CANADA
DOLLAR

Capital vs Talent

THE BATTLE THAT'S RESHAPING BUSINESS

By Dean Roger Martin and Mihnea Moldoveanu

The emergence of skill as the lynchpin asset in the modern economy has led to a fierce battle between capital and talent for the proceeds from the knowledge economy, say Dean Roger Martin and Mihnea Moldoveanu, director of the CCMF Centre for Integrative Thinking and professor of strategic management. And while it's unclear which side will prevail, at the moment talent is holding most of the firepower.

Throughout the 19th and early 20th centuries, the key assets most firms competed with were physical ones – things like minerals, oil, and land. As the 20th century progressed, these physical assets shifted from natural resources to plants and equipment, and financial assets became more important as a determinant of competitive advantage. The capacity to create dominant scale in plant equipment and locations is what set companies like **IBM, AT&T, GM,** and **Eastman Kodak** apart from their competitors.

The terms of competition had changed dramatically by the late 20th century, and dominant physical and financial assets no longer determined success. By 2000, many of the world's top 15 firms by market capitalization began with little or no physical or financial assets – including **Microsoft, Cisco, Intel, and Wal-Mart**. The vast majority depended on superior human assets for their advantage – great research scientists, inspired code writers, distribution geniuses, product innovators – and knowledge assets – patents, brands, know-how, experience. In short, in increasing numbers, leading companies were depending on talent.

The very revolutions in information technology, globalization and knowledge management that drove people-based assets from the 'back of the bus' to the driver's seat have changed the environment of the firms in which these people work. Indeed, they have changed the business environment itself, sparking a battle between talent and capital for the profits from the knowledge-based economy – and there's no end in sight.

How Talent got to where it is today

For talent, it has never been – and probably never will be – a better time to be skilled. Capital needs talent increasingly desperately, and in industries everywhere, talent is realizing just how badly it is needed.

One of the first identifiable salvos in the battle between talent and capital occurred in 1978, when filmmaker **George Lucas**, flush with success from *Star Wars*, negotiated a 50/50 split of the profits – before overhead and distribution costs – from **Paramount Pictures** from his next venture, *Raiders of the Lost Ark* (which **Steven Spielberg** directed and Lucas

ILLUSTRATION: BRUNO BUDROVIC

executive produced.) When capital accepted his unprecedented demands, it opened the door for other talent in Hollywood – and elsewhere – to follow.

Also in 1978, **Theodore Forstmann** founded the buyout firm **Forstmann Little**. At the time, managers of capital were typically being paid one-to-three per cent of assets under management annually. Tired of seeing providers of capital earning great returns on his advice while he earned relatively modest returns, Forstmann demanded the usual two per cent, plus 20 per cent of the upside over a six per cent annual return. Capital didn't even flinch – indeed, people tossed him money. Before long, **George Soros** followed suit with his Quantum Fund, and **John Doerr** and **Vin Khosla** weren't far behind with their venture capital fund for **Kleiner Perkins.**

And so it went. By using their relatively scarce talent as leverage, these savvy negotiators extracted a substantially bigger piece of the economic rents out of the hide of capital. The formula they invented is now the standard arrangement in the business, and because of it, lots of people have become extremely wealthy – including Forstmann, Soros, **Henry Kravis, William Lee**, and many others on The *Forbes 400*.

Another seminal event occurred in the wake of uber-capitalist **Warren Buffett's** 1987 investment of $700 million in investment bank and commodities trader **Salomon Inc**. Buffett, who joined the board at the time of his investment, fumed as he watched profits plummet between 1989 and 1990 to an anemic 10 per cent return on equity for shareholders. Meanwhile, compensation costs increased $120 million, as 106 investment bankers earned compensation of over $1 million on the basis of hefty bonuses. When Buffett took over as chairman in 1991, he engineered a $110 million reduction of the planned 1991 bonus pool for Salomon's 150 managing directors in order to improve the still-unsatisfactory shareholder returns.

At first this was seen as a victory for Buffett, the icon of capital, over talent, represented by the greedy investment bankers. However, like most battles, it was not quite as one-sided as it first appeared. The shareholders got their extra $110 million – but in the wake of the raiding of the bonus pool, Salomon faced a massive defection of its most talented investment bankers, from which, as many observers have noted, it never recovered.

> Talent – everyone from Hollywood directors, to venture capitalists, to strategy consultants, to investment bankers, to CEOs – decided that its share of the pie was too little, and that of capital was too big.

A parallel conflict – centering on the birth and development of the strategy consulting industry – was taking shape at the world's leading business schools. Brought into being by **Boston Consulting Group** in 1963, strategy consulting was an industry of small firms built almost exclusively on talent, not capital. By the mid-1980s, BCG was joined by numerous start-up firms, including **Bain and Company** and **Monitor**, as well as old-line firms, such as **McKinsey and Company**, **A.T. Kearney** and **Booz Allen Hamilton**, in an industry that grew for decades at over 20 per cent per year.

These firms decisively won the recruiting battles for talent at the world's leading business schools. By the mid-1980s, over 50 per cent of the graduating classes of the best business schools – including **Harvard**, **Stanford**, **Wharton** and **INSEAD** – were taking jobs at strategy consulting firms.

How did the strategy consulting firms do it? They simply paid dramatically more – in starting salaries, signing bonuses, year-end bonuses, and potential for compensation growth. Talented young business graduates used this new type of firm – owner-operated strategy consulting firms – to extract more of the available rents than they had been able to at the capital-backed major firms. For young MBA's, a consulting career often represented a shortcut up the corporate ladder, whose bottom end is most often contemplated by new graduates. More and more 'strategic' functions of the corporate head office were 'contracted out' to where the new talent was: in the strategy consulting firms.

In the movie business, a noteworthy event in the emerging battle was a 1991 purposely-leaked memo by then-**Walt Disney Studios** chief **Jeffrey Katzenberg**, chronicling the spiral of irrationality in the movie production business. Katzenberg argued that studios put up all the capital and took all of the risk, but the profit was being stripped off by the spiraling costs of movie stars, script-writers, and directors – the 'talent' as it is called in that industry. He argued that the industry would suffer from anemic profits as long as it continued to support the spiral of talent extracting all the profit. While he offered some suggestions, little has changed in the movie business – as new investors like **Edgar Bronfman, Jr.** have found out to their chagrin.

The CEO Connection

These more isolated incidents – investment bankers, strategy consultants, hedge fund managers, movie stars – spread to the public consciousness over the past several years with the public's reaction to the spiraling of executive compensation, especially CEO compensation.

In 1980, CEOs of large American companies were being paid 33 per cent less per dollar of earnings generated than in 1960. Shareholders of the time were happy – but it was not to last. As talent began to flex its muscles, between 1980 and 1990, pay for CEOs

doubled per dollar of earnings produced. And that was only the beginning: between 1990 and 2000, it *quadrupled*.

CEOs have been given unprecedented ability to share in the upside of their firms, with packages that have neared $1 billion in the case of executives such as **Coca Cola**'s **Robert Goizueta.** Increasingly, angry shareholders question why executives appear to be getting huge returns when shareholders – who supply the capital – are getting miniscule returns, a critique not dissimilar to that of Buffett a decade earlier.

Talent – everyone from Hollywood directors, to buyout fund managers, to hedge fund managers, to venture capitalists, to strategy consultants, to investment bankers, to CEOs – had decided that its share of the pie was too little, and that of capital was too big.

Why was talent able to draw this conclusion? Three reasons.

First, capital is abundant, and it is totally generic. A buck is a buck is a buck. It used to be associated with an owner – like **Morgan, Mellon,** or **Rockefeller** – but in the main, it isn't anymore. And one buck is pretty much the same as the next.

Second, the emergence of skill as the lynchpin asset. The knowledge economy had arrived, and more and more industries were becoming talent-centric. If you asked the *Fortune 500* CEOs in 1950 which they would prefer to keep – their human assets or their financial assets – it would be a no-brainer for financial assets. If you asked the same in 2003, it would be a no-brainer for human assets.

Third, mushrooming agency costs made capital almost wholly dependent on talent. The increasing complexity of the 'battlefields of business' on which companies competed with each other made 'dumb and blind' capital increasingly dependent, not only on talented 'experts', but also on 'watchdogs' that would help keep the talent in check. These watchdogs, of course, were also members of the talent class – attorneys, accountants and business consultants with the specialized knowledge to follow the intricate manoeuvres of those they were charged to monitor.

The Implications for Talent

Returns for increasing skills will be highly positive, so specialized skill acquisition will be critical. In particular, investing in education and life-long learning will have a high positive return for the individual.

Ever-increasing levels of applications to elite colleges and graduate schools represent recognition that skill acquisition is rising in popularity. The key for individuals will be to develop talent that is seen by providers of capital as essential to business success and differentiable. That is, small differences in talent level will make a substantial difference in business outcome. CEO compensation has risen so rapidly over the past decade in part because Boards of Directors have concluded that relatively small differences in CEO quality can leverage huge differences in share price performance of firms. For **Loblaws**, former CEO **Richard Currie** was an acceptable bargain at the hundreds of millions he was paid over his 25 years with the company.

Talent will increasingly flex its muscles, as it has already done in professional services and entertainment. Increasingly, pharmaceutical scientists and software designers will demand a direct slice of the value they create, rather than a wage plus small bonus. True, the boom cycle of the late 1990's may be over, and entrepreneurs may feel a tad squeezed by the venture capitalists they are re-negotiating their equity slices with. But that is only if one compares current deals with those struck at the height of the frenzy. Pre-1990, deals between venture capitalists and entrepreneurs look paltry compared to today's structures, in which residual claims by entrepreneurs on the value of the business they help to create are considered commonplace.

In choosing among industries, talent will be rewarded most highly if it picks industries that employ capital and require differentiated talent to win. In low-capital businesses – for example, legal services – the talent must generate all the rents that it appropriates. In more capital-intensive businesses – for example, investment banking or movie production – capital actually leverages the value-creating ability of the enterprise only to see (as did Buffett and Katzenberg) talent appropriate the rents generated by both itself and capital.

Talent should avoid industries in which capital can utilize relatively generic, fungible human resources, because in such cases, capital can appropriate a disproportionate share of the rents. Animated film production contrasts dramatically with live-action film production in this respect. While outstanding animation artists are well-paid, they do not earn – at least yet – anything close to the levels of movie stars, directors or screenwriters. Katzenberg understood well this difference and it informed his decision to challenge the Disney domination of animated feature films and make them a priority when he co-founded **Dreamworks Studios**.

Talent is still in its ascendancy, and will continue to make inroads. New forms of talent will get into the game – people like consumer brand builders and product designers. The key is uniqueness. Generic human assets will be the big loser in the battle between capital and talent – they will be like elephants dancing.

In choosing among industries, talent will be rewarded most highly if it picks industries that employ capital and require differentiated talent to win.

The Implications for Capital

It will be a miserable time for capital as it comes to terms with a completely changed reality. Capital will get increasingly hostile, tiring of having to pass itself through talent's hands in order to be used. And talent will increasingly recognize that it is indeed the gatekeeper, and can set the toll as high as the value it can create. Beleaguered capital will take two actions: it will collectivize; and it will politicize.

Despite the fact that they are providing a completely generic product – money – providers of capital think that that they deserve to earn a reasonable return on that generic input. Capital is increasingly going to wake up to just how generic and undifferentiated it is.

First, it will collectivize. The major holders of capital have become the institutions, in particular the pension funds. As **Peter Drucker** correctly predicted, pension funds have become one of the most important holders of capital. They will increasingly band together to attempt to use their leverage their collective power to offset the power of talent to extract rents.

Collectivization has already begun in Canada, as 19 of the country's largest pension funds and money managers have banded together to form the **Canadian Coalition for Good Governance** in an attempt to exercise shareholder power over executive compensation. The Coalition is headed up by the Rotman School's own **David Beatty, Conway Director of the Clarkson Centre for Business Ethics & Board Effectiveness** and professor of strategic management.

Collectivizing will provide relatively modest benefits on its own. As with any cartel, its members will have the incentive to cheat and undermine their own efforts. So the next step will be aggressive lobbying of governments to legislate in favor of capital – for example, to cap CEO salaries and reduce the use of options.

Capital will have to get used to the fact that in order to earn a return, it will have to create an environment in which it is particularly difficult for talent to appropriate the rents.

In such an environment, talented human assets create knowledge assets, such as patents, brands, know-how, or customer relationships, that the firm can appropriate, at which point capital – not talent – can earn a return on these assets. However, this will be increasingly tricky as talent figures out the 'game' – that is, that they are enticed to create a 'product' that is alienable (i.e. can be separated) from them and will be appropriated by capital. As they see this happening, talent will negotiate for an ever-greater proportion of the life-cycle rents of their creation before agreeing to create it in the first place. In some talent fields, such as recorded music, this happens already, as the talent receives compensation by way of royalty every time their music is played. However, it does not yet happen with artists, who do not receive a royalty every time their artwork is resold. Increasingly, talent such as research scientists at pharmaceutical companies will negotiate direct royalties on the drugs they are instrumental in creating.

It will be a particular challenge for capital to organize and structure enterprises conducive to its appropriation of rents. Why? Because its would-be allies in running the firms are none other than card-carrying members of the talent class – the CEOs and senior executives of its firms. While capital hopes to create a structure conducive to it appropriating the rents, the very talent it hires to do so will be busily figuring out how to appropriate the rents for itself rather than for capital. So capital will increasingly feel like an outsider, with nobody there to help it earn returns. As a result, we will see an enormous intensity of lobbying activity on the part of capital as it tries to deal with an unpleasant start to the 21st century. While there are no great answers for capital in this war, there are a couple of things to keep in mind.

First, don't pull an **Edgar Bronfman Jr.** Trading **Seagram's** and **DuPont** for **Universal** and **Polygram** was a dreadful idea from the start. Why? Because the movie and record businesses are as talent-intensive as any industries on the planet. Each has layers and layers of talent between capital and its potential returns, each with its fingers in the till and capable of grabbing a big handful. Capital will have to be much more attentive to the power of talent to extract the benefits.

Sexy industries with growth and highly-differentiated products – like the movie business – are not good for capital. Professional service businesses – like advertising agencies and consulting firms – are also bad for capital, which is simply put in to be held up at a later date.

The best businesses for capital are those in which assets can be built using relatively generic human assets that become the property of the corporation and don't really need talent to operate the assets. The Canadian bank retail businesses are a good exemplar. Not to be confused with their investment banking sides -- which are set up primarily to benefit their talent. **Procter & Gamble** is a good model for capital, because it is not dependent on any one brand manager or R&D scientist.

Second, capital has to watch for a run on the bank. There is a major contagion effect when talent breaks into new ground. It happened in Hollywood when Lucas set his precedent in the late 1970s, and it happened by the midpoint of the dot-com boom. But in each case, capital continued to invest, even as the talent kept asking for more and more of the spoils. And for capital, spoiled it quickly got.

The best businesses for capital are those in which assets can be built using relatively generic human assets that become the property of the corporation and don't really need talent to operate the assets.

The owners of capital are going to have to stay involved and add more value themselves. Unattached capital will get held for ransom more often than attached capital. That is to say, self-directed RRSPs will be tolled one fewer time than financial advisor-directed RRSPs. If you want real talent managing your money, it will charge top dollar for the privilege – so make up your mind that you really want it.

Conclusion

In the end, as in all wars, there will doubtless be some form of accommodation between capital and skilled labor. Both sides need each other, as has always been the case. But as in all wars, how each side fights the battle will significantly influence the nature of the accommodation, and whether or not they ever achieve anything resembling peace. RM