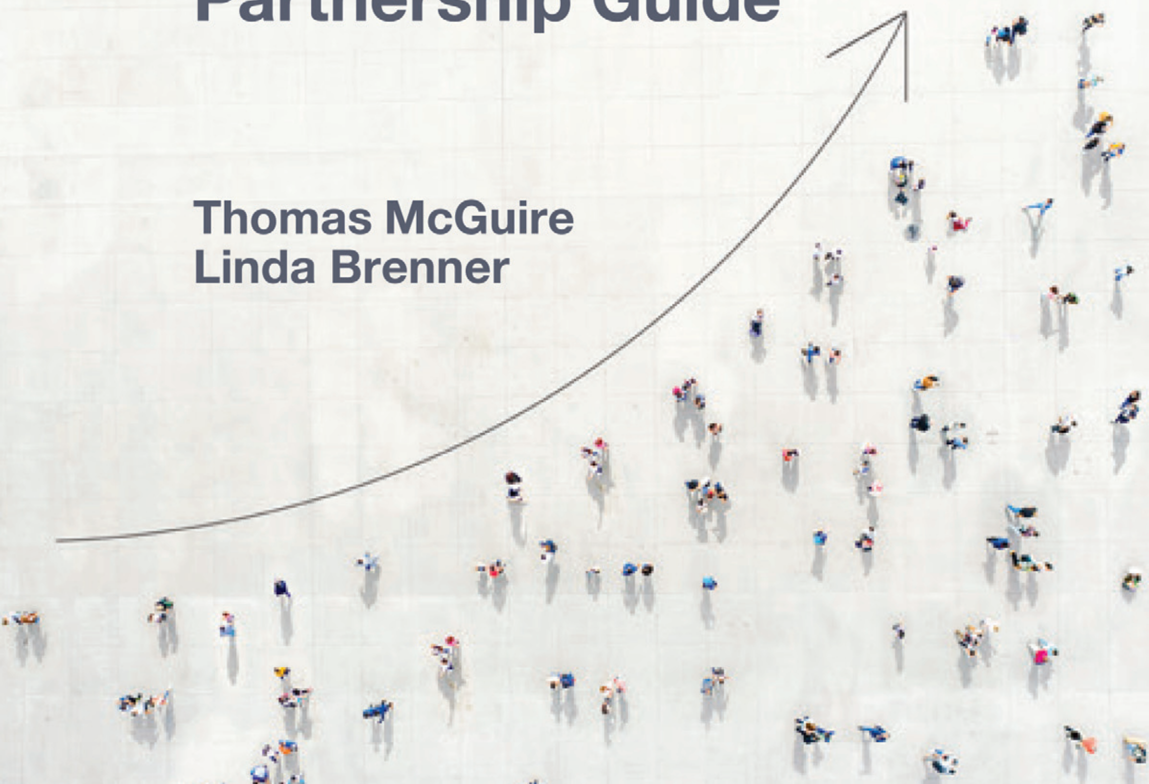
BUILDING BUSINESS VALUE THROUGH TALENT

The CEO and CHRO Partnership Guide

Thomas McGuire
Linda Brenner



BUILDING BUSINESS VALUE THROUGH TALENT

Tom McGuire and Linda Brenner draw on unique backgrounds spanning senior roles in operations, finance, and human resources to master the intersection of talent and market value. With *Building Business Value through Talent* they have created a common framework and language that finally optimizes the essential CEO and CHRO partnership in our knowledge economy.

– **Jack Stahl**, Co-Founder of CNEXT; a Virtual Mentoring Platform for Senior Leaders, Corporate Board Member, Private Equity Advisor, former CEO of Revlon, and President of The Coca-Cola Company

The connection between HR and business valuation has been nebulous until now. This guide informs a CEO how enterprise value, intellectual capital, and talent are linked – and how to take practical, measurable actions to maximize results with this in mind. HR no longer needs to worry about "having a seat at the table" – this proves that their role in our knowledge economy requires them to host the party.

– **Harold Osborn**, President and Chief Executive Officer, McIlhenny Company

It is easy to think of Finance as the steward of financial capital, and Operations as the steward of tangible assets. Tom and Linda's book shows HR how to be the steward of intellectual capital, which accounts for more than 80% of market valuation. Tom and Linda lay out clearly and conversationally, both the areas on which HR should focus to maximize this stewardship, as well as how the CEO should partner with HR to maximize the market cap of their company. With the ever-increasing influence of Talent on market valuation, *Building Business Value Through Talent* should be required reading for executives everywhere.

– **Andrew Lobo,** CHRO C2 Educational Systems, former CHRO at Arhaus, Inc.

Finally, an approach that proves the value of talent investments and guides HR decision-making in a data-based, value-creating way. This framework recognizes the critical connection between finance and talent that has been missing for far too long. This guide acts as a roadmap for positioning HR as the key to growing business value.

– **Deborah McFarlane**, Chief People Officer at EmployBridge, former head of HR for HD Supply Facilities Maintenance.

Tom and Linda have developed what will become the standard operating model for CEO and CHRO partnerships. What I appreciate most is that they have combined their practitioner backgrounds, along with their deep expertise in finance and talent management, to develop a value-added framework and guide for prioritizing, operationalizing, and measuring the true value of HR investments. They approach the work with a real-world perspective and this approach is long overdue.

– **Stacey Valy Panayiotou**, EVP-HR for Graphic Packaging International, former senior talent management, HR, Diversity & Inclusion and Organization Effectiveness leader for The Coca-Cola Company and Coca-Cola Enterprises, Inc.

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ABOUT THE AUTHORS

Thomas McGuire is unique in the talent management world as a person who has been both a Chief Financial Officer and a Global Talent Acquisition Director at well-known consumer product, NYSE companies.

Tom has 40 years of business experience following his first job out of college as a Peace Corps Volunteer in Central America. He began his business career as an external auditor in Columbus, Ohio, and after becoming a C.P.A. in 1982, left Coopers & Lybrand to join The Coca-Cola Company.

Tom spent his first years at Coke traveling around the world as an international auditor, followed by Corporate Finance roles supporting Latin America, Europe, and Africa. He assumed the Finance leadership role in the company's German Division in 1990 following the fall of the Berlin Wall. After playing a key role expanding Coke's business into the former East Germany, Tom returned to Atlanta in 1993 to work as part of the marketing management team reporting to the Chief Marketing Officer, Sergio Zyman. In addition to managing marketing financial plans, Tom was responsible for rebranding the World of Coca-Cola and Company Stores, building the WOCC Las Vegas and expanding the licensed merchandise business of the company. As a Vice-President in Coke's Marketing Division, Tom played a key role negotiating worldwide advertising agreements that led the way in establishing the industry trend toward fee-based compensation with agencies. From 1997 to 1999 Tom led the Global Talent Acquisition function at Coca-Cola, sourcing general management and marketing talent for worldwide operations and all talent for North America. In 1999 he moved into a role in Latin America, leading the development of a market-level strategy and integration plan for Peru following Coke's acquisition of Inca Cola.

In 2000 Tom joined Zyman Marketing Group in Atlanta, a developer of web-based marketing tools, as Chief Operating Officer. Following Zyman Marketing Group he formed a consulting venture, Human Capital Formation, LLC. In this business Tom provided consulting services that guided the redesign of the human resources functions and processes at clients including Children's Healthcare of Atlanta and Emory Healthcare.

In 2003, Tom joined Revlon, Inc., in New York City, serving as Revlon's Chief Financial Officer and then as President, Revlon International. During his tenure at Revlon, Tom led multiple debt and equity financing transactions totaling more than $2 billion, built the company's investor relations function, and implemented procedures to comply with Sarbanes–Oxley and other SEC mandated reporting requirements.

Tom rejoined the Coca-Cola Company in October 2007 as Group Director, Global Talent Acquisition, and focused on supporting the company's growth by developing and executing strategies to acquire top professional talent and independent contractors in the company's markets around the world. He built a globally based internal search firm at Coke and designed and implemented systematic measurement of talent quality for external hiring.

Tom retired from Coca-Cola and has worked with Linda Brenner since 2013, cofounding Talent Growth Advisors with Linda in 2015.

He and his wife Chris have been married 38 years and have 3 children: Olivia, Sean, and Patrick. In his free time Tom enjoys road biking, playing guitar and other instruments, and writing and recording music.

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Linda Brenner cofounded Talent Growth Advisors with the vision of helping business leaders improve talent results. The firms' clients include great brands such as Coca-Cola, Tabasco, Amazon, The Home Depot, Chick-fil-A, Raytheon, Microsoft, and Ogilvy.

Linda's innovative, results-oriented approach is coupled with a bias for action and a focus on measurable results. This same orientation is reflected throughout the TGA team of talent acquisition, talent management, and finance experts.

Prior to Talent Growth Advisors, Linda spent her professional career leading talent acquisition and talent management teams for Gap, Pepsi/Pizza Hut, and The Home Depot. Linda held a variety of roles at The Home Depot, including leader of enterprise-wide talent management practices including succession planning, talent review, and 360° feedback. Subsequently, she was then tapped to lead the company's talent acquisition centralization effort. In addition to centralizing TA for the first time in the company's history, under

Linda's leadership, The Home Depot also became the largest government contractor in the United States and forged first-of-their-kind partnerships with AARP, the Department of Defense, and the Department of Labor.

Prior to The Home Depot, Linda was with the Pizza Hut organization when it was still part of the Pepsi enterprise. There, she held a variety of roles, including HR generalist, national staffing manager, and the division's training and development group leader. At Gap, early in her career, she held operational roles in the Northeast division, including running the highest volume store there, until she moved to the company's San Francisco headquarters to lead a management development effort aimed at improving store performance.

Over the years, Linda has demonstrated a unique ability to break complex problems into manageable pieces and has led many teams to drive results in a timely, measurable, and results-oriented way. She works closely with business leaders and HR partners to create the business case, consensus, and tactical plan for change.

Linda holds a Master of Arts degree in Labor and Employment Relations and a Bachelor of Arts degree in Judaic Studies, both from University of Cincinnati. She and her family live in Atlanta.

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The proper man understands equity, the small man profits.

Confucius (551–479 BC)

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CHAPTER SUMMARIES

Important Instructions

At the Intersection of Talent and Market Value

This introductory chapter updates history, data, and formula for calculating the value of companies and the direct connection between Intellectual Capital, the largest component of market value, and specific critical talent within organizations. It is the foundation for tapping into the strategic opportunity presented to CEOs and CHROs.

Features at a Glance

Strategic Talent Function and Tools

This chapter describes in detail specific functions and tools of HR and how they directly impact value creation, whether or not the organization itself is fully cognitive of that impact in current state. Combined with the introductory chapter, the formula for creating value through talent, and the roles of CEO and CHRO in doing that, are revealed.

Installation

How to Start or Restart the Strategic HR Function

This chapter outlines how business value is created and its inescapable link to HR and, specifically, talent. We dive into methodologies for either building a customized HR function from scratch or transforming the existing function into an investment vehicle rather than an administrative cost.

Controls

The Most Important Facets of the HR Operating Model and How They Can Be Monitored

The ability to execute on HR initiatives is pointless without understanding what success looks like for the business and having the means to monitor progress and remediate shortcomings. The ubiquity of data in modern HR organizations can easily overwhelm and not effectively aid in making the highest priority decisions and course corrections. This chapter identifies the stages of execution and delivery in the HR Operating Model that are most essential to ensuring successful investment outcomes.

Changing the Filter

Refreshing the HR Operating Model Over Time

Even the ideal HR Operating Model today will not withstand the test of time for very long – the lens through which the model is viewed must be attuned with the business' evolving vision of itself. Since businesses are valued on future potential rather than past performance, this chapter spells out how to ensure your talent strategy is future focused and maximizes business value.

Care and Maintenance

Actions Taken Periodically to Keep the HR Operating Model in Working Order

Rather than going through a painful and inefficient cycle of off-and-on HR investment which eventually leads to wholesale rebuilding, this chapter examines how to prioritize spending on the HR Operating Model, so it continually supports value creation. What investment is foundational and what is discretionary? Putting HR on a "maintenance schedule" that is efficiently tethered to planning routines imbedded in the business is the key to maintaining an effective HR Operating Model.

Before You Call

A Checklist of What to Look at before Calling the Consultants

Let's face it, more often than one would like, calling the consultants often results in being advised to take actions that you already knew were necessary (but for some reason did not take). This chapter provides a checklist that CEOs and CHROS can refer to, of frequently seen symptoms when something is awry with the HR Operating Model, and what the most common causes are – many of which can be fairly easily corrected, others not.

INTRODUCTION

THE FUTURE OF HR? IT ISN'T WHAT YOU THINK

A lot of talk in HR circles lately has centered on the idea that HR needs to find a way to transform itself in an effort to gain a "seat at the table." Pleas from both inside and outside the function have implored HR to step up its game and undergo a transformation in order to deliver more strategic outcomes and business unit–aligned support.

In many organizations, HR transformation has meant taking an elaborate path to drive down costs and streamline people-related administrative work. In these cases, a successful HR transformation simply resulted in cost reductions but not necessarily quality outcomes. Others have attempted to transform HR in different ways including multiple reorgs, introducing various technology solutions, and even outsourcing parts of HR. At the most extreme end, some companies (often high growth tech companies) have elected to delay the creation of a formal HR function altogether.

Since *Fast Company* magazine first published the article, "Why We Hate HR" back in 2005, HR has been faulted, blamed, and "transformed" in an effort to make the function more relevant. More recently, several *Harvard Business Review (HBR)* articles have attempted to define what HR needs to do to get back on track. Everything from splitting the strategic part of HR from the more administrative part to taking a more holistic approach to help the middle 60% of performers has been proposed as a means for fixing HR. A 2015 *HBR* article by Peter Capelli, "Why We Love to Hate HR…And What HR Can Do About It," outlined steps for what HR should be doing now.[1] But these approaches all still miss the mark.

[1] Cappelli, P. (2015). Why We Love to Hate HR…and what HR can do about it. *Harvard Business Review Magazine*, July–August.

The ultimate problem with these recommendations is that they are operating outside of the context of business value. The "transformed" HR function lacks a clear definition of and objective evidence to signify its success. That's why we consider the movement toward HR transformation merely iterative and do not believe that it will ultimately be transformational. Until HR can solve the missing connection between value creation and critical ***human capital***, it will continue to fall short.

Who Moved My Table?

The issue is not a seat at the table. The table moved; that's the issue. After all, even in the most "transformed" HR environment, HR is still overly fixated on the role of people as it existed in the industrial age – in service of a company's value drivers, which at the time were primarily manufacturing assets. In our new economy, intellectual capital (IC) is the value driver and, as a result, the talent that produces it rules.

IC drives the market values of companies across all industries – one just needs to look to the IC value at companies like Facebook, LinkedIn, or Google. IC makes up nearly their entire market values. Even for more traditional, nontech companies like Walmart and John Deere, IC comprises more than half their value. Knowledge workers have become the most valuable asset for today's organizations and HR's challenge is a supply shortage and much higher portability than the manufacturing assets of old.

Yet, in spite of the many attempts at structural transformation, HR has not been able to adjust to this new reality. Our own experience and research have led us to assert three primary reasons as to why HR has been limited in its ability to achieve measurable progress toward its own "transformation."

1. *HR is untethered from business value.*
   Unconnected to the consequences of the business's performance, either positive or negative, HR operates in the absence of the same accountability framework within which other business leaders operate. The model that HR operates in hasn't changed since the industrial era – there is virtually no differentiation of HR deliverables among all of an organization's roles. At its core, HR does essentially the same thing for all roles, whether it is filling requisitions, compensating employees, planning for succession, or

managing performance. By failing to link HR strategies to business strategy and value creation for companies in a real, measurable way, HR is hindering its ability to play a genuine role in the success of the organization.

2. *HR is operating under the misguided and dated idea that parity equals fairness.*
   While this philosophy might have worked in a manufacturing-centric era, when talent was not the most important asset, this mindset today can have devastating consequences for a company over time. For companies in high IC industries like pharmaceuticals or technology especially, when resources are limited, they simply cannot be spread as evenly and thinly as possible but rather must be invested wisely and judiciously. The fact is, some individuals are more critical to a business because of the roles they play and the value the company derives from those functions. Historically, HR has been unable or unwilling to shift its mindset to make talent decisions based on this new context.
3. *HR is unable to help senior leaders identify where the most critical roles in the business are, based on the company's vision for the future.*
   HR has lacked the leadership and analytical skills to gain a clear understanding of value creation as it relates to hiring, talent development, and employee retention. Without a data-based mentality for decision-making and forecasting, HR cannot facilitate the discussions that are necessary to drive significant changes or overinvest in areas that are critical to the company's talent strategy. Part of this challenge is that HR professionals themselves tend to be more humanistic than capitalistic – according to findings from The New Talent Management Network, most HR incumbents are in the function because they want to help people.[2] Quite simply, their love for and interest in people typically outweighs their love for and interest in the business.

The bottom line is HR's most urgent challenge for the future is to transform itself by gaining an entirely new skill set. The administrative skills and humanistic attributes of the industrial age are now obsolete. Attention must be paid to learning how to define and lead change that is guided by a deep understanding of the value creation for an organization. If HR is unable to accomplish this, then it is destined to become obsolete as well.

[2] New Talent Managers Network, *State of Talent Managers Report*, 2013.

A New HR Model

Our belief is that it's not actually a question of HR transforming itself so much as it is the emergence of a new function that will blend two critical business competencies – HR and Finance. The fact is, many business leaders, especially entrepreneurs and start-up CEOs, have a visceral reaction to the notion of "Human Resources." They will do almost anything to avoid hiring HR people because they equate them with bureaucratic minutiae and administrivia. Netflix, which has been credited with "reinventing" HR by doing away with many traditional HR practices like paid time-off policies and formal performance reviews, is a prime example of a company that has taken this tack.[3]

Yet, these same business leaders clearly recognize the importance of talent to their success. Their resistance to HR is due to the perceived administrative burden, rather than the ultimate value they place on taking care of their top talent. At some point in an organization's growth, however, it becomes necessary to assemble some type of HR team. It seems evident that a new breed of human capital professionals is required to ensure that a measurable talent strategy can be developed that truly reflects a deep understanding of the connection between talent and the company's value creation.

In a manufacturing-based economy where tangible capital was the primary means of value creation and the largest expenditure, a close connection between Operations and Finance was required in order to fund and execute economically sound business decisions. Today, Finance and HR need to build an equivalent relationship since human capital is now the primary means of value creation as well as the largest expenditure in our new economy. This relationship will enable companies to maximize people-related financial outcomes and measure the results of these efforts.

In order to be successful, the role of CFO and the role of CHRO must evolve to complement each other. These two roles must champion a new way forward that is rooted in an understanding of the impact of IC on market valuations. The demand for human capital as a method for increasing the

[3] McCord, P. (2014). How Netflix Reinvented HR. *Harvard Business Review*, January–February.

value of IC, along with a scarcity of talent, underscore the need for a new model for talent management that will maximize a company's relevant IC.

Key Requirements: Strategy, Leadership, Process

As a first step in establishing this new model, companies should hone their focus on human capital by establishing a strategy that:

1. Facilitates agreement among senior leaders about how IC is produced and then designs a strategy that will maximize its creation.
2. Determines where IC exists within the organization and estimates the relative value of each IC component.
3. Compares where the organization currently is to where it needs to be in order to understand the talent implications of the most valuable IC components.
4. Agrees to overinvest in the attraction and retention of talent in critical roles to avoid future gaps.
5. Defines organizational goals that are related to the IC needs of the future.

More than a fine-tuning of the current HR or Finance roles, this approach reflects a completely new model that can break through the outdated frameworks and perceptions of ineffective HR roles and functions. While we refer to this new model as the "IC Strategy Team" in order to illustrate the point, it is less important to focus on having a different organizational structure or a new title than it is to ensure that this function has an understanding of value creation and an ability to master it.

This new IC Strategy Team that we recommend is truly a hybrid of traditional HR and Finance professionals and skills. In addition to focusing on analytics and measurement, this team also will have a deep understanding of the way in which assets are allocated in order to power market value, as well as expertise in how to attract, select, and retain a high-performing, diverse workforce. A melding of the capabilities of both HR and Finance is necessary to produce the appropriate business solution.

After the strategy has been developed and agreed upon by following the steps above, the process that will deliver the targeted results must define activities, technology, people, and measures. Process design discussions and decisions must ensure that the effort is focused on three guiding principles: increasing business value, overinvesting in critical roles, and measuring efforts and results.

Overinvesting in Critical Talent

Talent processes that are led by the IC Strategy Team will look vastly different than the ones managed by a traditional HR team. Under the new model, there is a laser-sharp focus on differentiating between critical and noncritical roles to guide talent investments.

For instance, under the IC Strategy Team approach, talent acquisition processes would more look like this:

- For critical roles, a team of highly skilled and compensated researchers and recruiters would work closely with hiring managers to find, screen, and close the most qualified candidates. This team would rival the strongest search firms in its ability to surgically find and remove talent from other occupations or companies when business needs dictate.
- For harder-to-fill, noncritical roles, a team of highly skilled recruiters would leverage tools and technology to research, target, and sell and win passive candidates.
- The noncritical positions that are considered easy to fill would be supported by junior recruiters who use technology and assessment tools to screen candidates before passing along the most qualified to hiring managers.

To be successful, this differentiated approach must carry over into all talent processes to continuously ensure that high-performing talent is retained in critical roles. Every step that HR takes must support this new philosophy. As a result, a whole host of commonplace HR processes and practices must change since they make little sense in an IC-driven world.

Take the typical onboarding approach at most organizations. Usually, the formal new hire orientation program is required for everyone and unvaried for anyone. Often led by junior HR or administrative team members, these programs typically focus on the completion of necessary paperwork and lectures related to complying with workplace rules. For a company that has just invested untold resources to entice a top performer to join its ranks, this can be a potentially disastrous first introduction to the organization.

From management training to succession planning and from compensation policies to standard employee engagement surveys, the typical HR approach of parity and equity is dangerously antiquated. Although it may be a bitter pill for HR to swallow, the overinvestment in critical talent is an essential strategy for enabling the creation of business value. Surely the employees working in Accounts Payable or Legal at organizations like Google or Facebook recognize that the Product Designers and Software Engineers are more critical to the success of the overall business. If a rising tide lifts all boats, then in fact, the logic behind overinvesting in those key roles rather than the noncritical Accounts Payable positions becomes crystal clear.

HR's historical attempt to make things "fair" for employees and mitigate exposure to risk often comes at the expense of successful business outcomes and can have a detrimental impact on the business in the long term. By first charting a path that narrowly targets the best talent approaches for a defined group of critical employees, companies can eventually roll out those practices more broadly across the organization. But the first step must begin with overinvesting in the most critical parts of the business and then moving outward.

Who Will Lead the New Model?

We won't pretend that this change to a differentiated, IC-focused approach will be simple. In fact, it will be a huge challenge for businesses and especially difficult for the traditional HR function. But it is absolutely necessary in order to drive sustainable growth via IC for the future.

Infusing HR with these new skills is a foregone conclusion and in some progressive organizations this has begun, albeit in fits and starts. However, even when the skill set and aptitude of HR is modernized in the ideal way, the process for connecting business strategy with talent capability must still be defined.

Building Business Value through Talent helps business leaders close the gap between "CEO and CHRO," between talent and market value. We use the designations CEO and CHRO both literally and figuratively throughout this book to represent the needed and often missing connection between the business and those responsible for supplying and sustaining its human capital.

This guide aspires to give business executives the framework and language to communicate critical business information to their HR partners in a way that can be translated into accurate human capital requirements. It equally aspires to provide HR partners with the framework and language to ensure they have received the information they need to be expertly acted upon.

1

IMPORTANT INSTRUCTIONS

At the Intersection of Talent and Market Value

Building Business Value through Talent is designed to enable CEOs and CHROs to jointly create and operate a talent function within their businesses that will deliver the essential human capital by effectively connecting talent and business strategies. In doing so, enterprise market value will be directly impacted by talent efforts in a positive way over a sustained period of time. Taking this path to a successful CEO and CHRO partnership is necessary due to the fact that intellectual capital (IC) now accounts for more than 84% of the average firm's market value and is an asset whose only source is people's talent.

Our first order of business in this guide is to define the relationship between talent and market value and provide a means for relating this topic directly to your own business.

Market cap growth in the twenty-first century has evolved to become a function of human capital productivity. As recently as 1980, the difference between book value and market value for the average US corporation was not significant. However, by the year 2000, the average company's market value already exceeded book value by about 75%.[1] This excess value that the market places on the average company's share price is attributable to the

[1] Giniat, E., & Libert, B. (2001). *Value Rx: How to make the most of your organization's assets and relationships* (p. 10). New York, NY: Harper Collins.

value of intangible assets, specifically IC in the form of brands, trademarks, patents, and other proprietary inventions and commercial secrets.[2] In fact, a nearly 250% increase to the underlying value of the Dow Jones Industrial Average in just the last 10 years, to a market capitalization of approximately $8.3 trillion, is a testimony to the "age of the knowledge worker." (calculated from Dow Jones (DJIA) Historical Total Market Cap, siblisresearch.com).

The way in which talent drives this increase is specific, as illustrated in the following pages.

Although a complex topic, simply speaking, company valuations are based on the discounted value of expected future cash flows. Every analyst following a company maintains a cash flow model that is constantly updated for news that may materially affect both the company's valuation and, in turn, advice given to investors regarding the fair value of the company's shares (and prospective fair value). Those future cash flows will be driven by the performance of a company's assets (Fig. 1.1). As such, although anticipated cash flow is used to calculate a company's market value, that value is ultimately assigned directly to the underlying assets – both tangible and intangible – as evidenced by *business combination accounting*.[3]

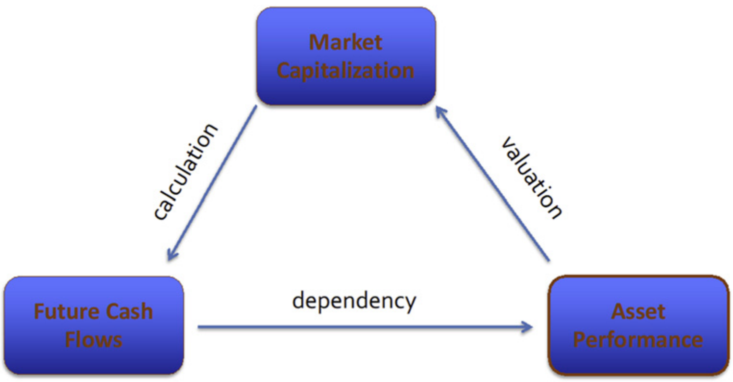

Fig. 1.1. Business Value Is Based on Future Cash Flow Driven by Asset Performance.

[2] McGuire, T. (2015). *Talent valuation: Accelerate market capitalization through your most important asset* (p. 1), Upper Saddle River, NJ: Pearson Education.

[3] McGuire, T. (2015). *Talent valuation: Accelerate market capitalization through your most important asset*, p. 25.

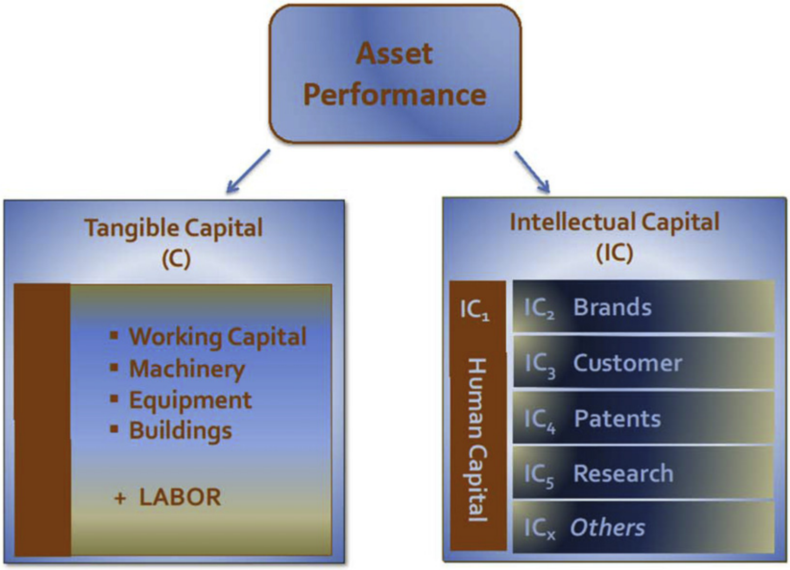

Fig. 1.2. Two Different Types of Assets.

Fig. 1.2 depicts the division of assets between tangible and intangible (intellectual). IC is the focus of *Building Business Value through Talent* because of its dependence on the human capital supplied by an organization's talent. Human capital is a part of IC, and in fact the only "active" component. It is the source of all other IC components, which are by definition "inert." It is the productive capacity of "knowledge workers," a part of the employed workforce. Human capital, the productive capacity of knowledge workers, can be thought of as the means of production for IC.

The actual value split between tangible and intangible assets for your business depends on a number of factors, most importantly the type of industry your business operates in.

To illustrate the relative value of IC for different companies, we use stocks in the Dow Jones Industrial Average. Table 1.1 shows the Intellectual Capital Index (ICI) for the listed companies for the year ended 2019.

In order to avoid confusing users of this information, our data omit oil industry and pure financial services stocks (five companies) in the DJIA. Those companies, which essentially trade the commodities of currency and petroleum, have unique GAAP accounting requirements for significant assets

Table 1.1. The 2019 Talent Growth Advisors Intellectual Capital Index.

Company Name	Rank		Enterprise Value	IC
	2019	2018	($ Millions)	Index
Johnson & Johnson	1	3	396,396	103%
Boeing	2	1	200,675	101%
Microsoft	3	2	962,215	101%
Apple	4	6	948,160	100%
Visa	5	4	348,439	100%
Procter & Gamble	6	7	294,478	99%
Merck	7	11	246,818	97%
Cisco	8	8	218,905	97%
United Technologies	9	9	165,818	96%
UnitedHealth	10	10	311,276	96%
Pfizer	11	5	259,142	95%
Nike	12	12	119,772	94%
3M	13	13	110,304	93%
IBM	14	19	188,801	91%
Home Depot	15	14	277,130	91%
Coca-Cola	16	15	268,486	90%
McDonald's	17	16	180,636	88%
Disney	18	20	277,749	87%
Walgreens	19	17	61,628	80%
Intel	20	21	281,018	77%
Wal-Mart	21	22	364,422	75%
Dow, Inc	22	new in 2019	55,179	71%
Caterpillar	23	23	110,597	67%
Verizon	24	24	362,784	62%
American Express	25	25	141,200	58%

and liabilities (oil reserves and financial capital reserves) that distort financial statements relative to other industries. As "commodity" businesses their value is not driven by IC in the same way as the other 25 DJIA companies.

The ICI is roughly the percentage of enterprise value (market value adjusted to be "debt free") that is represented by intangible asset values based on analysis of year-end financials and financial information. All of these companies' enterprise value is predominantly – some of them entirely – comprised of *intellectual properties* including technologies, processes, patents, and market-dominating brands. Even Walmart and Caterpillar which belong to tangible asset intensive industries have very significant intangible value due to their market leading practices which include customer service and innovation and are reflected in their industry-leading brand positions.

The average percentage of IC value for companies in the 2019 ICI study for DJIA stocks has increased to nearly 89% of market value, up from nearly 86% in 2015, continuing the upward trend.

The methodology for calculating the ICI, which can be done for any public or private company as long as the data are available, resolves accounting anomalies that result in inconsistent ways of dealing with *intangible assets* in regular financial statements.

The first step is to calculate the difference between a debt-free market value (enterprise value) and a debt-free shareholders' equity (book value) of the selected company. Market value for a public company is a calculation of shares issued and outstanding times the market price per share. Net debt is added to that number and to shareholders' equity from the 10-K to calculate *enterprise value* and *book value*.

The difference between enterprise value and book value is the first cut at the value of unrecorded intangible assets in the form of IC (with some exceptions to this rule such as oil reserves of energy companies). These are the assets that are not deemed measurable or certain enough by accounting standards to be included on the books of the company. Yet for investors, these assets are a solid bet, as evidenced by the volume of shares purchased at market value of their owners (think Disney, Coca-Cola, Procter & Gamble, and Pfizer).

Next, goodwill and intangible assets appearing on the company's financial statements as a result of prior acquisitions are identified. We add these components to the unrecorded intangible assets previously calculated to yield the value of total IC. As an example, in the case of Procter & Gamble, the value of the brands Gillette (acquired) and Tide (unrecorded) are in effect being added together as part of calculation of comparable total IC.

IC is entirely the result of *talent*, as is demonstrated in this guide. An important thing to note is that the value of IC includes the value the market places on an entity's human capital and can be accurately and objectively calculated for publicly traded companies (and with the right data, for nonpublic companies as well).

To summarize, the following algorithm is used to calculate what is deemed to be the ICI for a company:

Book Value:
Shareholders' Equity + Net Debt (that is, Debt − Cash and Marketable Securities)
Enterprise Value:
[Market Share Price × Shares Issued and Outstanding] + Net Debt
Intellectual Capital:
Intangible Assets (on books) + Goodwill + [Enterprise Value − Book Value]
Intellectual Capital Index:
Intellectual Capital ÷ Enterprise Value

The high levels of IC value are not confined to only the elite stocks in the DJIA that we've just discussed. IC value for the average public corporation today (S&P 500) exceeds 84%. What is the "means of production" for the majority of this enterprise value? People and their human capital. Yes, people are literally, not just figuratively, the most important asset of many companies across many industries in today's knowledge-driven economy.

This logic of connecting people with value should, once and for all, cast aside the notion that referring to employees as "assets" or "human capital" is derogatory or demeaning. In fact, it's just the opposite and, only when recognized as such, can organizations truly deploy talent in the way they have historically deployed other valuable assets.

Effective talent strategy design and execution is essential to building and sustaining business value because of the way human capital continuously creates and sustains the intellectual assets that in turn drive cash flow. As the "active" component of IC, human capital is dynamic, and the value of intellectual assets is accumulated over time through repeated human capital contributions (Fig. 1.3).

As an example of how this production of IC and market value come to life, we'll illustrate the pharmaceutical company Merck, from our list of DJIA stocks.

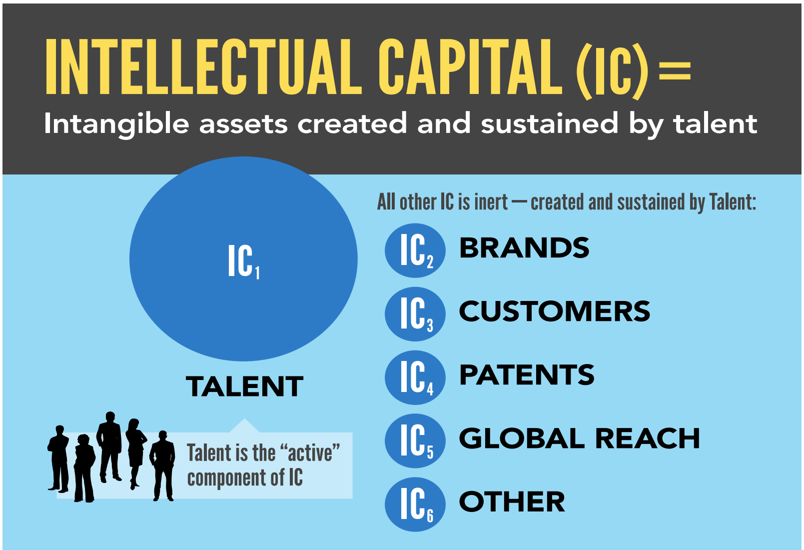

Fig. 1.3. Intellectual Capital (IC) = Intangible Assets Created and Sustained by Talent.

Like other companies in the pharmaceutical industry, Merck's value is almost entirely comprised of IC – most notably in its research and development prowess. Fig. 1.4 depicts a high-level breakdown of Merck's IC based

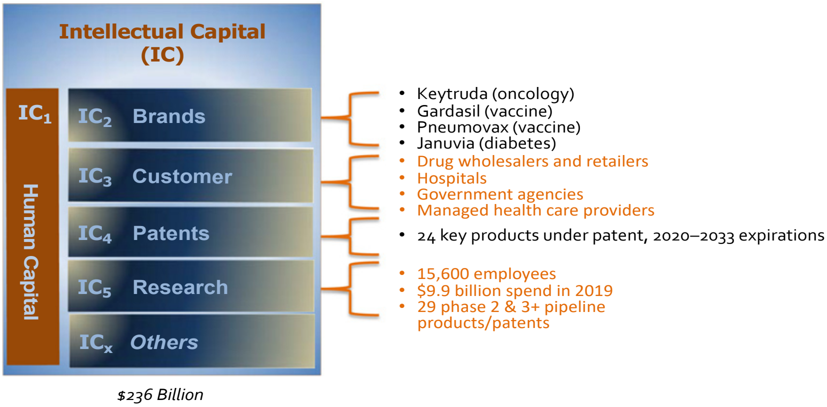

Fig. 1.4. Intellectual Capital Under the Microscope: Merck & Co., Inc.
Source: **2019 Merck & Co., 10K, selected illustrative data.**

on information reported in their form 10K filed with the Securities and Exchange Commission for the year ending December 31, 2019.

We calculated Merck's IC to have a market value of approximately $236 billion. About 22% of Merck's 71,000 employees are in its R&D function. This R&D workforce is responsible for developing and fielding dozens of blockbuster pharmaceutical products over the years including those shown as "brands" in the graphic – fully patented products with global distribution. This workforce has dozens of products in earlier stages of development as the pipeline for future revenues. This product competence allows the sales and marketing teams to present compelling propositions across a full array of customer channels in their industry, building deep relationships with distributors that constitute another distinct part of the firm's IC. Many of the 71,000 employees are in roles that support the drivers of business value, so they too are important to overall success. However, those in roles that are a direct part of the nearly $10 billion annual R&D investment are, in fact, the drivers.

The strategy to build business value through talent must have these "driver roles" in its bullseye – targeting how talent for these roles is most effectively identified, attracted, selected, hired, engaged, and developed. Successfully (and sustainably) attracting and retaining top talent in critical roles will, in turn, yield effective talent practices that will benefit talent across the entire organization.

The essential building block to this approach is understanding which roles in the organization produce which outcomes. The focus of your talent strategy will revolve around the roles deemed to drive business value. While many roles in your organization may support driving business value, typically, only some are considered "critical" because they actually drive that outcome. Also, typically, critical roles will fall within specific functional areas and cluster vertically (rather than horizontally) within the organization. For example, a vertical of researchers (entry-level through leader of leaders) in a pharmaceutical organization would represent such a cluster.

Fig. 2.4 (later in the book) demonstrates a simple model that can be used to categorize roles in your organization according to the degree to which they drive (or support) building business value, and the relative availability of qualified talent in the marketplace to fill those roles. Talent strategy is built around the categorization of these roles into four quadrants. Determining which roles drive and which support business value is a critical point in talent