

Rules of the Game for People Businesses

Succeeding in the Economy's Highest-Growth Segment



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FELIX BARBER

PHIL CATCHINGS

YVES MORIEUX

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For information or permission to reprint, please contact BCG at:

E-mail: bcg-info@bcg.com

Fax: +1 617 973 1339, attention BCG/Permissions

Mail: BCG/Permissions

The Boston Consulting Group, Inc.

Exchange Place

Boston, MA 02109

USA

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Note to the Reader

This report is dedicated to helping clients build accountable, engaged, and effective organizations in people businesses.

The authors would like to thank everyone who assisted in preparing the report—particularly Nicolaus Droste zu Vischering for his extensive research and analytical support, and Sally Seymour for her key support in the writing and editing process. Thanks also go to members of the editorial and production teams, including Katherine Andrews, Patricia Berrian, Gary Callahan, Kim Friedman, and Gina Goldstein.

We hope you find our insights helpful, and we look forward to your comments.

Felix Barber

Senior Adviser

Zürich

barber.felix@bcg.com

Phil Catchings

Senior Vice President and Director

Boston

catchings.phil@bcg.com

Yves Morieux

Vice President and Director

Paris

morieux.yves@bcg.com

Introduction

People businesses are the fastest-growing sector in developed economies. The world's top 25 people businesses in terms of revenues have as many employees as the top 25 global companies. They also have greater returns on assets, although their sales per employee are only one-seventh as high. People businesses—companies with high employee costs as a percentage of sales and with low investment in capital—have different business economics, respond to different strategies, and need to be managed by different rules.

Yet most managers and investors in people businesses have only the rules for traditional businesses to go by. It's no surprise, therefore, that sometimes they seem to be in the wrong game. Investors employing traditional financial metrics—such as return on assets or return on equity—to benchmark one people business against another are using the wrong scorecard. Companies that treat people management as a support function—delegating it to human resources, as traditional companies do—are less productive because they fail to require line management to provide the active coaching people businesses need. And chief executives who focus only on investing in human capital to achieve competitive advantage may be surprised to find that employees expect to receive most of the profits in return.

In this report, we focus on four areas of people businesses that are markedly different from traditional businesses: performance measures, people management, rewards, and strategies. We are convinced that

if managers of people businesses understand and play by the emerging rules for these enterprises, a significant portion of the global economy will realize major benefits in productivity and profits.

We have identified more than 100 for-profit companies throughout the world with revenues of \$1.2 billion or more in people businesses. (See Appendix I, page 31.) In addition, most large companies have employee-intensive activities, and a growing number are breaking these activities out as separate businesses. More

and more industrial companies, for example, are charging independently for service and advice, as well as for their products. When that happens, the manufacturer may offer to service the products of other producers, resulting in a new people business. Similarly, some banks are beginning to set up their retail businesses as commission-based brokerages—putting risk taking and product creation in a separate business unit and bringing in some products from outside vendors. These new retail financial-services businesses are people businesses. When large companies from any industry sector establish shared service centers for IT, HR, or other support activities, it is often only a matter of time before they begin to offer these services on the open market, creating new people businesses.

If your company is a people business—or about to develop one or several in the future—then this report is for you.

People businesses respond to different strategies and have different business economics, so they need different rules.

The Four Challenges Unique to People Businesses

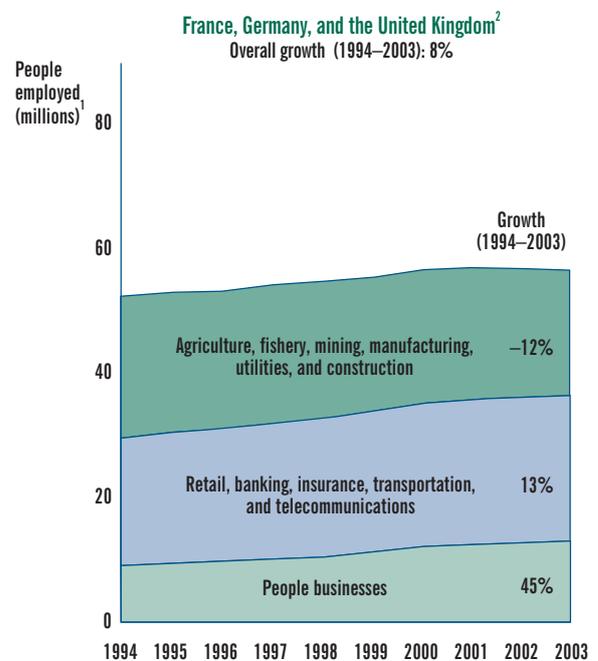
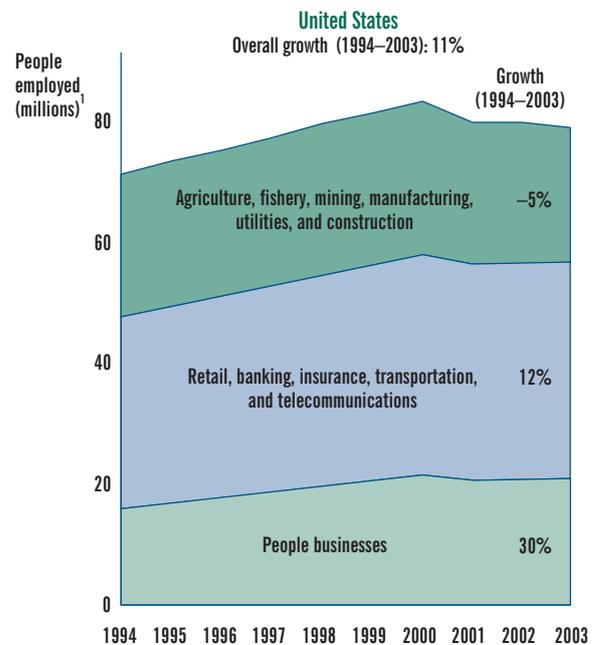
Over the past two decades, people businesses have become big business. They account for 25 percent of private-sector employment and well over half of employment growth in advanced economies. (See Exhibit 1.) People businesses cover a wide range of services, including

- accounting
- advertising agencies
- contract catering
- contract research
- couriers
- employment agencies
- engineering contracting
- facilities management
- financial advice and brokerage
- hospital management
- hotel management
- information technology and telecommunications services
- legal advice
- management consulting
- security

In all of these businesses, employees make up the greater portion of costs, and investments in capital are low compared with those costs. (See the insert “How We Define *People Businesses*,” page 8.) Not surprisingly, people businesses are major employers. The top ten for-profit people businesses, as measured by employees, have nearly as many employees as the top ten worldwide companies, as measured by market capitalization, although the ratio of employees to revenue in the former is more than six times what it is in the latter. (See Exhibit 2.)

Moreover, the top ten state-owned and not-for-profit people businesses have equivalent numbers

EXHIBIT 1
PEOPLE BUSINESSES ARE GROWING FASTER THAN OTHER SERVICE BUSINESSES



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

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

²The United Kingdom excludes Northern Ireland.

on their payrolls.¹ Many large partnerships (such as Accenture) and state-owned businesses (such as Deutsche Post World Net) have been floated on the stock market. What's more, the growth of people businesses—whether organic or resulting from consolidation—has been intense. The global share of the top seven advertising agencies, for example, has increased from 20 percent in 1996 to more than 60 percent today.

People businesses throughout the world offer a wide variety of services for a vast range of consumers and businesses. Although they differ in many ways and encompass both high-value-added talent businesses and lower-value-added services, they nevertheless share four distinctive challenges that make managing them very different from managing traditional businesses. These challenges relate to performance metrics, operations, compensation, and strategic advantage.

1. Not all people businesses create new jobs, however. Although rising incomes, larger numbers of unmarried employees, and increasing time pressure on working parents have created an enormous demand for consumer services, business services—once a part of the internal functions of industrial companies or the public sector—are now more likely to be outsourced.

- *Performance Measures:* Traditional, capital-oriented financial metrics—such as return on assets or return on equity—aren't suited to measuring the performance of people. For instance, achieving a high return on capital is easy if you don't require much capital.
- *People Management:* In people businesses, people management is a core operational process, not a support function. Furthermore, because employees are such an important element in both cost and value creation, managing them well is critical in driving investor returns.
- *Rewards:* People businesses, particularly the important segment of talent-based businesses, face unique compensation challenges. They are much more sensitive to pay and productivity than traditional businesses are. Setting compensation cannot be considered simply in terms of how much to pay employees. Compensation is also the primary determinant of shareholder risks and returns.
- *Strategic Advantage:* Although human capital is by far the most important source of value in people businesses, companies can only hire it, they

EXHIBIT 2

PEOPLE BUSINESSES ARE MAJOR EMPLOYERS

Global top ten for-profit people businesses by employment			Global top ten companies by market capitalization				
	Number of employees (thousands)	Revenue (\$billions)		Number of employees (thousands)	Revenue (\$billions)		
1	Compass Group	413	18	1	Wal-Mart	1,500	244
2	United Parcel Service of America	356	33	2	General Electric Company	300	134
3	Sodexo Alliance	308	13	3	HSBC Group	232	41
4	Deutsche Post World Net ¹	254	30	4	Citigroup	159	77
5	Group 4 Falck	246	5	5	Pfizer	122	45
6	ISS Group	245	6	6	Exxon Mobil Corporation	106	247
7	Hospital Corporation of America	242	22	7	BP	103	233
8	Securitas Group	211	7	8	American International Group	86	81
9	Aramark Corporation	200	9	9	Intel Corporation	80	30
10	FedEx	196	22	10	Microsoft Corporation	55	32
2,671			165	2,743			1,164

SOURCES: BCG analysis; FT Global 500, 2004.

NOTE: All data are for 2003.

¹Excludes logistics and financial services.

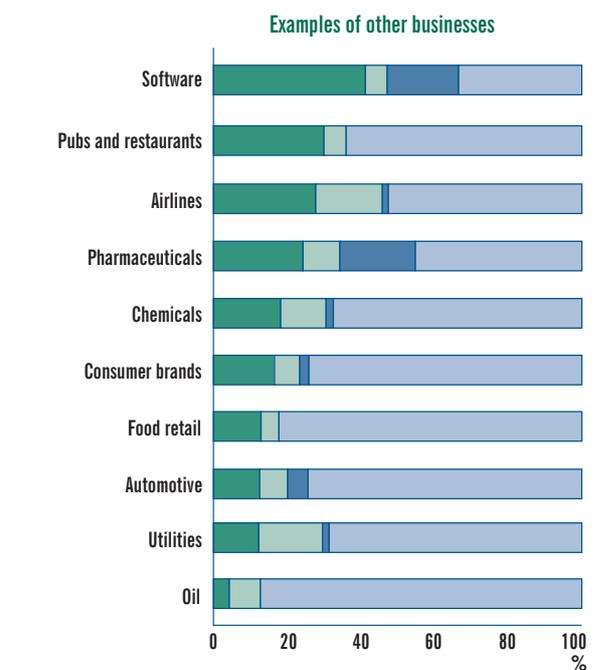
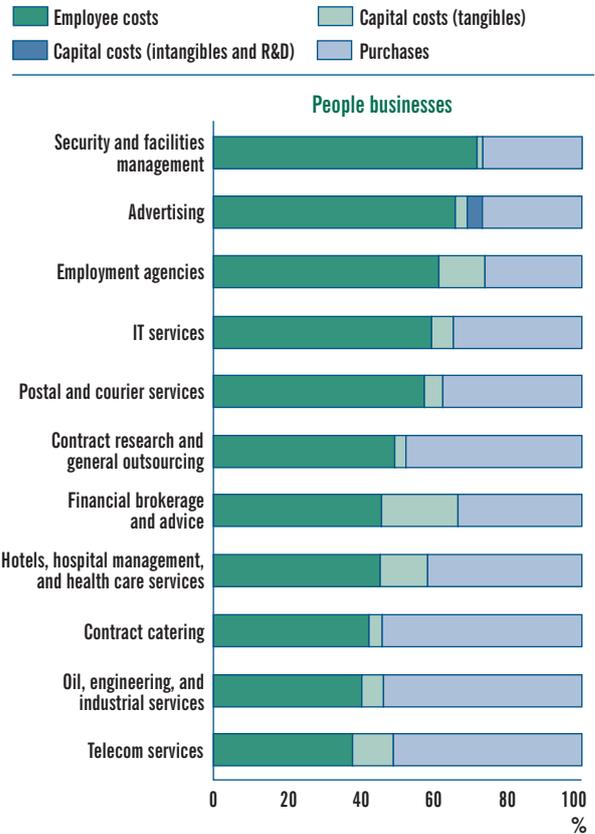
HOW WE DEFINE *PEOPLE BUSINESSES*

The cost structure of all businesses, before taxes, consists of just four different types of cost: employee costs, capital costs related to tangible assets, capital costs related to intangible assets, and purchases. Employee costs are fairly straightforward: salaries, benefits, and pension costs for employees, including management (but excluding those costs for employees working in R&D because we include R&D costs in the capital costs of intangible assets). Capital costs are made up of depreciation, interest, and a market-required rate of return on capital. Intangible assets exclude goodwill but include a capital charge on capitalized R&D. (It is always possible to create management accounts in this form using internal data.) We have defined *people businesses* narrowly as those businesses for which employee costs are predominant, capital costs are low compared with employee costs, and R&D investments are modest.

R&D-based businesses, such as standard software—in which a high percentage of employees are engaged in R&D—share with people businesses the first three challenges described in this report, regarding metrics, operations, and compensation. However, because of their high investment in intangible assets and their business economics—and the response to those challenges that these necessitate—R&D-based businesses are significantly different, and we have not included them in our narrow definition of people businesses.

The exhibit at right shows how closely typical companies in different industries meet the criteria for a people business. People businesses are those businesses for which the new management rules of the game—described in this report—most closely apply. However, the new rules are relevant to a much wider range of businesses as well. Businesses lie on a spectrum from people intensive to capital intensive. The traditional management rules, oriented to achieving a high return on capital, most closely fit the needs of capital-intensive businesses, such as process industries or property. But many businesses, such as restaurants or airlines, are in the middle of the spectrum. For these organizations, the old rules make sense, but additional insights can be gained from the new rules for people businesses.

EMPLOYEES ARE THE MOST IMPORTANT COST FOR PEOPLE BUSINESSES



SOURCE: BCG analysis.

NOTE: A significant share of purchases (such as office space) is also employee driven.

can't own it: human capital belongs to the employees. Because human capital does not offer opportunities for acquiring economies of scale, achieving strong strategic advantage in a people business requires changing the game and transforming the business economics by leveraging human capital with intellectual, organizational, or customer capital.

When employees make the difference, metrics, operations, compensation, and strategies need to

focus on returns from people—as well as on returns from capital investment. A manager's ability to measure the productivity of employees—and to enhance it operationally, reward it appropriately, and transform it strategically—is central to building sustained competitive advantage. It can't be done with traditional concepts of management. That is why people businesses need new rules of the game for managing their most critical resource: people.

Performance Measures for Employees

If what gets measured gets done, we won't manage people businesses well until we start measuring what matters most to them: employees and customers. So the challenge for most people businesses today is not asset productivity but employee and customer productivity. Many companies currently have adequate measures for customers. Few companies, however, measure the performance of their employees in a systematic way. Yet measures of performance, for people businesses, are probably the most important measure of all.

The Limitations of Capital-Oriented Metrics

Traditional capital-oriented measures tell us very little about employees. In fact, they can often be quite misleading. An IT services company's balance sheet, for example, may appear healthy in terms of return on capital, even though the firm may have lost half its top software engineers.

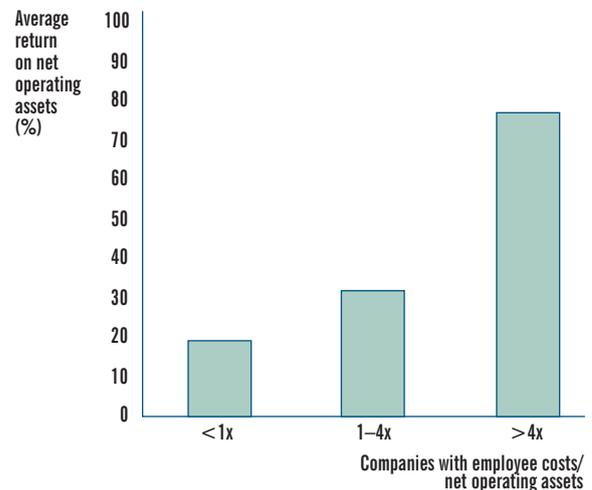
For people businesses, which often have few balance-sheet assets, achieving a high return on assets doesn't necessarily mean good performance.² Return on assets is strongly influenced by asset intensity. (See Exhibit 3.) If the asset base is small, even modest capital investments may cause big swings in return on assets—and high returns on assets are comparatively easy to achieve.

Return on equity is even more questionable as a benchmark of operational performance. About 30 percent of all large people businesses have negative equity, once you exclude goodwill. If they make a profit, they have negative return on equity. For roughly another 30 percent, goodwill accounts for more than half of equity. That means return on equity is largely determined by the size, frequency, and financing of acquisitions—and by goodwill accounting. (See Exhibit 4.) Interpreting the return on equity for people businesses is an arcane science.

2. The research for this section of the report is based on a sample of 44 of the top 100 people businesses in terms of revenues. We chose these companies because they publish their employee costs and we could easily estimate their share of capital costs. The companies studied represent a wide variety of industries, including advertising, contract research, catering, IT, telecom, medical services, and security and facilities management.

EXHIBIT 3

ASSET INTENSITY CAN AFFECT RETURN ON ASSETS AS MUCH AS PERFORMANCE



SOURCE: BCG analysis.

NOTE: Return on net operating assets (excluding goodwill and intangible assets) is before taxes. Data are from a 44-company sample of people businesses with more than \$1.3 billion in 2003 revenues.

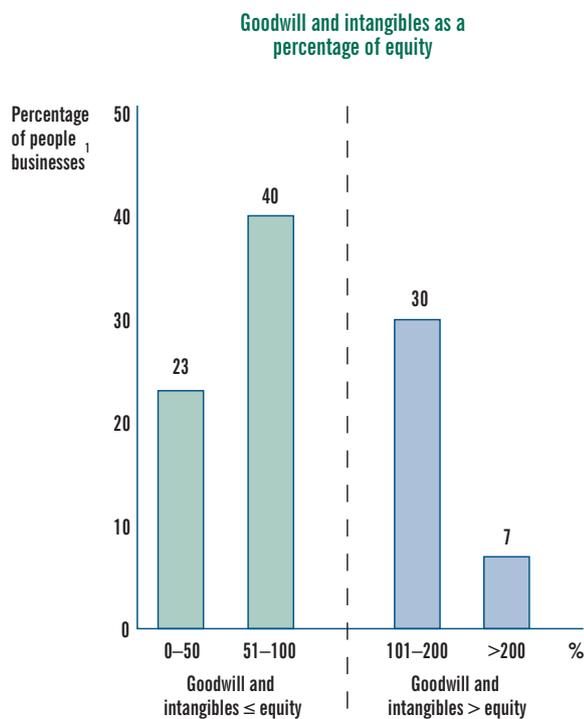
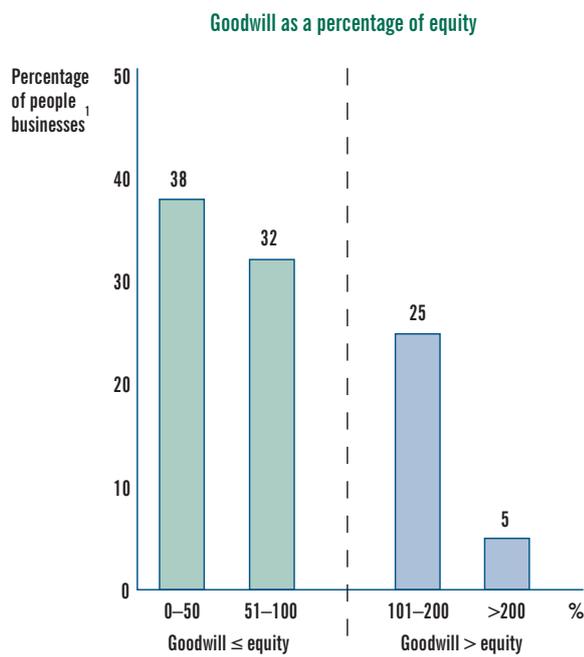
Reliable Metrics for Employee Performance

Fortunately, measuring the performance of people businesses is relatively straightforward. In these enterprises, employees represent most of the cost and create most of the value. What they do largely determines how customers behave. Management's task is to make employees more productive than they would be on their own, so the company can earn more for its work than it needs to pay its employees. Since employees are critical 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.

The idea of measuring employee productivity is nothing new. Why, then, have employee-oriented performance measures not caught on? Most companies already have some measures of employee productivity in place, but few pay much attention to them—particularly at the corporate level. That is probably because the most common measures of employee productivity, such as sales per employee

EXHIBIT 4

HOW PEOPLE BUSINESSES TREAT GOODWILL DETERMINES THEIR RETURN ON EQUITY



SOURCE: BCG analysis.

NOTE: The value for equity in these calculations consists of the company's equity and the minority's interests.

¹Data are from a 44-company sample of people businesses with more than \$1.3 billion in 2003 revenues.

and profit per employee, are easily distorted. They aren't comparable across different businesses or consistent for one business over time. For example, sales per employee—still the most common measure of employee productivity—is strongly affected by the level of outsourcing and capital investment in the business. If a business outsources activities carried out by half its employees—and the cost of outsourcing is the same as keeping those activities in-house—productivity doesn't increase but sales per employee doubles.

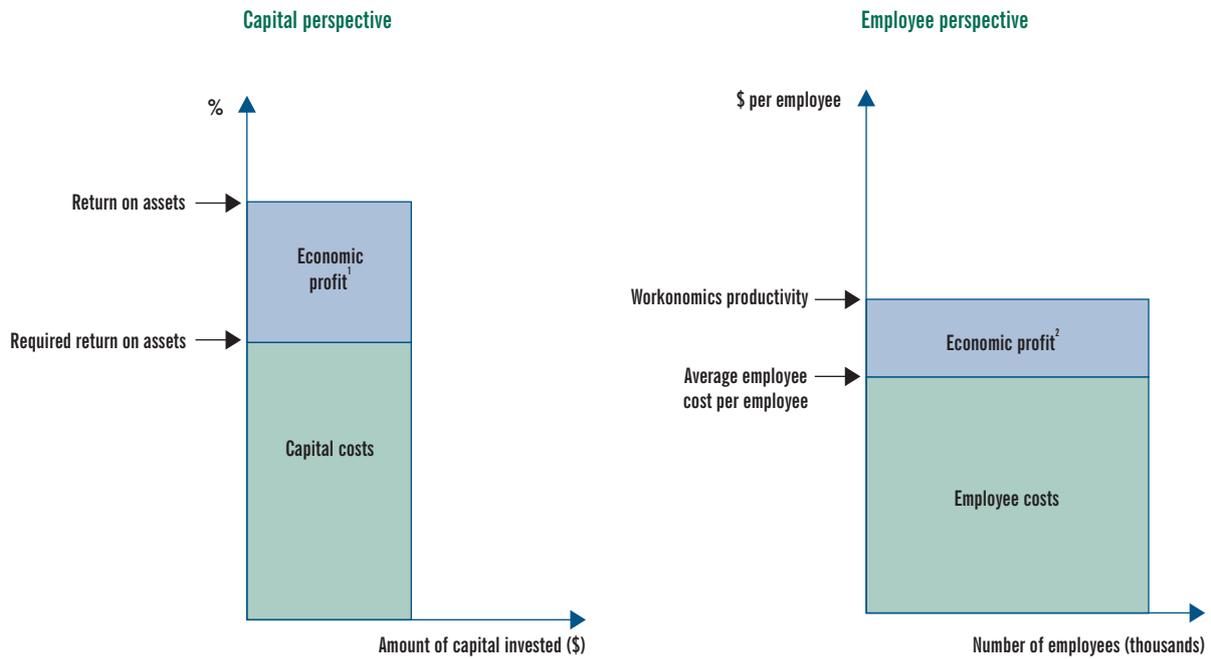
Our approach to measuring the performance of employees, which we call *workonomics*, eliminates these distortions and represents the true value of employee productivity.³ Common measures of shareholder value creation in a traditional capital-oriented performance management system, such as economic value added or cash value added, are variants 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 investors require.

Economic profit is likewise the key measure in the workonomics system, but it is defined from an employee- 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 considered are quite different. Workonomics turns the spotlight on the employee's contribution to value creation and suggests employee-oriented levers to improve it. (See Exhibit 5, page 12.)

3. 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 Eric Gutenberg award.

EXHIBIT 5

FOR PEOPLE BUSINESSES, AN EMPLOYEE-ORIENTED PERSPECTIVE ON SHAREHOLDER VALUE MAKES MORE SENSE THAN A CAPITAL-ORIENTED PERSPECTIVE



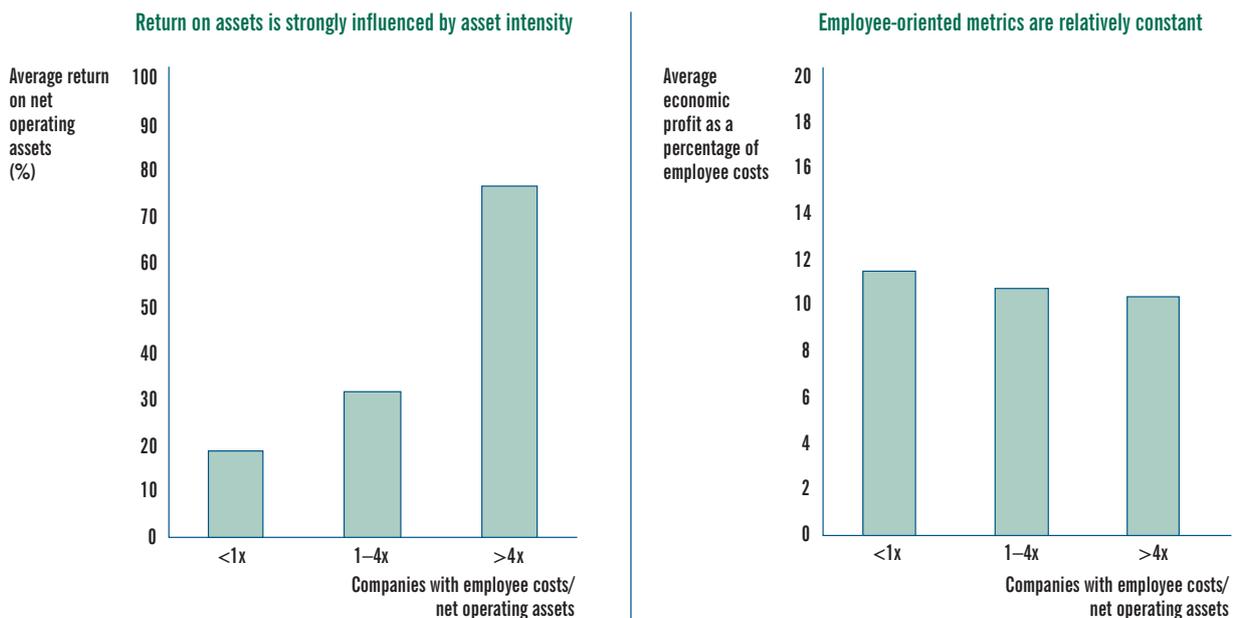
Source: BCG analysis.

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

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

EXHIBIT 6

FOR PEOPLE BUSINESSES, EMPLOYEE-ORIENTED METRICS ARE MORE CONSISTENT THAN RETURN ON ASSETS



Source: BCG analysis.

Note: Return on net operating assets excludes goodwill and intangible assets. Data are from a 44-company sample of people businesses with more than \$1.3 billion in 2003 revenues.

Interestingly, when people businesses use workonomics measures, their performance scores are more consistent than when they use return on assets as a measure. (See Exhibit 6.) Most companies fall within a relatively narrow performance band, with productivity between about 0 and 20 percent above employee costs (and the median around 10 percent). Performance differences among companies in this range are typically the result of variations in the quality of operational management. Only a few players stand out as achieving substantially higher productivity in relation to employee costs; these typically have not only excellent operations but also markedly superior strategic positioning.

The Importance of Linking Employee Metrics to Shareholder Value

A full set of employee-oriented metrics can be defined by asking the same questions about employees that have traditionally been asked about capital. (See Exhibit 7.) In a capital-intensive business, for example, we ask how well our capital investment—a chemical plant, say—is utilized. In a people business, we will ask how well employees are utilized. The parallels can be taken a long way. The passive side of the balance sheet, for instance, examines how capital investment is financed. It is equally meaningful to ask how human capital is financed. Fixed salaries are like

debt financing: the suppliers of human or financial capital provide capital for a fixed fee with limited risk and receive a low return. Variable compensation, profit shares, and options are more like equity. Human capital takes a risk and expects a higher return. A dollar's worth of profit sharing costs shareholders less than a dollar of fixed salary because it reduces their risk.

Obviously, engaged employees are critical for people businesses. To improve employee performance, you need to understand what motivates them. That calls for a new set of questions that have no equivalent in capital investments, since machine tools and chemical plants do not (yet) have emotions.

Most surveys designed to measure employee satisfaction and engagement are quite good, but they often accomplish their task the hard way: with long lists of questions that make it difficult for management to move from problems to solutions. To truly engage employees, companies need to meet their own business objectives and their employees' personal objectives. Many surveys bypass company objectives and move straight to the question of employee goals. A better survey would start with company objectives and the performance disciplines that enable them. Then it would relate employee objectives back to those disciplines. The results make it easier to move from problem to action. (See Exhibit 8, page 14.)

EXHIBIT 7

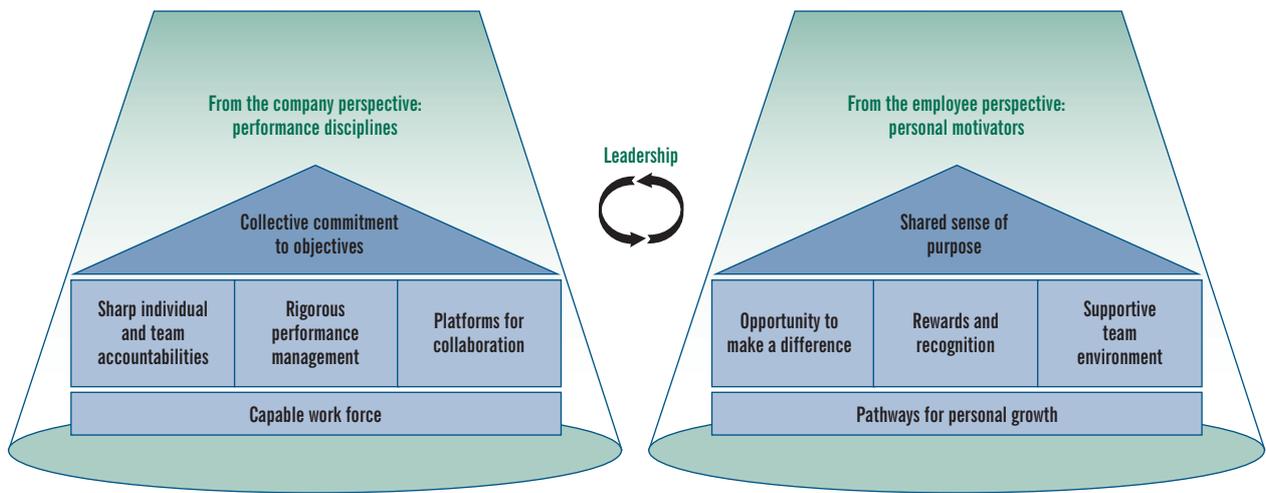
EMPLOYEE MEASURES CAN MIRROR CAPITAL MEASURES



Source: BCG analysis.

EXHIBIT 8

TO ENGAGE EMPLOYEES, COMPANIES NEED TO MEET THEIR OWN BUSINESS OBJECTIVES AND EMPLOYEE OBJECTIVES



Source: BCG analysis.

Employees are motivated at least in part by being part of a successful, effective, and efficient organization. Therefore, it makes sense to ask them not only how well they feel 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 whether 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 needs are being met in a way that also meets employees’ personal needs and motivates them to excel. Does the organization provide employees with roles that make them feel they can personally make a differ-

ence to the success of the company? Do the HR processes that ensure a competent work force also provide career development so that employees can learn and grow in responsibility?

Occasionally, company objectives and employee objectives are in direct conflict. For example, downsizing may be necessary to boost profits, but it’s not usually in the interests of the employees who are laid off. A company that has downsized does not depend for its long-term success on motivating laid-off employees. But if performance disciplines disregard the personal objectives of employees on whom the company *does* depend for its long-term success, then the disciplines will fail. What’s more, the failure will be particularly harsh in the case of customer-facing employees, for whom motivation is crucial to productivity. Good performance requires that both company and employee objectives be met. Employee surveys can accurately describe the extent, nature, and location within the organization where performance is lacking, but we advise in-depth management and employee interviews before and after administering employee surveys, to get a richer understanding of complex problems and challenges.

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 that, on average, a 5 percent improvement 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 strong people and operations management systems. One highly successful corporation with a portfolio of people businesses defines seven excellence indicators and introduces them across all the businesses. It is then the job of the director of excellence, who reports to the CEO, to oversee a system that quantifies the drivers of each indicator. Those drivers include such hard-to-assess processes as people development. The excellence measures are a key part of the postmerger integra-

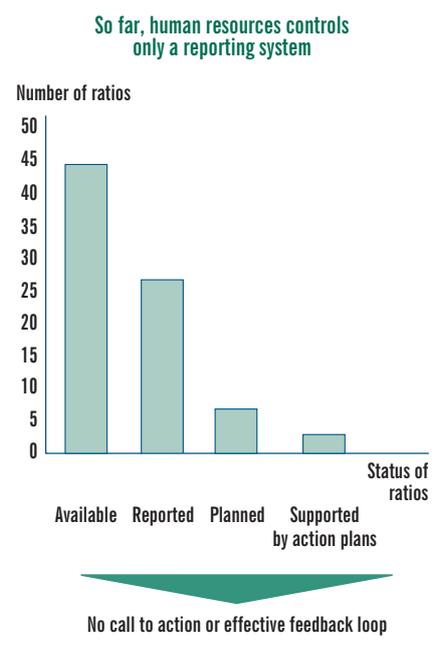
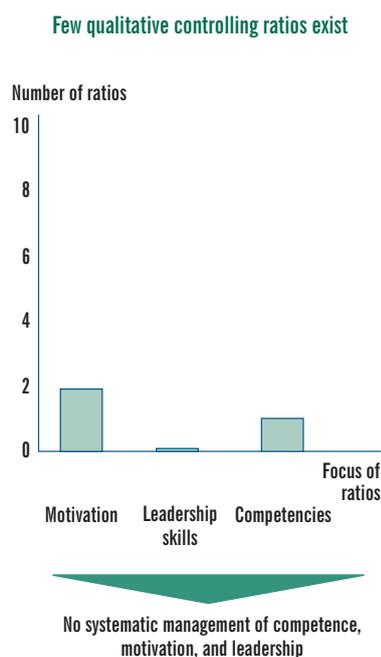
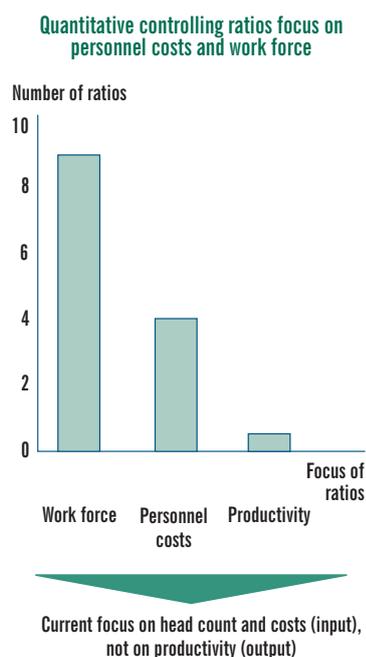
tion process for new acquisitions, and they play an integral role in reports and rewards.

The Building Blocks of Effective People Management

Good information is the starting point—but only the starting point—of a powerful operations and people management system. In addition, the information must be readily accessible, not merely available. And once it is accessed, it must be fully understood and then translated into action.

Companies frequently have better information about the costs of employees than about the value they create. Few companies do a good job of benchmarking their competitive performance in employee-oriented terms. But the hardest challenges come with moving from information to action. Employee performance indicators, for example, are often reported but rarely translated into a plan of action that is implemented with sufficient control. (See Exhibit 9.)

EXHIBIT 9
EMPLOYEE METRICS CAN BE SKETCHY AND RESULT IN LITTLE ACTION



Source: BCG analysis.

A finely tuned operations and people management system encompasses three levels: information (employee metrics, customer metrics, and benchmarks); understanding (employee competencies and engagement, customer satisfaction, and outstanding performers); and action (HR processes, organizational context, and business focus). All three levels are institutionalized and linked to create a fast and effective feedback loop. (See Exhibit 10.) Let's examine each of these levels in greater detail.

Information. It is critical to establish hard links between employee metrics and financial accounts. Linking accounts to employee metrics—such as employee productivity, utilization, and attrition; number of employees; and cost per employee—gives status and weight to the employee perspective. This approach is much more useful than a conventional balanced-scorecard approach, which offers only a soft link between financial accounts and people performance. The numbers can then inform management discussions about operational improvements.

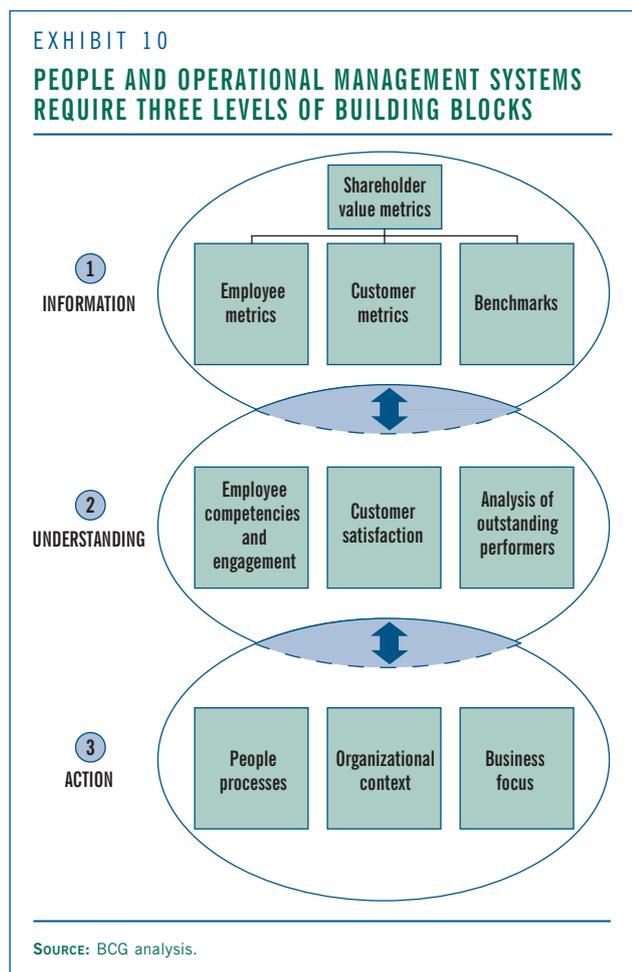
Since an objective measure of employee performance is crucial for managing employees and determining appropriate compensation, pushing for performance measures at the individual level is important. For traditional businesses, employee productivity is often hard to measure at the individual, or even the small-team, level. People businesses, however, have a high share of customer-facing activities for which the results on a granular level are immediately observable. But the data won't appear automatically. Accounting and behavioral norms have to be put in place. If, for example, hours spent on projects are not recorded, or are inaccurately recorded, then it won't be possible to link customer revenues with employee costs.

Hard links can also be established between customer metrics and financial accounts. Doing so is particularly helpful in consumer or small-business services that use direct marketing because it permits tracking of 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 create an important link between employee and customer perspectives.

People businesses typically serve customers from a geographically dispersed network of branches or offices. These offer an ideal opportunity to learn from regular, systematic internal benchmarks among performance units. Good internal benchmarks require central control over metrics and technology to facilitate comparisons across the group.

Finally, competitive benchmarks covering employee and customer performance indicators, as well as financial measures, are useful in assessing the *true* performance gap between competitors. Profit differences often understate the magnitude of a performance problem in situations where it is difficult for customers to change suppliers or for employees to change employers. Looking only at profit differences can lead to complacency and, at some later point, to a rude awakening.

Understanding. This level focuses less on absolute numbers and more on understanding how well a people business is motivating and training 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 outpacing or improving the poor performers. One important measure for understanding employee behavior is customer satisfaction. Not only is this a good indicator of how the employee is doing with current customers, but strong customer satisfaction scores can also be advertised to gain new customers.

Tracking employees who score significantly higher than others provides another way to understand the drivers of productive behavior. In high-value-added people businesses, there are often wide variations in productivity among employees—not just 50 percent but as much as 500 percent. Understanding what outstanding performers do differently is invaluable for improving the performance of other employees. Top-performing teams and employees tend to do the right things the right way. They use their time more productively and adapt service processes to reduce their costs and increase their value.⁴

Action. There are no results unless the work of gathering information is translated into action. Not surprisingly, changes in people management—management selection, compensation, career paths, and other HR processes—represent one powerful set of performance improvement levers in people businesses. However, developing an understanding of employee engagement and top performers often reveals quite different and equally powerful levers to increase productivity. Employee engagement, for example, is often hampered by poor organizational design. Resources and constraints must be adjusted so that the players in the game are better able to meet the company’s goals, as well as their own. Top performers often adopt a different and more profitable business focus. Other employees’ efforts may need to be refocused on more profitable customers, product groups, or activities.

The corporate center needs to decide how to leverage insights and understanding across the network. Depending on what is appropriate for the business,

either standardized best-practice processes can be introduced and constantly improved with new information, or knowledge networks can be established so that separate business-unit heads, branch or office managers, and other employees can learn from one another without the need for standardized processes.

A Tale of Two People Businesses: IT Services and Hotel Management

To appreciate the value that a good operational management system brings, consider the benefits that two very different people businesses were able to gain by changing the way they measured and evaluated their employees. In the first example, an IT services-and-software company introduced employee-oriented metrics. In the second example, a hotel management company was doing most things quite well but had one or two significant blind spots.

An IT Services-and-Software Company. The parent of the IT services company owned mostly asset-driven businesses, so it seemed natural to apply the traditional measures of return on sales and return on capital across its whole portfolio. And from that perspective, the IT services business’s performance looked acceptable. Its return on capital was above the required rate of return and similar to that of its parent. Yet the company was losing both market share and its best engineers. Feeling uneasy about the future, the parent decided to establish a new set of employee-oriented measures and benchmarks. Here’s what it discovered as a result.

Information. The new metrics revealed a much larger performance problem than conventional financial measures had indicated. It turned out that the IT services business was as much as 25 percent less productive than its competitors. Return on capital seemed satisfactory only because the business required very little capital. Productivity, by contrast, exceeded employee costs by only 3 percent, whereas benchmarked competitors achieved an excess of 12 percent. Furthermore, those same competitors

4. For a compelling argument supporting the links among employee engagement, customer satisfaction, and performance, see James L. Heskett, W. Earl Sasser, and Leonard A. Schlesinger, *The Value Profit Chain: Manage Employees Like Customers and Customers Like Employees* (New York: Free Press, 2003).

were paying their employees nearly 15 percent more. Although they offered a base pay similar to that offered by the IT services business, they complemented that pay with better benefits and higher variable compensation—advantages that were harder to spot initially. (See Exhibit 11.)

Deeper analysis helped pinpoint the problems more precisely. (See Exhibit 12.) Margins on “solution sales” (product licenses, installation, and service bundles) from the company’s own sales force were very good, but the sales force was small and attrition was high. In software installation, where most employees worked, the positive margins resulted from pay scales below industry levels. What’s more, utilization of the installation staff was down, and the company had trouble realizing full price on its installations. Service margins were high, but the volume was low. Product license fees were also low and failed to cover the cost of R&D. (See Exhibit 13.)

Analyses of accounts from a customer perspective (such as service revenues by customer in relation to installed base by customer) would have been useful, but the information couldn’t be gathered quickly, although it was available in company rec-

ords. This lack of customer information was, in itself, revealing.

Understanding. The software company’s own sales team was too small for two reasons. First, the company gave priority to using external value-added resellers (VARs), although that strategy had been unsuccessful so far. Second, it was difficult to hire more salespeople because their status relative to VARs was perceived to be low and compensation and incentives were also low.

In addition, engineering processes and staffing management were found to be causing some of the software installation problems. Although the company had not carried out formal customer surveys to assess satisfaction, rudimentary information revealed that customers were indeed unhappy with the installations, which often failed to be on time and on budget. The engineering hours required for installing basic software were not decreasing—as they should have been, considering that the company had years of experience with this type of service. The flaw in the experience curve turned out to be people management. Basic installations were being used to train new engineers, and although the smart ones quickly learned shortcuts, that knowledge was never transferred to their colleagues. As a result, the company lost the benefit of its best engineers’ experience when they moved on to more complex assignments or left the company. Meanwhile, competitors were moving faster to adopt more standardized, efficient installation processes.

R&D should have helped codify this learning and secure productivity gains, but it was frequently diverted to solve difficult one-off problems on custom installations. That explained the poor price realization on installations. It also partially explained the poor utilization. In order to cover up overruns, the engineers weren’t recording all the hours they spent on a project. Staffing management issues explained the rest of the low utilization problem. Installation project managers were trying to keep their top engineers to themselves, even when those employees were needed on other projects.

Low service sales were also in part a people management problem. Sales for services not covered by warranty—except for those of a few outstanding performers—were low because most service engineers didn’t see themselves as salespeople. And it was diffi-

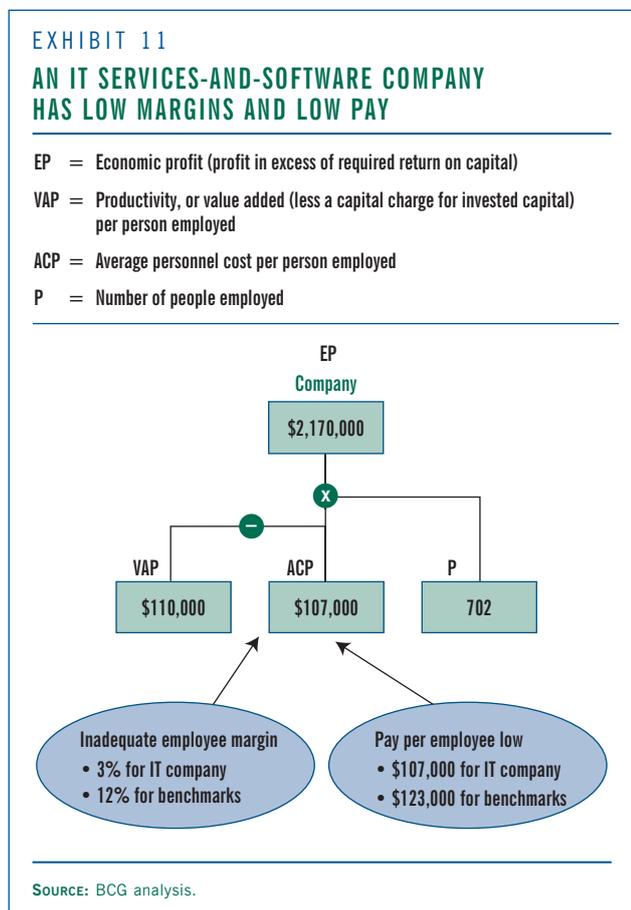
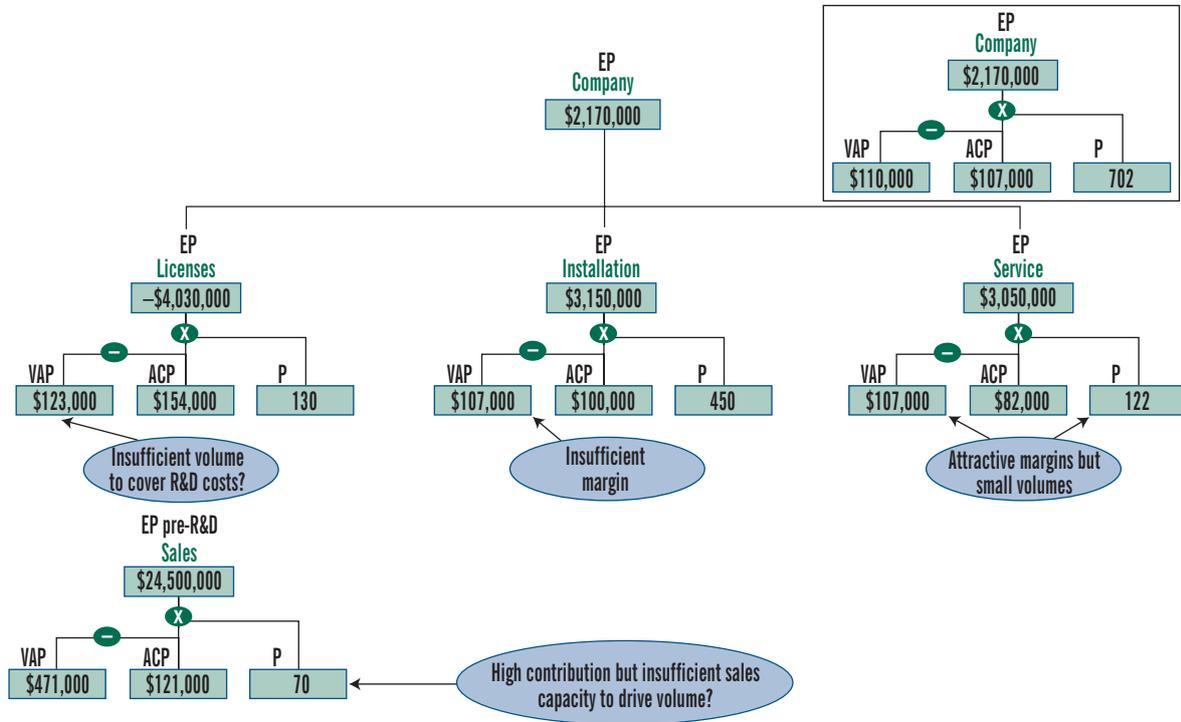


EXHIBIT 12

CONDUCTING A PERFORMANCE ANALYSIS BY FUNCTION IDENTIFIES ISSUES

EP = Economic profit (profit in excess of required return on capital)
 ACP = Average personnel cost per person employed

VAP = Productivity, or value added (less a capital charge for invested capital) per person employed
 P = Number of people employed



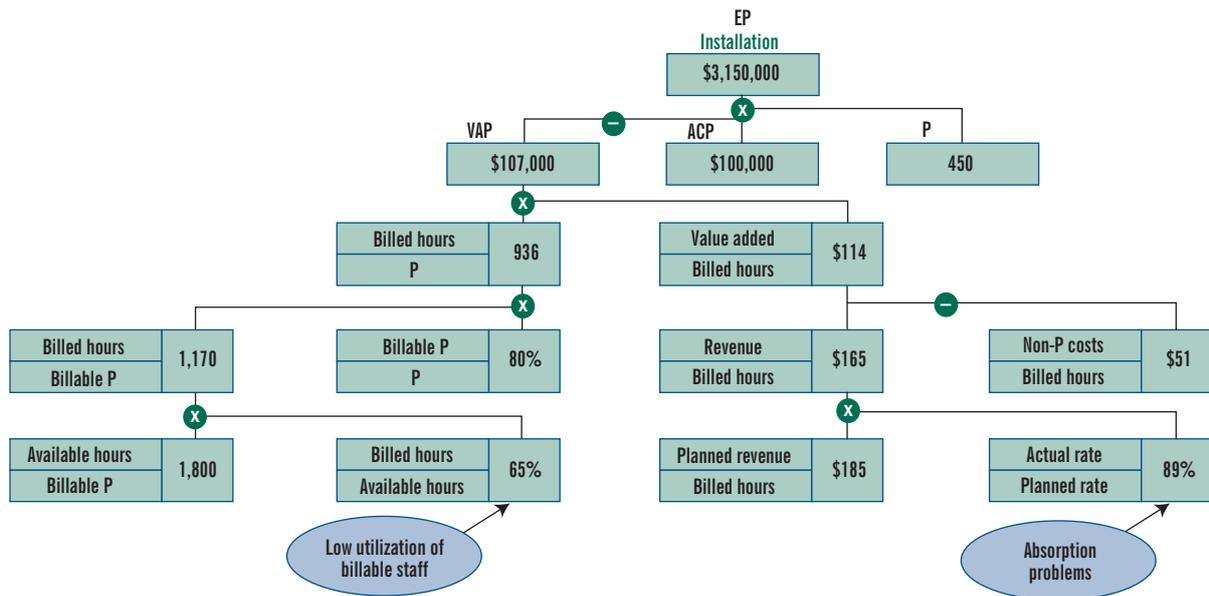
Source: BCG analysis.

EXHIBIT 13

DIVING INTO INSTALLATION DATA SHARPLY DEFINES SOME PROBLEMS

EP = Economic profit (profit in excess of required return on capital)
 ACP = Average personnel cost per person employed

VAP = Productivity, or value added (less a capital charge for invested capital) per person employed
 P = Number of people employed



Source: BCG analysis.

cult to manage, measure, and reward the service engineers on their sales performance because information on the installed base was hard to access.

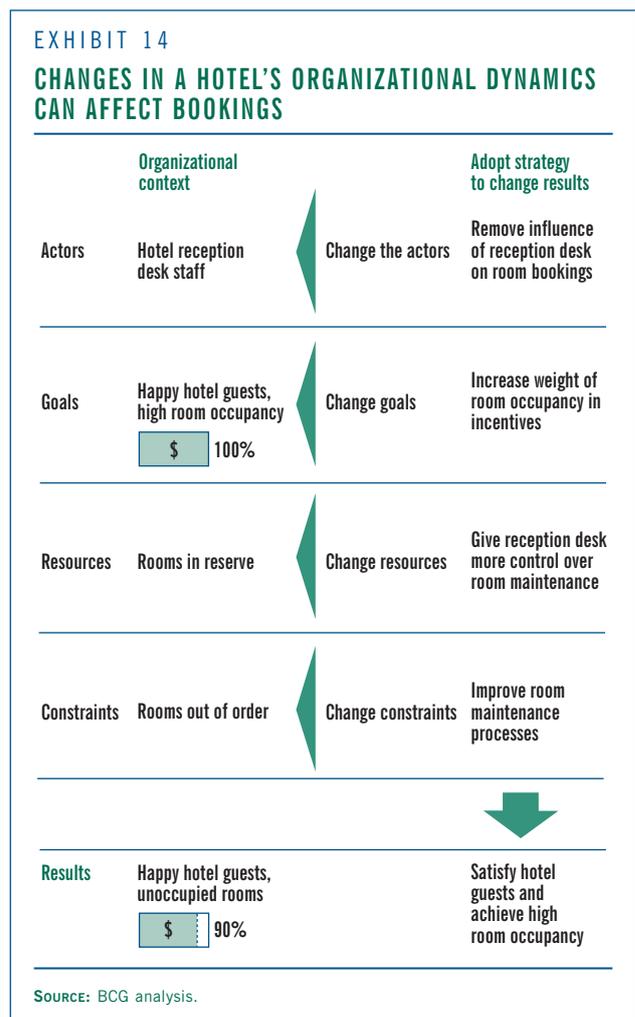
Action. Although the employee-oriented measures revealed many problems, they also suggested many opportunities to increase sales and productivity. The company could, for example, shift its focus from VAR sales to strengthening its own sales force. It could put more emphasis on training service engineers and on providing them with incentives to sell service to the installed base. It could introduce new project and staffing management processes in installation. It could focus R&D on capturing and codifying knowledge about basic software installation. And it could improve the employee- and customer-oriented information systems to plan, monitor, and control performance more effectively. However, because operational management was so poor, these problems were caught late. In the short term, compensation increases intended to hire, retain, and motivate the right staff were likely to absorb part of the gains.

A Hotel Management Company. As the IT services company found, problems concerning the management of operations frequently yield to a straightforward analysis. But sometimes a problem can seem intractable, at least at first. That was the situation a hotel management company faced. Although it was doing most things quite well, a couple of blind spots were causing inordinate problems. Specifically, the utilization of hotel beds, particularly in good months, never seemed to reach the levels management thought were possible. Potential guests were being turned away even when rooms were available. Because the reception staff people influenced the acceptance or rejection of reservations—especially last-minute reservations—management suspected that their attitude was responsible for the underbooking problem. So the company introduced training programs and adopted incentives. But rooms were still going unused.

It turned out that the problem was not, as originally supposed, apathy on the part of reception staff or, as some wilder speculation suggested, that these employees were deliberately sabotaging the hotel chain. In fact, the staff people did care about hotel

bookings, but they cared more about keeping hotel guests happy.

Their top concern was to avoid having hotel guests ringing reception or coming to the desk to complain that the television didn't work or the beds were unmade. The staff felt obliged to fix the guests' problems, but the only resource at its disposal was spare rooms. This was why these employees were loath to fully book the hotel. No amount of training was going to change their attitude. What might change it, however, was to provide reception staff people with other resources, such as a guarantee that rooms would be fully equipped, made up, and functioning. At the very least, they could be given some authority over those employees who could remedy such problems quickly. In short, hotel management needed to fix the organizational dynamics, not improve individual employees' motivation or capabilities. (See Exhibit 14.)



The Compensation Challenge

Compensation raises big issues in all businesses, but the impact of those issues is greatest in people businesses, where employees represent most of the costs and most of the value created. The appropriate distribution of rewards and risks between shareholders and employees, the effective use of variable compensation to reward and retain employees, and the equitable compensation of individual employees and of different classes of employee are hot-button issues in most people businesses. Here are some of the complexities they face.

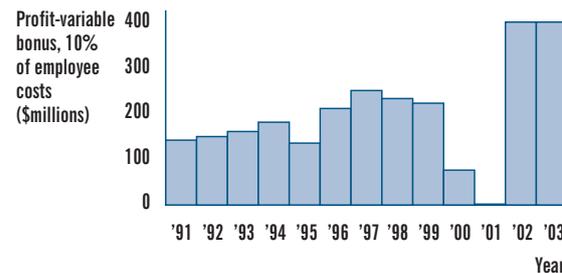
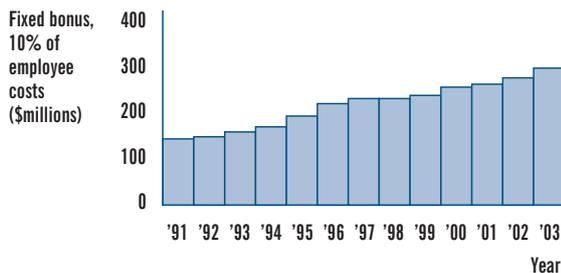
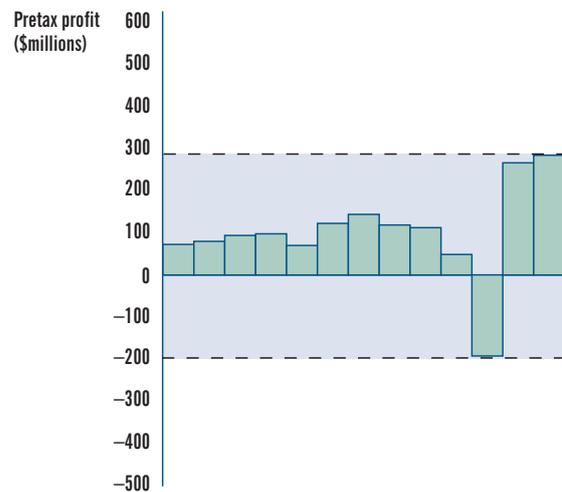
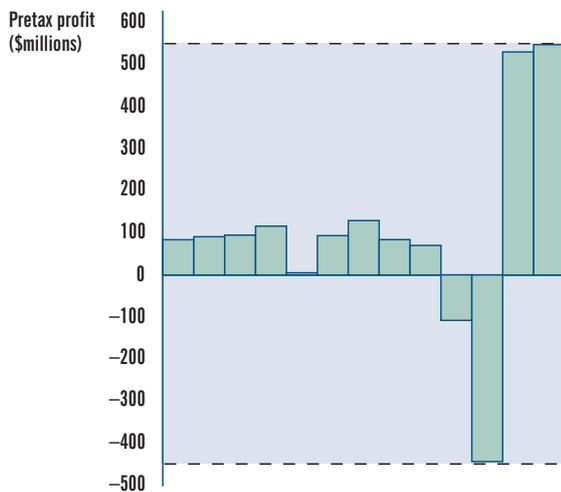
- Because operating profits in people businesses are typically only 15 percent of employee costs, even small changes in the level and structure of compensation have a major impact on the level and volatility of profits. If, for example, you pay

out 15 percent of your employee costs in variable bonuses, you are paying a sum equal to your operating profit. But consider also that if you exchange the 15 percent variable bonuses for fixed compensation—without changing employee compensation over the economic cycle—then operating profits become roughly twice as volatile, with correspondingly greater risks for shareholders. (See Exhibit 15.)

- Variable compensation that is based on performance (measured and paid on an annual basis) makes sense in many people businesses, especially those in which most employees are engaged in customer-facing activities and the productivity or profitability of individuals or small teams varies widely according to their own efforts. Compare

EXHIBIT 15

PROFIT-VARIABLE BONUSES REDUCE PROFIT VOLATILITY AND HENCE SHAREHOLDER COSTS



Source: BCG analysis.

that with an R&D business, where productivity is also variable but is measurable only over the long term and for relatively large teams, or with a traditional manufacturing business, where individual productivity results more from capital investments and defined production processes than from personal or team effort.

- Retention of key employees is a crucial success factor. Establishing long-term compensation with vesting and introducing noncompete policies are two ways to increase retention. However, there are legal restrictions on vesting and noncompete clauses in some countries and for some classes of employee.
- Many people businesses originated as partnerships or were put together through the acquisition of owner-managed businesses where the previous owners continue to work. That puts tough demands on a compensation culture that aims to provide a continued sense of ownership.
- If the management team consists of long-term employees and previous owners of independent companies who have earnouts negotiated at different times and at different stages of the economic cycle, there may be substantial differences in the contractual arrangements of managers with similar responsibilities. That can easily lead to disagreement over the explosive issue of what constitutes equitable manager compensation.
- Although productivity is comparatively easy to measure in people businesses, there can be practical difficulties in comparing the “worth” of different individuals. For instance, how do you compare the measurable value of customer-facing employees with the less measurable value of other employees? Or how do you compare the value of employees on a team when the value of individual members is harder to measure than that of the team as a whole?

Recognizing that every business encounters compensation problems that are unique to its circumstances, we would like to offer a few sugges-

tions for working through these issues in people businesses.

Competitive Compensation Benchmarks

A good compensation process begins with competitive benchmarks. In people businesses, variable compensation is often an important part of total compensation at all levels of the organization. In fact, when variable compensation is included, differences in compensation among individual employees in directly competitive businesses can be as great as 20 percent, independent of differences in local costs. As we saw in the IT services company’s story, those differences can seriously affect the perception of profits and organizational performance.

If bonuses account for a substantial percentage of compensation, high-performing companies will tend not only to have higher profits but also to pay their employees more, thereby enhancing their ability to recruit and retain staff. In contrast, the productivity gap that poor performers must close to catch up with the leaders is often larger than profit differences would suggest.

The Impact of Compensation on Shareholder Risks and Returns

In people businesses, compensation is the largest factor affecting shareholder risks and returns because people are the largest cost and the primary source of value. Modest changes in compensation can have a big impact on profits. Therefore, people businesses need to decide how explicit and direct they want the link between variable compensation and profits to be.

That link is most explicit and direct when the overall bonus pool is defined from the top down as a share of total earnings before bonus payments. Such an approach is common in investment banking and in some private banks, where bonuses may be set between 25 and 55 percent of overall earnings before bonuses. In most businesses, however, even when bonuses are equally high, the overall bonus pool is determined from the bottom up, according

In people businesses, employee compensation is critical because people are the largest cost and source of value.

to employees' personal targets. That often results in bonuses that are less linked with earnings since profits can mysteriously decline, even when employees meet their personal targets. Overall bonus pools can be difficult for top management to control when they result from a series of independent lower-level decisions. At the opposite extreme—where the bonus pool is set as a percentage of fixed salaries—the pool is controllable, but bonuses don't rise and fall with company performance.

Each of these alternatives will affect shareholder risks and returns differently. A dollar of profit-variable compensation costs shareholders, on a risk-adjusted basis, substantially less than a dollar of fixed salary. The cost difference is calculable. Management needs to be very clear about which scenario it is choosing and understand and communicate the consequences of that choice for shareholders.

Each alternative also has a very different impact on employees in terms of communicating a sense of ownership. A direct link between earnings and bonuses provides a more vivid sense of ownership than a target bonus in percentage of salary, with an award based on qualitative assessment.

The Logic of Compensation

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.

When it comes to the level of compensation, the key questions to address are how the company compares with competitive benchmarks and whether there is a reason for compensation to be higher or lower than those benchmarks. When it comes to the structure of the compensation plan, ask the following key questions:

- 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 term?
- Are these productivity differences measurable at the individual and team level?
- Could we make them measurable? What would the measures be? How could we put them in place?
- Have we clearly separated rewards for past achievement from rewards for current performance? (For example, rather than pay higher salaries to the previous owners of acquired businesses, could we more explicitly denominate higher compensation as an earnout and therefore associate it with the purchase price?)

Typically, if the productivity differences among employees are substantial and measurable, the share of variable compensation will be correspondingly high. Jobs in which performance differences can be measured annually are candidates for high annual bonuses. Jobs in which differences can be measured only over the long term—software development, for example—are candidates for long-term variable compensation, such as stock options.

If performance is readily measurable at the team level but hard to measure for individuals, then a top-down system of defining rewards, first for teams and then for individuals, makes sense. A top-down system that starts with an overall bonus pool based on overall performance, and then distributes bonuses to teams and individuals, ensures that bonuses will not remain high when profits fall. This can easily happen when bonuses are determined from the bottom up, on the basis of hard-to-measure personal targets.

In all businesses, but particularly in people businesses, bonuses should reflect the employee's contribution not only to producing value and managing costs but also to team building and apprenticeship. That requires a clear process of obtaining inputs from lateral and upward feedback. The Boston Consulting Group, which is itself a leading people business, explicitly considers a matrix of business management and people management in granting promotions, awarding bonuses, and providing performance management. (See Exhibit 16, page 24.) General Electric and other companies follow a similar approach.

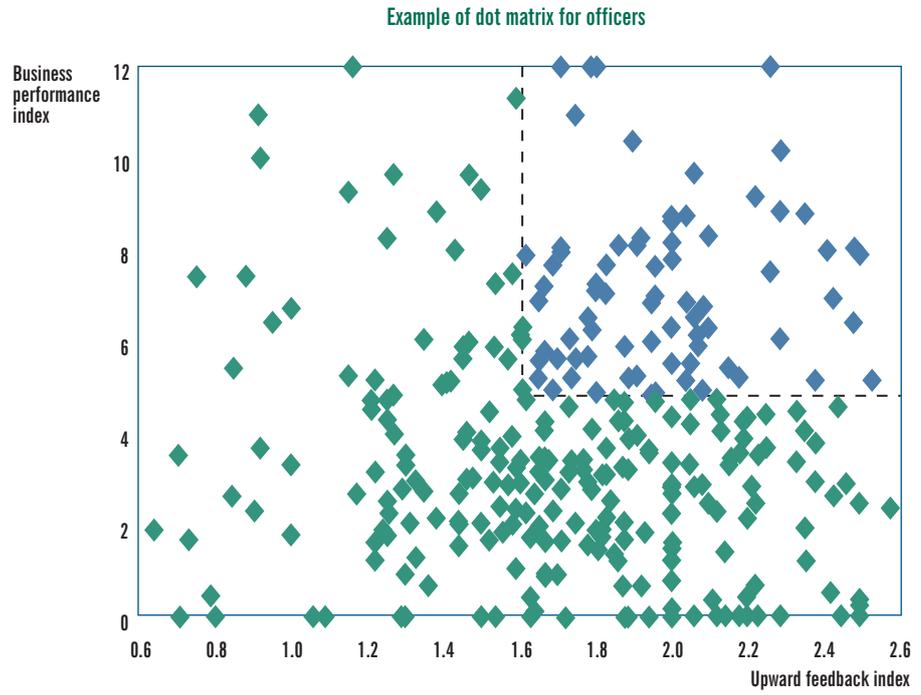
EXHIBIT 16

PERFORMANCE EVALUATIONS SHOULD REFLECT PEOPLE MANAGEMENT AND BUSINESS PERFORMANCE

Executive Upward Feedback and the Dot Matrix at BCG

Examples of apprenticeship questions in vice presidents' upward feedback

- Prioritizes initiatives realistically, resulting in sustainable workloads?
- Focuses team on key issues and provides appropriate guidance?
- Develops people effectively, coaches, and encourages?
- Builds affiliation and morale, and makes people feel part of BCG?



Source: BCG Vice President Feedback Survey.

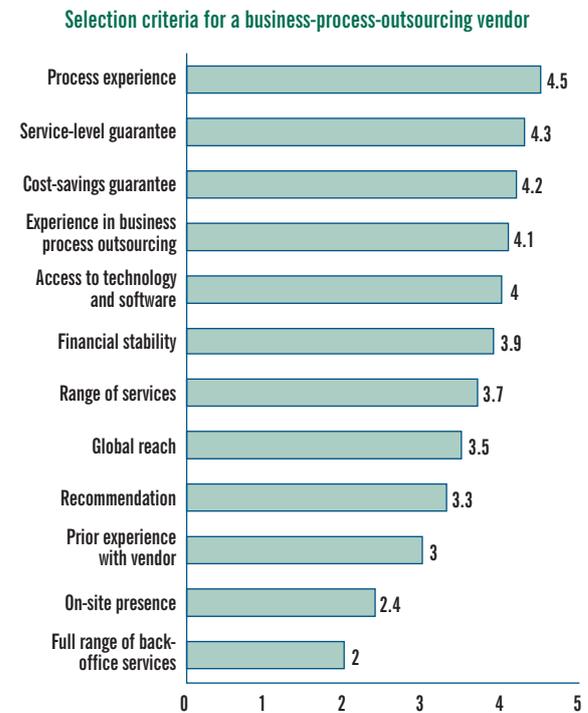
Note: Officers in the northeast quadrant of the matrix have not only good revenues but also good upward feedback.

The Ladder of Strategic Advantage

Most people businesses with truly superior returns have found a way to build organizational capital that creates substantial value over and above the value of their employees (and the added costs required to create that value). And in doing so, they have climbed to the top of the strategic advantage ladder. (See Exhibit 17.)

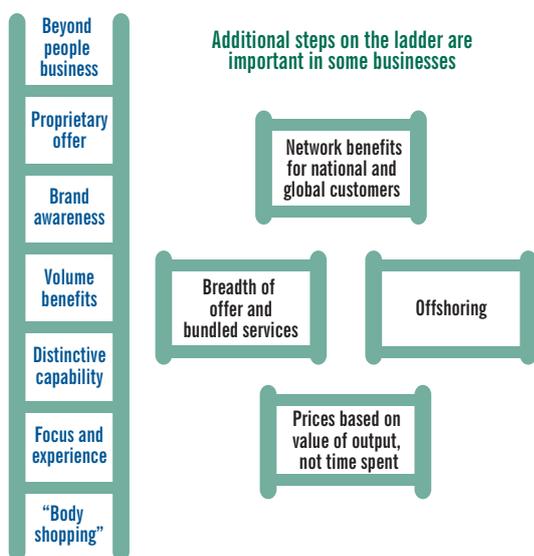
At its most basic, a people business is a subcontractor looking for opportunities to “shop bodies” at an hourly rate to companies that want to manage capacity flexibly. But at that level, the value added by the company over and above the value added by the individual employees is very limited. The subcontractor 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. In most surveys of business process outsourcing,

EXHIBIT 18
IN MOST PEOPLE BUSINESSES, CUSTOMERS RATE PROCESS EXPERIENCE THE HIGHEST



SOURCE: BCG interviews.

EXHIBIT 17
BUSINESSES NEED TO CLIMB THE STRATEGIC ADVANTAGE LADDER



SOURCE: BCG analysis.

process experience is right at the top of buying criteria, above breadth of experience or global reach. (See Exhibit 18.)

Typically, the more specialized the activity subcontracted, the greater the opportunity to add value. For example, in working with companies that have a portfolio of facilities management businesses, we found that their more specialized activities—such as cleaning a “clean room” in a high-tech production site (as opposed to cleaning an office building)—yield the better returns.

Often, however, the individual employee learns, but the organization does not—as we saw in the case of the IT services-and-software company. Organizational learning is a result of good organizational design and management processes, but it is difficult to get these right. Economies of scale and experience in people businesses tend to be less dramatic than in industrial businesses, where

processes are embodied and learning institutionalized in machinery or software.

Industry Consolidation and Business Economics

At some stage in an industry’s development, leading players will target aggressive growth to achieve scale benefits, often through acquisition. That has been the pattern in advertising, industrial cleaning, security, temporary help, and other sectors.

The initial phase of consolidation may be frustrating for the company leading the effort. There is often a period in which growth, particularly growth through acquisition, brings added costs of complexity but few scale benefits. People businesses may drive for growth in the belief that a number of potentially valuable activities—such as investments in national advertising, proprietary information systems, or product development—promise steep economies of scale. However, such investments will make economic sense only for companies above a certain size. During the consolidation process, there may be no competitors above that threshold for a long time. In other words, reaching the lower rungs on the strategic advantage ladder may initially bring few benefits in performance. But at some point, opportunities become attractive. H&R Block, for example, is a clear leader in U.S. personal-tax advisory services and an outstanding performer. It spends between \$100 million and \$200 million a year on marketing and advertising, but that represents only a small percentage of revenues. For smaller companies, the investment needed to make an impact with national advertising would be prohibitive.

Once the threshold for such scale-related investments is reached, competitive dynamics change. Before that, many competitors on the bottom rungs of the strategic advantage ladder can make reasonably good returns, and operations count for more than strategic position. But very few competitors reach the top of the ladder. A clear industry leader can make exceptional returns, while others fall far behind or are acquired.

The Evolution of New Competitive Advantage

Software businesses provide an interesting example of how people businesses can evolve to achieve

greater advantage. Most software applications start with customized products, of which the standard core represents a small part of the added value and is occasionally more “vapor ware” than software. At that stage, the business exhibits limited scale economies. But as experience with the application grows, so too does that standard portion of the added value in the business. (See Exhibit 19.) Volume and experience begin to provide competitive advantage, and R&D becomes a significant part of total value added.

For SAP, the world’s largest enterprise-resource-planning (ERP) software company and third-largest independent software supplier, R&D expenditures on its own new-product generation and applications represent 14 percent of sales. R&D is, essentially, a volume-sensitive fixed cost. It gives the company a potential for competitive advantage different from that of an IT services company that focuses predominantly on custom software contracts, consulting, or IT process outsourcing. Industry leaders in ERP systems, such as SAP, can transcend the people business category (as we have narrowly defined it) and achieve exceptional returns by exploiting the scale effects of their strong share position. (See Exhibit 20.)

Companies like SAP, with strong core products, can even outsource much of the software installation and customization to partners and focus on

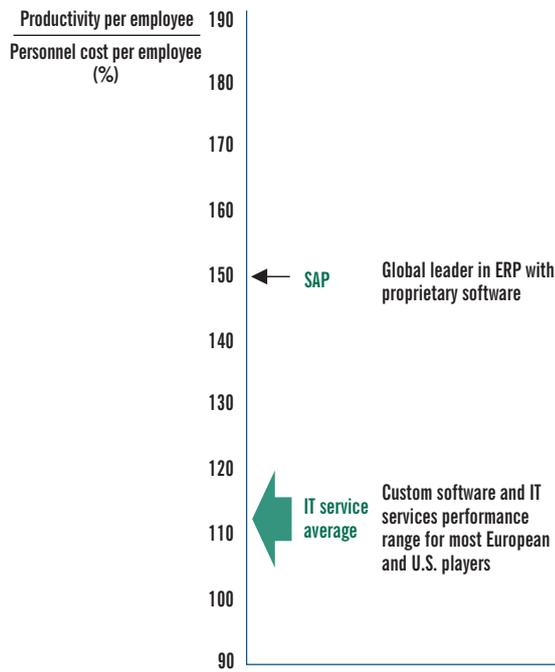
EXHIBIT 19 AS PEOPLE BUSINESSES MATURE, MORE PROPRIETARY PRODUCTS TEND TO EMERGE

A Business Software Product		
Time and cost for a typical contract	Previous-generation software	Current-generation software
Implementation time (hours)	5,600	3,333
Software revenues (€thousands)		
• Implementation	590	340
• License	90	130
Total	680	470
License/implementation ratio	1:6.5	1:2.5

SOURCE: BCG study.

EXHIBIT 20

PROPRIETARY CONTENT INCREASES THE POTENTIAL TO OUTPERFORM INDUSTRY PERFORMANCE RANGES



SOURCE: BCG analysis.

those parts of the value chain—such as product development and branding—that have strong scale effects and potential for high returns. Outside of software, few business-services providers have developed to the point at which the business value added—beyond employee management—is sufficient to become a separate business.

In consumer services, however, this pattern is quite common and explains why some sectors—such as hotel management and real estate brokerage—are less represented in the top global people businesses. The hotel business, for example, often splits into three parts: real estate companies that own the hotels; franchisers of hotel brands that own the brands, control the reservation systems, and define the corporate identity of the hotels; and franchisees that manage the hotels.

The hotel franchiser is no longer a people business. Instead, it subcontracts the people business to the franchisee and retains only the more scale-sensitive and less people-intensive value added. However, to the extent that the hotel franchiser adds value by offering franchisees benchmark

comparisons and standard processes for employee activities, the franchiser continues to leverage the people business in the metrics and people management processes.

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 does not 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 required quality standards. In addition, Cendant is the world’s largest residential real-estate franchiser, 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.

As companies create proprietary content and add value beyond that provided by their employees in their daily work, management must decide if shareholder value can best be created by keeping the people-intensive activities in-house or by focusing on the added business value and franchising or subcontracting people-intensive activities. That is true for all people businesses, including business services. In fact, as business services reach scale and mature, these issues, which many consumer services already face, may become more relevant.

Depth, Breadth, and Globalization

In climbing the ladder of competitive advantage, depth of experience typically counts more than breadth, but there are some businesses in which geographic spread and range of services are key. In advertising, for example, global reach is becoming more important as consumer and business brands increasingly look to global campaigns driven by one agency worldwide. In businesses that involve large-scale projects—such as oil field ser-

vices—or that bid on long-term contracts from public or private partnerships, a portfolio of skills may be valuable in securing and implementing the overall contract.

The Pricing Advantage

Pricing structures are also important for capitalizing on superior value creation as well as lower costs. Pricing by the hour is probably the least favorable contract for a people business whose proposition is superior value. A fixed-price-for-output contract, by contrast, provides an advantage for the competitor that can produce the same quality of work in less time, with fewer people, or at lower rates of pay. For competitors whose advantage lies in providing greater value for the customer, a success fee or a commission may offer the best opportunity—especially when the value of the advice for customers is considerably more than they have to pay for it. Some of the highest rates of return in our sample of people businesses are earned by financial services advisers and brokers operating on a commission basis in highly leveraged activities, such as commercial insurance brokerage and private banking. 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 advertising spending (good for agencies that create long-running campaigns, but risky) to fixed-fee structures, which limit the agency's returns to superior value creation for the customer, and, more recently, to pricing based on a fixed fee but with a performance incentive specifically related to the success of the campaign.

Somewhat paradoxically perhaps, the businesses with the most attractive pricing structures are often those with the poorest information about employee productivity. A business dependent on charging out hours has no choice but to carefully record the hours spent by employees on different jobs and the fees received for them. In contrast, if the business is

paid on commission, there is no customer pressure to measure the cost in employee hours of doing the work. Without customer pressure, however, those hours may not get tracked, even if the information would be highly valuable in understanding employee and customer profitability.⁵

Offshoring

By definition, people businesses have high employee costs as a percentage of their total cost structures, which makes them ideal candidates for moving offshore to lower-wage countries. But many services have to be provided on the spot. There's little value in having a cheap and very high-quality hotel available in Kuala Lumpur if you are on a business trip to London. It is also difficult to clean an office or mow a lawn from a thousand miles away.

Many people businesses are protected from offshoring, but some, such as call centers and IT services, are not. In the initial period of substitution, very attractive returns can be made by competitors moving people businesses offshore. Wipro, a leading Indian IT services provider, is a case in point. Supplying IT services to customers in the United States, Europe, and Japan, Wipro has increased sales at a compound annual growth rate of 50 percent for the past five years to achieve an annual revenue running rate of \$1.7 billion in the third quarter of 2004. Employee costs that are a fraction of what competitors spend in the United States and Europe make exceptionally high margins possible. (See Exhibit 21.)

Outstanding Performers at the Top of the Ladder

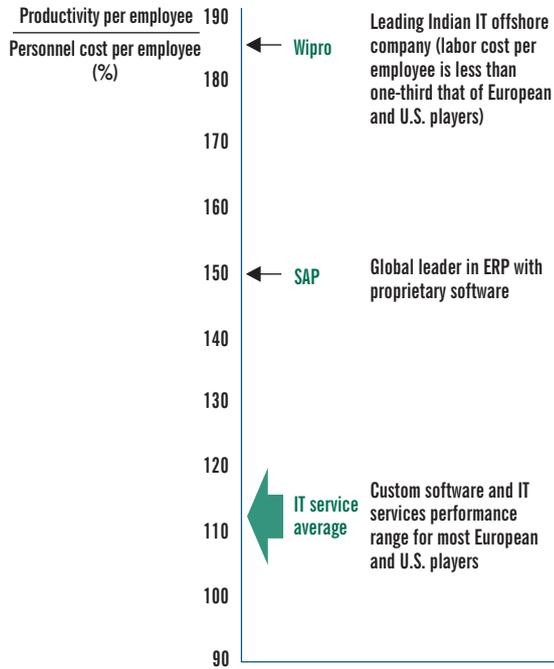
We found that the best performers among the top people businesses in our sample achieved productivity per employee of more than 30 percent above employee costs. That compares with an average for most people businesses closer to 10 percent. Except for a few that depend on low employee costs, these outstanding performers are all at the

Businesses with the most attractive pricing strategies often have the worst data about employee performance.

5. For this observation, we are indebted to Mark C. Scott, *The Professional Service Firm: The Manager's Guide to Maximising Profit and Value* (Chichester, England: John Wiley & Sons, 1998).

EXHIBIT 21

LOW-COST LOCATIONS OFFER EXCEPTIONAL PERFORMANCE WHEREAS ARBITRAGE OPPORTUNITIES PREVAIL IN IT SERVICES



SOURCE: BCG analysis.

top of the strategic advantage ladder. In Appendix II on page 32, we detail what it took to reach this level of achievement for five businesses from very different industries: H&R Block (personal tax advice), Rentokil Initial (hygiene and pest control), SAP (ERP software), The Capita Group (business process outsourcing), and UBS Wealth Management (private banking).

All five companies are clear leaders in large market segments—some with a truly extraordinary market position. H&R Block, for example, has more than 11,000 locations in the United States and is responsible for filing 15 percent of all personal tax returns in that country. All these companies have been able to convert their market position into strong brand awareness, reputation, and position. Capita, for instance, was awarded 24 percent of all large U.K. business-process-outsourcing contracts and was nominated the “most admired support-services company” three years in a row. And all five companies have used their volume and experience to build distinctive capabilities. Rentokil Initial, for example, has standardized hygiene and pest-control processes and uses its network density—a benefit of its market share—to create a cost advantage in customer service. UBS enhanced its customer relationships by introducing a trained and monitored “trusted adviser” process.

Most of these companies have found a way to create a truly proprietary offer, which has taken them to the next level of people businesses—and even beyond. SAP created a standard in ERP software and has moved beyond people by building substantial R&D-based intangible assets. Rentokil Initial invested in microbiology for washroom hygiene and produced a range of products to support and differentiate its services. H&R Block came up with the innovation of e-filing taxes, which, in turn, led to the new customer benefit of fast tax refunds. The company has also leveraged the customer knowledge it has gained in filing tax returns into a range of financial products, such as loans against expected tax refunds and mortgages.

Rules of the Game for People Businesses

People businesses are important and becoming more so. They are the biggest, highest-growth sector of employment in advanced economies. For that reason, they 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. Answer the same questions about employees that, in a traditional accounting view, you would answer about capital investments. As an input to managing employee engagement, measure employee perceptions about whether you are meeting company and employee objectives.
- Second, develop a sharp, fine-tuned operations and people management system that covers three levels: information (employee metrics, customer metrics, and benchmarks); understanding (employee competencies and engagement, customer satisfaction, and outstanding performers); and action (HR processes, organizational context, and business focus). People businesses require far more granular information and understanding than traditional businesses do. The leverage from getting the people management system right is five to ten times what it is in

other businesses because people are five to ten times more important in relation to invested capital. People management is a core process for line management.

- Third, use compensation, particularly performance-related compensation, as a versatile lever for managing people and profits. How compensation schemes are designed and implemented can have everything to do with shareholder risks and returns. Getting compensation right provides key employees with a sense of ownership. Getting it wrong can be highly divisive.
- Fourth, continuously renew strategic advantage by finding ways to be a better people business. Climb the strategic advantage ladder, transforming the company into a business whose organizational capital and intellectual property are adding at least half as much value as employees.

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. It's a new game. Don't play it by the old rules.

Appendix I: The Top People Businesses Around the World

Revenues, 2003 (\$billions)

Security and facilities management (15)			
Tyco International*	7.4	Willis Group	2.1
Securitas Group	7.3	The Vanguard Group	2.0
ISS Group	5.5	CB Richard Ellis	1.6
Group 4 Falck	5.2	Arthur J. Gallagher & Company	1.3
Emcor Group	4.5	Hotels, hospital management, and health care services (14)	
AMEC*	4.5	Hospital Corporation of America	21.8
Rentokil Initial	4.1	Tenet Healthcare Corporation	13.2
Secom Company*	4.0	Marriott International	8.7
The ServiceMaster Company	3.6	Accor	7.7
Johnson Controls*	3.3	Fresenius Medical Care*	6.4
Imtech Corporation	2.4	HealthSouth Corporation (2002)	4.3
ABM Industries	2.3	Triad Hospitals	3.9
Bilfinger Berger*	1.5	Universal Health Services	3.6
Ferrovial*	1.5	Community Health Systems	2.8
Prosegur	1.3	Health Management Associates	2.6
Advertising (7)		DaVita	2.0
Omnicom Group	8.6	Sana Kliniken	2.0
WPP Group	6.7	Gambro	2.0
Interpublic	5.9	Générale de Santé	1.3
Publicis Groupe	4.4	Contract catering (7)	
Havas	1.9	Compass Group	18.4
Dentsu	1.7	Sodexo Alliance	13.2
Grey Global Group	1.3	Aramark Corporation	9.4
Employment agencies (4)		LSG Sky Chefs Group	3.0
Adecco Group	3.1	Elior Group	2.7
Manpower	2.1	Gate Gourmet Group	1.7
Randstad Group	1.2	Delaware North Companies	1.6
Vedior	1.2	Oil, engineering, and industrial services (17)	
IT services (18)		Bechtel Corporation	16.3
IBM Global Services	42.6	Halliburton Company	16.3
Electronic Data Systems Corporation	21.5	Schlumberger	13.9
Computer Sciences Corporation	14.8	Suez Group*	10.6
Accenture	13.4	Fluor Corporation	8.8
HP Services	12.3	United Technologies Corporation*	8.4
Cappemini	6.5	Aker Kvaerner Group	5.5
Siemens Business Services	5.9	Jacobs Engineering Group	4.6
SAP*	5.4	Siemens Industrial Solutions and Services*	4.5
Unisys	4.7	URS Corporation	3.2
Affiliated Computer Services	3.8	CH2M Hill	2.2
Atos Origin	3.4	Aecom Technology Corporation	1.9
BearingPoint	3.1	SGS	1.8
CSK Corporation	3.1	Penauille Polyservices	1.8
LogicaCMG	2.8	Birla Parsons	1.7
Oracle Corporation*	2.1	WS Atkins	1.6
TietoEnator	1.6	Ryder System*	1.4
Tata Consultancy Services	1.5	Telecom services (11)	
Compuware Corporation	1.3	T-Systems International	12.0
Postal and courier services (5)		BT Global Services*	9.4
United Parcel Service of America	33.5	NTT Data Systems Technologies	7.3
Deutsche Post World Net	30.5	Getronics	3.0
FedEx	24.7	Equant	2.9
La Poste*	15.7	NextiraOne	2.3
TPG	13.4	Convergys Corporation	2.3
Contract research and general outsourcing (7)		Ericsson*	2.3
Science Applications International Corporation	6.7	Telecom Italia*	2.2
Lockheed Martin Corporation*	6.6	Lucent Technologies*	1.8
Serco Group	2.2	Telefonica*	1.2
Quintiles Transnational Corporation*	2.0	HR, consulting, accounting, and law (12)	
Interserve Group	2.0	Deloitte Touche Tohmatsu	16.4
The Capita Group	1.8	Pricewaterhouse Coopers	16.3
Altran Group	1.5	Ernst & Young Global	14.5
Financial brokerage and advice (12)		KPMG International	12.2
Marsh & McLennan Companies	11.6	McKinsey & Company	3.0
Aon Corporation	9.8	Booz Allen Hamilton	2.7
FMR Corporation	9.2	BDO Seidman	2.6
Merrill Lynch & Company	8.9	Hewitt Associates	2.0
UBS Wealth Management	5.0	Grant Thornton	1.8
Crédit Suisse Private Banking	4.4	Towers Perrin	1.4
H&R Block	4.2	Clifford Chance	1.4
Charles Schwab & Company	4.1	Skadden, Arps, Slate, Meagher, & Flom	1.3

Source: BCG research.

*The organization's service business only or its people-business units only.

Appendix II: The Strategic Advantage of Outstanding Performers

	Beyond people business	H&R Block <ul style="list-style-type: none"> • Brand • Standard processes • Unique service combination • Financial advisory partner 	Rentokil Initial <ul style="list-style-type: none"> • Proprietary, vertical value chain • Network density 	SAP <ul style="list-style-type: none"> • Proprietary software • R&D 14 percent of sales
	Proprietary offer	<ul style="list-style-type: none"> • First with e-filing and fast refunds • Unique service combination (office, online, and financial services) • Mortgages now 50 percent of profits 	<ul style="list-style-type: none"> • R&D and product investment: microbiology and washroom hygiene • Proprietary equipment manufacture 	<ul style="list-style-type: none"> • First with popular standard ERP software
	Brand awareness	<ul style="list-style-type: none"> • Between \$100 million and \$200 million on marketing and advertising • Very high U.S. consumer awareness 	<ul style="list-style-type: none"> • Strong, long-established pest-control brand 	<ul style="list-style-type: none"> • Interbrand/<i>Business Week</i>'s thirty-fifth-ranking global brand • Strengthened by deep partner-network support
	Distinctive capability	<ul style="list-style-type: none"> • Low-cost standard processes • 87 percent of clients with refunds compared with U.S. average of 77 percent • Customer relationships leveraged to cross-sell financial services 	<ul style="list-style-type: none"> • Standard service processes • Network density resulting in substantial cost advantage 	<ul style="list-style-type: none"> • More than 25 industry-specific business solutions • Software (my SAP) linking e-commerce to ERP
	Greater experience	<ul style="list-style-type: none"> • More than 11,000 locations in the United States • 15 percent of all U.S. tax returns 	<ul style="list-style-type: none"> • Dominance in U.K. pest-control hygiene • Founded with 1924 contract to debug U.K. Parliament buildings 	<ul style="list-style-type: none"> • Global leader in ERP software • 36,000 installations • 1,000 partners
	Clear focus	<ul style="list-style-type: none"> • Personal tax preparation and advice 	<ul style="list-style-type: none"> • Hygiene core • Refocus under way following expansion to broad BPO portfolio 	<ul style="list-style-type: none"> • ERP software
"Body shopping"				
* * *				
	Beyond people business	The Capita Group <ul style="list-style-type: none"> • Capital, scale, and reputation for megacontracts (such as BBC TV and TfL CCS¹) 	UBS Wealth Management <ul style="list-style-type: none"> • Swiss branding • Distinctive, standardized CRM 	
	Proprietary offer	<ul style="list-style-type: none"> • Joint venture with Indian partner resulting in additional offshoring opportunities 	<ul style="list-style-type: none"> • Swiss banking secrecy laws 	
	Brand awareness	<ul style="list-style-type: none"> • <i>Management Today</i>'s "most admired support-services company" for three consecutive years • Royal Bank of Scotland awarded "company of the year" 	<ul style="list-style-type: none"> • Strong global reputation • Focus on personal and institutional trust 	
	Distinctive capability	<ul style="list-style-type: none"> • Integrated provider: IT, HR, CRM, infrastructure, and general process reengineering • Proven ability to make it happen 	<ul style="list-style-type: none"> • Client relationship experience • Explicit trained and monitored "trusted adviser" process 	
	Greater experience	<ul style="list-style-type: none"> • 24 percent of all large U.K. BPO contracts • 36 percent market share in life and pensions outsourcing 	<ul style="list-style-type: none"> • World's largest private bank • 737 billion Swiss francs of invested assets in second quarter 2004 • 140 years in private banking 	
	Clear focus	<ul style="list-style-type: none"> • White-collar outsourcing • United Kingdom and Ireland only 	<ul style="list-style-type: none"> • Private banking (offshore) 	
"Body shopping"				

SOURCE: BCG research.

NOTE: SAP was not included as a people business in ratio comparisons because of high proprietary content but is included here to illustrate the potential to become a people business.

¹BBC TV's license fee collection and Transport for London's Congestion Charging Scheme.

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