Performance Improvement Council

EMPLOYEE LIFETIME VALUE

USING CUSTOMER LIFETIME VALUE TO DEMYSTIFY EMPLOYEE LIFETIME VALUE

This document examines properties shared by Customer Lifetime Value and Employee Lifetime Value, which is explored in further detail in a 45-page research report entitled Employee Lifetime Value: Measuring the Long-Term Financial Contribution of Employees*. This white paper and the full report were produced by the Forum for People Performance Management and Measurement and the Performance Improvement Council, a strategic industry group within the Incentive Marketing Association.*

The authors of the report establish a better understanding of how the benefits of investments in employees can be measured financially and in other related ways that contribute to Customer Lifetime Value.

When almost any company can easily access the same raw materials, production technologies, management systems, machinery and equipment as its rivals, it is human value that often distinguishes one competitor from another. In a global economy based on knowledge, intangible assets and resources, the ability to manage and leverage human capital and talents has become increasingly critical. Workforces are now the true value creator for many organizations. Economists, business experts and academics have studied and written exhaustively about the factors that motivate and engage individuals to become long term customers, and have even created an area of study classified Customer Lifetime Value (CLTV). This process aims to understand the true value of customer longevity so that an organization can ensure that it is spending the right amount of money and resources. Until recently, CLTV's internal counter-part, Employee Lifetime Value (ELTV) has received relatively little attention. With employees playing an increasing role in maximizing Customer Lifetime Value, there is an increasing interest in the concept of Employee Lifetime Value.

This white paper delves into one of the key elements, approaching ELTV with a CLTV mindset, and is based on the recent comprehensive report produced by the Forum and the Performance Improvement Council entitled *Employee Lifetime Value: Measuring the Long-Term Financial Contribution of Employees.* The report explores empirical studies, conceptual articles and industry surveys from both academic and professional sources.

An Historic Lack of Focus on ELTV

Despite the progression toward more formal accountability systems and methods that measure people performance, the measurement of employee value has drawn little attention from academics and practitioners. The reasons are obvious – in the prevailing mindset, products and brands and, to a lesser extent, customers, have been regarded as the source of profit and value while employees have been treated as a cost. When a workforce is regarded as a cost, an organization seeks to minimize it. Hence, organizations have not had the wherewithal to do comprehensive views of their employees' value because they have not seen the value in gathering and analyzing information on employee contribution to performance . The information available to organizations typically includes mere demographics (employee age, gender, salary and bonuses); however, critical information on performance, workplace behavior, attitudes, and loyalty has only recently been collected. The authors of the report establish a better understanding of how the benefits of investments in employees can be measured financially and in other related ways that contribute to Customer Lifetime Value.

Why ELTV Requires Serious Consideration

Employee Lifetime Value: Measuring the Long-Term Financial Contribution of Em-

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ployees aggregates statistics and study results based on a broad array of literature that make a compelling case for addressing the importance of ELTV including the following:

- A Brookings Institute study found that nearly 85% of a company's assets are related to intangible capital tied up in knowledge and human talent;

- A company that lost all of its equipment but kept the skills and know-how of its workforce could be back in business relatively quickly. A company that lost its workforce, while keeping its equipment, would never recover. (McLean 1995);

- Employees are the major source for a company to increase competence and profits. (Michael Porter 1995);

- The U.S. labor market is predicted to have more than 10 million surplus jobs to fill in 2010 (Herman 2004);

- Employee turnover costs companies in the United States more than $140 billion annually in recruiting, training, replacement, administrative and other costs (Keep Employees Inc.);

- Corporate interest in retention management and succession planning is growing, with 57% of companies worried about long-term workforce requirements and 61% worrying about the cost and disruption to the organization because of frequent turnover. (HR Magazine);

- Even with a recession, the decline in people entering the workforce in the next five to 10 years and increased immigration restrictions will put a strain on companies seeking both skilled and unskilled labor.

Viewing ELTV Through a CLTV Lens: The Seven Constructs

An ELTV framework, like the framework of CLTV, shifts the focus to people and their behaviors as the primary drivers of success. The availability of empirical research on CLTV provides insights that can be applied to ELTV models, notably the following seven concepts.

1) Consistent versus sporadic relationships. In purchase situations where customers have naturally ongoing relationships with an organization, CLTV models can be easily implemented. In contrast, CLTV models suffer from the problem of idiosyncratic customer purchase behavior for many purchase situations. For example, a retailer computing CLTV would find it difficult to estimate CLTV when customers are inconsistent in their patronage over time. Similarly, ELTV models are easier to compute when employees have regular, ongoing employment relationships with an employer. ELTV calculations are more difficult for part-time, temporary or contract employees, or for full-time employees who vary from working in a direct revenue producing job such as field sales and administrative functions such as support services or management.

2) Variations on highest value people over time. CLTV research has looked at the consistency in which customers are high-value customers from year to year. Malthouse and Blattberg (2005) found that about half of the customers who are of high value in one year are not in that same category the following year. This makes it difficult to implement specialized market offerings for best customers as frequently done with loyalty programs. In comparison, one would expect that employees that have the highest lifetime value measure in a given year have a high likelihood of being in that category in the following year. However, the extent to which the same employees perform as such remains an empirical question. ELTV can also vary from year to year. A high degree of variability in computed ELTV from year to year would make it difficult to consistently manage employees relative to their contributions to a company. ELTV is likely to vary most over time when random and inconsistent external factors such as environmental, regulatory, or economic conditions change significantly.

A trucking company could increase profits 50 percent by cutting driver turnover in half.

3) Linking lifetime value to decision-making systems. Recent research has developed advanced models that connect customer lifetime value metrics to decision-making systems. This approach provides an automated way to determine the allocation of marketing communications or pricing offers to individual customers. The analogous situation for employees would be decision-support systems that link ELTV metrics to HR systems for the allocation of training, specialized workplace opportunities and even bonuses of rewards.

4) Network effects for employees and customers. An industry white paper published by Oracle (2006) spells out the impact that network effects – personal relationships among customers – have on measured customer lifetime value.

Some customers act as opinion leaders and influencers. Their value to a company, aside from their own purchasing, is in influencing other customers. Employees also have network effects that relate to financial value. Some employees are valuable because their presence helps with the retention of other valued employees. Other employees contribute indirectly to financial outcomes by positively influencing workplace environment and corporate culture. Network effects are difficult to quantify and, for the most part, are not included in customer or employee lifetime value models.

5) Advanced mathematical models for lifetime value computation. In the CLTV literature, some work has been done to develop advanced mathematical models to measure lifetime value. Advanced statistical models can be used to estimate the underlying statistical properties of customer or employee lifetime value. The benefit of such models is that they allow for the prediction of the expected value of a new customer, or employee, based on comparisons to existing customers or employees.

6) Interventions that alter lifetime value. One of the most important recent developments in CLTV analysis is the inclusion of controllable marketing variables as inputs that can effectively change measured lifetime value. Crowder, Hand and Krzanowski (2007) explore how decisions by firms about whether or not to invest in a customer influence lifetime value. The exact same decision faces organizations evaluating employee lifetime value. Essentially the question addresses the extent to which lifetime value can be increased by management interventions such as personalized service or customized products for customers or training and rewards for employees. This approach advances lifetime value analysis to a recursive level – that is, the recognition that lifetime value is not always a given, but can be influenced by proactive interventions.

7) Quantifying value for mergers and acquisitions. When one firm acquires another, the "buyer" takes on a customer base and expects to serve that customer base more efficiently than the purchased firm did. Haenlein Kaplan and Beeser (2007) provide a CLTV model to value a customer base to assist in mergers and acquisition. Similarly, the acquiring firm takes on a workforce, which it too expects to be able to manage more profitably. An ELTV applied in this context becomes part of the overall valuation of an organization. One benefit of this is that it recognizes, in a way valued by CFOs, that workforce is a financially quantifiable asset.

These seven examples demonstrate that CLTV research provides rich data that is informative to ELTV applications. Given that both measurement situations involve assessment of people, we can expect parallel developments in lifetime value measures for both customers and employees. Using ELTV in juxtaposition with the CLTV guide (to better conceptualize and access), business managers and HR personnel can accumulate superior insight into the one true factor that determines ultimate organizational success: its people.

Some employees are valuable because their presence helps with the retention of other valued employees.

Performance Improvement Council

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A Strategic Industry Group within IMA

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