

## Leadership Development ROI: Using Talent Management to Drive Firm Value

The “resource-based” view of firm performance is a long-standing theory which states that the basis of a firm’s true value is rooted in its organizational, leadership and human capital. It also states that the most readily accessible source of non-imitable competitive advantage resides in its human capital. Indeed, who or what is driving a firm’s policy, procedure, productivity, innovation, and change if not its people – its leadership? However compelling this argument may be, modern research methods have not been equal to the task of accurately capturing the dollar value of improvements made to leadership and human capital systems in organizations. This has resulted in persisting questions regarding the investments made in processes such as succession planning, leadership development, and developmental coaching.

Fortunately, over the last five to ten years, a critical mass of applied research with *Fortune 500* companies has accumulated in area of measuring ROI for talent management processes. These studies are consistent with existing research in that they show that integrated, strategically-aligned leadership and people development practices improve “soft side” outcomes like job satisfaction and organizational commitment, and have even been shown to reduce concrete outcomes such turnover and absenteeism. *But what is particularly interesting are the new findings showing that strategic leadership and people development systems can drive a firm’s revenue, its profitability, and its market share.* The only question is: Do enough business leaders and CEOs know about it?

### The Evidence: Driving Top Line Value

Research involving participation from over 300 separate firms<sup>1</sup> has shown that organizations that have strategically aligned talent management, succession planning, and executive development systems have significantly higher financial performance than those firms that do not. The indices used to capture these significant differences include:

- Productivity (units per employee);
- Cash flow (Gross rate of return on assets per employee) and;

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**In a study of a total of 293 publicly held firms, firms with highly developed leadership development, succession planning, and executive development programs had a significantly higher market value of \$8,882 per employee.**

- Market value

In fact, the 100 or so firms ranked in the top third in terms of the quality of their talent management, succession planning, and executive development systems showed dramatically better fiscal outcomes than those in the middle third. Specific results based on actual firm performance showed that the top firms had:

- An average increase of 5.2 % in per employee productivity, valued at \$44,380 in per employee
- An average increase of 16.3% in cash flow, valued at \$9,673 in per employee cash flow using a discount rate of 8% over a five year period
- An average increase of 6% in market value, valued at \$8,882 per employee

Note: The results above are expressed as average increases across the 100 firms in the top third as compared to average values of the 100 firms in the middle third and are expressed in *per employee* units to control for differences in firm size.

## The Rigor: The Validity of the Results

An obvious first reaction the striking numbers shown above is to question the adequacy and quality of the research that produced the estimates. However, in this regard, the quality of the research is exemplary.

First of all, the measures used to capture firm value estimates reflect both accounting-based, as well as market-based indicators of financial performance. For example, the market value of firm's in this research was calculated using Tobin's  $q$ . This is a future-oriented and risk-adjusted capital-market measure of financial performance. It reflects both current and anticipated profitability by dividing the market's valuation of a firm's assets by their current replacement cost<sup>2</sup>. Ultimately, it is a market based indicator of fiscal health that is highly accurate.

Further, advanced causal modeling techniques were used to control for such factors that could have affected the accuracy of the results obtained including: firm size, sales growth, capital holdings, union coverage, industry type, R & D expenditures, stock variability, and extent of industry competition. As can be seen, the number of extraneous factors that could have influenced the results of this research were minimized. Ultimately, the results showing the value that good talent management practices can

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**Talent management systems lead to firm value through making processes effective and leading and managing changes to processes. The result is increased customer satisfaction, brand loyalty, and market share.**

provide are compelling.

## The Road From Talent Management to Firm-level Performance

At this point, it is useful to ask: How do highly refined talent management processes manifest themselves in firm performance? The answer to that question resides in several truisms about the sometimes complex chain of events that interact to create an organization's value. According to Harvard Business school Professor, Robert Kaplan<sup>3</sup>, an organization gains market value through a five-stage process:

- **Stage 1:** Build a highly capable, strategically integrated talent management system – resulting in increased capability, creativity and predilection for performance
- **Stage 2:** Leadership and human capital builds effective regulatory and operational processes, customer management systems, and innovation systems
- **Stage 3:** Effective systems are engaged, innovations are brought to the fore, processes improved through constructive conflict
- **Stage 4:** Quality, availability and functionality are delivered to customers
- **Stage 5:** Value creation – firm value, market share are increased commensurate with the sustainability of the previous stages

As can be seen, the key component of the process of creating firm value is building and leveraging the leadership systems and capabilities. Besides the benefit of increased firm value, the value created by leveraging leadership and human capital is a source of *sustainable* competitive advantage. Too often firms chase the short-term goal of increased stock price, only to find that their efforts result in damage to their long-term strategy. Building leadership “bench-strength” provides a sustainable source of advantage that will power the operational aspects of the firm for years to come.

## A Leadership “Systems” Approach: Creating Firm Value through Talent Management

Despite the positive news regarding the value of talent and leadership system management, the research discussed provides little guidance on

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exactly what organizations should do to maximize their value. At Jackson Leadership Systems (with partners like Sonar 6), we specialize in advising on, designing, and implementing system-wide talent management processes. Consistent with the research discussed above, our value proposition to our clients involves enhancing the leadership and human capital that drives firm-level performance. From recruitment and selection, to succession planning, assessment centers, and executive coaching, we help our clients drive their top line value. Our philosophy is to work in close contact with the CEO and/or HR VPs and Directors to provide increased ROI for leadership and talent management systems. Compared with the value that is provided, the investment in leadership systems development is miniscule.<sup>4</sup>

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<sup>1</sup> Huselid, M., Jackson, S. E., & Schuler, R. S. (1997). Technical and Strategic Human Resource Management Systems as Determinants of Firm Performance. *Academy of Management Journal*, 40, 171-188.

<sup>2</sup> See Endnote 1.

<sup>3</sup> Kaplan, R. S., & Norton, S. P. (2004). The Strategy Map: Guide to Aligned Intangible Assets. *Strategy & Leadership*, 34, 10-18

<sup>4</sup> Thanks to Henryk Krajewski for his contribution to this White Paper.