FINANCIAL REVIEW BOSS

Features

Talent v Capital

By Roger Martin | Image by Super Gympie

We're still living in a material world, but the skills that are in high demand are the intangibles: creativity, knowledge and imagination.

SO THERE'S a new dynamic between the workers and the owners, a new power differential between labour and capital. In fact, forget labour – now it's all about talent and its ability to argue for a bigger share of profits. With human capital – talent – in the driver's seat, financial capital is increasingly realising just how generic and undifferentiated it is.

That means taking a new approach to where it invests, and new tensions between the very highly paid talent and shareholders. Time to take a look at where the battle lines have been drawn. PLUS Tom Peters on how the need for speed is shifting the power in our organisations.

Throughout the 19th and early 20th centuries, the key assets most firms competed with were physical – minerals, oil, land. As the 20th century progressed, physical assets came to include plant and equipment rather than natural resources, 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 such as IBM, AT&T, General Motors and Eastman Kodak apart from their competitors.

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

The very revolutions in information technology, globalisation 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.

For talent, it has never been – and probably never will be – a better time to be skilled. Capital needs talent desperately, and in industries everywhere talent is beginning to understand 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, flushed 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. 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 & Co. At the time, managers of capital typically were 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 Vinod 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, including Forstmann, Soros, Henry Kravis and William Lee, have become extremely wealthy.

Another seminal salvo occurred in the wake of uber-capitalist Warren Buffett's 1987 investment of $700 million in the investment bank and commodities trader Salomon Inc. Buffett, who joined the board at the time of his investment, fumed as he watched profits plummet from 1989 to 1990 to an anaemic 10 per cent return on equity for shareholders.

Meanwhile, compensation costs increased $120 million as 106 investment bankers earned compensation of more than $1 million on the basis of hefty bonuses. When Buffet took over as interim 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 investment bankers, from which, as many observers have noted, it never recovered.

A parallel conflict centring on the 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 new firms, including Bain and Company and Monitor, as well as old-line firms, McKinsey & Company, A.T. Kearney and Booz Allen Hamilton, in an industry that grew for decades at more than 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, more than 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.

Strategy consulting

How did the strategy consulting firms do it? They 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 to extract more of the available rents than they had been able to at the capital-backed major firms.

In the movie business, a noteworthy event in the emerging battle was a 1991 memo by then Walt Disney Studios chief, Jeffrey Katzenberg, that was leaked to Varsity magazine. Katzenberg argued that studios put up all the capital and took all the risk, but the profit was being stripped off by the spiralling costs of movie stars, scriptwriters, and directors – the "talent".

He argued that the industry would suffer from anaemic profit as long as it continued to support the spiral of talent extracting all the profit. While Katzenberg offered some suggestions, little has changed in the movie business.

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

CEOs have unprecedented ability to share in the upside of their firms, with packages nearing $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 are getting minuscule returns. Talent had decided that its share of the pie was too little and capital's was too big.

Why was talent able to draw this conclusion? First, capital is abundant, and is generic; a buck is a buck is a buck. It used to be associated with an owner – Morgan, Mellon, Rockefeller – but in the main, it isn't anymore. And one buck is pretty much the same as the next.
Second, skill has emerged as the linchpin asset. With the arrival of the knowledge economy, 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.

Roger Martin is dean of the Rotman School of Management at the University of Toronto and author of The Responsibility Virus (Basic Books, 2002). He has written extensively for the Harvard business review.

What it means for talent

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

Ever-increasing numbers of applications to elite colleges and graduate schools represent recognition that skill acquisition is rising in popularity. The key 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 rapidly over the past decade in part because boards have concluded that relatively small differences in CEO quality can leverage huge differences in share price performance.

For GE, former CEO Jack Welch was an acceptable bargain at $900 million for his 20 years as CEO.Increasingly, talent will flex its muscles, as it has done already in entertainment. Pharmaceutical scientists, consumer brand-builders and software designers will demand a direct slice of the value they create.

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

Talent should avoid industries where capital can utilise relatively generic, fungible human resources, because capital then can appropriate a disproportionate share of the rents. For example, while outstanding animation artists are well paid, they do not earn – for now – anything close to that of movie stars, directors or screenwriters.

Katzenberg understood 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. The key is uniqueness. Generic human assets will be the big loser in the battle between capital and talent.

What it means for Capital

It will be a miserable time for capital as it comes to terms with a completely changed reality. Capital will become increasingly hostile, tiring of having to pass itself through talent's hands in order to be used. And talent will begin to recognise 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 collectivise and politicise.

Despite the fact that they are providing a completely generic product – money – capital providers think they deserve to earn a reasonable return on that input. Capital will wake up to just how generic and undifferentiated it is.
First, it will collectivise. The major holders of capital have become the institutions.

As Peter F. Drucker correctly predicted, pension funds have become one of the most important holders of capital. They will band together to attempt to use their leverage, their collective power, to offset the power of talent to extract rents.

Collectivising 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 favour of capital – for example, to cap CEO salaries and reduce the use of options.

Capital will have to get used to living with the reality that it neither deserves nor will earn super-normal returns for supplying a completely generic good. In order to earn a return, capital 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 become tricky as talent figures out the game – that is, that they are enticed to create a "product" that is alienable (ie, can be separated) from them and will be appropriated by capital. As they see this happening, talent will negotiate for an even 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 painters, who do not receive a royalty every time their artwork is resold. Talent such as research scientists at pharmaceutical companies will negotiate direct royalties on the drugs they create.

It will be a particular challenge for capital to organise 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. While capital hopes to create a structure conducive
to 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 begin to feel like an outsider, with nobody there to help it earn returns. As a result, we will see an enormous intensification 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 industry on the planet. Each has layers of talent between capital and its potential returns.

In the movie industry, there are production companies, agents, movie stars, producers, screenwriters, music suppliers and publicists – each with a finger in the till and each capable of grabbing a handful. The record business has a combination of exuberant talent and illicitly downloading kids. Capital will have to be more attentive to the power of talent to extract the benefits.

Sexy industries with growth and highly differentiated products – such as the movie business – are not good for capital. Professional service businesses – advertising agencies, consulting firms – are also bad for capital, which is 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 need talent to operate them.

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 George Lucas set his precedent in the late 1970s, and it happened by the midpoint of the dotcom boom. But in each case capital continued to invest, even as the talent kept asking for more of the spoils. And capital quickly became spoiled.

The owners of capital will have to stay involved and add more value themselves. Unattached capital will be held for ransom more often than attached capital.

That is, self-managed retirement funds will attract a lower charge than those managed by a financial advisor. If you want real talent managing your money, it will charge top dollar for the privilege – so decide whether you really want it.

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