

THE ECONOMICS OF RETENTION

Improving economic conditions, an impending skilled labor shortage, and the proven link between low turnover and profitability are forcing organizations to take a new look at employee retention. Sound retention strategies not only can head off a future problem, they can save money and improve sales today.

Employees come and go: For most employers, that's a fact of business life. And it's also a fact that there are costs associated with employee turnover, both tangible and intangible. Hiring involves the time and costs associated with interviewing, evaluating, and selecting new employees. There are training costs to bring a new employee up to speed in a job. And there are the less tangible costs of not having a skilled employee in the job when you need one—costs that can be measured in terms of customer satisfaction or lost customers.

All of these costs add up, even for lower paid workers. Some sources put the cost of hiring and training an hourly worker at 300 to 700 times the worker's hourly wage. HR.com, a human resources Web site, has estimated that it costs two to three times more to replace a worker than to keep an existing employee—even when you're replacing an unproductive employee with one who is more efficient.

Turnover, and the costs associated with it, may be manageable during tight economic periods, when employees at all levels are more likely to stay put. But when the economy improves, turnover increases, and it is often a company's best employees that jump ship especially if they are feeling underappreciated or undervalued.

The Looming Labor Shortage

On top of this economic ebb and flow and its effect on employee turnover and retention, there is also the likelihood of a severe labor shortage in the U.S. by

2010. According to a 2000 Bureau of Labor Statistics study, there could be a shortage of four million workers by 2006, and by 2010 there could be 10 million more jobs available than there are employees to fill them in the U.S. A labor shortage of those dimensions will cause the cost of acquiring new employees to skyrocket, and it will make having an effective employee retention strategy critical to the success of any business.

Putting a retention strategy in place today not only can head off potential problems later on, but provide almost immediate benefits in terms of sales and customer satisfaction.

The Hidden Costs of Turnover

Many top executives secretly like turnover. That's why so many businesses tolerate double-digit turnover rates every year. These executives believe that turnover saves money by keeping the average employee on the low end of the pay scale. The longer an employee stays, the more they will earn. It's easy to harbor this point of view because it's often difficult to truly measure the cost of turnover over time.

In fact, the dollars-and-cents cost of turnover differs from industry to industry and company to company—it can range from a couple of thousand dollars to tens of thousands of dollars per employee lost—but in almost every case, the cost will be much more than the typical employer imagines.

Stores with higher retention rates were found to generate higher profit margins.

Here's a rundown of some of the costs (both tangible and intangible) that have been connected with turnover:

- **Pre-departure costs**—such as the reduced productivity of an employee who is discontented and using company time to look for another job, plus the costs of any efforts to retain the employee once he or she has announced intent to leave.
- **Termination costs**—those related to termination of employment, including exit interviews, security precautions, pay calculations, and other recordkeeping

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costs, plus the unemployment tax impact and payments for severance, accrued vacation time, retirement plan contributions, and any extension to benefits.

- **Recruitment costs**—related to advertising, recruiting, interviewing, pre-employment evaluations, security and background checks, hiring bonuses, relocation, etc.
- **Training costs**—the cost of training new employees in necessary job skills can be significant.
- **Productivity costs**—related to new workers, who are generally less productive, require more supervision, and contribute less to customer satisfaction.
- **Vacancy costs**—lost sales or lost productivity while the position remains vacant, plus the cost of overtime or temporary help to fill in.

The sum of these costs can amount to many times the employee's salary when fully loaded to reflect the resulting costs in terms of product quality, customer service, brand representation, and all of the other areas that suffer when an employee leaves, as well as during the replacement period.

Turnover and Profitability

Even those companies mindful of turnover costs might overlook the impact on the bottom line. In a landmark study involving a national food chain reported in *The Service Profit Chain: How Leading Companies Link Profit and Growth to Loyalty, Satisfaction, and Value*, James Heskett, Earl Sasser, and Leonard Schlesinger found that stores in the top 20 percent for employee retention were 55 percent more profitable than stores in the bottom 20 percent.

The impact on customer relationships is especially visible with turnover among sales or customer service employees.

Customer relationships may be affected, customer satisfaction can decline, and sales or customers may be lost. In large part, this is because of the knowledge and experience these employees have with customers.

Turnover can affect other departments as well. In IT departments, for instance, a departing employee may be leaving with knowledge of software code changes that will take months or years of experience and training for a new employee to acquire.

As Frederick F. Reichheld, a director of Bain & Company and author of *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value* (Harvard Business School Press, 1996), found from his firm's studies of a variety of industries, "The true cash-flow consequences of employee turnover far exceed most manager's intuitive estimates. In fact, the turnover tax on corporate earnings, although invisible in most a counting systems, is larger than any state or federal tax." For instance:

- **Customer selection.** Experienced salespeople and marketers, for instance, "are much better at finding and recruiting the best customers," Reichheld says. Bain & Company research has shown this to be true in the life insurance industry, where policies written by new agents are generally found to have a lower net value for insurers.
- **Customer retention.** Long-term employees have been shown to create higher customer loyalty in such industries as banking, brokering, and auto service. But even in manufacturing, Reichheld says, "long-term employees can produce better products, better value for the consumer, and better customer retention."
- **Customer referrals.** Loyal employees can be a source of new customers. When Reichheld's firm examined "the economic penalties

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of excessive employee churn" at one trucking company, for example, it found that the company "could increase profits 50 percent by cutting driver turnover in half." At a stock brokerage it found that "a 10 percentage point improvement in broker retention (from 80 percent to 90 percent) would increase a broker's value by 155 percent."

The Critical Elements

What causes turnover? What factors are likely to encourage an employee to remain with his current employer? Is it compensation, benefits, working conditions, or something else?

Compensation is undoubtedly a factor, particularly in highly competitive markets. A comparative analysis of wages and financial performance for Wal-Mart Stores Inc. and Costco Wholesale Corp. by *Business Week* magazine, for instance, found that the higher wage approach adopted by Costco has resulted in a workforce that is more loyal and more productive. In fact, not only are Costco employees more highly paid, but while Sam's Club and Costco produce about the same revenues—\$35 billion and \$34 billion,

respectively—Costco accomplishes this with one-third fewer employees. *Business Week* asserts that “Costco [has] one of the most productive and loyal workforces in all of retailing. Only 6 percent of employees leave after the first year, compared with 21 percent at Wal-Mart.” And that “saves tons, since Wal-Mart says it costs \$2,500 per worker just to test, interview, and train a new hire.”

Comparisons like this are one of the reasons that most employers blame employee turnover on compensation and benefits issues, while the truth is that most employees leave over dissatisfaction with factors other than pay.

In fact, noncash incentives may be more effective and less costly than increasing compensation or offering cash incentives to promote retention. The American Productivity and Quality Center in Houston says that it generally takes an increase of 5 to 8 percent of an employee’s salary to change his or her behavior. However, using noncash incentives, behavior can be influenced at a cost that is closer to 4 percent of the employee’s salary.

Performance-Based Retention

Many companies focus on retention by addressing critical work-life issues such as day care, health care, elder care, vacations, flextime, sabbaticals, and charitable work. However, addressing work-life issues alone doesn’t necessarily align employee retention with critical organizational goals. It’s not enough to have satisfied employees; success comes from having satisfied employees motivated to continually improve performance. So, companies seeking a performance-oriented approach to employee retention might seek to enhance work value in some of the following ways:

- **Employee involvement** in job design, goal setting, and selection of rewards.

- **Clear communication** about company goals and ways employees can contribute to and share in its success.
- **Incentive programs** that reward people for significant and measurable performance improvements.
- **Recognition programs** offering meaningful recognition to employees for both tangible and intangible contributions to their company.
- **Project-oriented approaches** in which all employees can work on diverse, limited-term assignments rather than being sequestered within a single department or function.
- **Developing talent exchanges** to enhance careers by connecting employees with appropriate projects, roles, and positions within their companies.
- **Training through coordinated programs** designed to enhance employee know edge and then rewarding employees for that increased knowledge. Consider crosstraining to enhance skills and improve productivity. This both satisfies employees and equips them to perform better.
- **Fostering feelings of support** by setting clear goals for employees and rewarding them upon accomplishment, and by promoting consistent values and recognizing people who embody them. This directs retention resources to actions and values that have a measurable benefit to the organization.
- **Creating an atmosphere of fun** with spot “atta-boy” rewards, contests, or meetings, specifically related to organizational goals and values. This creates an atmosphere conducive to retention while keeping the focus on achieving goals.

The Role of Motivation

Higher levels of motivation can translate into a 53 percent reduction in employee turnover, according to recent study by Steven Condly, associate professor at the University of Central Florida, Orlando, conducted for the SITE Foundation. No retention strategy can succeed without addressing the issue of employee motivation. “Incentives, Motivation, and Workplace Performance,” a study conducted by the professors at the University of Southern California for the International Society of Performance Improvement, found the following factors critical to fostering motivation and loyalty.

- **Work value.** *The research confirmed that people stay motivated when they value their work, no matter how mundane the task. Someone building a house for low-income tenants might get pleasure from the most arduous labor, knowing the good that can come from the effort. Organizations can foster work value by recognizing contributions in a meaningful way, and regularly communicating the organizational goals toward which each employee can contribute. They can add to satisfaction through use of incentive programs that set goals for quality or quantity, and reward those who achieve or surpass them.*
- **Training.** *Many people draw satisfaction from developing the capability to do their jobs better, or acquiring additional skills or responsibility.*
- **Support.** *Most people gain satisfaction from knowing that their organization appreciates their effort. This often comes in the form of meaningful recognition to those who achieve their goals or who exemplify important organizational values.*
- **Emotional appeal.** *Yes, people work better when they feel happy. Properly structured incentive and recognition programs can foster an atmosphere of fun and excitement, even in dreary jobs.*
- **Measurement.** *Knowing how one is doing in the pursuit of a goal is another way to create satisfaction. Effective measures of quality and productivity keep employees focused on goals, especially if accompanied with proper recognition when they succeed.*

- **Addressing the measurement issue** by instituting “real-time” goal setting, performance measurement, and skills development programs to ensure that people always know where they stand, and to address performance issues and skill gaps before they become problems.

Other key points:

- **Compensate fairly.** No one said that compensation will have *no* effect on turnover and retention. Determine a fair wage in your labor market and do what you can to meet it. A fair and equitable wage and benefits package is the foundation for a successful employee retention program.
- **Build trust.** As mentioned above, a “climate of trust” is one of the factors that influence employee retention. Trust is built with employees through fair working conditions, management responsiveness to employee concerns, realistic performance expectations, and open communication, including one-on-one communications between managers and employees whenever possible.
- **Don’t limit motivation efforts** to star employees. Incentive, reward, and recognition programs should be expanded to include as many employees as possible, rather than just the top 5 or 10 percent. Remember, it’s that large middle range of employees that can contribute the most in terms of improved productivity and lower turnover costs.

Where to Begin

The best place to begin an employee retention strategy is with an evaluation of the whole corporate environment and an audit of all of the practices and programs that impact employees. Typically, this will mean reviewing all incentive and recognition programs, benefits and wellness packages (from insurance to time off), compensation packages, and other structures.

Another helpful process is to assess the organization’s cultural vitality, including employee perceptions about the company and its offerings. Identify the issues that might contribute to employee turnover, and conduct a survey. If people are leaving the organization, why are they leaving? Are there trends in these separations?

It’s also important to start at the top of your organization. A company-wide employee retention program will not succeed without visible senior officer commitment. The results of your company’s audit of the costs associated with employee turnover—both tangible and intangible—should be enough to convince top executives that their return on investment in a retention strategy will be significant.

Who’s in Charge

Turnover traditionally is viewed as a human resources issue, but it is also a sales and marketing issue. Many organizations lack the cooperation between external and internal marketing necessary not only to create an atmosphere conducive to retention but to better link retention strategies to measure sales and marketing outcomes, i.e., increased sales, customer retention, profit margins, etc.

The real ownership of an employee retention program, however, should fall to the department or the executive with the most at stake in terms of the cost of turnover and the value of employee retention—whether that’s with sales, customer service, manufacturing, warehouse management, retail operations, or elsewhere. Some have suggested that ownership reside in a coalition of HR and marketing because it is important for companies to understand that *they* need to market themselves to employees just as if they were an important customer segment.

No matter who oversees the retention program, it’s important to understand that its success will rely on the

Higher levels of motivation can result in a 53 percent reduction in turnover.

efforts of frontline managers and supervisors across your organization. Training managers on retention tactics and holding them responsible for implementing a retention strategy will be critical.

Based on the compelling economics of reducing employee turnover, it shouldn’t take a labor shortage to force companies to wake up to the benefits. Many companies that fail to understand the economics might have no choice in the coming years, when they find themselves continually outbid for the best employees in their area.

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