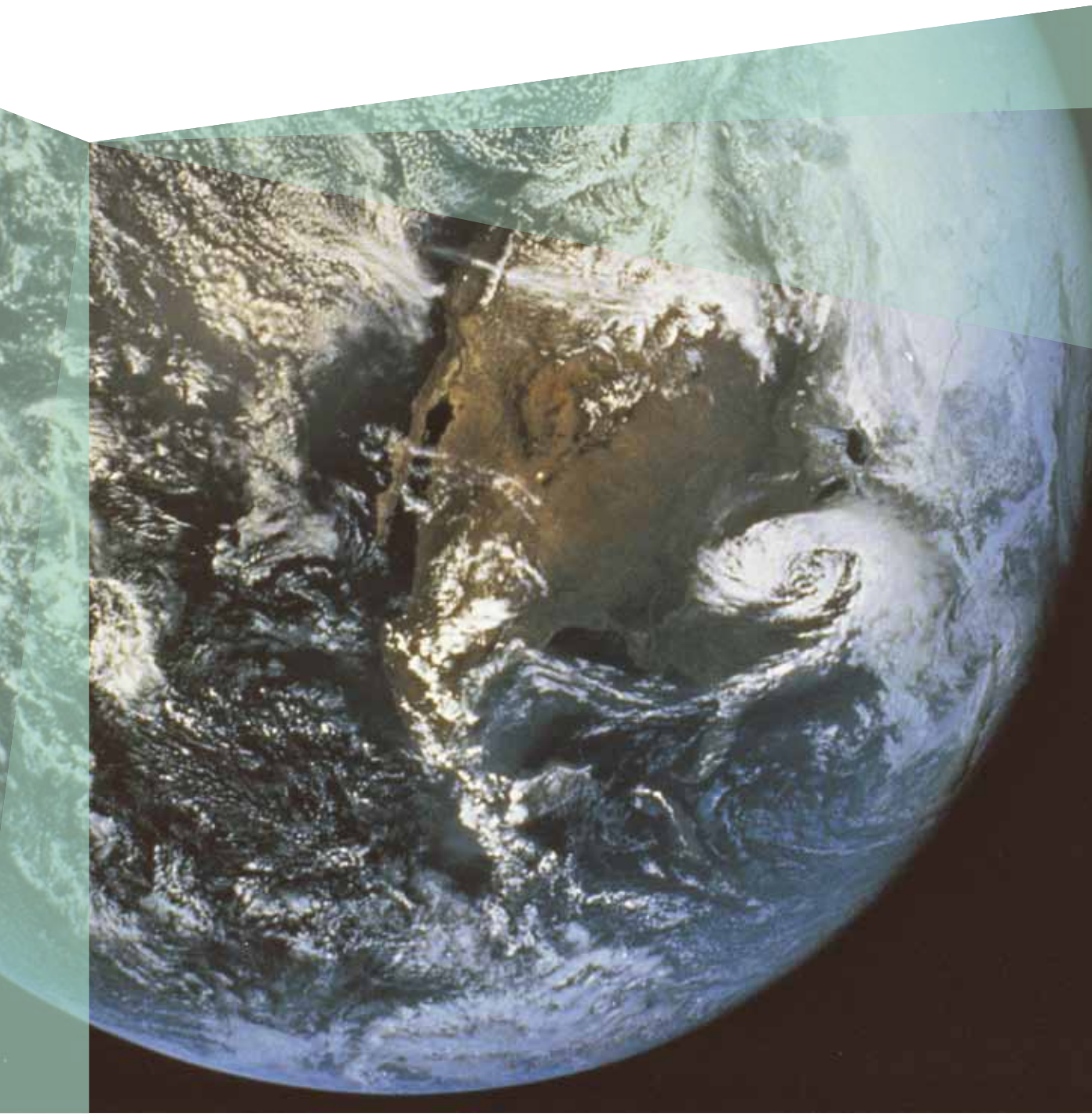
MERCER

TALENT • HEALTH • RETIREMENT • INVESTMENTS

MONETISING LEADERSHIP QUALITY
THE ANALYSTS' LENS ON LEADERSHIP EQUITY



MARSH & McLENNAN COMPANIES

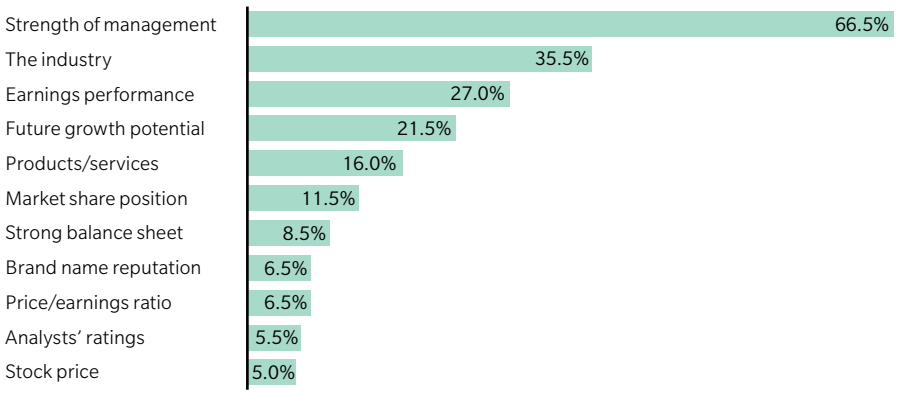
MONETISING LEADERSHIP QUALITY

THE ANALYSTS' LENS ON LEADERSHIP EQUITY

Who controls the assets that have the most sway with equity analysts? If you said senior talent leaders, you would be right – but probably puzzled as well, given what most investors talk about when they refer to the critical assets of a business.

We came across this insight when we were delivering a senior leadership programme for Mercer to a large global pharmaceutical organisation. The firm's Vice President of Investor Relations was making a presentation to the group and showed the chart contained in Figure 1 below. In this figure, you can see that the most important factor that analysts consider in formulating their stock price recommendation is the "strength of management". Being somewhat sceptical about these survey findings, we explored other studies, such as those recently published by Deloitte (2012), which examined the same issue, and all show the same result. Analysts are heavily influenced by the strength of management or leadership when coming up with their recommendations regarding a firm's worth – in the simplest terms, to buy, sell or hold.

Figure 1
Most Important Factors Influencing Investment



Factors representing less than 5% are not shown.

Source: Research of 200 financial analysts by Corporate Branding, LLC

Nevertheless, we still remained somewhat puzzled because we had assumed, like many others, that analysts were primarily interested in quarterly results and what are commonly referred to as the "hard" or "tangible" assets in determining a firm's worth versus something so nebulous as "leadership". Although we do know that when examining a firm's assets, analysts consider what is called "goodwill", which encompasses such things as the quality of leadership, we did not think it significantly affected their estimates of a firm's worth. We were totally wrong, as it not only affects their estimates, it affects them on par with some of the most tangible assets.

Yet, while remaining somewhat sceptical of the idea, we decided to further check our assumptions concerning the contribution by management and leadership to estimating a firm's worth by listening in on a sample of analyst calls. The calls, which are arranged by organisations' investor relations groups, provide analysts an opportunity to hear from and ask questions to the chief officers and other senior executives. As we listened to these calls, we coded the kinds of questions raised by the analysts. Of the 100+ questions analysts posed on these calls, only three of them pertained to leadership, and of those, two were seeking clarification on executive appointments. We also reviewed a randomly selected set of 20 analysts' recommendations drawn from across industries. None of them specified leadership as a factor contributing to their buy, sell or hold recommendation. These findings were rather curious given what we found in the research studies.

THE ROLE OF LEADERSHIP QUALITY

We thought that on the one hand, analysts say that leadership strength is important, but on the other hand, they do not seem to be focusing on it – at least in questioning it or gathering data to estimate their value. This inconsistency led us to the next step in our quixotic journey to determine how the strength of management and leadership factored into determining an analyst's estimate of a firm's value, which involved interviewing 40 analysts from all around the globe and across industries. Among other questions on the topic of estimating a firm's worth, we asked them: "How do you factor leadership quality into your recommendations?"

The first thing we learnt was that the more experienced analysts (more than five years' experience) take what we would call a *three-pass approach* to valuing leadership:

- First pass: forecast cash flows – In the first pass, they do the basic math. The analysts gather the macroeconomic, industry and company data that allow them to forecast the future cash flows of the organisation for the next five to10 years, and to impute the future value of the stock. In this first pass, the analysts look to Investor Relations for data and look to the CFO and CEO to explain the organisation's strategy and the footing they believe will deliver these estimates or numbers.
- Second pass: adjust for near-term risk – In the second pass, most analysts ask whether the short-term targets (one to two years) are attainable and, if not, they try to determine and apply risk factors accordingly. To set the appropriate risk factors, the analysts we interviewed rely on historical databases provided by third-party vendors and pooling of other analysts' forecasts (weighted by historical accuracy, such as an analyst's StarMine ratings, which is sort of a box score representing the analyst's accuracy in predicting a firm's performance). These analysts also listen to the Chief Operating Officer or Head of Manufacturing on Investors Day as he or she describes specific enhancements the organisation has made to address known execution issues, ranging from the implementation of new technologies to reconfiguring supply chains. Based on all the data, the analysts move their estimate of the price up or down to an execution-risk-adjusted price.
- Third pass: adjust for long-term risk – In a third pass, the more experienced analysts ask a similar question pertaining to the risk associated with the forecast, but with this pass they are now looking at three to 20 years. Typically these analysts have followed organisations in turbulent industries facing radically changing markets, consumer tastes, regulations and technologies. As a result, in this third pass, the analysts essentially ask themselves whether the leaders at the top and those emerging can get their organisations from here in the near term to there in the long term. As they set out to answer this question, they do not seek data from the organisations they follow and also make no reference to the data in their recommendations. They essentially go outside of the organisation to gather whatever data they can from a broad range of sources – for example, websites, trade magazines, interviews, etc. – that they use to come up with their final estimates.

OTHER FACTORS IN GAUGING LEADERSHIP PERFORMANCE

We were still left wondering why most analysts don't seek data on predicting leadership performance, and why they choose not to specifically reference leadership in their recommendations. These 40 interviews indicated that the reason appears to be the analyst's approach to examining leadership. Specifically, when we asked each analyst to choose a particular organisation they follow and to share their assessment of the leadership in that organisation, they told us stories they had heard about the leaders. They described previous roles the leaders had played in other organisations and the lore around their impact. They also shared their personal impressions of the leaders, gained from their observation of Investors Day presentations or through other public venues. Consistently, their main focus was on the top management team as the source or locus of leadership.

It became increasingly clear to us that the analysts didn't highlight leadership in their recommendations because their judgements were based on highly subjective input that they could not rigorously defend. Specifically, analysts never referenced any empirical studies or shared any specific facts about judging leadership beyond what one could discern from a leader's resume or watching the leader present. For most of the analysts we talked to, leadership assessment is a subjective, "artistic" judgement. They would say that their judgement is based on years of observing leaders, tracking their decisions and noting their impact. Absent from these descriptions is any specific evidence-based model or framework that they would leverage to make their judgement on the firm's leadership quality. Essentially, the final stock price estimates linked to management or leadership strength are based on the analyst's intuitive judgement, which none of the interviewees could actually explain other than to say, "It's a best guess or something you just do based on your gut impression or intuition." So, we don't know how they come up with the actual discount rate or estimate of leadership quality, and neither do they.

Actually, the way that analysts make their decisions about leadership does not differ from what most decision theorists would say is a plausible approach to arriving at a final judgement. In a situation where a complex phenomenon needs to be evaluated, an assessor with deep experience in this situation is more than likely effective when he or she judges the patterns rather than gets stuck in analysing every bit of data. We talked to one head of Investor Relations who put it well. He said, "Even if you could boil leadership strength down to one comparative number, the analysts wouldn't believe it – they know it's more complicated than that."

THE IMPACT OF ASSESSMENTS ON STOCK PRICING

Our last finding was the most surprising. We asked each analyst by how much they adjust their stock price estimate to reflect their assessment of the organisation's leadership quality. All gave answers in excess of 5%, and some had previously made adjustments by as much as 30%–50%. To validate these and our other findings, we conducted an online survey in 2011 of a broader global sample of 305 analysts through a partnership with Forbes Insights. Three-quarters of the analysts in this global sample indicated that they have adjusted stock price estimates in excess of 15% on average and, again, the more experienced the analyst, the greater the adjustment.

We believe that the implications of our findings are profound for senior leaders and those involved in the management of this talent. In the third pass, analysts watch senior leaders, track their decisions, compare notes with other industry observers, ask competitors and executive professionals what they think about the leaders, and reflect on their own experiences with those leaders and the stories they hear about them. Based on this aggregated information, analysts may adjust their stock price estimate by as much as 15%. In passes one and two, the analysts look to the CEO or COO for data, background guidance, interpretation and elaboration. In the third pass, although no one was named, executives managing the leadership talent in organisations – such as the Chief Leadership Officer and the Chief HR Officer – are the logical source for a more comprehensive assessment of the strength of top team leadership and management.

After we completed our research, we shared our findings with several senior leaders responsible for talent management and noted three consistent reactions. First, all of them were surprised (as we had been) that analysts ranked management or leadership strength so high in the assessment criteria. Second, they were quick to recognise that this provides a significant opportunity for them and their organisations to think about how they develop and promote their leadership-quality "brand." One talent leader captured it well: "There aren't many things we can do as an organisation that add 15% to our equity value overnight." Third, they indicated that some key shifts were required if they were to succeed in exploiting this opportunity. We specifically heard about six shifts. (See Table 1 on page 6.)

Table 1
Key Shifts for Senior Talent Leaders

SHIFT	FROM	TO	REQUIREMENTS
1. Importance of leadership quality	Low on organisation's and CEO's agenda	Top of organisation's and CEO's agenda	Need to be "street savvy" and understand how analysts estimate your firm's stock price
2. Lens for leadership quality	Private, internal matter	Exposed, public matter	Need to become a marketer of your firm's leadership quality and systems that develop such quality in the same way your firm markets products/ services
3. Who is responsible for leadership quality	HR responsibility	Collective responsibility of the top leadership, including talent leaders	Need to develop a trusted voice with the analysts in areas where the estimates of your leadership quality may not always be where you hope they would be, but your estimates are defensible, rigorous and relevant to what analysts need
4. Goal of analyst interactions around leadership quality	Telling them what we want them to know that presents a positive picture	Providing them with reliable and valid, verifiable data that track the quality of leadership and management	Need to develop systems that provide rigor, relevance and reliability that analysts will trust in determining what represents the quality of leadership
5. Focus of what to communicate around leadership quality	Showing them how we are improving our leaders against a competency model and, in turn, the return on investment	Empirically demonstrating existing capability of leaders relative to achieving the targets in the firm's strategy (risk of asset)	Need to frame leadership quality relative to strategic risks, pointing to the gaps and the methods that will be used to close those gaps
6. Target population for leadership quality	Current top-level leaders	Leaders in the wings and multiple levels within an organisation, ultimately gauging the quality of the entire "leadership system"	Need to be more transparent with succession plans, progress towards developing the leadership talent required and key milestones that detail progress towards optimising the leadership talent profile of the organisation

At a recent Conference Board session attended by Fortune 500 Chief Leadership Officers in May 2012, we asked the talent leaders in attendance to complete an anonymous survey gauging their current ability to meet these six requirements. Less than 5% rated themselves as ready. Interestingly enough, the analysts are ready, but the individuals who manage the leadership-talent brand in organisations are not ready yet.

CONCLUSION

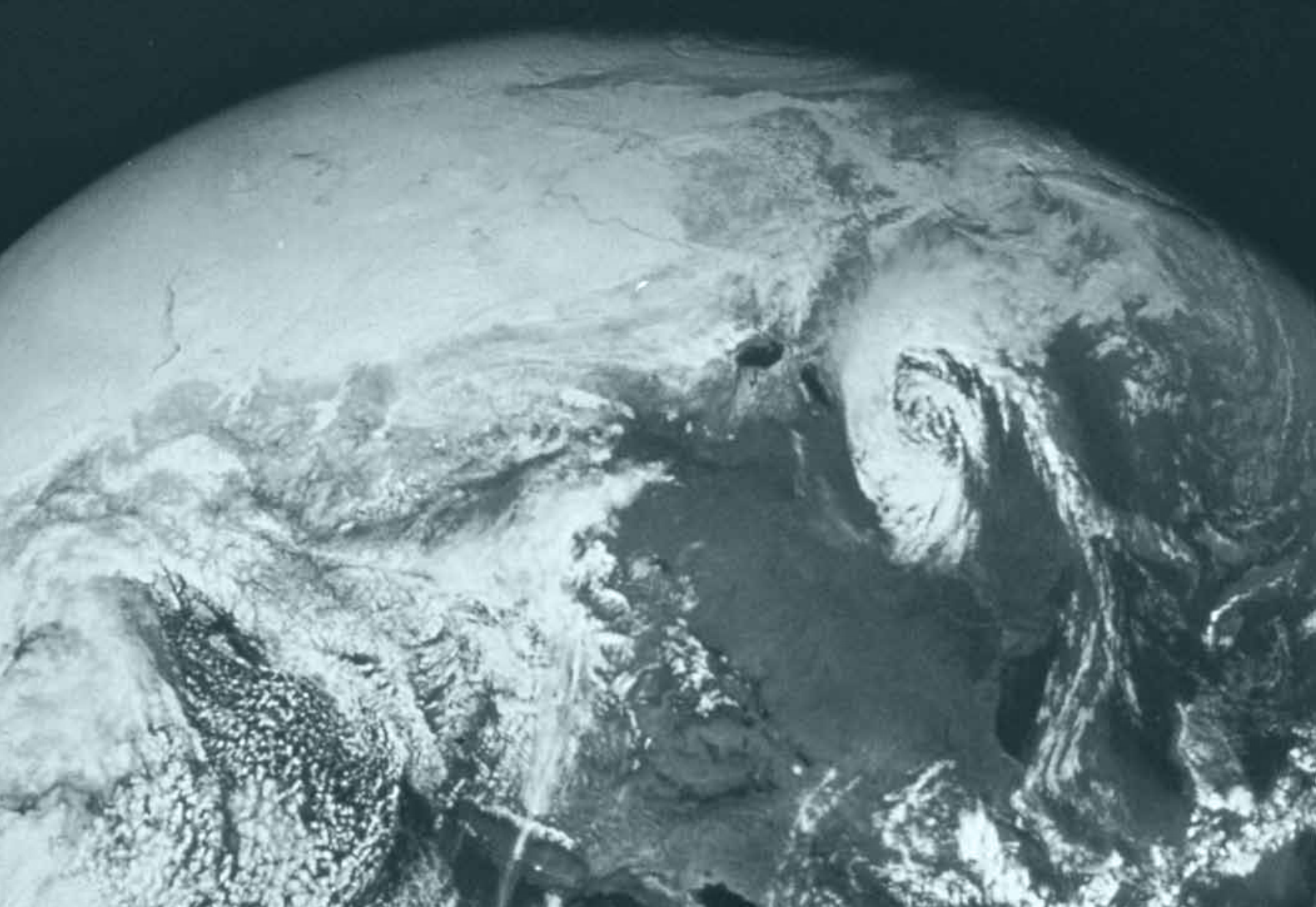
In 1997, the clarion call for HR leaders was to improve their understanding of how the business works so they could serve business leaders more effectively – the ubiquitous desire of HR leaders to assume "their seat at the table" of top management. Fifteen years later, a new clarion call may be around the corner. HR and senior talent leaders are being asked to develop their business acumen further. Going forward, they will be expected to understand how the business is valued externally so they can monetise the value of the business leaders they serve more effectively. At least 15% of a firm's worth may be dependent on whether they hear that call.

ABOUT THE AUTHORS

Susan Dunn is a Partner at Mercer. Based in Portland, she can be reached at +1 503 866 3524 or susan.dunn@mercer.com.

Bruce J. Avolio is the Executive Director of the University of Washington Foster School of Business Centre for Leadership and Strategic Thinking.

For further information on leadership equity and leadership development in Europe, please contact Cora Lynn Heimer-Rathbone at +44 (0) 1625 543 614 or cora-lynn.heimer-rathbone@mercer.com.



MERCER

For further information, please contact
your local Mercer office or visit our website at:
www.mercer.com

Argentina
Australia
Austria
Belgium
Brazil
Canada
Chile
China
Colombia
Czech Republic
Denmark
Finland
France
Germany
Hong Kong
India
Indonesia
Ireland
Italy
Japan
Malaysia
Mexico
Netherlands
New Zealand
Norway
Peru
Philippines
Poland
Portugal
Saudi Arabia
Singapore
South Korea
Spain
Sweden
Switzerland
Taiwan
Thailand
Turkey
United Arab Emirates
United Kingdom
United States
Venezuela

Copyright 2012 Mercer LLC. All rights reserved.

10989J-HC-131212