



Furloughs, layoffs, and recovering from Covid-19

Although the exit from lockdown is on the horizon, there are signs that the return of consumer demand may be slow. As such, many corporates face a staffing conundrum more difficult than that seen during the financial crisis. How long should corporates wait before furloughs become layoffs? Just how important are staff?

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In this piece, we use the experience of the 2008-09 financial crisis to see how quickly corporates recovered when they made different staffing decisions. We analyse several metrics to help determine the importance of staff. Indeed, by one measure, staff are far more important today than they were in the growth period before the financial crisis.

We also examine an essential metric for corporates: Human Capital Return on Investment. From our sample of large companies, we find that companies that are struggling may have the most to gain.

Finally, we analyse what sort of shape companies are in to handle the virus-induced recession. Of course, the length of the reopening process will determine much, however, corporate margins and the price they pay for cost of goods has a significant impact.



Companies are maintaining the relationship with their staff

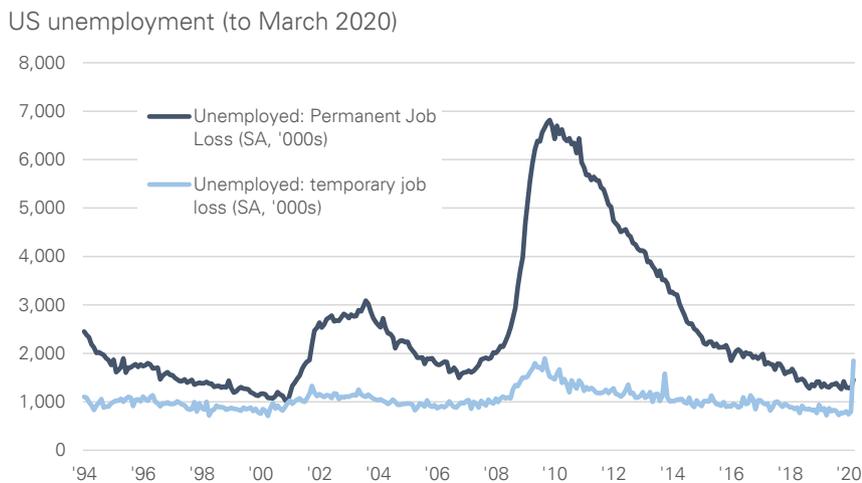
As countries look to reopen their economies, corporates face a rather savage irony. While the timing of the covid-19 recession seems relatively predictable, that 'certainty' creates extra layers of uncomfortable decisions that are not usually necessary in other recessions. This 'predictable uncertainty' is also weighing heavily on the minds of employees. Indeed, a quarter of employed Americans think they are likely to be laid off in the next 12 months. That is the highest proportion since 1975, according to a Gallup poll.

To search for some order amidst the uncertainty, it is interesting to note some lessons from the financial crisis. A recent comment from Stephen Squeri, chief executive of American Express, illustrates this nicely. He commented that, during the financial crisis, it may have been beneficial to endure lower profits and retain staff so the firm could "hit the ground running" when the economy began to grow again. Of course, firm-specific factors can significantly alter this equation.

Perhaps the biggest differences between how companies are managing their staff during the current crisis, and how they managed them during the financial crisis of 2008-09, is the huge increase in furloughing rather than permanent layoffs.

Indeed, the following chart shows that in March, for the first time, more Americans are temporarily unemployed than those permanently unemployed.

Figure 1: Temporary layoffs exceed permanent ones for the first time



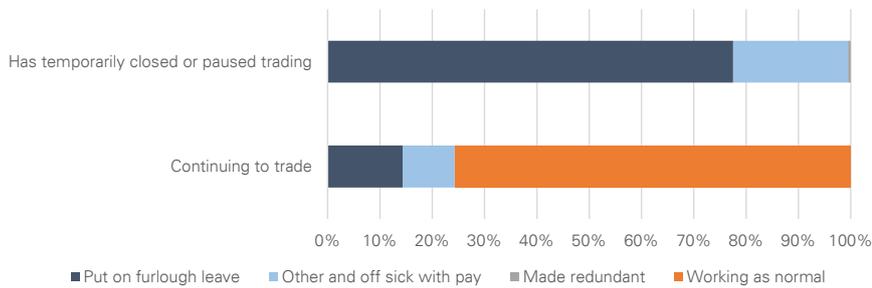
Source : BLS, Haver Analytics, Deutsche Bank

A similar trend can be seen in the UK. Although time series data is inconsistent, in the period to 5 April, 27 per cent of the workforce had been furloughed. The following chart shows how businesses have responded. The key point is that permanent layoffs have been very limited. This has been the case even though many businesses have voiced concerns at the length of time it has taken the government's support packages to hit business bank accounts.



Figure 2: Permanent layoffs have been very limited in the UK

Proportion of workforce by working arrangements by status of business: 23 Mar-5 Apr



Source: Office of National Statistics

There is a similar trend in the use of furloughing in Germany where the level of short-time workers has jumped to levels not seen since the financial crisis while those permanently unemployed have not climbed by nearly as much. This data, though, should be considered in line with Germany's well-established Kurzarbeit policy in which the state pays part of an employee's lost wages if their company sends them home. This is argued to have helped Germany recover from the 2008 financial crisis.

The three factors in staff retention

There are three reasons for the use of furlough schemes rather than layoffs. The first is simply that most economists and firms expect the corona crisis to be short, even if it is very deep. Therefore, some companies see it as sensible to maintain as attached as possible with their staff so that they can reopen as painlessly as possible.

The second reason is more nuanced and applies to some firms more than others. Namely, there is a risk of reputational damage in laying off (or even furloughing) staff that exists today perhaps more so than in most other crises. This is particularly the case for large, profitable, or high-profile companies. Just one example is the public outcry in the UK when some football clubs furloughed support staff. As corporates seek to be on the front foot, some have publically stated they will not lay off staff until at least the worst of the current crisis is over.

The third reason for firms' reluctance to lay off staff is discussed in the next two sections. Essentially, staff have increasingly become more important to companies. Indeed, our analysis shows that employees are more important to companies now than at any time in recent history. That means that companies that better understand the impact of their staff on operations and profits will likely be the ones that recover the quickest from the corona crisis.

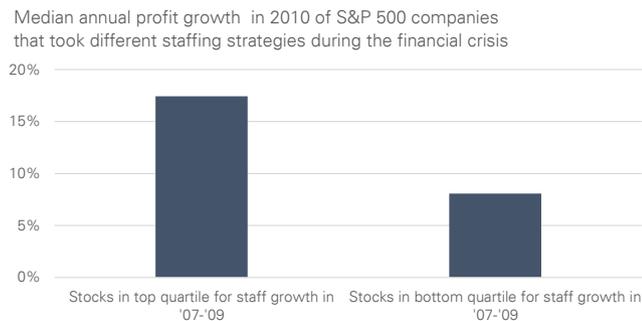


Staffing decisions made during the financial crisis helped determine how quickly a company recovered

While many managers may agree with Stephen Squeri's view that holding onto staff through a downturn makes it easier to hit the ground running in the upswing, market and investor pressures often win the argument. That will particularly be the case in the event of a prolonged pandemic or a delay in distributing a vaccine.

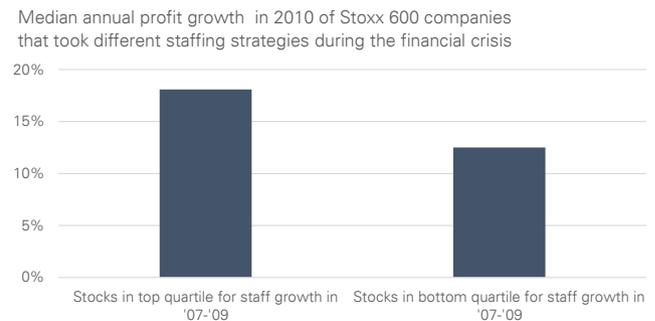
Against that pressure, managers can look at the experience of firms coming out of the financial crisis. Indeed, as the following chart shows, US companies with the highest growth in staffing (or, put another way, the lowest decreases in staffing) during the financial crisis saw their subsequent profits grow at almost double the rate of companies that had the lowest staffing growth. The picture is very similar in Europe.

Figure 3: Recovery from the financial crisis was skewed towards firms that kept staff ...



Source : Factset, Deutsche Bank

Figure 4: ... on both sides of the Atlantic



Source : Factset, Deutsche Bank

Of course, there are some accounting points to consider as well as some correlation/causation issues in this analysis. Some companies that were adversely affected by the crisis also took time to recover for reasons that were out of their control. However, the striking difference between the two groups of companies (or rather the two different staffing strategies) is certainly an indicator of the importance of staff continuity during a downturn. In the next section, we delve further into why staff are more important now than in the past.

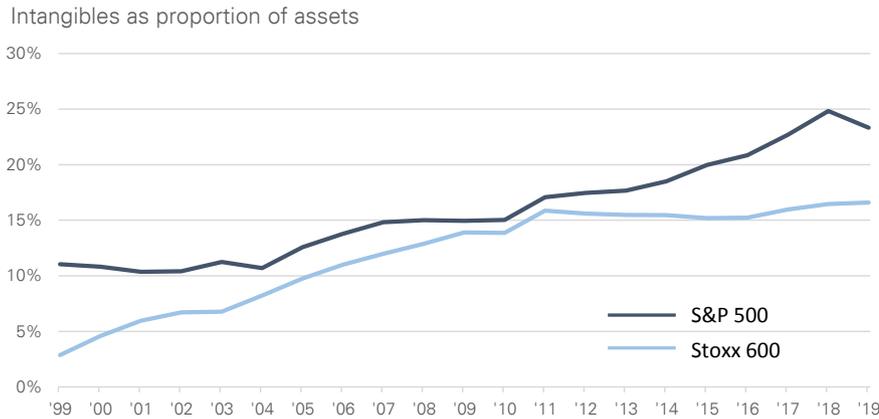
The importance of staff has only increased

There are many ways to measure the 'importance' of staff. All are imperfect. The first way we examine is to analyse the importance of intangible assets to a company. This is a guide as, over the long run, it is an indicator of the amount of value that has been created by assets that are not on the balance sheet – primarily employees.

As the following chart shows, intangibles now represent 23 per cent of S&P 500 company assets. That is half as much again as just before the financial crisis. In Europe, Stoxx 600 companies have also grown their intangibles, albeit at a slower rate. Accounting rules do play into the differences, but the trend is clear.



Figure 5: Rising intangibles is one indicator of the rising value of staff



Source : Factset, Deutsche Bank

Of course, there are various arguments as to why using this measure as a proxy for staff importance is overly simplistic. Among them is that intangibles can be created merely by overpaying for a corporate acquisitions.

This overpaying argument is valid, however, one counter is that intangible levels offer a guide to the weight companies are willing to pay for revenues that cannot easily be produced by buying physical assets. In other words, those revenues are the product of 'people power' and companies that desire those revenues feel it is cheaper to acquire the output of that 'people power' rather than build them from scratch.

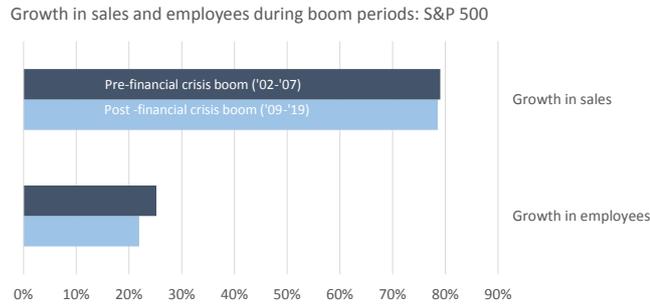
There are also indications that corporates were overpaying for acquisitions in similar amounts before the financial crisis. Indeed, during this time, intangibles rose from 10 per cent of assets to 15 per cent, a rise of half – exactly the same rise as that experienced during the post-financial crisis boom.

The boom period before the financial crisis has a striking similarity with the boom period after it. During the trough-to-peak of both periods, the growth in median company sales and employees was almost identical.

In Europe the picture is a little different. In the post-financial crisis world the relationship between employees and sales fell away as the impact of the sovereign debt crisis, and other European-specific issues, resulted in a longer period of restructuring.

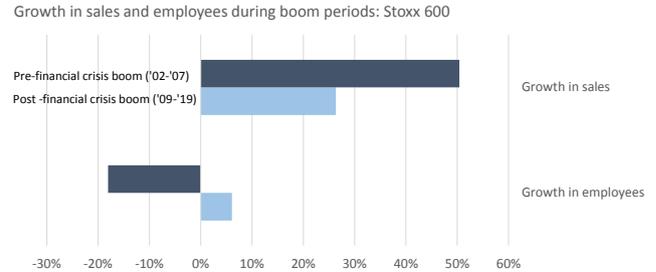


Figure 6: The boom periods before and after the financial crisis have strong similarities ...



Source : Factset, Deutsche Bank

Figure 7: ... although specific factors have curtailed the effect on the continent.



Source : Factset, Deutsche Bank

Profits and the importance of staff

Quite simply, companies now make a lot more profit from each of their employees than they did in the past. Large US companies now generate over \$55,000 per staff member each year, a significant jump from the roughly \$38,000 generated just in the boom time just before the financial crisis. Meanwhile, European companies generate just over €33,000, a little higher than the pre-crisis level, however, a strong climb since its aftermath.

Figure 8: In the post-financial crisis world, the profit-generation capacity of staff has increased at a rate faster the GDP, inflation, and other metrics

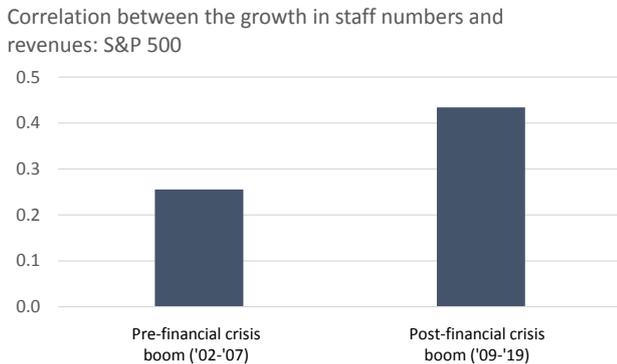


Source : Factset, Deutsche Bank

Not only do companies generate more profit per staff member, that profit has become more predictable, at least in the US. That is to say, in the most recent growth period, more staff equalled more profit – more so than in the prior growth period. While correlation is not necessarily causation, given the last growth period was a lengthy ten years, it is a long enough time frame to consider taking seriously. As we mentioned earlier, some post-financial crisis, European-specific factors help explain the odd result in that period.

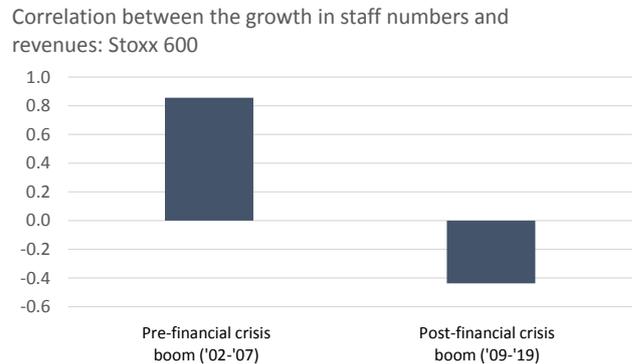


Figure 9: Staff numbers have become more important to revenue growth post-crisis



Source : Factset, Deutsche Bank

Figure 10: European companies have seen restructuring complicate revenue growth



Source : Factset, Deutsche Bank

Companies are in better shape to withstand the current crisis

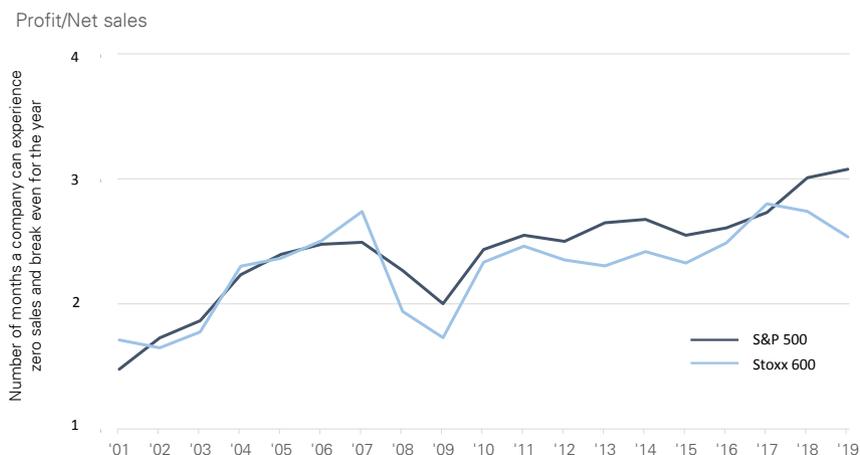
If the analysis in the prior section is a guide, many corporates have more to lose from letting staff go today than they did in prior crises. This is certainly because of the continued shift towards the knowledge economy. With more of a firm's operations and revenues dependent on the knowledge of workers, the hiring and firing of staff increasingly disruptive. When these workers are fired, they take knowledge with them; when new ones are hired, they take longer to learn the ropes.

The good news for corporates is that there are several reasons why firms are in better shape to withstand the current crisis, stimulus schemes notwithstanding. One is seen by examining some of the most talked about metrics over the last two months. Perhaps the most popular is 'Days Solvency with Zero Revenue'. A close cousin of this metric is 'Days to Profit Breakeven with Zero Revenue'. Both are metrics that investors and managers had never contemplated until this year. But with economies outlining reopening strategies, the latter is a useful baseline for companies unsure as to how quickly consumer demand will return.

Due to the expansion of company margins since the financial crisis, companies have the ability to 'hold their breath' for longer. One way to look at this is to assess the length of time that a company can experience a complete lack of sales and still breakeven. This is a twist on assessing company profit margins. It also accounts for the fact that if no sales are made, then 'cost of goods' expenses are not required.



Figure 11: The ability of corporates to withstand demand shocks has increased over the past decade



Source: Factset, Deutsche Bank

How the value of human capital affects return on equity

While we have so far inferred the value of employees through various metrics, there is a way to better value employees more directly. The method is described in the new ISO standard on Human Capital reporting. This is easiest to do for European companies as disclosure of staff costs can be more consistent than it is in the US.

To calculate 'Human Capital Return on Investment', we conducted a deep dive into the financial accounts of individual European stocks. The results can be muddled by outsourcing policies but, nonetheless, the data showed some unexpected conclusions.

The first unexpected result is the relationship between Human Capital Rol and subsequent share price movements, Returns on Equity, and a firm's overall staff costs.

In short, the higher a company's staff costs, as a proportion of its total operating costs, the lower its Human Capital Rol. The easy conclusion to make is that companies that employ a lot of people have little discipline about how they use their staff. However, this is not necessarily the case.

When we break down companies into quartiles based on their staff costs, we find that companies in the highest quartile of staff costs see little correlation with Human Capital Rol. One potential reason for this is that when a company has very high staff costs, managers pay closer attention to hiring decisions and put more effort into justifying hires.

When we move down to mid-range companies, that is, companies in the middle two quartiles for staff costs, we begin to see a negative correlation between the size of staff costs and Human Capital Rol. Moving further down into the bottom quartile, that is, companies that have the lowest staff costs, these companies exhibit a



strongly negative relationship between their staff costs and Human Capital Rol.

So, it seems that in firms where staff costs are not a large proportion of the cost base, managers are less troubled by ensuring that new hires are justified. The additional hires that are brought in do not bring in enough revenue to compensate.

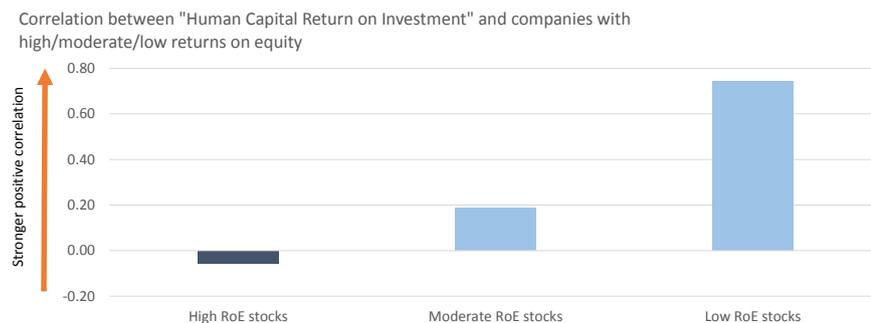
This might be easy to explain if these companies were young, high-growth companies. But this is not the case. Our sample of low-staff cost companies was dominated by energy, utility, and consumer firms, very few of which can be classed as young or high-growth. It is true that there are some company or sector-specific reasons for this. For example, energy and utility firms tend to be high-fixed cost firms and thus have their cost base dominated by depreciation. That said, there were a notable number of firms in this group with low fixed costs.

When we look at perhaps the most important fundamental measure of a company's performance, return on equity, it is quite striking to see which companies exhibit the strongest relationship between RoE and Human Capital Rol.

As the following chart shows, companies in the top quartile for RoE see very little correlation with Human Capital Rol. As we move down the RoE spectrum, companies with mid-range returns have a small positive correlation – that is, where companies in this group have higher RoE they tend to have higher Human Capital Rol.

When we move down to the worst stocks, in terms of RoE, we find a strong positive relationship between RoE and Human Capital Rol. This implies that, if the worst performing firms can increase the efficiency of their hiring decisions, this can have a substantial effect on their returns (of course, the flip side of this equation can also be true).

Figure 12: Human Capital Rol is critical for firms with low Return on Equity



Source : Company reports, Factset, Deutsche Bank

The final word

Where covid-19 has crushed a firm's revenues, managers stand in an unenviable position. An easy short-term fix is to cut staff. However, the experience of the financial crisis shows that a firm's recovery after the crisis may highly depend on the staffing decisions taken during the crisis. And, that is before considering the reputational damage that some firms have experienced after furloughing



employees.

Furthermore, as firms with low returns on equity seek to navigate the current crisis, they should feel encouraged that more efficient staffing decisions, with hiring and layoffs, will allow them to have a greater say in their own destiny.



Appendix 1

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