INVESTING IN GRAY MATTER: EVALUATING A FIRM'S HUMAN ASSETS

By Marcus W. Robins

If you want to buy shares in a company that depends primarily on brain-power, you need to make sure that those brains are going to stick around.

When an oil pipeline company suffers a spill, it shows up in the next financial report. But when a high-tech firm has its top product development team stolen by a competitor, you may never know, unless you work to find out.

The real assets in today's growth companies are human ones.

"My assets walk out the door every night," says one high-tech CEO. "We have to be a good place to work so they'll come back the next morning."

Investing in Information Age companies calls for a new kind of due diligence from investors. You want to be confident that the companies you invest in have the best people and are taking every step possible to keep them.

Unfortunately, the balance sheets and quarterly reports we use today were developed to describe companies that consider "capital" limited to cash and capital equipment. They tally up the value of hard assets such as locomotives and rolling mills, not the value of gray matter in their employees' heads. Nowhere in a 10-K report do you find even the most basic information about a company's workforce that might give you a handle on its quality: the average level of education, the annual rate of turnover, or any measure of employee commitment to the company.

It's clear that such things are important. In the past three years, public companies on Fortune magazine's "100 Best Companies to Work For" list have averaged 37% a year in stock price appreciation, compared with 25% for the S&P 500. In contrast, companies that have acquired others and arrogantly treated the employees they gained like hard assets have seen those employees stream out the doors, taking much of the acquisition's value with them.

Here are ways to find out whether a company in which you want to invest has good people, as well as the ability to keep them.

ASK FOR CREDENTIALS

Exponent, Inc., is a large engineering firm that's unusual both for the work it does and for its status as a publicly traded company (Nasdaq: EXPO). Exponent's engineers specialize in analyzing failures. Exponent was called in when a plant in Henderson, Nevada, that made oxidizer (ammonium perchlorate) for space shuttle flights, exploded in May 1988, leaving behind only a massive crater and scorched earth. No obvious cause was in sight. The oxidizer should not have blown up on its own—it needs a fuel present to burn. And the plant had strict safety provisions in place. It was Exponent engineers who found stress cracks in a 16-inch natural gas pipeline far from the plant, and proved that gas leaking from the cracks followed a branch line under the plant and percolated up into the building until it found a spark.

Michael R. Gaulke, CEO of Exponent, says there are two basic approaches to hiring top consulting engineers—either seek out experience, or go for the top academic credentials. Exponent opts for the latter approach because it

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often deals with puzzles never solved before.

"The engineer who's trading on experience tends to always take the approach that's worked for him before, while the one with an academic background can come at it from any angle," Gaulke believes.

When Exponent goes up against a firm with a seat-of-the-pants approach, "we will win every time," he promises.

He advises investors to ask for credentials. Any company that professes to have a powerful base of knowledgeable employees will know how many Ph.D.s it has aboard. Gaulke can quote Exponent's brainpower figures at the drop of a hat: Out of 638 employees, 378 are engineers and the rest are support staff. More than 70% of technical staff members have graduate degrees, and 172 have doctorate-level credentials. Fully 47 of the company's 52 principals hold a Ph.D.

WHY WOULD THEY STAY?

Next, recognize that in a knowledge-based economy, the people with the best minds are in tremendous demand. You can assume that corporate recruiters contact them regularly with plump offers of salary, titles and signing bonuses.

How can you be sure the brilliant minds you backed with your stock purchase won't be working for the competition next week?

One way is to check out the incentive stock option program. This is one thing that will show up in official filings, though it may be written in the usual impenetrable legalese. Instead, ask the investor relations office about the plan, especially its vesting provisions. The vesting period should match what's typical for that industry. If it's shorter than average, you may not have enough assurance that the talented people will stay long enough to bring products to market and make some money for you. If it's any longer, they'll see it as less attractive than what the competition is offering.

Perhaps the best situation for investors, managers, and employees alike is a plan that offers regular new options grants with rolling vesting periods. That plan continuously gives talented people a reward for staying the next year, then the next, on into the future.

Find out if there are any conditions in the plan that would trigger immediate vesting—for example, if the company is acquired in a hostile takeover. Be aware that when the options vest, it not only removes an incentive to stay but also provides a psychological push out the door, not to mention a nice pile of capital that programmers and engineers can use to set up businesses on their own.

Also, remember that options are only valuable if the stock price continues to climb. When you get a proxy ballot asking you to approve repricing of options that have gone nowhere over several years, fight the urge to think only of your potential dilution and consider a "yes" vote.

Concentrex (Nasdaq: CCTX; formerly CFI ProServices), which provides software to connect banks with their customers, has steadfastly refused to consider repricing employee stock options, even though the stock price has been flat or worse for several years.

"We would never reprice, purely on an investor perception basis," says CFO Kurt Ruttum. For the most part, Concentrex has held onto its staff, but lately it has suffered some losses, particularly among its sales force. One of the troubles with incentive rewards is that they backfire if the company can't follow through.

WHAT'S THE TURNOVER?

A call to the human resources office of a company on your prospective investment list should tell you the annual employee turnover. In high tech, under 10% is excellent.

Exponent has 20% to 25% turnover in its administrative staff, but single-digit turnover among its engineers.

"We have even fewer who leave to work for a competitor," Gaulke says. That's not because the company uses "non-compete" agreements, which are contracts barring ex-employees from working for a competitor for a set number of years. Indeed, in most states such contracts are unenforceable anyway, because courts are reluctant to keep people from supporting themselves in their chosen careers. Companies that rely on non-compete contracts to assure loyalty may simply foster worker resentment at being treated like indentured servants.

Besides providing a good working atmosphere and incentive stock options, companies can use other approaches to lower the turnover rate. Intel, for example, offers all its employees a fully paid, eight-week sabbatical after seven years of service. Employees stay on to get that highly prized break. Intel's package of benefits, which includes such perks as cash for adoptions, a discount stock purchase plan and other goodies, is sometimes known as "the golden handcuffs."

A company's location, surprisingly, can be important to its turnover rate. Silicon Valley, for instance, tends to show higher turnover rates because it is such a hotbed of tech activity. The companies are constantly raiding each other's talent. Meanwhile, companies away from the action usually exhibit lower turnover rates because their staff would have to move across country to take another job.

In general, companies away from the tech centers such as San Jose and Austin find it easier to keep people, but harder to recruit them. The most career-minded tech experts seem to favor the hotbeds because it's easier to grow a career there—the next step on the career ladder is always just down the street.

Ruttum claims that having multiple locations—Concentrex has offices in 12 different cities around the county—helps it gain the best of both worlds, and insulate it against talent raids by competitors.

"We get hit once in a while, but all 12 never get hit at once," Ruttum says.

WHO'S GROWING THE STAFF?

Very few companies have the funds necessary to go out and hire the best-credentialed, most-proven talent. The best investment prospects understand that limitation, and put resources into maximizing the potential of the people they have. An adequate training budget or generous tuition reimbursement plan is often a very good indication that a company will improve its talent over time and remain attractive to its workers.

It also means the company is keeping its people's skills fresh. While Exponent can hire thoroughly credentialed engineers for its business, Concentrex can't because it works at the cutting edge of software development, where industry tends to run far ahead of academia.

Training is also a critical component in what might be called the new equation of loyalty. Companies can no longer promise lifetime employment as they once did, but they can substitute a new promise: We'll help you grow in the job and keep you employable, so when you move on, you can carry your career forward. That kind of promise, ironically, can do a lot to keep people on the job for the long term.

WHY INCENTIVES FAIL

America was the birthplace of behaviorism, the psychological theory that all human action is shaped by patterns of rewards and punishments. American business was the first to put behaviorism into practice in the workplace, and now other countries seem to be following suit. Japan recently approved the use of American-style stock options, and executives at Germany's Daimler are angling for the kind of pay packages their counterparts at Chrysler have enjoyed for years.

"If pop behaviorism were a religion, American managers would have to be described as fundamentalists," says researcher Alfie Kohn. The "do this and you'll get that" philosophy runs so deep in American business that it's rarely even questioned.

The problem with that, though, is there is more and more evidence that "do this and you'll get that" doesn't work. And America, once the birthplace of behaviorism, is now becoming the forefront of a backlash against the theory.

Kohn, in his book, "Punished by Rewards," discusses why two groups of people told to work a puzzle will behave differently based on whether or not they get a reward. The first group stops working as soon as the reward is handed over; those who go unrewarded keep working because they find the puzzle fun. Many other studies indicate that "extrinsic" rewards undermine the "intrinsic" motivation that drives people to do their best work.

"The evidence suggests . . . that extrinsic motivators in the workplace are not only ineffective but often positively counterproductive," Kohn writes. In other words, the handcuffs may be golden, but people still know they're handcuffs.

Management guru Peter Drucker comes down on Kohn's side. Today, knowledge workers know more, at least about their own areas of expertise, than their bosses do. The relationship of a manager to her workers is more like the relationship of a conductor to an orchestra.

"What this means," Drucker writes, "is that even full-time employees have to be managed as if they were volunteers. In this, the typical corporation can learn a lot from the Salvation Army or the Catholic church.

"Like volunteers who work for the church or the army, knowledge workers own their means of production, which is their knowledge. Their means of production are theirs, unlike the machinery, the buildings, the raw materials that industrial workers require to do their jobs.

"Furthermore, we have known for 50 years that money alone does not motivate employees to perform much more than it motivates volunteers. Yes, dissatisfaction with money grossly demotivates . . .

"What motivates workers—especially knowledge workers—is what motivates volunteers. Volunteers, we know, have to get more satisfaction from their work than paid employees precisely because they do not get a paycheck. They need, above all, challenge. They need to know the organization's mission and believe in it. They need continuous training. They need to see results."

Ruttum says he's convinced financial reward is not at the top of high-tech workers wish lists. "It may be up there, but it's really not number 1," he says. "More important is whether the work you're doing is exciting."

Concentrex had a very loyal staff in the mid-1980s, when it developed loan application software that revolutionized American banking. Then the sense of mission declined, and turnover turned up. Now, Ruttum hopes, the staff is once again charged up over the potential of Internet banking and what Concentrex can do to change the world once again.

Gaulke at Exponent appreciates the difference between a company driven by "extrinsic" rewards and one with a true sense of mission, one that someone might just volunteer to work at. The company learned part of the lesson the hard way, through experience.

In 1992, for example, Exponent tied 80% to 90% of workers' compensation to their ability to bring in business.

"There are a lot of deviant behaviors that arise out of that," Gaulke says. Engineers would hoard work, or hire inferior people so no one would outshine them. Exponent has moved away from that system over the past eight years; its base compensation is now higher and makes up a much bigger proportion of salary. "We solved a lot of problems by going away from the incentive pay system."

Now, he says, Exponent's pitch for recruiting and retaining the country's best, most creative engineers is simple and direct: "If you're an engineer, this is the best sandbox in the country."

People tend to assume that, while they themselves are driven by high ideals and the desire to do a good job for its own sake, others must react only to punishments and rewards. The evidence proves that is a mistake for both managers and investors.

BEYOND STOCK OPTIONS

Finding the Information Age companies that will recruit and keep the best people means looking beyond stock option plans.

As you are sizing up a company in which to invest, take time to ask yourself the simple question: Is this a place I'd like to work?

It will go a long way to finding investments that will outperform over time. ◆