

Prince, The Valuation Approach to ROI

THE VALUATION APPROACH TO ROI

E. Ted Prince

To be Published in Chief Learning Officer Magazine

November 2006

etedprince@perthleadership.org

www.perthleadership.org

Submitted to Chief Learning Officer July 2006

TABLE OF CONTENTS

TABLE OF CONTENTS 2

THE VALUATION APPROACH TO ROI..... 3

E. TED PRINCE..... 3

 THE ROI PROBLEM..... 3

 VALUATION - THE FUNDAMENTAL GOAL OF HR..... 5

 MEASURING VALUATION 6

 LINKING BEHAVIORAL CHANGE AND VALUATION 8

 THE LIMITS TO USING VALUATION IN ROI..... 10

 CONCLUSIONS 11

THE VALUATION APPROACH TO ROI

E. TED PRINCE

ROI approaches in HR have, to date been unsophisticated and largely irrelevant to the needs of top executives and shareholders. In this article we will discuss the basis for this assessment and suggest a new approach to address the ROI issue.

The ROI Problem

The fundamental problem with ROI approaches in HR is that they are based on the assumption that HR projects should show a positive “return” in financial terms. This reveals a lack of awareness of what sorts of measure are used for other areas of the corporation. The most important, strategic initiatives in a corporation are evaluated on their likely impact on the change in valuation of the corporation.

It is true that, for short-term projects which are not viewed as having a strategic impact, a straight project-based measure such as cost-benefit may be used. But, as experienced

Prince, *The Valuation Approach to ROI*

businesspeople are well aware, such short-term measures are usually irrelevant for major initiatives which are designed to make the corporation more valuable in a material way.

Current ROI approaches are based on cost reduction and project benefit methods.

However these approaches do not address the issue of what would occur if a positive ROI did not bring about a positive change in company valuation. Nor do they consider how a negative ROI should be viewed if its impact on company valuation were positive.

These are not academic issues. In any corporation, the ROI on any major initiative in product development or marketing and sales will ultimately be judged by its impact on future valuation, not whether or not it might or might not make a profit in and of itself, which it will usually not do. If I am a \$10 B per annum corporation, do I really care that the ROI on a training project was 15%, positive or negative? As a CEO what I really want to know is whether the training project will contribute to the achievement of the valuation goals the board has set and that the shareholders desire based on their investment hurdles.

Linked to this set of misapprehensions is the misguided concept that HR projects should be “profitable” in the sense that they result in a positive return defined in short-term financial terms. The true test of the impact of HR projects is that they contribute to the achievement of corporate valuation objectives, even if the projects themselves should show a negative return, not just in the short- but also in the longer-term.

Prince, *The Valuation Approach to ROI*

The fundamental problem is that current ROI measures, project-based as they usually are, present a worms-eye view of the problem, not a shareholder view. HR is inappropriately applying project-based management methods to initiatives which require program-based measures. Once we change our perspective to a valuation program view, measurement issues become much clearer.

Valuation - the Fundamental Goal of HR

It is well-understood that the process of evaluating return for HR, as for any initiative, should be linked with what the goals of the project were in the first place. Within HR there is much discussion about satisfying numerous stakeholders. These include employees, citizens (e.g. for social and environmental goals) as well as shareholders. However for most boards and CEOs, there is one over-riding goal and that is shareholder value.

Valuation is the only measurement that a shareholder understands ultimately. If the ROI on every project that HR ever undertook was positive and valuation and earnings per share declined, then the shareholder is worse off and will evaluate these HR programs as having failed. These same measures of valuation will also be, ultimately, the only ones that have real relevance and meaning to the CEO and the board.

If shareholder value declines and is reflected in lower earnings per share, (EPS), then no matter what the view of other stakeholders, the shareholder will have less money in his or

Prince, The Valuation Approach to ROI

her pocket. In that case the CEO and management team will almost certainly lose their jobs not to mention top HR people. The company will decline in value relative to its competitors. It will lose market share. It may even fail or be acquired in a distress sale.

HR needs to realize first and foremost that its mission is the building of shareholder value. This means increasing the valuation of the company on both an absolute and a share-adjusted basis. Once this is understood, we can start to build approaches and measure to evaluate ROI of HR initiatives. We call this the valuation ROI approach.

Instead of implementing what are often irrelevant project-based ROI measures. HR needs to adopt valuation ROI approaches so that it will be seen as relevant to shareholder and valuation requirements

Measuring Valuation

We can use the conventional methods of company valuation to judge ROI of HR initiatives. These include market capitalization, return on assets, price-to-earnings, price-to-sales and earnings per share. It does not particularly matter in principle which one of these is used. The precise measure will depend on the type of HR initiative we are evaluating, how well we can establish the linkage between the two, and the sorts of data that are available.

Prince, *The Valuation Approach to ROI*

But how do we evaluate HR programs that do not have a positive financial impact in the short-term but bring about positive changes in valuation as measured by measures such as market capitalization?

In this context we may also consider and reject the conventional HR approach to profitability. The debate on ROI now often is seen as attempting to increase profitability in order to increase company value. This may or may not be a correct assumption.

High company profitability may well be associated with a decreasing valuation. This occurs frequently in large companies with commodity products within mature markets where high profitability is accompanied by ever-declining valuations, absolutely and relative to competitors. Essentially the company is choosing short-term profitability at the expense of longer-term valuation improvement.

In such an environment HR needs to understand what the company is really trying to achieve and adjust its initiatives and its ROI approaches to incorporate the enterprise's valuation objectives. This may – or may not according to the circumstances - imply that many HR initiatives may need to have negative short-term returns – that is, a negative ROI – in order to achieve the longer-term valuation increases that will herald a return to longer-term financial health. This is a strategic issue which needs to be decided at strategic levels, not as a project-based ROI discussion.

Prince, *The Valuation Approach to ROI*

An HR program which has a short-term negative ROI in project terms but which brings about positive changes in market capitalization and earnings per share in the medium- and longer-term has a positive valuation ROI. For example, if market capitalization increased by \$500 million yet the short-term ROI as measured in traditional terms was negative (the program's costs exceeded financial benefits by, say 100% with total costs of \$6 million and a net deficit of \$3 million), it is highly positive if we take into account its impact on valuation. In fact the valuation ROI here has a positive multiple of over almost 100!

It might be objected that using valuation ROI is applicable only to public companies. This of course, is not true. Any company has a value, whether or not it is reflected in a public stock price. Private companies have their own, well-established (but, of course, not foolproof, just as with a public company) ways to measure their own value and valuation and thus their own valuation ROI. HR in both public and private companies has a responsibility to understand how it impacts the value of both types of company.

Linking Behavioral Change and Valuation

If HR's goal for ROI is valuation improvement, how will it know when its initiatives bring about such a result since the valuation impact will take place some time after the behavioral impact? The conventional approach would again rely on a series of project-based cost-benefit analyses to extrapolate this to a valuation contribution (such as using net financial contribution combined with a price-to-earnings multiple). However this is a

Prince, *The Valuation Approach to ROI*

backwards-looking measure since it is based on an historical event which may not be sustained. What we really need is a forward-looking measure based on behavior. This provides us with predictive power.

Conceptually this approach is very attractive. But to be able to work and to be measured it requires an underlying model that links the behavioral changes resulting from HR programs to be linked formally with financial performance and valuation outcomes.

Our research has demonstrated that financial styles of executives can be identified and measured. Financial styles lead to systematic biases in decision-making that result in predictable impacts on both an individual's financial performance and outcome. This allows us to make inferences about the impact on company valuation of executive and management teams. The issue is how to identify and measure these styles in a useful way that can be utilized in practice.

Our work has led to the development of assessments that identify and measure a manager's financial style and its financial performance and valuation impact on their organizations. These can be used to reveal to executives and managers the systematic and innate biases in their financial decision-making and as the basis for developmental approaches to help them improve. This provides a direct linkage between individual and team behavior, financial styles and company valuation outcome.

Prince, The Valuation Approach to ROI

Financial impact improvement programs allow us to show executives and managers how their financial style impacts the financial performance and valuation of their organization. Such programs can compare the valuation goals of the organizations with the financial styles and valuation impact of managers to reveal to what extent the alignment needs to be improved to achieve the requisite positive impact on valuation. In this way we can link HR programs directly with valuation ROI.

The Limits to Using Valuation in ROI

Notwithstanding the above, judgments will still need to be exercised in determining the ROI of HR programs using the valuation ROI approach. Valuation change is a complex matter involving numerous variables. Any change in valuation will be due to numerous factors. Identifying the impact of an HR program needs to identify these other factors and to assess how much is due to the HR program.

One of the best ways of measuring this impact is through surveys of executives and managers that have undergone the program to improve their financial impact. We do not reject using traditional project-based ROI measure providing they are used appropriately and in the correct circumstances. Project-based ROI measures can be used as an important component in a valuation ROI approach.

Intangible factors will, of course, still be important. In evaluating valuation ROI of HR programs, we need to include their direct contribution to valuation increases and their

Prince, *The Valuation Approach to ROI*

impact in building the infrastructure for future improvements, which cannot be directly measured in the short- or even the medium-term through valuation ROI, just as they cannot with project-based ROI measures.

Conclusions

Measuring the ROI of HR programs is a complex issue and we do not claim that the valuation ROI approach provides the ultimate answer. However it achieves two goals which are not currently recognized:

- It defines ROI in valuation terms, the most important measure for top management, boards and shareholders.
- It provides a way of linking managerial behavior to financial outcomes.

The valuation ROI approach can thus become another important tool in conjunction with other ROI approaches to increase the contribution of HR to the value of the company and its human capital.

Dr. Prince is author of [The Three Financial Styles of Very Successful Leaders](#) (McGraw Hill, 2005). He is Founder and CEO of the Perth Leadership Institute in Gainesville, Florida and a Visiting Lecturer in the Warrington College of Business Administration in the University of Florida. He can be reached at etedprince@perthleadership.org.