

EMPLOYEE LIFETIME VALUE:

“THE PEOPLE IMPACT” ON FINANCIAL SUCCESS

This document examines properties shared by Employee Lifetime Value and Customer Lifetime Value, which are explored in further detail in a 45-page research report entitled “Employee Lifetime Value: Measuring the Long-Term Financial Contribution of Employees.” The white paper and the full report were produced by the Forum for People Performance Management and Measurement and the Performance Improvement Council.

Introduction

The global economy is in the midst of a radical change from a product-based economy to an information and service economy in which value creation is focused on people, and their intellect and institutional knowledge. In this new environment, workforces, not physical assets or technology, are the real value creator.

According to a Brookings Institute study, nearly 85 percent of a company’s assets are related to intangible capital tied up in knowledge and human talent. Given the impact of people on a company’s profit and overall financial performance, it is extremely important to find a way to measure the long-term financial contribution of employees.

Organizations need to be able to measure the value of people, and need to understand the value of people over extended periods of time in order to make intelligent decisions about how to invest in their employees and to ensure they are appropriately valuing their workforce. The concept of Employee Lifetime Value (ELTV) is a long-term metric with insights on measuring the financial value of an employee to an organization.

This white paper reviews the concepts, metrics, and applications of employee

lifetime value so that employees can be viewed as contributors to the cash inflow of organizations. We consider issues such as recruiting, hiring and retention. We also show how ELTV links to qualitative measures such as employee satisfaction, engagement, and loyalty, as well as more traditional measures of employee performance. The overall goal is to demonstrate how ELTV, much like the parallel customer lifetime value (CLTV) framework, fits into a strategic approach to management that considers employees and their behaviors the primary drivers of success.

In addition, this paper addresses the strategic role that human resource professionals can play in leading their organizations with strategies and programs intended to bring out the best in people performance.

Reviewing Employee Lifetime Value (ELTV)

Employee lifetime value is defined as a quantitative measure of the long-term contribution an employee makes to an organization. The full report made a special effort to spell out exact interpretations of what qualifies a person as an employee, what constitutes “lifetime,” and how value is determined.

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For the purposes of this white paper, the term “employee” refers to anyone working for an organization, on either a full- or part-time basis, who is enrolled in a formal compensation system. This takes into consideration the large and growing numbers of workers in contract, temporary help, on-call, or other alternative work arrangements, who do not fit in the traditional employee-employer relationship. Formalized compensation systems provide information (e.g., performance metrics) that can be used to compute employee value.

In addition, the ELTV model considers “lifetime” as the total duration of the employment relationship because it has the advantage of being customized to the exact length of each employee’s relationship with the employer. Considerations include shrinking lengths of job tenure as more individuals are opting for flexible labor arrangements with frequent job changes.

The reasons given for the change from a stable to a flexible workforce are widespread, but globalization, innovation, more portable data and

communication technologies, tight labor markets, and employee desires for self-fulfillment are among the most critical factors.

This flexible workforce presents a distinct challenge in the ELTV measurement process, as the whole idea of ELTV rests on the assumption that employees remain with a firm long enough to make investments in them worthwhile. This is why people-friendly retention strategies are extremely important.

Defining and Determining Employee Value

Despite new methods and systems for measuring people performance, the measurement of employee value has drawn little attention from the business community. In the current business environment, products and brands and, to a lesser extent, customers, have been regarded as the source of profit and value while employees have been treated as a cost. When a workforce is regarded as a cost, an organization seeks to minimize it.

Historically, employee value has been associated with longevity or seniority, with tenure as the basis for promotions, wage increases, benefits and vacation time. Part of the reason for basing compensation and benefits on longevity was the lack of information on the contribution of individual employees to financial performance. However, technology in the form of software tools such as SAP or Oracle HR solutions provide extensive information that allows companies to attribute revenues and costs to individual people.

In its simplest form, the value of an employee is best represented by specific measurable flows of money to an organization that can be directly attributed to an employee's performance. The best example of this is revenue generated by a field salesperson. Other examples include retail sales, service personnel in health care, financial services, travel services and the like.

However, many other forms of employee-generated value exist. This may include instances of non-selling employees convincing people to become customers, or employees' enthusiasm for a job making a company look attractive to potential customers or employees.

Similarly, employees can contribute value by identifying or implementing cost savings in production, purchasing, distribution, pricing, or a host of other areas. Employees can also generate a great deal of goodwill through interpersonal relationships, inside and outside the workplace.

The above examples demonstrate that a comprehensive assessment of employee value cannot be limited to just direct, measurable cash flows. Unfortunately, these benefits are difficult to measure and are often unrecognized by management until it is too late, such as when an employee with such exceptional qualities leaves the company.

Building and Using the ETV Model

A model of ELTV may vary from industry to industry, from one organization to another, or from one business environment to another. However, there is a general ELTV model that can be applied, with modifications, to a variety of business situations.

Generally, the ELTV model computes a dollar return to an organization attributable to an employee. The model rests on the assumption that investment in a workforce will yield future cash in-flows. So, a lifetime value model is about the value an organization obtains for investing in people; not the "return" derived from dividing all cash in-flows by the entirety of expenditures.

Constructing an employee lifetime value model requires a series of steps to assemble the required information, including:

- Selecting employees for inclusion in the analysis;

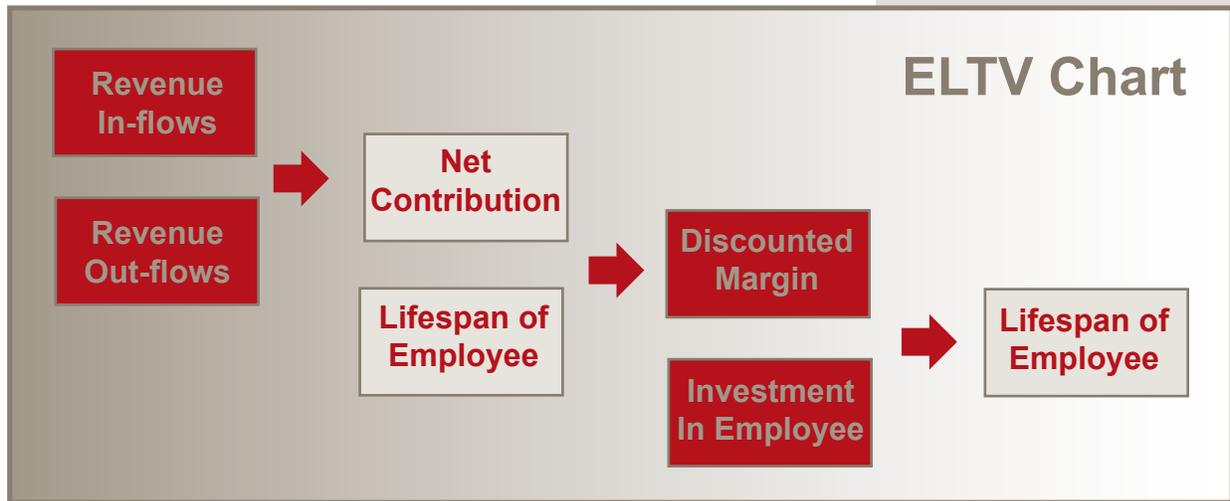
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- Obtaining information on financial in-flows to the organization;
- Allocating financial in-flows to individual employees based on a company-specific methodology;
- Compiling and/or predicting financial in-flows for each time unit;
- Obtaining information on costs of maintaining employee;
- Assigning costs to individual employees for each time unit;
- Constructing a financial model which includes discounting monies over time if needed.

Once these elements are gathered, a lifetime model can be constructed.

As a note, salaries and wages are considered part of the ongoing cost of maintaining an employee and should not be subtracted from the financial in-flows attributed to an employee to yield a net contribution as depicted in the general ELTV model below.

However, estimating ELTV requires careful thought and a clear understanding of the business situation and the intended



application of the analysis. An organization evaluating ELTV must have a clear understanding of the business situation and intended application of the analysis.

What's learned from ELTV Results?

Once an organization has implemented ELTV, the next consideration is how to use the data gathered from the work. A central premise in evaluating employee value is that value will differ, often dramatically, across employees.

This value differentiation is analogous to the concentration of customer lifetime value and typically shows a small portion of customers provide the large majority of revenue- the so-called 80-20 rule, or Pareto principle.

Employee lifetime value is likely to be highly concentrated among a small set of employees in some, but not all, situations. This is called the performance variance principle – the idea that employee lifetime value will vary dramatically across employees in workplace situations where individual ability and performance matter substantially.

In work which involves complexity, decision-making, ambiguity, or a substantial amount of interpersonal contact, in which individuals differ markedly in ability and performance, lifetime value will vary across employees. So, given the general trend toward more complex, information-based work, one would expect employee lifetime value to vary more as time goes on.

Given the variability of this information, companies can ask a number of strategic questions about their workforce. Examples include:

- How does employee lifetime value vary over time?
- What characterizes the employees with the highest (or lowest) lifetime value?
- What is the relationship between employee lifetime value and hiring and training practices?
- How does employee lifetime value relate to our retention rate?

The ability to address questions such as these is what makes the measurement of employee lifetime value so important for organizations.

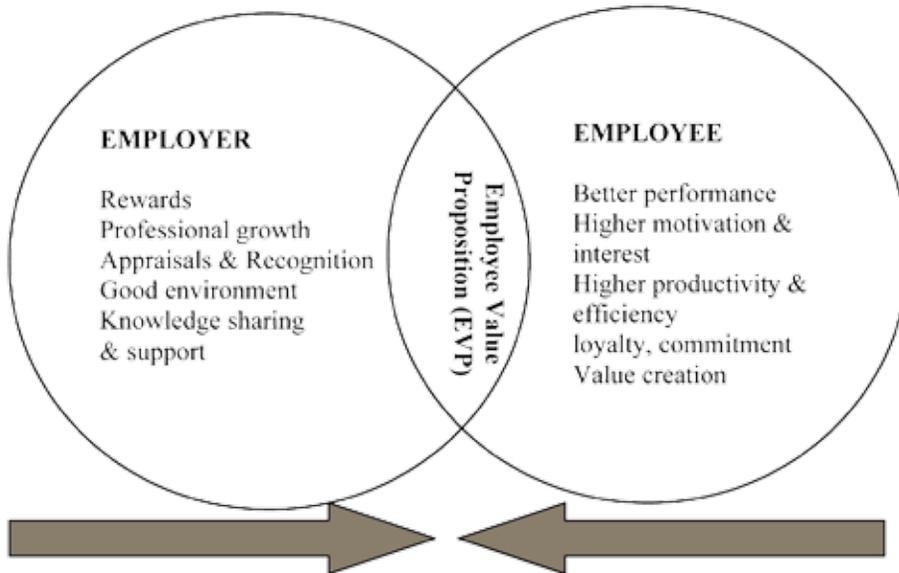
ELTV and the Employee Value Proposition (EVP)

While ELTV represents a method for organizations to measure and quantify the long-term value of employees, it does not address the value of the firm to the employee. Here we consider a flip side of employee value – the value of the organization to the employee that contributes directly to the employee's capability to contribute to the firm.

The relationship between an employee and an organization starts with the employee value proposition. It is defined as, "The holistic sum of everything the people in your company experience and receive while they are a part of the company – everything from the intrinsic satisfaction of the work, to the environment, leadership, colleagues, compensation and much more. It's about how well the company fulfills people's needs, expectations, and even their dreams." (Michaels et al. 2001)

The employee value proposition is based on the idea that effective financial investment in a person produces added value as measured by yield or interest, and that dollars spent properly on people can greatly increase the value of each

employee (Dahl 1988). Graphically, the employee value proposition looks like this:



Many firms say that they have pushed re-engineering and automation as hard as they can. Now, they must raise productivity by managing employees more efficiently.

The employee value proposition involves both rational (money) and emotional (appreciation) aspects. Rationally engaged employees understand how their work contributes to the success of the organization and have a clear line of sight between their roles and the company's objectives. In contrast, emotional factors refer to the sense of inspiration and accomplishment that employees get from their work and their being a member of the firm. Emotionally engaged employees feel inspired to do their best, and recommend their company as a good place to work.

Like the EVP model, ELTV is heavily dependent on hiring people that organizations can not only recruit, but also retain. The hunt for skillful and competent employees is no longer confined to blue-chip companies. This trend can be found everywhere in the corporate world, from credit card companies and hotel chains to the retail trade. Many firms say that they have pushed re-engineering and automation as hard as they can. Now, they must raise productivity by managing employees more efficiently (The Economist 2006).

ELTV and Meeting Labor Market Challenges

One of the benefits of ELTV is that it helps an organization adopt a conceptual framework that places employees and their performance at the center. Such a framework is beneficial because of the developing challenges in the labor markets, not the least of which is employee retention. Even in today's shaky economy, there are serious concerns over a looming labor shortage and its impact on retention.

Labor analysts warn of a shortage of skilled workers in many fields. The Bureau of Labor Statistics of the U.S. Department of Labor predicts that by 2010, the U.S. will have 167 million jobs available – all looking for the most suitable talent. However, the labor pool projections for 2010 show 157.7 million workers. Hence, the U.S. labor market is predicted to have more than 10 million jobs than the market can fill (Herman 2004).

Baby boomers reaching retirement and continued globalization are leading to the war for talent. A 2005 survey by Deloitte Consulting shows 10% to 15% of companies reported shortages already

in both R&D and sales functions, while 15% to 20% expect to have shortages in IT within the next five years. These shortages will affect organizations on many levels, including decreased productivity and employee morale.

The financial impact will also be sharply felt. Several studies have examined the cost of losing long-tenured and short-tenured employees. When a company replaces a two-year employee, the potential loss to the company is about \$9,000. When the same company replaces a three-year employee, the potential loss jumps to approximately \$47,000, figuring in separation, replacement, training and additional "indirect" costs such as lower productivity and reduced customer loyalty.

One of the premises of ELTV is that investments made early in an employee's lifetime pay off in subsequent years. One of the most important concepts in an ELTV-based approach is that, over time, the cost of investments in employees drop significantly as workers become more experienced and have stronger personal relationships with management, co-workers and customers.

Relating ELTV to Other Metrics

In addition to the ELTV model, there are other metrics which can be used to measure employee financial contributions. These measures complement the ELTV model, and provide a broad assessment of employees and their performance.

Profit per Employee

The advantage of measuring profit per employee is that it is readily available data and easily calculable. It can be used as an example of a company's competitiveness as these numbers can be easily compared to its competitors' figures.

Profit per employee is positively related to ELTV. Both metrics combine measures of profit or income with costs and investments. They differ in that profit per employee measures a very aggregate level of performance, but does not differentiate between individual employee contributions. ELTV is far more detailed because it gets to the more granular level of individual employees and therefore can be more closely associated with management practices designed to improve efficiency in performance. Both profit per employee and ELTV do not figure in a firm's physical assets or major capital investments.

ELTV and Return on Investment (ROI)

Return on Investment (ROI) metrics might be useful for measuring short-term return on discrete investment in employees, while ELTV is all about long-term financial flows to an organization. Therefore, one must be careful in using lifetime value as the return measure in applying ROI to employee investments.

The trick is to properly define the time increment to be long enough to represent employee performance over a sustained period of time, yet be short enough to provide a meaningful outcome measure for a specific investment, such as a training or incentive program.

Intangible Employee Lifetime Value: The Human Capital Index

There are a number of employee attributes which represent intangible employee lifetime value, such as communications skills, customer satisfaction, teamwork and leadership. One of the possible metrics which could be used to measure these qualities is the Human Capital Index®, developed by Watson Wyatt Worldwide. It is a simple, straightforward way of calculating the team or an individual employee value. It is made up of four sub-metrics:

- Number of years in the business/field;
- Level in the company (by job grade or organization chart level);
- Performance rating;
- Number and variety of positions/assignments held.

Each of these four factors needs to be given a weight, based on its relative importance. Then, each individual would be given a score once a year based on these four factors. Three of the four are hard objective measures. The performance rating comes from a performance review and may include several factors. The index will tell a company about the strength of its team and give it a way of calculating the true cost of the loss of a key person.

When both ELTV and human capital are measured, a more complete picture of an employee's value emerges.

Why Measure ELTV? Why Not?

The understanding of value of an individual employee or team can help an organization to identify talents and better allocate funds to maximize performance. Each organization must first determine what type of employee value it finds most important to its business success.

The significance of measuring employee value directly can be very beneficial, affecting a broad spectrum of the HR organization's responsibilities. ELTV becomes the basis for mapping out individual de-

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velopment programs, appropriate reward and appraisal systems and performance measurement. At a strategic level, ELTV can provide aggregate data for workforce planning and modeling analogous to the way marketing departments customize products or marketing communications to individual customers.

The Strategic Role of the HR Professional, Organization

The Employee Lifetime Value concept provides an important opportunity for HR professionals and their departments to play a much broader, more valuable role in their organizations' future success. HR should become an important part of strategy development because of the importance of human capital in the ability of the firm to carry out its strategy. HR specialists, along with financial managers, should be in charge of measuring employee value.

Aside from the more traditional roles of HR – recruiting, hiring, compensation and benefit program design, and record keeping – the new role of HR practice should include determining appropriate organizational structure changes and developing strategies to improve employee

performance. With the increased role of people in today's knowledge-based economy, the HR department should be included in the strategic business planning process and top management of a company, rather than merely serving as a support function.

Most strategies, like mergers, acquisitions, entering new markets and launching new products, fail not because of poor thinking, but because of poor execution. These failures are often the result of poor human capital management.

This opens the door for HR professionals to add important value to their companies if they can deliver programs, plans, and thinking that aid in developing and executing business strategy, as well as enhancing employee value.

Clearly, in today's marketplace, competitive advantage and differentiation for companies comes not only from customers, but also from the energy, passion, talents, and creativity of its people. Therefore it is critical for an organization to have the ability to measure individual and team performance.

Now, more than ever, the employee lifetime value measurement concept is an important tool for sharpening a company's competitive edge.

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The Forum for People Performance Management and Measurement, which designed the study, is a research center affiliated with the Medill Integrated Marketing Communications (IMC) graduate program at Northwestern University. A central objective of the Forum is to develop and disseminate knowledge about communications, motivation and management so that businesses can better design, implement and manage people-based initiatives both inside and outside an organization, www.performanceforum.org



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