MANAGING HUMAN CAPITAL AS AN ASSET VS. AN EXPENSE

This white paper is a collaboration between Entrepreneurial Equity Partners ("e2p"), a food-focused middle-market private equity investor, and Malk Partners ("Malk"), an ESG and impact advisor to private market investors.

Introduction

This white paper explores how investing in human capital management can improve businesses' financial and operational performance by aligning the goals of investors, employers, and employees. To do so, we first discuss legacy concepts of private equity investors' and employers' relationships to human capital. We then call for the adoption of a new relationship to human capital and a shift in mindset by using independent data and research to demonstrate the business impacts of strong and weak human capital management practices, respectively. We share our view on how private equity can leverage its role to improve human capital management practices and, thereby, employee experience, business performance, and investment returns. We conclude by describing e2p's evolution from an ethos- and philosophy-driven approach to adopt an asset-first stance towards human capital management. While early in its journey, we describe e2p's portfolio-wide mandate on Human Capital, an accompanying Human Capital Maturity Model to frame future investment and anticipated benefits, and an example of progress within the portfolio.

The Relationship Between Investors, Businesses, and Employees

Traditional Frictions with Labor

One of the more common, stereotypical, and publicly unappealing features of the private equity (PE) playbook is the layoff. Though it goes by many names – "consolidation," "rationalization," and "rightsizing" – and is justified by just as many concepts – "synergies," "redundancies," and "cost efficiencies" – the underlying truth that PE's entrance into a business can mean more terminations and fewer overall jobs remains the same.

It is not hard to imagine, given this trope, why, historically, PE has not often been viewed as "pro-human capital." In fact, this specific tactic offers a clarifying insight into PE's traditional relationship with human capital. In seeking to maximize returns on the capital allocated to them primarily by enhancing the performance of their portfolio companies, PE investors often strive to minimize costs when feasible and thus have largely viewed human capital as a cost center.

This is the same reason why, in early 2024, the White House convened PE allocators and investors representing over $1T to obtain human capital-related commitments, including to the freedom of association, the right to a safe and healthy workplace, the elimination of child labor, and similar. While these might seem foundational and expected, the White House's intervention demonstrates its skepticism in PE investors' ability to uphold and actively invest in these principles.

This view – of human capital largely as a cost driver – is not necessarily different from how many direct employers approach the matter. Deloitte estimates that 50%-60% of Fortune 500 company spending is attributable to human capital. One might expect this to be an even larger share

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>
> Harvard Business Review

among private companies, given the relatively high overhead costs associated with being a public company that private companies can avoid. Therefore, to manage overall costs, businesses have historically approached human capital from an expense management mindset, focusing on efficiently allocating workforce size, compensation, benefits, and perks.

This limited concept – of human capital as a driver of costs and expenses – has often led investors and employers to overlook the inherent value of positive human capital relations. We argue that a careful review of relevant data, insights, and anecdotes can lead to the rightful conclusion that human capital is better understood as an asset worth investing in and that PE investors and employers stand to benefit from taking this approach.

Creating Value by Valuing Employees

As noted by the Harvard Business Review, investing in dedicated human capital programming can reduce absenteeism and turnover, safety incidents, and employee litigation, potentially leading to a 50% increase in returns. In this section, we explore several of the mechanisms for this relationship.

Potential Upside

STRONG PRACTICES

- Solicit and assess feedback
- Invest in compensation and benefits
- Invest in worker health and safety programming
- Offer professional development programming
- Host team building events

EXPECTED BENEFITS

- Increased retention
- Increased productivity
- Increased learning
- Increased engagement
- Increased safety

Businesses can reframe how they view the workforce and begin considering it as a built-in talent pipeline rather than a revolving door. Businesses can empower employees to grow within their organizations through strategically designed professional development programs, which minimize turnover and maximize the retention of valuable, company-specific expertise. A study from Deloitte found that organizations with strong learning cultures experienced engagement and retention rates that were 30%-50% higher than comparable peers without such programming. The same Deloitte study found that companies with strong professional development practices were 92% more likely to develop novel products, 56% more likely to be first-to-market, 52% more productive, and 17% more profitable. Additional research has found that companies that invest $1,500 on training per employee can see an average of 24% more profit than companies that invest less. Relatively low-cost investments in human capital can drive outsized business outcomes.

Research suggests businesses that foster a positive workplace environment benefit from higher productivity and decreased turnover, which drives improved business performance. 76% of U.S. workers say having a close friend at work makes them more likely to remain with their employer. Compare this to “toxic” corporate cultures, an attribute that is 10.4 times more likely to contribute to employee churn than issues related to compensation.

While employee culture and relationships are critical to retention, so too are benefits and compensation. Businesses that pay competitively benefit from increased productivity. Per a 2020 paper, warehouses that increased wages saw productivity increase by more than their payroll costs — and turnover dropped 19%. Research shows that paid sick leave, which is unavailable to almost two-thirds of low-wage workers in the U.S., is associated with a drop in workplace injuries (and the associated costs discussed previously), and further that paid family leave is correlated with a 5% increase in productivity. One of the more progressive forms of compensation — offering employee equity — can have the joint impact of increasing employee wealth and increasing retention and productivity. This is the main thesis of Ownership Works, an initiative led by KKR and over 80 partners to advise investors and companies on how to implement employee equity programs.

Worker health and safety programming is another essential investment for maximizing productivity. Liberty Mutual found that every $1 invested in workplace safety resulted in returns of at least $2, demonstrating that strong workplace safety programming has upside potential. Safety initiatives have also been correlated with up to a 7.5% increase in rate of return on capital, per a study cited by the Center for American Progress. Businesses that invest in employee safety protect against incidents and demonstrate a genuine commitment to welfare, enhancing employee loyalty and productivity.

Avoidable Costs

WEAK PRACTICES

- Mis-aligned employee-owner incentives and below-market compensation and benefits
- Under-investment in safety controls
- Under-developed training and development programming
- Under-investment in workplace culture
- Failure to check work authorization
- Poor union relations

POTENTIAL LOSSES

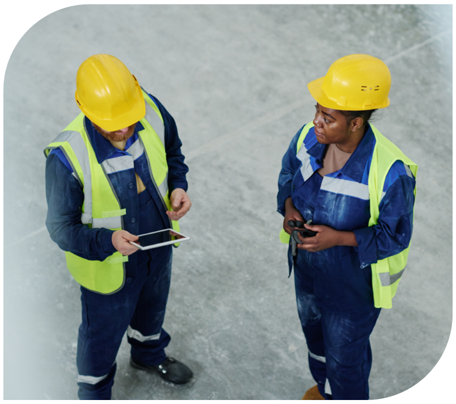
- ⊗ Recruiting costs
- ⊗ Retraining costs
- ⊗ Litigation
- ⊗ Regulatory violations
- ⊗ Operational disruptions
- ⊗ Insurance premiums and payouts
- ⊗ Customer attrition

The Cost of Minimizing Costs

The cost of human capital is often thought of primarily as the compensation paid out to employees each year. Though these costs are more predictable and visible and, therefore, more easily managed, we cannot overlook other cost drivers that result from an overly aggressive cost reduction stance towards human capital. Failure to manage and engage the workforce can expose businesses to heightened costs associated with turnover rates, regulatory violations, workers' compensation claims, and litigation.

Turnover represents a risk for employers across all industries, resulting in significant costs associated with talent recruitment and loss of productivity between departure, onboarding, and replacement training. Gallup estimates that replacing a single employee can cost between 50% and 200% of their annual salary, depending on how entry-level or senior their role. Employees in management and executive roles have replacement costs averaging 213% of their total salary. Considering that one in three employees said they were "very likely" to look for a new job in the next 12 months, according to research published by Bankrate in 2023, costs can quickly add up. Gallup found that 52% of exiting employees said their manager or organization could have done something to keep them in their role. Research thus indicates that turnover can generate significant costs and that some of these costs may be avoidable. The efforts taken to avoid turnover need only to cost less than the avoided turnover to be worth the investment.

Weak human capital management practices can also compromise workplace visibility and regulatory compliance, leaving companies vulnerable to noncompliance, reputational scrutiny, and a poor workplace culture. For example, estimates from Pew Research Center indicate that undocumented human capital accounts for ~5% of the U.S. workforce. The highest concentrations of undocumented human capital across states include Nevada (9%) and Texas (8%); the highest industries include farming (26%) and construction (15%). Businesses employing undocumented employees face a heightened risk of regulatory scrutiny and disruptive incidents. In one targeted operation in 2019, U.S. Immigration and Customs Enforcement (ICE) officers raided six work sites across five food manufacturing companies, including Koch Foods and Peco Foods, resulting in 680 arrests. Beyond the acute disruptions caused by such raids, businesses employing undocumented immigrants can lose their license to operate or pay fines for each individual employee for whom they fail to maintain the required documentation. These workers are also more likely to fear retaliation for reporting workplace abuses, which can lead to a vicious cycle of non-compliant and substandard working conditions.



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Child labor presents similar regulatory and public scrutiny risk and has become a greater topic of concern in the U.S. since 2018. In the past few years, multiple high-profile stories have revealed the illegal employment of minors in dangerous workplaces. In one case, Packers Sanitation Services Inc. (PSSI) was found to have employed at least 102 children in dangerous working conditions with chemicals and saws. As a result, PSSI was fined $1.5M ($15,138 for each specific violation). This trend, therefore, concerns not only the well-being of children, which is an utmost social priority, but also the financial health of all businesses.

Another risk warranting attention is workplace safety. Poor employee engagement and oversight can directly lead to costs associated with regulatory violations, workers' compensation claims, and efficiency losses from days lost or transferred due to injury. In a 2021 study of U.S. workplace safety, Liberty Mutual estimated that employers paid $1B per week for direct workers' compensation costs. On a case-by-case basis, the National Safety Council estimated that the average cost of a workers' compensation claim between 2020-2021 was $41,757.

The longer holding periods typical in PE investments provide time to undertake complex operational changes, as well as to adjust practices in response to new challenges or in the spirit of continuous improvement.

Additionally, OSHA recently increased the maximum penalty for willful or repeat violations to $161K, underscoring that investments in safety performance are worthwhile to avoid such penalties. Though these values can begin to suggest the incremental cost of a workplace safety incident, even this picture is incomplete. A 2015 study found that poor workplace safety controls are associated with increased employee turnover, showcasing employees' emphasis on their own physical safety in the workplace and adding another cost driver into the fold.

In sum, the costs of weak human capital management can far exceed its cost-saving benefits. In many cases, the real business benefits come from investing in human capital.

What Private Equity Can Do to Impact Labor Management

The Strategic Advantages of Private Equity

Given the stated financial impacts of human capital, it stands to reason that PE investors should be interested in, and should seek to drive change in, their portfolio companies' approaches to human capital management. In fact, PE investors are uniquely positioned to drive this change – specifically "control-oriented" PE investors who can implement initiatives at the board level. With greater control over company operations and a prominent presence on boards, PE firms have the oversight to help companies adopt best practices. Longer holding periods associated with most PE investments provide time to undertake complex operational changes and adjust practices in response to new challenges or in the spirit of continuous improvement.

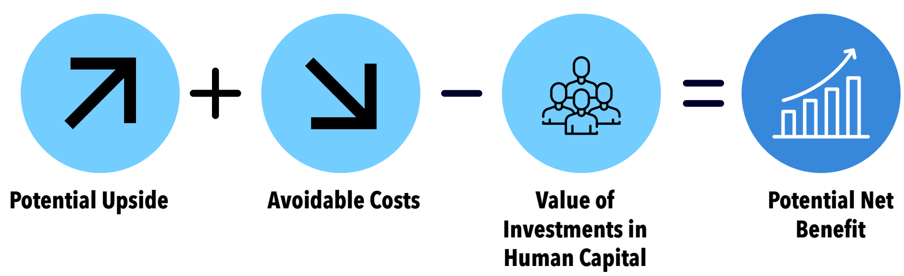
PE firms with strategic industry focus are particularly well-suited to serve as thought partners on human capital practices. Their familiarity with the industry often translates to deeper insights into typical challenges associated with workforce management, including the applicable regulatory landscape, human capital market dynamics, and hurdles posed by business growth.

PE firms can fulfill their commitments to shareholders by promoting portfolio-wide alignment and driving initiatives that foster employee engagement, cultural cohesion, professional development, and workplace safety. This will ultimately create value for both the workforce and the business as a whole.

> We view strong labor practices as an essential piece of our strategy to improve operational and financial performance at our portfolio companies, and thereby our investment returns.

e2p's Approach to Labor Management

e2p strives to leave employees, customers, communities, and investors better after partnering with a portfolio company. Consistent with our stated mission, e2p is evolving from an ethos- and philosophy-driven approach to take an asset-first stance towards human capital. We view strong human capital practices as an essential component of our strategy to improve operational and financial performance at our portfolio companies and, thereby our investment returns. As an investor in the food and food-related industries, where unauthorized workers, safety, and engagement are prominent issues, we have a particular opportunity to manage human capital conditions and their impacts. Our thesis on the financial impact of human capital-related initiatives and investments is best demonstrated by the below:



While we are early in our journey, we have developed and are actioning a plan aligned with this investment thesis. Consistent with our North Star Smart Investing Program, we have developed a portfolio-wide mandate on Human Capital and an accompanying Human Capital Maturity Model (see below for additional detail). Specifically, e2p has developed a "North Star," or guiding ambition, for each of our portfolio companies' human capital strategies – to "pursue preferred employer status." Our goal is to support portfolio companies' development of stronger human capital practices with the aim of becoming an employer of choice in their respective markets.

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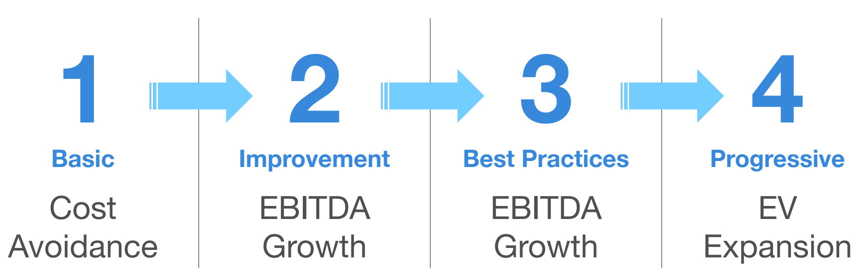
We will continue to refine our strategy, as well as share our learnings and best practices with other members of the PE and food value chain communities. In pursuit of innovative "next" practices, we are collaborating with the Aspen Institute through its 2024 Economic Mobility Fellowship to explore and contribute to ongoing discussions on progressive human capital practices. This includes transformative practices which can optimize the enterprise value of human capital assets, align a high-performing workforce, and create a sustainable impact for employees, customers, communities, and investors.

Human Capital Model

To identify opportunities in portfolio companies' labor practices, e2p distinguishes between four phases of labor program maturity. The phases are: Basic, Improvement, Best Practices, and Progressive. Our goal with any given portfolio company is to help them:

- Advance between these phases during our ownership and
- Achieve the associated financial impacts.

Four Phases of Labor Program Maturity



A company in the “Basic” phase focuses on compliance with foundational practices to avoid anticipated risks and associated costs, outsized incidents and disruptions. Illustrative practices include quarterly temp agency and documentation audits (i.e., I9, E-Verify, alien authorization), anonymous reporting hotlines, and periodic security audits. Where companies are determined during diligence or onboarding to be missing some of these core practices, we seek to provide the resources to close these gaps.

We encourage companies looking to improve upon their labor management practices to focus on employee communications. This is both to identify opportunities for improvement through feedback and to raise employees' awareness of the company's commitment.

They can then explore the “Improvement” phase. The Improvement phase incorporates a central diagnostic tool to be distributed annually. Survey results inform targeted engagement strategies specific to each company aimed at reducing turnover while improving morale to enhance productivity, grow margin, and optimize human capital assets. We encourage companies looking to improve their human capital management practices to focus on employee communications. This is both to identify opportunities for improvement through feedback and to raise employees' awareness of the company's commitment. Therefore, in addition to engagement surveys, the “Improvement” phase includes town halls, newsletters, and other mechanisms to engage employees directly.

Companies interested in continuous improvement can then enter the “Best Practices” phase by executing on the opportunities they've uncovered. Employers can use employee feedback to provide targeted management training, expand their professional development offerings, update their mission, vision, & values, or otherwise take clear steps to respond to employees. Specific best practices can be identified by looking at the successes of other portfolio companies, reviewing competitor practices, or engaging third parties for advisory and thought leadership.

Finally, the “Progressive” phase is for companies ready to become leaders on human capital. These companies see creative, thoughtful approaches to human capital management as an opportunity for competitive differentiation. The practices that differentiate them are more likely to be novel or to require significant investment. They often focus on progressive compensation and benefits (such as employee ownership), work-life balance, diversity, equity, and inclusion (DEI), and career mobility. Specific examples include offering compensation benchmarked to “living” wages, as opposed to legal minimum wages, and establishing employee ownership mechanisms, among others.

e2p Case Study : Ya YA Foods

This approach to human capital management has begun to drive improvements among our portfolio companies. One of the companies that has achieved positive results is Ya YA Foods. The following describes their journey towards more progressive human capital practices and the outcomes they have achieved to date.

Ya YA Foods Toronto is proud of its new Canadian heritage. Founder Yahya Abbas aims to give other new immigrants their first work opportunities in Canada. Oftentimes Ya YA is the stepping stone to employees taking more advanced opportunities in other workplaces or taking their newfound knowledge and financial savings "back home" after a year or two. In the past, this was a satisfying reputation as an employer.

As Ya YA looked closer, however, it began to recognize the hidden and overt costs of turnover – over the full employee lifecycle these range from recruitment to onboarding to training, retraining, and overall knowledge transfer. While still committed to its reputation as a beacon for new Canadians, Ya YA identified this as a cost worth addressing. Ya YA wondered if it could adapt its ways of working to reduce turnover dramatically yet still accommodate those who wished to move on to more advanced opportunities (perhaps in the same workplace, when possible) or return to their home country (perhaps on unpaid leave, temporarily).

There was not a single "magic pill" but rather a variety of tactics –both short-term and long-term – which made up the collective improvements to Ya YA's strategy. Below is a summary of tactics used in the past 18 months.

2022 Q4

Salary analysis to identify market-based pay gaps

Targeted recruitment efforts (vs "post and pray" approach) to ensure candidates of best fit

2023

Interview training for hiring managers, including more widespread adoption and proper use of "McQuaig" pre-employment assessments

Better communication to candidates about job requirements, work environment and shift schedule (to avoid New Hire turnover)

Streamlined onboarding experience, improving the "first impression" aspect (also to avoid New Hire turnover) and better hand-off to their Team Leader

Relentless focus on Gallup employee engagement survey results, both at work team level and now site-wide committee actioning those elements with most common themes (Q4 and Q5)

New Leadership training, focused on new frontline leaders

2024

Enhanced recognition program, specifically targeted at those with 10+ years of experience (which Gallup survey showed were the least satisfied) via new Service Awards program and Vacation Accrual enhancements

Company match to RSP & 401k programs

As a result of these interventions, Ya YA has seen remarkably steady improvement in our turnover rates . Going forward, Ya YA plans to implement additional practices to drive continued improvement. Upcoming considerations include "Stay Interviews" and a deeper focus on identifying themes from exit interviews. Though not the only portfolio company to make such strides, we feel that Ya YA Foods' journey is demonstrative of the progress we aspire to see every portfolio company make under our ownership.

"What we have seen at Ya YA Foods is a fundamental shift from accepting high turnover rates to a steady, deliberate focus on retaining talent and keeping turnover at or below the manufacturing industry average of ~25%."

Lisa Taillefer, VP Human Resources, Ya YA Foods

Looking Ahead

As we continue to test our thesis on human capital as an asset vs. an expense, we plan to make our practices and learnings publicly available. We will report back on insights, progress, and ROI with the intention of catalyzing a mindset shift, uncovering a new source of value for PE, and enabling a new relationship with human capital.

We invite others to contribute to this transition and look forward to engaging with our portfolio companies, their employees, and other members of the broader investment, food chain, and human capital management communities to advance these topics.

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About Malk Partners

Malk Partners is the preeminent advisor to private market investors for creating and protecting value through environmental, social, and governance management and impact investing. Founded in 2009, Malk Partners advises many of the world's leading alternatives managers investing across private equity, growth equity, venture capital and private credit by helping them define ESG goals, achieve ESG results, and guide their portfolio companies in driving value creation and mitigating risks. The firm is headquartered in New York. For more information about Malk Partners, please visit www.malk.com.

About e2p

Entrepreneurial Equity Partners ("e2p") is a lower middle-market private equity investor based in Chicago with a strategic focus on the food sector. We believe in the joy of food and its power to nourish life and bring people together. It's why we've made it our mission to transform entrepreneurial dreams into the next big thing in food and beverage. For more information about e2p, please visit www.e2p.com.