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The challenge of change

Transforming business through
better human capital management



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In many parts of the world, historically state-owned enterprises are transforming to become more business- and market-focused organizations. In this article, three Mercer experts discuss how successful transformation requires significant changes in the HR function and in how the organization manages human capital.



Transforming human capital management in state-owned enterprises



By Cameron Hannah, Jack Lim and Jim Matthewman

Q: In what parts of the world today is there major activity regarding the transformation of state-owned enterprises (SOEs) into more business-focused or market-focused entities?

Cameron Hannah: One obvious hub of major business investment and transformation activity is the Middle East. Over the past two years, due mainly to high oil prices, there has been a lot of surplus capital generated around the region. One of the consequences has been that local organizations – which are state-, semi-state- and privately owned – have begun reinvesting those surplus earnings in order to modernize and grow.

In terms of Eastern Europe, it really is two distinct regions with respect to SOEs and business transformation. In Central Europe, which includes countries such as Poland, Hungary, the Czech Republic, Bulgaria and Romania, multinationals began entering in the early 1990s, bringing their Western ways of working with them. A lot of transformational work within SOEs began then in this first wave, and we find now that their HR functions and pay programs are not dissimilar to what you see in Western Europe.

If you go further east to Russia, Ukraine and Kazakhstan, for instance, you find many more similarities to the Middle East. In those countries,

there are many large SOEs that have yet to go through significant business reengineering and the associated HR transformation. They represent the second wave of business transformation, and we believe that we will see much more change there over the next 10 years.

Jack Lim: Within Asia, the major business transformation of SOEs today is happening in mainland China. This is a major undertaking in a Communist-run country. There is also transformation taking place within SOEs in other Asian countries. There are numerous business opportunities in Vietnam and the same dynamic as we see in China, but those transformation efforts are generally 10 to 20 years behind the activity in China.

Jim Matthewman: When we talk about SOEs, it's important to remember that there are different levels of state ownership. In many areas, it's rare to have wholly owned government entities competing directly with private entities. Across Europe, we do see quasi-governmental entities competing head-on with private entities. And there are many private entities – especially in the utility, telecom, energy and financial industries – where the state still has significant shareholding. These organizations are transitioning into the private sector, but the government is reluctant to let go until it is comfortable that the market is behaving in a truly competitive way.

These different levels of SOEs all have an impact on the legacy and culture of the organization and its ability to be as competitive as other private-sector organizations. They face different constraints, such as whether board members are appointed by the government, whether business plans must be submitted to the government for approval, and whether the entity can participate in M&A transactions to meet its growth aspirations.

Q: What are the drivers of change? Are the drivers similar globally or do they vary by region or country?

JL: The drivers of change in Asia vary somewhat by country, but I'll focus on China, where we see most transformation currently taking place. The change here is being driven mainly by China's movement from a planned to a market-driven economy. Some 25 to 30 years ago, at least 95 percent of the companies in China were state-owned. Today, these businesses need to transform if they are going to participate and succeed in the new economy.

JM: Some of what we're seeing in Eastern Europe also relates to the movement from a centrally controlled to a capital-based economy. In Eastern Europe, where the markets tend to be inefficient and monopolistic, many governments now want to be part of a greater Europe. To do so, they have to open up their markets not only internally, but also to the European Union. So that is one big driver of change in the region.

Another driver of privatization and transformation in this region is the entry of organizations from the US and the more mature markets in Europe, which see these emerging markets as fantastic areas for growth. Consumer demand in these markets is currently unsatisfied, and these multinationals want to get a slice of the action. These companies are being very aggressive and they know how to capitalize on these opportunities.

In the Middle East, the driver is a bit different. Today, oil is more than \$80 a barrel, whereas it used to be \$25 to \$30 a barrel, so there is three times the amount of money floating around. Countries such as Qatar, UAE and Saudi Arabia are all looking to invest this money rapidly and are doing so by investing in the modernization and transformation of many SOEs.

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Q: What are the implications of this change for the HR function?

JM: Rapid changes in these emerging business environments are requiring massive changes in HR. Quite often, the HR function does not have the skills or capabilities to handle transformational change. Sometimes the opening up to competition is happening so rapidly that these organizations are on “burning platforms” where they could lose 30 percent to 50 percent of market share. There needs to be a strong will to change, and HR is under tremendous pressure to act as a catalyst to pull the organization through.

JL: Most big SOEs in China previously operated like government bureaus, with the HR function serving as a personnel department. But today’s organizations require HR to be run the way a private company runs HR. The previous focus on government compliance and documentation is changing. It now needs to be more business-driven and aligned with business strategy. Making this change successfully requires an HR staff with different skills and competencies, able to handle the new functional responsibilities. We see this through Mercer College Asia, which provides training and education for HR professionals in Asia.

CH: We’re seeing the same thing in Europe and the Middle East. The historic organization would have had HR purely as an administrative function. But the business need, as these organizations transform, is for HR

to become more business-focused and needs-driven. There is a strong trend toward a more typical Western European/US HR organizational structure encompassing things such as business partners, a shared services function and centers of expertise. Associated with those elements is the need for technology enablement and, to a certain extent, outsourcing.

I would say, though, that most SOEs have yet to begin a real transformation of HR. Instead, they are commencing to build the capacity of the HR function. These organizations have yet to really embrace concepts such as pay related to performance or to substantially modernize their rewards structure and the way services are provided by the HR function.

Q: What are the implications of this change for the management of human capital?

JL: It requires a huge mindset shift, from top executives to all employees. Everyone is having to think differently throughout the organization. They are familiar with the previous management system and may fear changing from the old system. Also in China, people have been trained to think that everyone is an equal part of the company. The focus has been on internal equity. But today, these organizations must become performance-driven. They need to differentiate pay, differentiate roles, etc. So this is another key implication of the change.

CH: Another major human capital issue has to do with the availability of key talent to run these modernized businesses. While the educational systems in Eastern Europe are very good, they are turning out people who are not business professionals and who lack the relevant qualifications. In the Middle East, the top echelon is very well-educated, but if you go down two or three levels, the degree of competence is much lower.

So leadership is beginning to recognize that business education is important, and that high-potential and leadership-development activities are required. They are emphasizing more opportunities to grow and develop.

JM: I would say that business transformation also has major implications for the talent mix within many SOEs. Most of these organizations, historically, have emphasized technical skills in their hiring, so that 60 percent to 70 percent of the organization may be made up of technical staff. But as they open themselves up to competition and move away from the guaranteed markets and prices and profits of the past, they are finding that they

have a real shortage of talent in sales, customer service and marketing. They now need these sorts of resources desperately.

Companies also are dealing with aging workforces, since they primarily rewarded tenure rather than performance and typically made workforce cuts on a last-in, first-out basis. Another factor in Eastern Europe is that many young professionals have left their home countries for Western Europe in search of better jobs. We are seeing an influx of Polish, Bulgarian and Balkan workers in the UK, with little movement of labor going the other way. In the Middle East, many organizations are going through the same transformational changes at the same time and are competing for the same kinds of talent. This is causing a run on key talent in the market.

To deal with all of these talent issues, SOEs need to identify mission-critical jobs and the succession plans and talent-management plans that go with them. They also have to get better at identifying where the necessary talent is going to come from and at developing that talent for critical roles.

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Q: What barriers are these organizations encountering with respect to both the HR function and human capital management? What are they finding to be most difficult and why?

JM: One is the challenge of leadership. Sometimes it is hard to convince the original top team of the need for change. Often it requires a new CEO to come in and make this happen. In the Middle East, in particular, the royal families are very large and very influential. The family network is as much an influence as leadership ability.

A second barrier is relatively low levels of engagement among employees. Most SOEs have an entitlement culture and absolutely no management of poor performance. The majority of the workforce is looking for an equitable relationship as opposed to pay-for-performance where everybody is differentiated. There is also a huge concern from the workforce that their managers are not trained to implement performance-based systems, which leads to distrust and lack of consistency in using those systems.

Third, people have been rewarded on tenure and probably receive a whole stack of allowances for all sorts of reasons that usually have no relationship to work. These become quite difficult to negotiate or change going forward. And there are socioeconomic question marks about how the state has previously funded pay, benefits and pensions.

Another barrier, especially in Eastern Europe, is a general lethargy or lack of urgency among both management and staff regarding the change. This can be a serious matter. This reluctance to change is compounded by slow, consensual decision making where everyone feels a right to be involved in the decision.

Finally, there may be legal barriers to redundancy in many countries, which can make it very difficult to manage an exit policy and can slow efforts to change the makeup of the workforce.

CH: I agree that leadership can be a barrier. Leaders need to get on board and be open to the change, or they need to be replaced. Engaging line managers is also a challenge. Leadership needs to communicate more effectively with line management about why and how the change should occur. The broader workforce also can create barriers. Often, employees accept the change, but they don't really embrace it. They are comfortable and familiar with the way the company has been traditionally run.



JL: Changing people's mindsets takes time. That's one of the key barriers we see. Also in China, SOEs need to balance their commercial and social responsibilities, and those priorities sometimes conflict. When companies go public, they need to meet certain financial performance requirements. This may entail cutting jobs and differentiating pay. But because many of these SOEs are so big, they also need to consider their social responsibilities, which include taking care of people. The word we hear a lot in China is "harmony" of the society. If a company decides to lay off employees, the government will not favor such a move. And neither will employees, who have become so familiar with the stable SOE environment. They may not be able to compete in the labor market and may find it hard to get new jobs. This is especially true for older employees, who often find it hard to learn new skills.

Q: Are there organizations that have made this transformation successfully? How have they done it? What can we learn from them?

JM: It can be a long and difficult journey, but we are seeing significant change in most of the organizations we have worked with. One key to their success has been the adoption of an integrated people strategy aligned with the changing business goals. This has been required to drive deep organizational change and ensure that there is clarity about why changes are being implemented.

In addition, successful organizations have adopted a new performance-management approach that tends to stress new behaviors and core competencies – particularly, to become customer-centric and more personally accountable. And these organizations have made significant investments in line-management skills.

From the HR point of view, successful organizations have created new HR organizations that are less transactional and more strategic, and have backed this up with new HR systems, processes and technology. And because the skill sets in HR are not usually what they need going forward, these organizations have worked to impart new skills to the new HR function as a key to success.

CH: The organizations that have been most successful have brought in Western talent where skills and capabilities were missing and have used business consultants when needed. In Russia, local organizations have hired senior talent from many other countries in the world, putting them on their local payroll. In the Middle East, you frequently find that the senior individuals have an expatriate sitting alongside them, like an individual consultant.

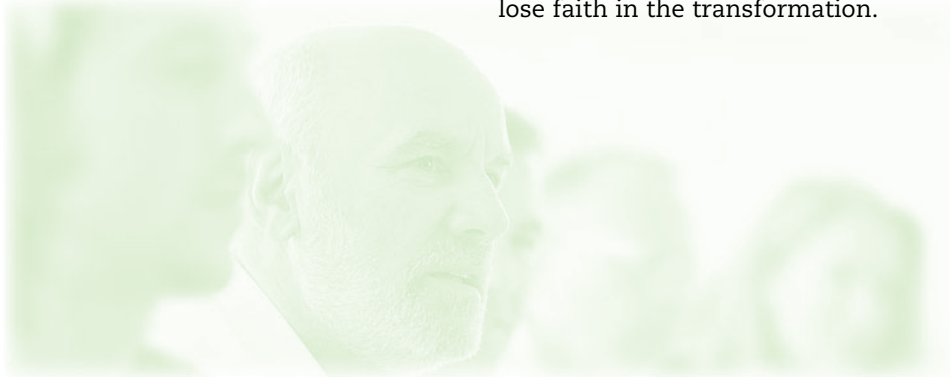
They have also removed people from the organization who were blocking change and have chosen people who instill a much stronger sense of leadership direction. The top executive has to be open to change or has to be renewed.

JL: There are many SOEs in China that have been making great progress in transforming HR as part of a larger business transformation. After two or three years of effort, they already have a good HR management system in place and many managers become very supportive of the new methodologies.

Organizations embarking on transformation need to remember that this work is difficult. To make the change, companies need to be patient and persistent. The HR function can't be changed in a few months and can't be done as a one-off project, but needs to be done as a series of change initiatives.

Also, the work needs to be driven by C-suite people, not just HR managers. Some organizations are telling us that transforming HR is most important to their overall business transformation, but only a few CEOs are directly involved in HR transformation. In order to succeed, the driving force should be from the top. Business leaders also need to "walk the talk." If they want the organization to adopt a pay-for-performance approach, for example, they need to start with the CEO and vice presidents.

Finally, getting the pace of change right is proving to be very important. If the organization changes too quickly, it can be very destabilizing. But if the pace of change is too slow, people will lose faith in the transformation.



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- Ensuring responsible executive remuneration
- Enhancing HR effectiveness

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