Shareholder Value Advisors

September 18, 2017

The Honorable Jay Clayton
Chairman
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: Human Capital Management (HCM) Disclosures Rulemaking Petition File 4-711 – 07/06/2017

Dear Chairman Clayton:

I am writing in support of the Human Capital Management (HCM) Petition filed with the Securities & Exchange Commission by the Human Capital Management Coalition on July 6, 2017.

I am the President of Shareholder Value Advisors Inc., a consulting firm that helps companies improve shareholder value through better performance measurement, incentive compensation and valuation analysis. I've done extensive research to measure management and employee incentives and assess their impact on company performance. I'm the author of *EVA and Value-Based Management* (with Professor David Young of INSEAD) and many articles on measuring pay for performance and improving pay design. A short bio is included with this letter.

The HCM petition says that "we view effective human capital management as essential to long-term value creation and therefore material to evaluating a company's prospects" and recommends that the SEC engage in a public standard-setting process to identify required disclosures in nine categories of human capital management data including workforce compensation and incentives. **I strongly support the HCM Coalition's view and proposal**.

I would also like to provide evidence that standardized HCM disclosure will allow investors to significantly improve their valuation analysis and estimates of future return. The HCM petition cites research studies by Bassi & McMurrer and by others showing that better HCM management practices improve company performance and stock returns, but these studies are based on proprietary surveys of human resource practices, and hence, don't show that there is standardized HCM disclosure data that investors could use to improve their valuation analysis and assessment of company performance.

It's possible to show that standardized HCM disclosure will help investors because one component of HCM data, total employee compensation, is already reported by almost 1,700 companies reported in Compustat. 249 S&P 1500 companies and 811 other U.S. companies report total employee compensation although nearly 70% of these companies are in the financial sector. 588 Compustat companies incorporated outside the U.S. also report total employee compensation and only 12% of these companies are in the financial sector. Many of these non-U.S. companies may file financial statements under International Financial Reporting Standards which require disclosure (IAS 19).

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Total employee compensation data can be used to improve valuation analysis and estimates of future return by:

1. Calculating two dimensions of average employee pay: “alignment” and “performance adjusted cost”, and
2. Relating those two measures to “changes in future growth value”.

Future growth value is the market value premium over the perpetuity value of current earnings. Over the past 20 years, future growth value (“FGV”) has been 35% of market enterprise value for the median S&P 1500 company and above 50% for the median company in four of the 24 GICS industry groups: semi-conductors, pharmaceuticals, media and software. Surprisingly, about one in six S&P 1500 companies has negative FGV. The assumption that market value is discounted cash flow value implies that FGV is the present value of future economic profit improvement (where economic profit is profit after a charge for debt *and* equity capital). Negative FGV is evidence that investors believe the current profit level is not sustainable and new investment will earn less than the cost of capital.

Alignment tells us how closely average employee pay tracks company value. It’s the correlation of average employee value added and company value added where employee value added is actual pay minus market pay (after-tax) and company value added is the sum of economic profit and employee value added. Top quartile alignment is 0.90, while bottom quartile alignment is 0.07. Performance adjusted cost is the average employee pay premium when company value added is zero. The pay premium at zero company value added is +10% at the top quartile vs -12% at the bottom quartile, and +27% at the top decile vs -22% at the bottom decile. My research shows that revenue growth is more valuable, i.e., adds more FGV, when alignment is high and performance adjusted cost is low.

I’ve included two attachments to this letter to provide more background on these analyses: (1) a paper published in the Summer 2016 *Journal of Applied Corporate Finance* on “A Better Way to Measure Operating Performance” and (2) a presentation on “Linking Average Employee Pay Practices to Long-Term Value”.

Sincerely,

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President

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Steve O'Byrne is President and co-founder of Shareholder Value Advisors Inc., a consulting firm that helps companies increase shareholder value through better performance measurement, incentive compensation and valuation analysis. His publications include:

- "A Better Way to Measure Operating Performance (Or Why the EVA Math Really Matters)" in the *Journal of Applied Corporate Finance* (Summer 2016)
- "Three Versions of Perfect Pay for Performance (Or The Rebirth of Partnership Concepts in Executive Pay)" in the *Journal of Applied Corporate Finance* (Winter 2014)
- "The Three Dimensions of Pay for Performance" in the *WorldatWork Journal* (4th Quarter 2013)
- "How 'Competitive Pay' Undermines Pay for Performance (and What Companies Can Do to Avoid That)" (with Mark Gressle) in the *Journal of Applied Corporate Finance* (Spring 2013)
- "Achieving Pay for Performance" in *Conference Board Director Notes* (December 2012)
- "Assessing Pay for Performance" in *Conference Board Director Notes* (October 2011)
- "Six Factors That Explain Executive Pay (and its Problems)" (with Professor David Young of INSEAD) in the *Journal of Applied Corporate Finance* (Spring 2010)
- "What Investors Need to Know About Executive Pay" (with David Young) in *The Journal of Investing* (Spring, 2010)
- "Why Capital Efficiency Measures Are Rarely Used in Incentive Plans, and How to Change That" (with David Young) in the *Journal of Applied Corporate Finance* (Spring 2009)
- "Why Executive Pay Is Failing" (with David Young) in the *Harvard Business Review* (June 2006)
- *EVA and Value Based Management* (with David Young), McGraw-Hill (November 2000)
- "Executive Compensation" in the *Handbook of Modern Finance* (1997)

Prior to co-founding Shareholder Value Advisors in 1998, Mr. O'Byrne was head of the compensation consulting practice at Stern Stewart & Co. (1992-1998) and a Principal in the executive compensation consulting practice at Towers Perrin. Prior to joining Towers Perrin in 1979, he worked in the tax department at Price Waterhouse and taught mathematics at Loyola University of Chicago. Mr. O'Byrne holds a B.A. degree in political science from the University of Chicago, an M.S. in Mathematics from Northwestern University and a J.D. from the University of Chicago.