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Valuation of Human Capital

November 2025

Importance of valuing human capital

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In today's business landscape, we tend to gravitate towards the tangible plant, property, equipment, spreadsheets, and balance sheets. These are the things that we can either see, touch, measure, and audit easily.

But what if the true source of lasting value in your organisation isn't your latest machine or your capital structure?

What if it's something far less tangible but infinitely more powerful?

Human capital relates to collective knowledge, skills, creativity, and leadership of an organisation's workforce. While traditional HR functions may have tracked headcount and training hours, this blog shifts the lens to seek a broader perspective within human capital.

We're going beyond the classic HR dashboard to ask:

- ***How does one value the human engine of the company?***
- ***How do you translate talent, innovation, and leadership into financial relevance?***

In the pages that follow, we'll unpack a structured, valuation-centric framework for human capital, moving from soft metrics to hard numbers, from potential to performance, and from intangible buzzwords to tangible business impact. If your business is still thinking of people as cost-centres rather than value-drivers, now is the time to flip the script.

Why human capital matters in valuation?

In an economy where ideas scale faster than infrastructure, human capital has emerged as the defining asset of enterprise value

- In **knowledge-driven industries** (consulting, IT services, creative media, healthcare), human capital is the primary driver of enterprise value, and people aren't just resources; they are the business model
- In mergers and acquisitions, this reality plays out tangibly: acquirers routinely tie deal success to the **retention of key employees**, embedding retention bonuses and earn-outs directly into purchase price adjustments
- Human capital impacts extend across every financial lever:
  - **Revenue generation** (through innovation, relationships, execution)
  - **Cost efficiency** (productivity per head, attrition costs)
  - **Strategic flexibility** (leadership optionality in entering new markets, pivoting models, or scaling operations)

The message is clear: **Human capital** isn't a footnote in valuation; it's a line item that moves the deal

Why leadership compensation goes beyond salary?

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For senior management, value creation extends beyond individual performance; it's about strategic decisions that shape a company's trajectory. Leadership pay often combines salary with long-term incentives like **ESOPs, RSUs, LTIPs, performance bonuses, retirement benefits, and perquisites.**

These instruments are valuation tools, aligning executive wealth with shareholder value. Deferred or equity-linked payouts are treated as capitalised retention assets, reflecting the economic cost of keeping key talent invested in growth. In M&A or investment deals, gross-ups or retention pools may be structured to secure continuity and client relationships, effectively pricing leadership as a real option.

Treatment of Incentive and Deferred Compensation

- **Employee Stock Option Plans (ESOPs):** Treat vested and expected future grants as part of total compensation cost. Unvested ESOPs linked to performance should be capitalized as retention assets, reflecting their role in reducing attrition and securing future productivity

Read More on ESOPs here - https://artovaladvisors.com/valuation-of-esop/

- **Long-Term Incentive Plans (LTIPs):** Value LTIPs using probability-weighted payouts based on performance targets. In an income-based DCF, adjust cash flows by incorporating these as non-cash but economically relevant expenses, ensuring EBIT margins are not overstated
- **Deferred Compensation / Retention Bonuses:** These should be capitalised and amortised over their service period, similar to prepaid retention costs. In M&A scenarios, model them explicitly as continuity costs, necessary to preserve forecasted cash flows

Regulatory and Taxation Considerations

- **Equity Incentives**: Taxed at vesting or exercise, with potential capital gains on sale; require corporate approvals and securities disclosures
- **Performance Bonuses & Profit Sharing:** Taxed as ordinary income; may need board or shareholder approvals
- **Retirement & Deferred Compensation:** Tax-efficient but subject to labor law and vesting rules
- **Perquisites & Fringe Benefits:** Tax treatment varies; regulatory rules dictate reporting and disclosure

These factors are critical in valuation, as they determine the net economic cost to the company and the actual benefit to executives, ensuring accurate pricing of retention obligations and strategic continuity.

Approaches to valuing human capital

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Cost-Based Approaches

This method asks: What would it cost to rebuild our workforce from scratch?

- **Replacement Cost Method:** What it would cost to hire, train, and onboard employees of similar quality
- **Historical Value Method:** Captures the cumulative spend on recruitment, training, and development, capitalized over their useful life. Rarely used since it reflects cost incurred, not economic benefit expected

KPIs/Adjustments

- Recruitment cost per hire
- Training cost per employee
- Attrition-adjusted replacement value

Income-Based Approaches

Here, human capital is valued by the economic returns it generates

- **Human Capital ROI:** Incremental EBIT per employee relative to cost
- **Productivity-Based DCF:** Allocate a portion of free cash flows attributable to workforce productivity. Used specifically in Human capital valuation strategies

KPIs/Adjustments

- EBIT per employee
- Estimate future economic benefits attributable to key individuals or workforce (e.g., revenue from their client accounts, cost savings, or product outputs)
- Adjust for attrition probability and useful life.
- Discount those expected benefits using a risk-adjusted rate

Market-Based Approaches

This lens values human capital through peer and market comparisons

- **Comparables**: Benchmark revenue/employee or market cap/employee ratios against peers
- **Deal Premiums:** Valuation premiums paid in transactions driven by workforce synergies (e.g., acqui-hires), Microsoft/Inflection deal

KPIs/Adjustments

- Market multiples (EV/Revenue per employee)
- Peer group productivity metrics

Importance of valuing across hierarchies (1/3)

Not all employees contribute equally to enterprise value. Leadership drives vision and strategic outcomes, middle management converts that strategy into execution, and operational staff maintain continuity. Recognising this hierarchy ensures valuation models capture where value truly resides and how risk scales across levels.

- **To capture the true economic weight of people in enterprise valuation, human capital must be assessed across organisational layers**
- **Each level from leadership to front-line operations drives value differently, with distinct risks, costs, and retention dynamics**

Hierarchy Level	Focus Area	Key Approach
Leadership & Upper Management	Strategic decisions, vision, and client relationships	• **Cash Flow Differential Method –** Measures value loss from leadership exits • **Probabilistic Method –** Adjusts EV for probability of key-person departure **Includes:** (Numerical illustration of both approaches)
Middle Management	Execution quality, scalability, and performance transfer	
Operational/Entry-Level Workforce	Process continuity and productivity	
Hierarchy-Weighted Valuation Framework	Integration of all levels into a unified model	Weighted average by contribution: Numerical illustration of both approaches

Importance of valuing across hierarchies (2/3)

1. Leadership and Upper Management

Valuation Focus: Strategic decision-making, capital allocation, and client networks. Their absence often leads to valuation discounts

KPIs/Metrics:
- Incremental EBIT tied to leadership-driven deals or strategies
- Executive replacement cost (headhunting fees, opportunity loss)
- Retention-linked incentives (bonuses, LTIPs, golden parachutes)

Adjustments:
- Apply a **key-person discount** to the enterprise value if leadership dependency is high

Approach 1: Cash Flow Differential Method

This approach quantifies the loss in firm value if the key person exits and operations take time to stabilise

Example:
- Base case (with key person): **annual EBIT = 100 crore**
- If key person exits: **EBIT expected to drop by 15%** for 2 years before recovery
- **Discount rate = 12%**

$PV\ of\ loss = 15\% \times 100 \times \left(\frac{1-(1+0.12)^{-2}}{0.12}\right) = 25.4$ crore (approx.)

- Base enterprise value (DCF) **= 500 crore**
- **Key Person Discount = 25.4 / 500 = 5.1%**

So, a **5% discount** is applied to the enterprise value to reflect dependency on the key individual

Approach 2: Probabilistic Method

When leadership continuity contracts or retention programs are in place, analysts use probabilities to model the expected loss. They're used as modifiers within income-based or scenario-based valuations, especially when valuing key persons, leadership continuity, or retention-linked payouts.

Example:
- Estimated probability of CEO departure = **20%**
- Value loss if departure occurs = **15% of enterprise value**
- "Key Person Rate"=**20% × 15% = 3%**

Hence, the adjusted enterprise value becomes

- $Adjusted\ EV = Base\ EV \times (1 - 0.03)$

If Base EV = 500 crore → Adjusted EV = **485 crore**

Importance of valuing across hierarchies (3/3)

2. Middle Management

Valuation Focus: Execution quality, scalability, knowledge transfer

KPIs/Metrics:

- Team productivity ratios (EBIT/team vs peers)

Adjustments:

- Weak mid-level execution - reduce operating margins in projections
- Attrition at this level is modelled as scenario risk - higher SG&A or onboarding costs

3. Operational / Entry-Level Staff

Valuation Focus: Daily operations, output volume, and process continuity

KPIs/Metrics:

- Attrition rate × replacement cost per employee
- Revenue per employee

Adjustments:

- High churn - inflate SG&A in DCF

Hierarchy-weighted valuation framework

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To integrate these insights, a hierarchy-weighted model can quantify total human capital value:

Aggregate Workforce Value:

- Start with productivity-based valuation (e.g., EBIT per employee × headcount)

1

Apply Hierarchy Weights:

- CXO/Leadership → premium × risk-adjusted multiple
- Middle Management → neutral/premium depending on execution quality
- Staff → primarily attrition-adjusted cost base

2

Scenario Analysis::

- Retention vs attrition modelled for each layer

Apply probability-weighted adjustments to projected cash flows

3

Note to final adjustment for total compensation

Components of Total Compensation

- **Fixed Pay:** Base salary, statutory benefits, and allowances
- **Variable Pay:** Performance-linked bonuses, commissions, and profit-sharing
- **Deferred Pay:** Retention-linked or deferred bonuses amortised over the service period
- **Equity Incentives:** ESOPs and LTIPs, valued on a probability-weighted basis considering vesting and dilution impact
- **Indirect Costs:** Recruitment, training, and onboarding expenses are capitalised over useful employment periods

Key Valuation Adjustments

- **Leadership Dependence:** Apply key-person discounts where enterprise value is concentrated in a few individuals
- **Attrition Risk:** Model attrition as a probability-weighted adjustment to operating margins and SG&A
- **Retention Costs:** Capitalise future retention or continuity bonuses in cash flow forecasts
- **Productivity Premiums:** Apply resilience or efficiency premiums where managerial strength reduces volatility
- **Automation Optionality:** Treat automation-led cost savings as call options on future efficiency gains
- **ESOP / LTIP Recognition:** Reflect as non-cash component but economically relevant expenses impacting EBIT and valuation multiples
- **Scenario Modelling:** Use retention vs attrition scenarios across hierarchy layers to adjust expected cash flows

Illustrative case studies

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Transaction Background	Impact
• **Fictional -** A mid-sized IT consulting firm was acquired by an Indian digital transformation player • While ABC's tangible assets were modest, **40 crore in net fixed assets** • Base **Enterprise Value 320 crore (8× EBITDA)** • However, due diligence revealed that over **70%** of the client relationships and delivery IP were tied to just **15 senior consultants and partners** • **Paid 240 crores as cash** consideration for the business, **80 crores** in **retention-linked payouts** (ESOPs, LTIPs, and deferred bonuses) spread over **three years**	**From a valuation perspective, this meant:** • **240 crore** was attributed to **enterprise value** • **80 crore** was classified as **capitalised human capital**, reflecting the cost of retaining key value drivers • Effectively, **25%** of total consideration represented the value of human capital continuity, showing how acquirers directly embed human capital valuation into transaction pricing
• A mid-sized SaaS company with **100 crore EBITDA** and **500 employees**. Analyst aims to adjust enterprise value (EV) for human capital factors • **EV/EBITDA** multiple (industry average): **12×** • Base **Enterprise Value**: **1,200 crore** • Value Contribution (**Leadership - 15%, Middle-Level - 25%, Entry Level - 60%**)	• Leadership dependency **3% key-person risk discount** = **1,200*3% = 36 crore** • Attrition cost (5%), Replacement & onboarding cost inflation = **(1,200*85%)*5% = 51 crore** • ESOP / LTIP obligation, Deferred compensation capitalised = **20 crore** • Retention bonuses, Modelled as 1-year cost = **10 crore** **Adjusted EV** = **1,200-36-51-20-10 = 1,083 crore**, reducing the **EV by 9.75%**

When intellectual, client, or execution capital is concentrated in people rather than systems, valuation must explicitly account for the cost of retaining those people and not just replacing them

Challenges in human capital valuation

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As powerful as the idea of valuing human capital may sound, translating it into numbers is far from simple. Unlike machinery or patents, people are dynamic, mobile, and multidimensional, making their valuation both an art and a science

Data and Measurement Gaps

Human capital valuation depends on consistent, high-quality data. HR systems capture headcount and training spend, while finance tracks productivity and margins. Both should be viewed together and not in isolation. Quantifying attributes like innovation, leadership, or culture remains inherently difficult

Attribution Complexity

Is revenue growth driven by sales talent, superior processes, or brand equity? In most organizations, performance results from collective effort, making it challenging to isolate human impact. This creates noise in models that aim to assign value to people-driven outcomes

Subjectivity in Assumptions

From estimating replacement costs to projecting productivity-linked cash flows, many inputs rely on managerial judgment rather than observable market data. This limits comparability and makes valuations sensitive to bias or optimism

In essence, valuing human capital requires humility. It’s not about perfect precision, but about building structured, transparent frameworks that reveal how people drive enterprise value. When treated with the same discipline as other assets and interpreted with context, human capital valuation becomes not just a measurement exercise, but a step toward more informed strategic decisions.

Conclusion - The real asset hidden in plain sight

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- In a world where technology depreciates, patents expire, and capital structures evolve, it's the human capital, the ingenuity, leadership, and resilience of people that sustains enterprise value
- To ignore it or treat it as a secondary input is to misunderstand what truly powers a business
- A structured valuation of people brings visibility to what has always been implicit: that every strategic pivot, client relationship, and innovation stems from human capability
- As organizations evolve, the line between financial capital and intellectual capital will continue to blur. Those who can quantify, nurture, and retain their human engines will not only command higher valuations but will also build enterprises that endure disruption

Human capital isn't a cost centre - it's the continuity premium of your business. And the sooner you start valuing it as such, the clearer your true enterprise value becomes

- Valuing human capital requires more than just counting employees or HR costs. It demands a hierarchy-sensitive, KPI-driven approach that connects people directly to enterprise cash flows and risk
- By using cost, income, and market frameworks and adjusting for leadership, middle management, and staff contributions, analysts can capture the true economic weight of human capital in enterprise valuation

Just as not all assets are valued equally, not all employees are valued equally. Recognising this hierarchy and pricing the risk of losing it is what separates a surface-level analysis from a professional valuation

Thank You…!

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