PERSPECTIVES PAPER

TIME TO GET TANGIBLE ABOUT INTANGIBLE ASSETS

PART 2: HUMAN CAPITAL INTROSPECTIVE

May 2022

International Valuation Standards Council

Time to get Tangible about Intangible Assets

Part 2: Human Capital Introspective

The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

By: Kevin Prall and members of the IVSC's Business Valuation Board

The ideas and opinions set out the IVSC's Perspectives Papers do not necessarily reflect the views of the firms represented amongst the author group.

"Our people are our most valuable asset" – Ubiquitous, but not understood…

In Part 1 of our series, we examined the Case for Realigning Reporting Standards with Modern Value Creation. While long acknowledged as a challenge of common accounting frameworks and related financial reporting regimes, a tipping point has seemingly been reached. The debate has shifted from why the problem should be addressed, to what should be done and how it can be implemented. Within this discussion, and those to follow, our goal is to encourage debate and help ensure that the what is value relevant and the how is operable across time, geography, and scale.

The matter as to whether such improvements ultimately reside within financial statements, or whether they are central pillars of evolving sustainability standards, is outside our scope. As such, we'll leave the *who*, *when*, and *where* for others to comment.

Human Capital[i] Insights at a Glance:

- Human Capital is the foundation from which all intangible assets are created, yet our understanding of Human Capital value creation and rigor around value measurement is less evolved than other intangible assets.
- To assess Human Capital value creation, one must consider the synergistic effect amongst the workforce as well as the network effect with other assets, especially intangible assets.
- Evidence suggests that investors require more information on the impact Human Capital has on enterprise value.

- As the role of Human Capital in enterprise value creation evolves, the techniques to measure its value may need to change as well.

Introduction

As outlined in Part 1, in this paper and those to follow, we will examine four categories of internally developed intangible assets:

- Human Capital
- Brand and reputation
- Technology and data assets
- Customer and relationship assets

First, in this paper, for Human Capital we will:

- Examine how Human Capital generates value for organisations and the attributes of such value creation,
- Analyse how investors assess the enterprise value creation attributable to Human Capital via KPIs and investments; and
- Discuss the value measurement techniques used to estimate the value of Human Capital directly.

Human Capital and Value Creation

The phrase "our people are our most valuable asset" is ubiquitous within corporate communications. The idea is echoed by business leaders across geographies, sectors, and size. Recognising the importance of Human Capital is obvious but understanding and measuring its role in enterprise value creation is much more difficult. Even though all intangible assets emanate from an organisation's Human Capital, our understanding of Human Capital value creation, and the rigor around value measurement of Human Capital, is in many ways less evolved than nearly all other intangible assets.[ii]

Multiple macro level trends add to the urgency for both enterprises and investors to grasp the nuances of Human Capital value creation. First, is the state of the current labor market. Given the difficultly, time, and expense of accumulating and retaining Human Capital, it's now not uncommon to see asset and business acquisitions in which getting access to Human Capital is the driving force for consummating the transaction.

Also driving the increased emphasis on Human Capital is the continued momentum of ESG. A key aspect for the evaluation of social criteria is an organisation's ability to grow, retain, and nourish human capital.

Most ESG reporting presumes a link between ESG and value. In the ISSB's recently issued first exposure draft, within the preamble articulating the need for sustainability standards, the ISSB specifically notes workforce as one of the key resources subject to the standards and critical to the assessment of an entity's enterprise value.[iii]

The emphasis on Human Capital within ESG and sustainability initiatives have helped change the market's perception of its workforce. Most now see human capital as an asset to invest in, rather than an expense to be managed. In fact, certain private equity asset managers now tout differentiated strategies focused on identifying organisations which have underinvested in Human Capital, with the premise that additional investment in Human Capital will drive excess increases in enterprise value (excess return).[iv]

This trend is not limited to the highly educated end of the workforce. A recent Piper Sandler research report on the restaurant and hospitality sectors noted that "Looking forward, we reiterate our thematic view that brands [branded restaurant chains] proactively investing in Human Capital (including, but well beyond any minimum wage threshold) remain best-positioned in the current environment."[v]

As public mindset shifts from Human Capital as an expense to reduce and toward the mindset of an asset to invest in, the shift results in stark differences in the nature and capacity for value creation, as well as techniques to measure its value.

Assessing Human Capital at the individual level (i.e., the collection of individuals' knowledge, skills, and experience) fails to recognise that the output from Human Capital is not merely a sum of their individual parts or efforts. Rather, individuals within a workforce are complementary assets to one another, thus creating a synergistic effect in which their output is not the sum of their individual outputs. Rather, its reasonable to expect that Human Capital will exhibit value creation characteristics more similar to other intangible assets, such as non-linear value creation and a weaker relationship between cost and value. This synergistic effect continues to grow in importance as business models shift to a knowledge-based economy.

In addition to the synergistic effect that exists amongst the workforce, there exists a network effect with other assets such as technology, brand, and relationship assets. Put simply, the ability to create value from these assets is both a function of the assets' own characteristics, and the capacity of the Human Capital to deploy the assets.

This shift in mindset also results in stark differences in the assumed economic life. At the individual level, the life of the Human Capital would typically be viewed as short and a function of employee turnover. However, casual observation will note that Human Capital at many organisations is largely maintained and enhanced over time despite the regular turnover of individual employees. Most organisations implement procedures to pass on such knowledge or redundancies in skillset and knowledge to ensure the maintenance and continued growth of Human Capital.

The table below summarises the contrasting perspectives:

	Value Creation Perspective:	
Attribute	**Sum of Parts**	**Human Capital**
Market Perception	Focused on cost	Focused on value creation
Value Creation Characteristics	Cost is more likely to approximate value (i.e., 1-to-1 relationship)	Non-Linear with varying relationship between cost and value (value could be </=/ > cost)
Complimentary Assets	Value is sum of individual components	Individual components are complementary assets which create synergies
Relationship with other Assets	Value is not a function of other assets employed	Human capital has a network effect when leveraged with other assets and will drive higher and lower returns for those assets based on the human capital deploying it.
Economic Life	Short life based on turnover	Very long life based on ability to transfer knowledge

In summary, the value of an enterprise's Human Capital is not simply the sum of individual employee values. This is largely due to 1) the synergies created amongst the workforce and 2) the network effect of the workforce when combined with other intangible assets. The impact of the synergistic and network effects is most relevant in the intangible-rich industries and less so in more (traditional) capital intensive industries.

Investor Insights on Human Capital

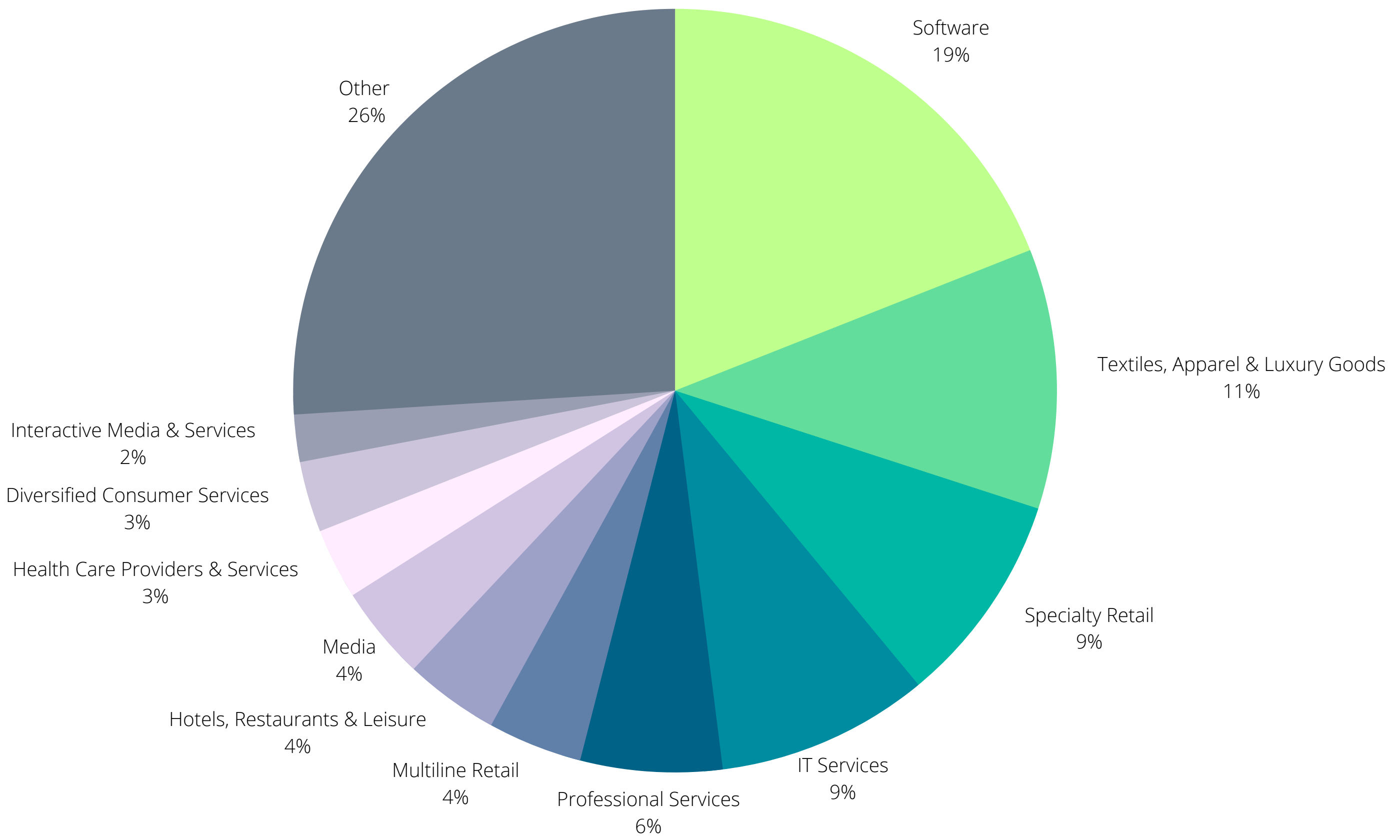
While the mindset around Human Capital value creation has started to shift, the information produced within the current reporting frameworks has not, leaving a gap between the information reported and the information desired by investors.

The current frameworks largely fail to provide sufficient detail on basic direct costs of Human Capital, let alone more value relevant KPIs such as employee satisfaction, investments in training and education, timing to fill open positions (i.e., relative labor scarcity), and voluntary turnover. While ESG reporting has begun to collect and synthesize these inputs, like all challenges with current ESG frameworks, there is a lack of standardisation, attestation, and harmonisation. More standardisation is needed.

The lack of relevant information has led investors to seek creative solutions to obtain relevant information on the investment in and value creation from Human Capital. For example, in January 2022 UBS began publishing Evidence Lab Quarterly CRO Glassdoor Employee

Review Monitor. The UBS process collects more than 6 million reviews from over 8,000 employers. UBS states that "Glassdoor reviews can be a useful indication of employee satisfaction within a company and help to identify changes in sentiment or explain underlying trends in turnover." The UBS process determines an overall score for each company which is then utilised to assess absolute performance, relative performance to peers, and trends in both over time. UBS believes "hiring and retaining talent is a key focus in the people heavy [...] businesses, and we believe this has become increasingly important with industry M&A and the larger macro environment (wage / hiring pressures)." [vi]

The use of Glassdoor for insights on Human Capital is pervasive across investment banks and industries. Our research identified over 600 analyst reports issued in the last year that reference Glassdoor for insights or analysis. The 600 different analyst reports represent an increase of almost 50% over the previous 12-month period. In addition to the sheer quantum of mentions, the below breakout by sector provides interesting observations. For example, the technology sectors represent a large share of the total mentions. These sectors reference strong competition to attract and retain top talent as a key enterprise value driver.



Going a step beyond the accumulation and analysis of Glassdoor data, we see multiple examples of investors utilising data from sources such as Glassdoor to estimate the value creation from the synergistic effect within the workforce and the value creation from the network effect with other intangible assets (e.g., technology). For example, a Credit Suisse banking sector analysis determines Dollar value created per Dollar of staff costs, effectively quantifying a company's relative success at deploying Human Capital compared to its peers. Similarly, another Credit Suisse report screens for improving return on staff costs as a potential way to identify companies which may reflect the roll-out of innovative products and services and/or the implementation of innovative processes.[vii]

Another Credit Suisse report for the Engineering and Construction sector, examines how other productive assets are combined with Human Capital, and how much additional return is generated by the network effect. They utilise this approach in a peer benchmarking analysis to gauge scope for improvement in productivity and the potential for increases in enterprise value (i.e., excess returns).[viii]

BNP Paribas also has examples of assessing Human Capital for peer group comparison. Within an analysis of the retail industry, BNP notes that they score companies on employee wellbeing by looking at scores on third-party employee review websites (i.e. Glassdoor and Indeed), gender and ethnic diversity metrics, employee turnover and Human Capital scores from Factset. For the retail industry, only a handful of companies include a summary of results from employee satisfaction surveys within the annual ESG report. The report notes that Best Buy, Tractor Supply Company, AutoZone, and Home Depot provided some form of employee engagement scores, but otherwise had to rely on third party information such as Glassdoor for all other companies.[ix]

Even though resources like Glassdoor and Indeed provide information which are not subject to verification or consistency, their use for both qualitative and quantitative insights by investors is common. Additionally, such resources only provide insights on a narrow portion of Human Capital KPIs. For instance, as discussed further below, the relative labor scarcity for a particular company or industry is critical to understanding required returns on both an absolute basis and relative to returns required by other scarce intangible assets. Such metrics may include the number of open positions to total FTEs, average time to fill open positions, average change in cost for newly filled positions, and more. Development and implementation of a consistent standardised approach is needed.

Value Measurement

While the analyst insights above help to show the importance of Human Capital in corporate value creation, the shift in mindset also adds to the complexity in the measurement of Human Capital value. As the understanding of how Human Capital creates value for an organisation has evolved, the methodology to measure its value has not.

Historical methodologies to value workforce are focused on costs to recreate the collection of employees. For example, although not separately identified, workforce is typically valued as part of a business acquisition as an input into the valuation of other intangible assets. In this context, best practices for valuing the workforce examine the costs avoided by the buyer associated with recruiting and training employees (e.g., the Replacement Cost Method of the Cost Approach). The key assumptions used in the Replacement Cost Method to value an assembled workforce are: the number of employees, their fully loaded direct cost, the estimated recruiting costs, and the costs associated with the estimated lost productivity for the ramp up period from the time an employee is hired to when the employee reaches full productivity.

The historical method is aligned with the viewpoint that the value of Human Capital is the sum of its parts. It fails to account for the synergies created amongst the workforce and network effect with other assets. Recent market transactions support the premise that a method focused on cost likely undervalues Human Capital, as these market indications of value are significantly higher than cost-based valuation measurement models would suggest.

For instances in which Human Capital plays a more central role in the entity's value creation, a more appropriate method should consider the returns generated or required by the Human Capital rather than the cost incurred. However, determining the appropriate proportion of the enterprise cash flows to allocate to Human Capital versus other assets requires new considerations. For example, relative scarcity can provide key insights. In much of the current labor market, Human Capital is perhaps the most scare intangible asset. As Human Capital becomes scarcer, it's required return and related value increase relative to other assets deployed.

Relative scarcity can be incorporated into existing models. For example, in many of the transactions we see in which Human Capital is the primary asset, buyers often point to a critical time dependent opportunity which requires additional or new Human Capital. To account for such timing considerations, valuers often utilise the With-and-Without Method to capture the potential lost opportunity. Unlike the Replacement Cost Method, the With-and-Without Method would allow the valuer to consider the relative scarcity of the desired human capital, the length of time to accumulate the Human Capital, and the lost profits that would result from not acquiring Human Capital at scale.

In instances in which the Human Capital is not a primary value driver for the entity, the Replacement Cost Method may still be appropriate, but additional considerations around inputs and assumptions are likely appropriate. Common assumptions within the application of the Replacement Cost Method take a narrow view of cost. The below are insights on those assumptions which could be explored to enhance the application of the Replacement Cost Method:

1. The Method implicitly assumes an infinite supply of commoditised labor is available to immediately source, interview, and procure to create the workforce. There is no consideration for time and related lost opportunities.
2. The Method is narrowly focused on direct compensation as the cost metric, and not on other investments that are made in Human Capital.
3. The Method assumes no turnover in the time needed to accumulate the Human Capital.
4. The Method assumes that every person hired achieves full productivity and does not leave the entity. This effectively assumes no hiring mistakes or issues in the onboarding process.
5. Within the lost productivity calculations, cost for the employee is utilised without any consideration of a return element. For workforce, the required return is often assumed to be equal to the overall cost of capital of the entity; however, that assumption likely requires additional considerations for the relative value added and risk associated with Human Capital in the given circumstance.


Conclusions and Next Steps

While we admittedly don't have all the answers, we believe the above insights can help spur additional dialogue, help inform standard setters and similar stakeholders in order to drive value relevant policies, and ultimately improve value measurement considerations.

In our next article we will explore brand and reputation. Central to the next article, and the others to follow, will be the consideration of network effect between each intangible asset. For example, there is strong evidence that a strong workforce can reflect positively on an entity, thereby enhancing its Brand. Alternatively, an entity's strong and desirable brand can help recruit and retain Human Capital, ultimately decreasing recruitment and training costs and perhaps even overall compensation expense.

The IVSC would be interested to hear your feedback on the subject discussed in this paper.

[i] For purposes of this paper, Human Capital refers to the collective knowledge, skills, and experience that resides within and amongst an enterprise's workforce.
[ii] This may partly be due to the recognition requirements in accounting frameworks, as recognised assets need to be separable and/or arise from contractual rights. Human capital cannot be compelled to be contractually secure for more than a short term and is rarely separable from the entity.
[iii] Exposure Draft on IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information
[iv] Two Sigma Impact: Finding Untapped Value in the Workforce - Two Sigma
[v] Piper Sandler Industry Note: Restaurants and Branded Hospitality, December 20, 2021.
[vi] Life Sciences & Diagnostic Tools UBS Evidence Lab inside: CRO Glassdoor Employee Review Monitor: PPD (TMO) Top Ranked And Largest Positive Ratings Change In 4Q, January 20, 2022.
[vii] Credit Suisse, HOLT Global Financial State of Play Heading into 2020, December 6, 2021.
[viii] Credit Suisse, HOLT Sustainability Toolkit – Capital Gains, Sharpening the focus on resource productivity, September 2, 2021.
[ix] BNP Paribas, Hardline Retailers, ESG: Hard line to take, December 13, 2021.

International Valuation Standards Council
20 St Dunstan's Hill
London
EC3R 8HL
United Kingdom
www.ivsc.org