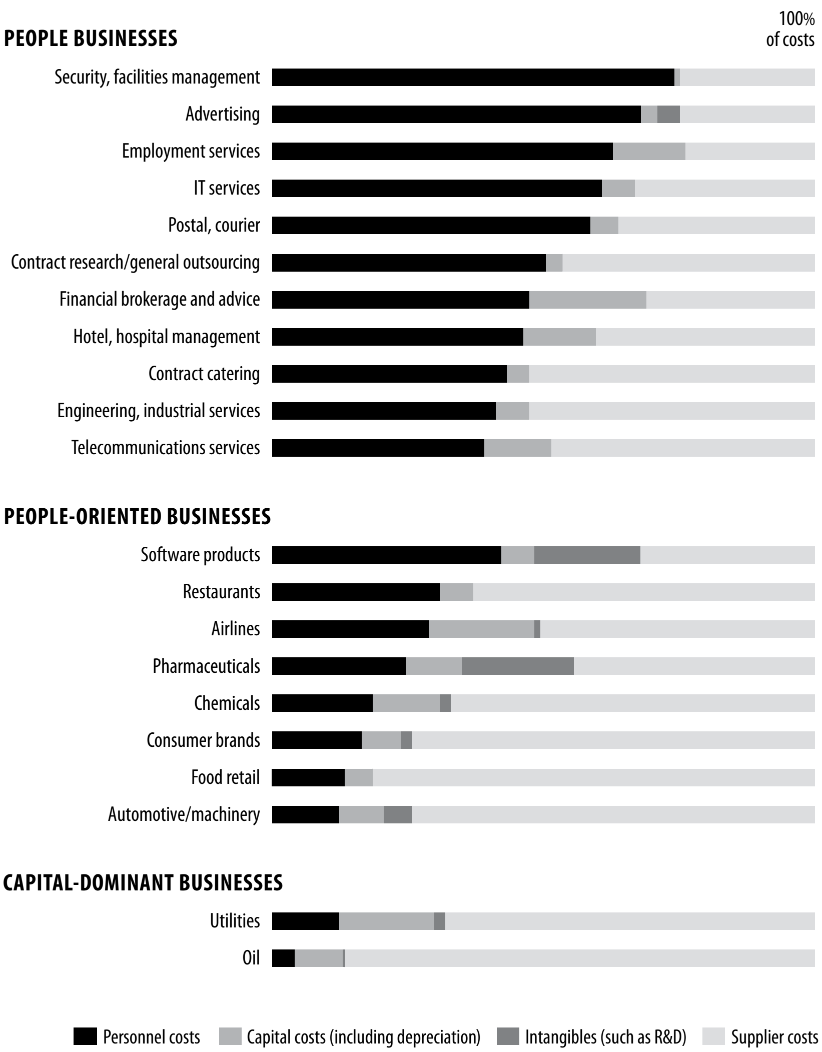
We are hardly the first observers to note the measurement and management challenges posed by the increasingly people-heavy and capital-light nature of business. But in our view, most efforts to take account of this shift focus on the wrong things. For example, attempts have been made to "fix" the balance sheet by including intangible assets. While these attempts certainly have value, they miss a crucial point: The critical resource of most businesses is no longer capital—that is, assets that a company owns and utilizes at as high a level as possible. Rather, the critical resources are employees whom a company *hires* and must motivate and retain. The fact that companies don't own their employees, as they do their capital assets, is why methods for valuing "human capital" on balance sheets are so tortuous.

Focusing on intangible assets is troublesome for people businesses in other ways. Whereas the level and nature of traditional capital investment largely determine how productively employees can work, there is huge variation in employee performance at a people business—an investment bank, a hotel, an advertising agency—and the variation is completely independent of assets, tangible or intangible. And while the value employees create in some businesses does take the form of intangible assets—intellectual property, brands, and the like—most employees in people businesses create short-term value directly for customers, month for month and year for year, without the intermediary step of creating an intangible asset.

At a certain point, struggling to make things fit into an existing model no longer makes

Where Does the Money Go?

People businesses are those with relatively high employee costs, a high ratio of employee costs to capital costs, and limited spending on activities, such as R&D, aimed at generating future revenue. But people costs exceed capital costs in an array of other businesses as well, as the following breakdown of typical costs by industry shows.



Source: Annual reports and Boston Consulting Group analysis

How People Businesses Fit In

A major fault line runs through the business landscape—and even through individual industries and companies—separating organizations that are, to varying degrees, people intensive from those that are, again to varying degrees, capital intensive. Companies whose shareholder value is clearly driven by people—whose employee costs can be three or more times their capital costs—share some important qualities, including the need to use employee-oriented instead of capital-oriented operating performance measures.

This divide is intersected by another fissure (somewhat less evident but crucial nonetheless) that separates businesses whose activities are oriented toward creating value in the present from those whose activities are designed to create future value. In most businesses, the majority of employees are engaged in activities—manufacturing a computer, repairing an elevator, selling a car—that create current value for their company. In some businesses, however, a substantial percentage of employees (or contractors) are engaged in activities—developing a new generation of software, researching a potential new drug, or, to some extent, building a brand—that are aimed at creating future value through the development of intellectual capital or some other intangible asset.

A business that is not only people intensive but also future oriented is different in some important respects from the people businesses that focus on generating current value. For one thing, employee performance is harder to assess using measures based on annual financial accounts, as this year's work may create value only in subsequent years. Although it is usually possible to measure employee productivity fairly accurately at a corporate level, methods to assess the current performance of an individual or a team are more problematic. Consequently, performance-related compensation needs to be long-term—stock for the software engineer or pharmaceutical researcher as opposed to annual bonuses for the investment banker or the department store manager. In addition, while the performance of current-oriented people businesses is exceptionally sensitive to day-to-day operations and employee management, future-oriented businesses tend to be extremely scale sensitive: When the value of R&D expenditures becomes predictable, those investments effectively become fixed costs that can generate increasingly large winner-take-all revenue numbers.

The matrix presented here looks at the distinct economics and strategic challenges facing businesses categorized along the two dimensions: current value versus future value and people intensive versus capital intensive. A company is positioned on the matrix according to the different ways in which it creates value. It can be even more interesting to position different activities of a single company on the matrix. For example, a pharmaceutical company deconstructs into three types of businesses: those whose value is derived from physical assets (pharmaceutical production), from intangible assets (R&D), and from "human assets" (sales and marketing)—the latter being the strictly defined people business whose human resources aren't really assets at all because they aren't owned by the company. Given the different characteristics of these three businesses, each must be managed in a different way. The matrix highlights the performance levers that are best suited to each type of business.

	CAPITAL INTENSIVE	PEOPLE INTENSIVE
FUTURE VALUE	**Physical and Intangible Assets** (INTEL) ▪ Use capital- and employee-oriented performance indicators ▪ Focus on scale effects (high market share = high market value) ▪ Offer fixed and variable compensation	**Intangible Assets** (SAP) ▪ Use employee-oriented performance indicators ▪ Focus on scale effects (fixed cost of investment = leverage potential) ▪ Offer long-term variable compensation (options)
CURRENT VALUE	**Physical Assets** (BP) ▪ Use capital-oriented performance metrics ▪ Focus on investment choices to drive performance ▪ Offer fixed salaries (except for top management)	**People Businesses** (OMNICOM) ▪ Use employee-oriented performance metrics ▪ Focus on operational improvements to drive performance ▪ Offer short-term variable compensation (annual bonuses)

The People Business 40

Major people businesses are emerging across a variety of industries. These include companies in traditional people-oriented industries as well as major business units in capital-oriented companies.

RANK	COMPANY	INDUSTRY	($ billion 2003) REVENUE
1	IBM Global Services*	IT services	42.6
2	UPS	Postal and courier	33.5
3	Deutsche Post World Net*	Postal and courier	30.5
4	FedEx	Postal and courier	24.7
5	Hospital Corporation of America	Hospital management, health care	21.8
6	EDS	IT services	21.5
7	Compass Group	Contract catering	18.4
8	Deloitte Touche Tohmatsu	Accounting, consulting	16.4
9	PricewaterhouseCoopers	Accounting, consulting	16.3
10	Bechtel	Oil, engineering, industrial	16.3
11	Halliburton	Oil, engineering, industrial	16.3
12	La Poste*	Postal and courier	15.7
13	Computer Sciences Corp.	IT services	14.8
14	Ernst & Young	Accounting, consulting	14.5
15	Schlumberger	Oil, engineering, industrial	13.9
16	Accenture	IT services	13.4
17	TPG*	Postal and courier	13.3
18	Tenet Healthcare	Hospital management, health care	13.2
19	Sodexho	Contract catering	13.2
20	Hewlett-Packard Services*	IT services	12.3
21	KPMG	Accounting, consulting	12.2
22	T-Systems*	Telecommunications services	12.0
23	Marsh & McLennan	Financial brokerage and advice	11.6
24	Suez*	Oil, engineering, industrial	10.6
25	Siemens*	IT services, industrial	10.4
26	Aon	Financial brokerage and advice	9.8
27	Aramark	Contract catering	9.4
28	BT Global Services*	Telecommunications services	9.4
29	Fidelity Investments	Financial brokerage and advice	9.2
30	Merrill Lynch	Financial brokerage and advice	8.9
31	Fluor Corporation*	Oil, engineering, industrial	8.8
32	Marriott*	Hotels	8.7
33	Omnicom Group	Advertising	8.6
34	United Technologies Corp.*	Oil, engineering, industrial	8.4
35	Accor	Hotels	7.7
36	Tyco*	Security, facilities management	7.4
37	Securitas	Security, facilities management	7.3
38	NTT Systems Integration*	Telecommunications services	7.3
39	SAIC	Contract research	6.7
40	WPP	Advertising	6.7

* Services business only or people-oriented business units
Source: Annual reports, company Web sites, Hoovers

sense. Liberated from the straitjacket of capital-oriented approaches, a people-intensive business can measure and manage performance by focusing on employees as employees, without having to pretend that they're "capital" or that their value comes entirely from the creation of intangible assets.

People-Oriented Measurement and Management

So if you run a people business—or a company that includes one or more of them—how do you figure out your true performance? And once you know what it is, how do you enhance that performance operationally, reward it appropriately, price it advantageously, and, ultimately, transform it strategically?

Performance Measurement. You start with the right set of performance indicators. The ideal measures will highlight the major drivers of business results, alert you to emerging problems, and provide some hints about their causes. You can get this kind of information by relating performance to people employed rather than to capital employed. Fortunately, doing this is remarkably easy. You simply reinterpret economic profit—for example, EVA or CVA—so that it reveals the difference between employee productivity and employee cost rather than the difference between capital productivity and capital cost. In other words, you calculate economic profit using a people rather than a capital denominator.

The logic isn't complicated. You start with sales per employee and subtract supplier costs (including outsourced activities) per employee and capital costs (including depreciation and a capital charge to cover the cost of debt and equity) per employee. The remainder is a measure of employee productivity. Subtract employee costs per employee, and you have economic profit per employee. (For an explanation of the process and how it can be applied to an actual company, see the sidebar "Measuring the True Performance of a People Business.")

The beauty of this approach is threefold. First, unlike many people-oriented metrics, it is grounded in hard financial information gleaned from a company's own accounts rather than in soft assumptions about the impact of human performance on outcomes. Second, it yields realistic returns because the employee denominator of the performance ratio is sub-

Measuring the True Performance of a People Business

When a business has relatively high employee costs, traditional capital-oriented performance measurements such as return on assets can be irrelevant, if not misleading. An alternative approach, based on a company's existing financial information but focused on employees, can tell you how the business is truly doing and suggest ways to improve performance.

This method starts with a variation on the usual technique for calculating a business's economic profit. Instead of asking how much capital is used in the business and what the productivity of that capital is compared with its cost, you ask how many employees work in the business and what their productivity is in comparison to their cost. (For a depiction of the two approaches and how one leads to the other, see the exhibit "A New Way to Calculate Economic Profit.") While both methods yield the same measure of economic profit, the employee-oriented calculation, by highlighting the productivity of people rather than of capital, isolates the main driver of performance in a people-intensive business. This information can be used to identify meaningful levers for improving performance both at the corporate level and among business units within the organization. It is also useful in assessing the performance of your business in comparison to your rivals'. (One caveat: The employee cost data needed to do the people-oriented calculation, although reported to investors by European companies, are sometimes only available internally for U.S. companies.)

Take the case of a high-tech company with a portfolio of businesses, many of them engaged in manufacturing. As part of a regular review of its operations, the company decides to focus on its IT Services business. This business is profitable, and, although its return on sales is lower than those of the company's manufacturing businesses, its return on capital and its economic profit in relation to capital invested are higher than for the company as a whole. Using the tools they are familiar with, senior managers conclude that IT Services is doing just fine.

But is it really? Relating its performance to its few assets—mainly receivables and employees' personal computers—is practically meaningless. By contrast, a people-oriented performance metric offers valuable insights. (For a look at how IT Services uses this metric, see the exhibit "Isolating the People Performance Drivers.")

At the level of the overall business, the new metric reveals a problem that conventional financial measures have obscured. While IT Services' capital productivity is satisfactory, its employee productivity is low. The return exceeds employee costs by only 3%, compared with an average of 12% achieved by rivals (whose businesses are analyzed using the same people-oriented metrics). Furthermore, competitors are paying their employees nearly 15% more than IT Services is, in the form of higher benefits and performance-related compensation. In fact, if pay were adjusted to match competitors', IT Services' slim margins would be wiped out.

The same method can be used to pinpoint specific problems

A New Way to Calculate Economic Profit

The standard calculation for economic profit can be reformulated—by substituting some basic components and by using standard algebra—to focus on the productivity of people rather than capital. This equation yields the same result but highlights the employee-related performance drivers of a people-intensive business.

Start with the calculation of economic profit from a capital-oriented perspective:

$$\text{ECONOMIC PROFIT} = [\underbrace{ROI}_{\text{\% Return on Investment}} - \underbrace{COC}_{\text{\% Cost of Capital}}]\ \underbrace{IC}_{\text{Invested Capital}}$$

Replace "return on investment" with its equivalent, "earnings divided by invested capital":

$$= [\underbrace{E/IC}_{\text{Earnings/Invested Capital}} - COC]\ IC$$

Use algebra to arrive at:

$$= E - [COC \times IC]$$

Replace "earnings" with its equivalent, "revenue minus personnel costs minus supplier costs minus depreciation":

$$= \underbrace{R}_{\text{Revenue}} - \overbrace{PC}^{\text{Personnel Costs}} - \underbrace{SC}_{\text{Supplier Costs}} - \overbrace{D}^{\text{Depreciation}} - [COC \times IC]$$

Use algebra to factor in a key people-oriented element, the number of people employed, and introduce two metrics, namely, employee productivity and average personnel cost per person employed:

$$= \left[\underbrace{\frac{R - SC - D - [COC \times IC]}{P}}_{\text{Employee Productivity}} - \underbrace{\frac{PC}{P}}_{\text{Avg. Cost/Person}} \right] \underbrace{P}_{\text{People Employed}}$$

The result is a calculation of economic profit that is meaningful to people-intensive businesses:

$$\text{ECONOMIC PROFIT} = [\underbrace{EPR}_{\text{Employee Productivity}} - \underbrace{ACP}_{\text{Avg. Cost/Person}}]\ \underbrace{P}_{\text{People Employed}}$$

The new, people-oriented equation mirrors the capital-oriented one. Employee productivity corresponds to capital productivity—that is, return on investment. The average personnel cost per person employed corresponds to the cost of capital. The number of people employed corresponds to the amount of invested capital.

Note: From a capital perspective, economic profit is usually calculated on a post-tax basis to be comparable with (post-tax) capital costs, while from a people perspective, it is usually calculated on a pretax basis to be comparable with (pretax) employee costs.

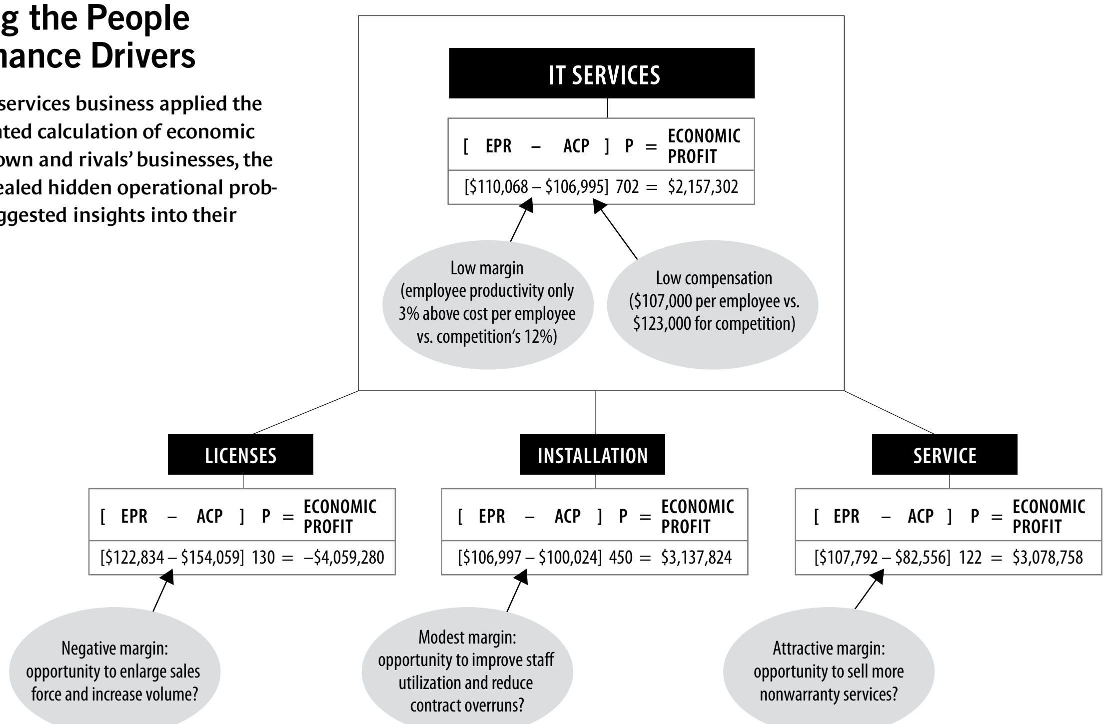
deeper in the organization. IT Services has three main revenue streams: software licenses, installation, and follow-up service. The analysis indicates that the product license operation is doing poorly, with fees insufficient to cover the R&D costs. Service margins are attractive, but the relatively small number of people in the operation is a sign of low service volume. In software installation, where most of the employees work, the (modest) margins are achieved only because employees are paid below industry levels. Extending the quantitative analysis of productivity further down into the installation business reveals that there is poor utilization of software engineers, who spend only 65% of their time handling customer orders, and that the group has contract overruns on orders amounting to more than 10% of budgeted time.

A more complete version of such an analysis—covering these and other factors, such as recruiting success, attrition, and overhead staff ratios, all of them quantitatively linked to employee productivity, average cost per person, and number of employees—creates a management dashboard that is a first step toward identifying the causes of problems. For example, license fees fail to cover R&D costs primarily because the company’s small sales team, although productive and making good margins on contracts, isn’t able to attract new recruits and thereby drive up volume. This is because of both poor compensation and the sales team’s low status relative to the value-added resellers that the company has identified as its strategic sales channel (even though this new channel has yielded little in the way of revenue). Problems in the service operation stem from the fact that service engineers generally don’t see themselves as salespeople and therefore don’t look for opportunities to sell service updates that aren’t covered by warranty. As for the installation business, contract overruns result largely because installing “basic” software remains time-consuming, despite IT Services’ years of experience. The problem: Knowledge is not transferred to new employees when experienced engineers move on to more complex assignments.

While there are specific actions the company can take in response to each of these problems, more generally the company needs to address the issue of employee retention. Because the parent company hadn’t realized that its margins were based in part on below-market compensation for its employees, the performance gap is greater than simple profit differences from competitors had suggested. Using the new employee-oriented data, the company can transform IT Services into a truly high-performing business.

Isolating the People Performance Drivers

When an IT services business applied the people-oriented calculation of economic profit to its own and rivals’ businesses, the analysis revealed hidden operational problems and suggested insights into their causes.



Note: Numbers have been rounded to the nearest dollar.

Capital-oriented metrics aren't much help in assessing a people business, as they tend to mask weak performance or indicate volatility where it doesn't exist.

stantial. Third, it provides meaningful employee-oriented comparisons across a portfolio of operations within a company that aren't skewed by such things as outsourcing or capital investment.

People Management. It goes without saying that managing people is a key task for any company. But in a people business, this task becomes central to success. Because employees represent both the major cost and the major driver of value creation, people-management moves that lead to even small changes in operational performance can have a major impact on returns. Consider a typical security and facilities management company in which operating profit is 10% of employee costs and economic profit is 8% of employee costs. In such a case, a 5% improvement in employee productivity increases operating profit by 50% and economic profit by over 60%.

Given the high financial stakes, people management needs to be a core operational process and not solely a support function run by the human resource department. Line managers have a vital role to play in improving employee productivity, in terms of both business issues (such as whether to concentrate on large or small accounts) and management issues (such as how to create an organization and work environment that foster productive output). If success in a capital-intensive business comes primarily from making the right investment decisions, success in a people-intensive business comes from hiring the right people and putting in place processes and an organization that makes them productive.

Managers also need to ensure that employees' interests are aligned with a company's business objectives and their execution. Companies often use surveys and other tools to assess how well they are meeting employees' personal goals. Too often, however, these tools focus only on traditional HR issues, such as work/life balance, benefits, and training. But employee satisfaction and engagement are more likely to be destroyed by conflicts at work than by conflicts between work and "life." A sales manager is charged with selling products from several divisions, but each division gives him a sales target that assumes he will focus on that division's product. Another manager's career depends on a promotion within two years, but she oversees a new service line that will take at least four years to gain traction in the marketplace. The right survey can help spot such conflicts between employee interests and company objectives. Diagnosing and addressing them—however uncomfortable for the senior line managers who may be the source of the problem—is crucial to keeping employees engaged and productive.

Finally, people can't be effectively managed in the absence of relevant performance information—information that can and will be acted upon. It's astounding how little of this exists at many companies. We've already seen that the major metric, employee productivity, is often calculated using misleading methods. But consider this as well: If employees are, indeed, a company's "greatest asset," you might expect to find some hard information about them in the annual report: How many employees are there? How much do they cost? How productive are they? After all, you'll find detailed answers to equivalent questions about a company's capital assets. The most you'll find in many annual reports—at least in the United States, where only banks are required to report their employee costs—is a round estimate of total head count. And even that number is suspect, as Finance and HR often have different methods of defining and counting full-time employees. While more information is available internally, there still are usually big information gaps in areas such as wanted-versus-unwanted attrition, average tenure of employees, and allocation of training funds.

Of course, people businesses need more than people-specific information: For example, customer-related metrics are central to any company and are often needed to measure the productivity of individual employees. But all too often, the problem is not a lack of information but the failure to use it. Information generated and reported by a company remains just that—reported. In one company we worked with, the HR department had nearly 50 employee-related metrics at its disposal—for example, unwanted attrition—but only a handful were actually used by line managers in making operations-management decisions.

Compensation. The economics of people businesses raise unique compensation challenges. Just as people businesses are particularly sensitive to employee productivity, so are they many times more sensitive to pay than traditional businesses. Indeed, the unwitting

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chief executive who focuses on investing in a company's "human assets" to achieve competitive advantage may be surprised to find that employees (unlike inanimate assets, such as manufacturing plants and brands) expect to receive all the returns. Furthermore, in a people business, compensation involves more than how much to pay employees; it is also the primary determinant of shareholder risks and returns.

Variability is at the heart of people-business compensation because productivity differs dramatically from one employee to another, depending on an employee's capabilities and the efforts of individuals or teams. Compensation that recognizes this variability and that is calculated and paid accordingly, on an annual basis, is an appropriate strategy when it comes to most employees in people businesses.

Performance-based variable pay needs to reach far down into the organization. In people-based businesses, unlike typical capital-based businesses, mid- and low-level employees can have a tremendous impact on performance, regardless of investment decisions made by the CEO. A good store manager, for example, can improve store productivity by 5% of sales. This may sound obvious, but it isn't by any means appreciated universally. People businesses embedded in asset-intensive corporations, in particular, often operate with little variable compensation. And we have seen some surprising inconsistencies in people-based businesses: For instance, a large retail franchisor that also operated and managed many of its own stores offered the store managers almost entirely fixed compensation, while its franchisees' earnings were sharply dependent on the performance of the stores they managed.

An emphasis on variable compensation in a people business has benefits beyond the obvious one of generating those operational improvements that can so dramatically boost performance. It can also significantly reduce the volatility of earnings and thus make the company more attractive to investors by reducing their risk. Because employee costs represent such a large portion of total costs, even small changes in the level and structure of compensation can have a major impact on the level of profits. Take a typical people business with operating profits that are 15% of employee costs. If, over the course of an economic cycle, the company pays out 85% of employee costs in fixed salaries and 15% of employee costs in the form of profit-variable bonuses, operating profits will be half as volatile as they would be if the company paid out, over that cycle, an equal amount but all in the form of fixed salaries. The compensation for this shift in risk from shareholders to employees: Companies with strong performance typically pay their employees better than their competitors.

Pricing. Economies of scale and experience in people businesses have tended to be less significant than in industrial businesses, where processes are embodied and learning institutionalized in machinery or software. That means large people businesses don't necessarily have cost advantages over smaller competitors—indeed, often quite the reverse. A people-oriented business such as a software company, with a big investment in future-focused and largely fixed-cost activities such as R&D, will clearly see a cost benefit as sales volume increases. But a strictly defined people business, with its near-term value creation, generally won't. This makes it critical for people businesses to price their products or services in ways that enable them to capture a share of any additional value they create for customers.

The most basic approach is *pricing by the hour*—what you might call a body shop model. Even high-skill businesses such as IT services commonly "shop bodies" at an hourly rate to customers that want to manage capacity flexibly. The value added by the company above that created collectively by its employees typically is limited—as is the return to the company.

A potentially more attractive pricing scheme is the *fixed-price-for-output* contract. A company that works more effectively and thus delivers a product or service at a lower cost or of a higher quality than its competitors (or its customers) can benefit from this approach. By completing the work in less time and with fewer people, the business adds value beyond that delivered by the employees. One way for an organization to achieve this is to focus on a particular activity in order to accumulate experience and know-how—think of a company that offers a specific medical procedure, such as dialysis, at hundreds of clinics. This will typically lead to higher returns because, with the right management, experience will improve the speed, quality, and cost with which the service can be performed.

For organizations whose advantage lies in providing a potentially very high value-add for the customer, a *success fee or commission* may offer the best returns—especially when customers have a lot at stake and the value of the service offered could far outweigh what customers are charged. Some of the highest rates of return on employee costs are earned by financial services advisers operating on a commission basis in highly leveraged activities such as investment or private banking. Although the percentage-based fee for, say, managing the funds of wealthy individuals is relatively small, the absolute amount of the fee is substantial. (Of course, when the stakes are lower, the reverse may be the case: A typical employment agency must take a relatively large percentage of an employer’s pay to a new employee in order to earn an adequate return.)

Since industry pricing structures can change over time, people businesses should try to influence them to their advantage. In advertising, for example, the typical pricing structure has shifted from a percentage of a client’s advertising spend (good for agencies that develop long-running campaigns, but risky) to fixed-fee structures (which limit the agency’s returns on superior value creation for the customer) to, more recently, pricing based on a fixed fee but with a performance incentive specifically related to the success of the campaign.

Implications for Strategy

These progressively more advantageous pricing strategies suggest a number of larger business strategy issues raised by the economics of a people business. Because the most important “assets” of such a business can walk out the door when they choose, the company needs to leverage its people with something that *it* creates, something that *is* scale sensitive, something that will allow shareholders to share returns with employees.

Truly successful people businesses—those with economic profit that is 30% or more above their employee costs, rather than the typical 10%—have created assets that make the companies much more than the sum of their employees. For example, H&R Block, which provides personal tax preparation services in the United States, has invested heavily in its brand—it spends nearly $200 million a year on marketing and advertising—and has developed such innovative services as the first widespread e-filing of income taxes. Rentokil Initial, which provides hygiene and pest control services, has standardized processes and uses its high network density in the United Kingdom to create a cost advantage in customer service. Software company SAP converted previously customer-specific software development activities into standardized products with reusable elements.

Each of these companies, despite the people-intensive nature of their businesses, moved far beyond an offering based on the short-term value of individual employees’ work, in the process becoming less like strictly defined people businesses. In fact, the goal for many people businesses looking 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 the data centers of IT services companies. Ironically, as companies develop proprietary content and add value beyond that which their employees provide in their daily work, top management may conclude that shareholder value can best be created by outsourcing or franchising people-intensive activities. In the case of business services companies, this would complete a cycle that started with their providing, on an outsourced basis, those very services for someone else.

Such a shift reflects the constant evolution of an increasingly people-based economy and highlights the need for senior managers of people-intensive businesses—as well as the investment community—to creatively develop and apply a new set of performance measures and management practices.

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