The PEO Industry in Transition

Four waves of industry evolution, the coming era of consolidation, and implications for your business. A look at the dynamic PEO marketplace. **By Benjamin Gordon and Matt Gordon**

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More than a few heads turned in the week following Valentine's Day this year, and it wasn't just from the roses. On February 21, Nautic Partners announced that it had acquired Oasis Outsourcing, the largest privately-held professional employer organization (PEO) in the country. This announcement put into the forefront the quiet but growing consolidation wave beginning to sweep PEOs and the HRO sector.

Undoubtedly, Nautic did not acquire Oasis just to milk the revenue stream generated by 55,000 worksite employees (WSE) under contract. Nor was it seeking simply to grow organically at the prevailing industry rates. Nautic, a private equity firm with $1.8 billion of capital under management, bought Oasis to serve as a platform for a vigorous acquisition campaign. The end goal will be to position Oasis as a top industry leader and ultimately to go public. Small and mid-sized firms serving the outsourced HR sector (including PEOs, HROs, and ASOs) should take notice: the competitive landscape is changing.

THE PEO INDUSTRY TODAY

An industry consolidation may not be welcome news for the average mid-sized PEO owner, who has reaped the benefits of two strong years in the market.

For more than a decade, the PEO market has been ripe with opportunity. According to NAPEO, the PEO industry is comprised of approximately 700 firms that generate gross revenues (including payroll, taxes, and insurance premiums) of $51 billion. In total, the PEO industry services between two and three million employees and has been growing in excess of 20 percent a year. While these are very impressive numbers, the industry has not even scratched the surface.

Currently, the domestic PEO industry's core market, consisting of firms with fewer than 500 workers, employs an aggregate of 80.8 million workers. The average annual salary is approximately $25,000, yielding a potential market of more than $2 trillion dollars. The PEO industry has only penetrated approximately 2.5 percent of its core market. In short, there is much room for growth. This opportunity is attracting outside capital, fueling mergers and acquisitions, and, in turn, feeding consolidation.

It was once said of the underachieving son of a famous senator that "he had a lot of potential … and always will." Some would argue that the same could be said of the PEO industry. From the beginning, it has been marked by periods of high growth, high potential, high change, and in some cases, high disappointment.

The industry began in the 1980s and has had several fits and starts, punctuated by periods of prosperity. Despite the recent growth, it may be surprising to note that during the past decade, the industry has not significantly increased the number of worksite employees under contract. According to a research report published in 1997, the PEO industry had an estimated two million employees under contract. This is roughly the same number as today and an even lower percentage of the total workforce.

While this statistic may be a bit disheartening, it is worth understanding the four-phase history of what happened between then and now, and the history shows how the industry (finally) is poised to deliver on its long-awaited potential.

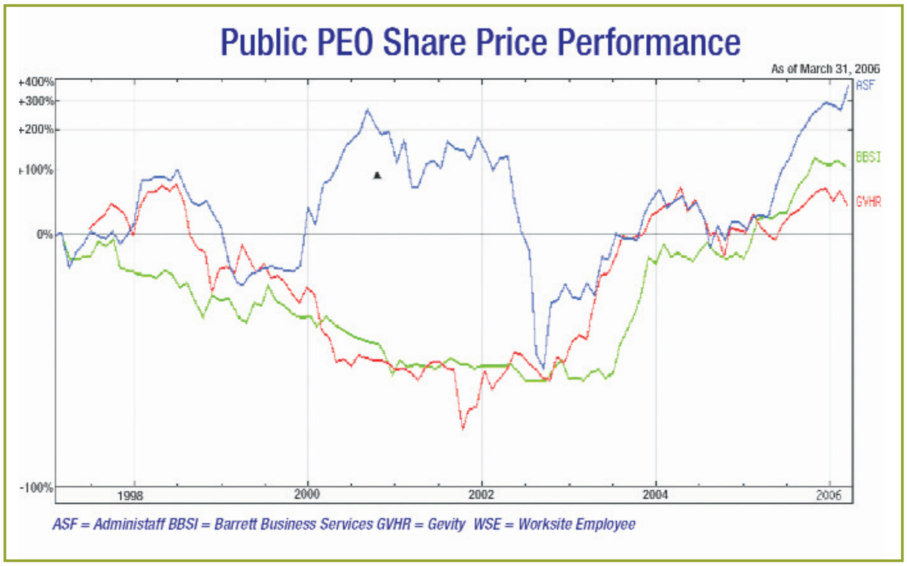
■ **Rapid Growth.** The first phase was marked by rapid growth. In the mid- to late-1990s, the PEO industry enjoyed growth rates in excess of 20 percent. Many firms including GevityHR (formerly called Staff Leasing Inc.), Administaff, and the notable (if not notorious) Team America all completed successful IPOs. By 1999, mergers and acquisitions valuations were placing a value upwards of $2,000 on each worksite employee.

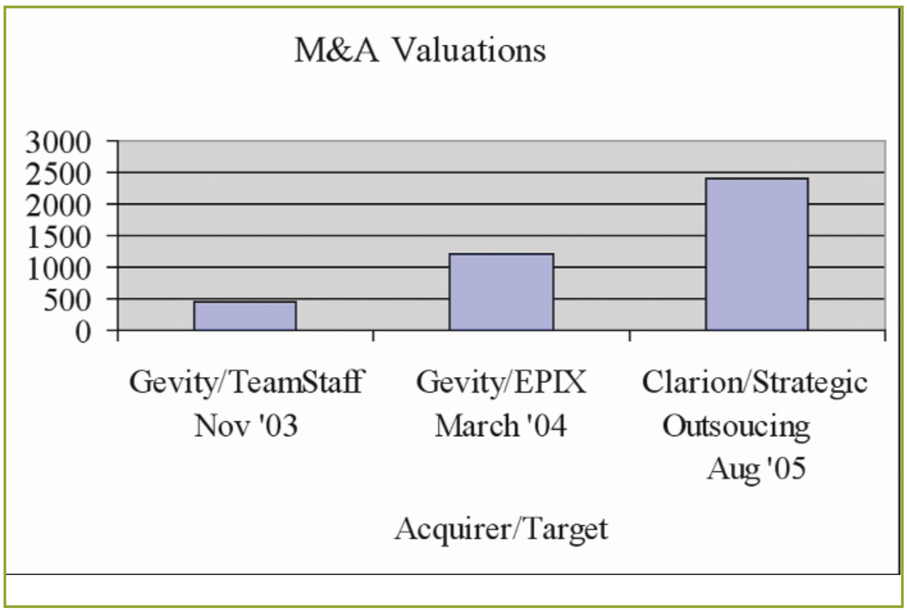
■ **Sudden Decline.** The second phase was punctuated by legal challenges and market declines. The good times for the PEO industry ended with the bursting of the dot-com bubble and the ensuing recession in 2000. Small businesses, both the core market and engine for growth of the PEO industry, went out in droves, as did many of the PEOs that served them. If things were not bad enough, the industry, which had always been dogged by claims of legal maneuvering to avoid taxes, was hit by several high-profile workers' compensation scandals, including the infamous case of Simplified Employment Services (SES) in 2001.

The worst was yet to come. The 9/11 attacks further weakened the U.S. economy and the PEOs' existing and potential client base. Shortly thereafter, in 2002, CNA helped precipitate the worker's comp insurance crisis by exiting the PEO market. Within a year, the number of carriers offering policies to PEOs declined from dozens to less than 10. The net effect of this series of negative shocks was a culling of the industry. As many as half the PEOs went out of business. Shutdowns rippled through the industry, including a typical firm such as Core Employer of Florida. The industry squeeze of 2000-2003 culminated with the bankruptcy of the publicly traded Team America in late 2003.

■ **Maturation.** The third phase consisted of a maturation of the PEO industry, leading to more stable growth. Things started improving in 2004. The U.S. economy resumed its growth. This recovery was fueled by small businesses, which created as many as 80 percent of all new jobs, according to the U.S. Department of Labor. With this growth came renewed PEO prosperity and growth. In turn, valuations started to recover, both for publicly traded companies and for privately held companies in the mergers and acquisitions market.

Amid this third phase, a handful of leaders have begun to gain disproportionate benefits. For example, from the beginning of 2003 until the end of Q1 2006, public PEOs Gevity, Barrett, and Administaff saw share-price increases of 530 percent, 1,204 percent, and 797 percent, respectively. In the M&A market, three representative transactions from November of 2003 through August of 2005 show how company valuations on a per worksite employee basis increased by almost 450 percent.





Today, we believe the PEO sector is poised for a fourth phase: consolidation. As the market matures, and as outside capital pours into the market to fund the strongest companies, PEOs with the most resources will increasingly gain a competitive advantage and, in turn, will come to dominate what has been a fragmented market until now. Small and mid-sized firms may find it harder to achieve their historical levels of growth and profitability.

WHY THE BIG WILL GET BIGGER

As a result of the three phases of change during the past decade, the PEO sector today consists of more efficient firms that are ready to capitalize on the sector's enormous market opportunity. However, unlike past periods of growth, this resurgence will continue to be led from the top down, as the industry leaders consolidate their market positions. The big will get bigger because of their competitive advantages, which, in turn, are based on their underlying cost economies of scale and differentiating technologies. These large-company advantages are outlined below.

—Underwriting Economics: PEOs, by their nature, aggregate insurance underwriting risk. A PEO faces enormous financial insecurity unless it is able to aggregate a large, well-diversified risk pool. The disruptive events of the past decade forced a number of small firms into bankruptcy. In contrast, most larger firms, with the exception of Team America (a public company that failed due to over-leverage), were able to survive.

—Regulatory Burdens: Larger PEO firms are better equipped to handle the increasing amount of government and self-imposed regulation. Currently there are 28 states with formal licensing requirements for PEOs, which represents a significant increase from 16 a decade ago. These government regulations are being supplemented by industry-based, self-regulation from the PEO sector itself. The ESCA (Employer Services Assurance Corporation) provides a certification program that helps alleviate both potential client and regulator concerns over a PEO's financial stability and legal compliance. In addition, the Certification Institute offers a workers' compensation risk management certification that was developed in conjunction with risk managers, insurance brokers, carriers, NAPEO, and the ESCA to ensure a best-practices approach to risk management issues. As regulatory burdens increase, larger firms will continue to gain advantages.

Fig. 3 PEO M&A ACTIVITIES

DATE	TARGET	ACQUIRER	TARGET WSE
2/04	Advantec	Trident Capital	20,000
6/05	TriNet	General Atlantic	20,000
8/05	Strategic Outsourcing	Clarion Capital	32,000
2/06	Oasis Outsourcing	Nautic Partners	55,000

LARGER COMPETITORS ARE NOW BRINGING THEIR COST ECONOMIES AND MULTI-MILLION DOLLAR TECHNOLOGY PLATFORMS TO BEAR—OFFERING THE MARKET GREATER VALUE, NUMEROUS SERVICES, AND LOWER PRICES. AS A RESULT, THE "DO NOTHING" STRATEGY IS LIKELY TO YIELD LOWER GROWTH, SMALLER MARGINS, AND THE RISK OF SERIOUS BUSINESS ATTRITION AS THE MARKET SURGES FORWARD.

—Technology: Throughout the HR outsourcing sector, aggressive companies are investing millions in sophisticated web-based tools, powerful back-office databases, and other related automation software. This is creating new opportunities for these firms, as they can grow faster, provide more services, and generate superior value by using completely automated systems to handle the needs of hundreds of clients with tens of thousands of employees.

For instance, Administaff implemented its eBusiness service platform in 1998, helping push its compound annual growth rate in average monthly worksite employees paid from 26 percent for the previous two years to 33 percent for the two years following the introduction. Currently, the company is on its fourth generation of enhancements, including the addition of small and medium business software services that it acquired from HR Tools in December of 2005 for $6.3 million. Through these efforts, the company has grown to more than 94,000 worksite employees under management at the end of 2005.

Today, to compete effectively, PEOs will increasingly need to be prepared to invest several million dollars in superior technology. On the one hand, this poses a serious challenge for smaller firms that are not prepared to make these investments. On the other hand, it creates major opportunities for companies that choose to fund aggressive technology initiatives. In short, leading-edge technology investments can pay off under a broad range of scenarios.

NEW CAPITAL AND CHALLENGES

The renewed prospects for the PEO/HRO industry have led to renewed capital inflows. In the last two years, private equity firms have purchased four major industry players to serve as platforms for significant expansions:

The amounts flowing into the sector have been significant. Advantec raised more than $26 million from Trident Capital in early 2004. Clarion purchased Strategic Outsourcing for $77 million. Although the data was not publicly disclosed, assuming similar metrics, the Oasis transaction may have been in the $130 million range. Given that Oasis was the largest private company in the industry, it would not be surprising if the amount was even higher.

The private equity sector is accelerating its rate of investment in the PEO market. Private-equity firms and their portfolio companies completed 22 transactions in 2005, double that of 2004.

As private equity pours into the HRO sector, competition inevitably will accelerate. Private equity firms generally invest in companies that they believe can achieve a return of more than 30 percent. In the short run, not all private equity-backed companies will achieve outstanding success. In the long run, smart capital will fuel smart companies to compete more aggressively, and the fragmented PEO market will come to be dominated by a handful of giants.

The changing and increasingly competitive landscape will force the small and mid-sized PEO owners to take a hard look at their strategic options for survival. In a consolidating market, there are generally three main strategic options: buy, sell, or do nothing.

■ **Be the Acquirer.** Becoming a major industry acquirer is probably the most difficult path to follow for a small or mid-sized PEO firm. This strategy requires a highly differentiated service offering and growth strategy to become a category leader. In addition, winners will ▶

require major investments to develop leading skill sets in target identification, transaction execution, capital-raising, and post-merger integration. While not impossible, very few firms will be able to go this route successfully.

provide access to offensive resources that allow for expanded marketing and additional products and services for clients and a broader portfolio of customers, locations, and capabilities to cross-sell both entities.

Fig. 4 MAJOR PEOs

COMPANY	WSE	OWNERSHIP
GEVITY	137,000	PUBLIC
ADP TOTAL SOURCE	126,000	PUBLIC
ADMINISTAFF	94,000	PUBLIC
OASIS OUTSOURCING	60,000	PRIVATE EQUITY
SCI	45,000	PRIVATE
STRATEGIC OUTSOURCING	40,000*	PRIVATE EQUITY
PRESIDION	33,000*	PUBLIC/SUB
BARRETT BUSINESS SERVICES	21,000	PUBLIC
ADVANTEC	20,000ˆ	PRIVATE EQUITY

**As of 2004* *ˆEstimated*

One challenge of this strategy is that PEO scale is valuable to achieve but hard to manage. The overwhelming majority of firms in the industry are relatively small companies, serving fewer than 3,000 worksite employees. Most of these companies are run by their owners, who make the day-to-day decisions about the business. Once a PEO begins to grow past the 5,000 to 10,000 worksite employee range, the requirements become too large for any individual to manage. At this point, the company needs to invest significant capital in IT infrastructure (both client-side and internal) as well as its organization and personnel. For this reason, only the few largest firms have both the skill sets and the capital to make this an effective strategy. As Fig. 4 shows, only nine companies are believed to have achieved total WSE or more than 20,000. All but one are either publicly traded or backed by large, private equity.

■ **Pursue a Sale or Merger.** In a consolidating marketplace, the most viable survival strategy for a well-run, mid-sized PEO is typically to sell to a strategic acquirer. This route can quickly provide the defensive scale to compete successfully in a consolidating market but it can also

Most importantly, as seen in the Strategic Outsourcing transaction, valuations are at all-time highs. While not every seller is destined to get more than $2,000 per WSE, overall, the market timing has never been better. Recently, Pro HR of Meridian, ID took this route, selling to Barrett for $5.5 million in December of 2005.

In addition, a sale can be structured in a variety of ways, providing a PEO owner several different options. Sometimes, owners immediately exit the business. Often though, the energy and inventiveness of the owner is what makes the business an attractive acquisition candidate. Many owners prefer to stay on and continue building the business. In turn, many buyers prefer to maintain the entrepreneurial energy that sellers can generate. Further, as part of a sale, an owner can often choose to roll forward their equity into the new company (often on a tax-free or tax-deferred basis), or take some or all of the equity value off the table in cash to help better diversify their personal wealth portfolio.

■ **Do Nothing.** The default strategy is to simply do nothing. This may seem especially compelling against the backdrop of 20-percent growth in the past two years. Unfortunately, the landscape is changing. Currently, many small and mid-sized PEOs differentiate themselves by offering individually tailored "white-glove" levels of customer service. There are hundreds of firms in this category. While this approach was successful in a fragmented environment where benefits of technology and scale were not decisive, this is no longer the case. Larger competitors are now bringing their cost economies and multi-million dollar technology platforms to bear—offering the market greater value, numerous services, and lower prices. As a result, the "do nothing" strategy is likely to yield lower growth, smaller margins, and the risk of serious business attrition as the market surges forward.

A WAKE-UP CALL

While the past two years have been good for small and large PEOs alike, recent events should serve as a wake-up call for smart, mid-sized firms. The industry is finally poised to deliver on its promise of providing a significant portion of HR services to the small businesses of America, but the benefits of this next phase of growth will not be distributed evenly. Larger firms with greater capital, management, and technology infrastructure will be in an increasingly superior position to offer better services to the market at pricing levels that smaller firms cannot match. Many have already started gearing up for the consolidation that will greatly increase their market share and cement their positions as leaders in the overall HRO industry.

While these changes may be unsettling, smart PEOs will take advantage of the resulting opportunities. The owners of small and mid-sized PEOs will prepare for tough questions and tougher answers about what it will take to survive. Most importantly, the shrewdest PEO owners will then be prepared to act.

The Valentine's week announcement was a wake-up call. In this era of post-Valentine consolidation, the best mid-sized PEOs will take note, smell the roses, and choose a winning strategic course. HRO

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