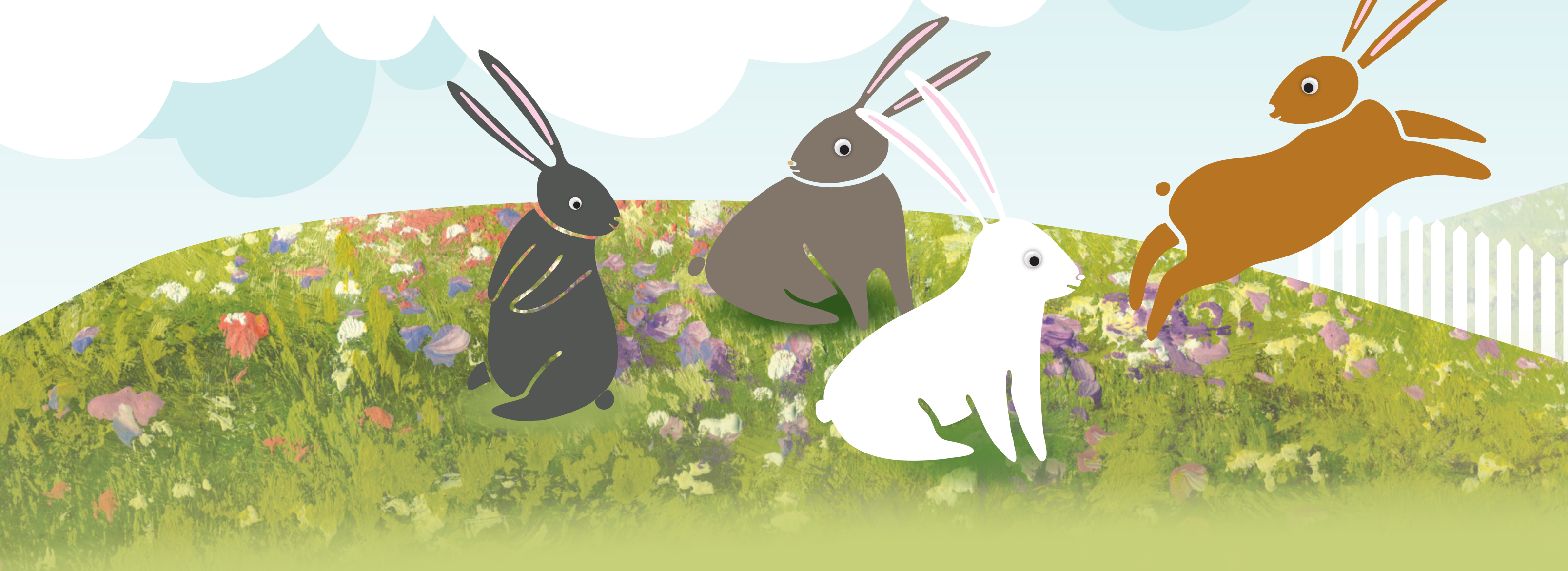
INTERNAL AND EXTERNAL GROWTH DRIVERS



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Growth is a result of execution upon internal and external drivers. A PEO has control over internal drivers, but rarely has influence over macro external changes, aside from lobbying efforts. An executive team that conducts scenario planning can recognize external change indicators quickly, which may result in a competitive advantage. A PEO should optimize internal drivers and ensure appropriate positioning to promptly capitalize on external changes to stimulate growth.

This article will separate internal from external drivers. It will also make a distinction between revenue growth and profit growth drivers. Reviewing each separately will provide increased visibility about the factors that influence growth.

It is important to view revenue growth in comparison with earnings before interest, taxes, depreciation, and amortization (EBITDA) growth. A business owner may be pleased with 20 percent revenue growth and 10 percent EBITDA growth. However, I would challenge that comfort. From my perspective, EBITDA growth should equal or outpace revenue growth. If not, the PEO is leaving profit on the table. As a PEO grows, its variable costs fluctuate, but fixed costs as a percent of revenue should reduce over time. As a result, EBITDA should have a higher growth rate than revenue. An exception is when a PEO makes a large reinvestment into the company.

A PEO should focus on two growth facets simultaneously: top line and bottom line. A PEO with a singular focus on either will not optimize results. When focused solely on the bottom line, there may be increased profit due to efficiency. When top line is the sole focus, efficiency may suffer, which will impact working capital and could promote loose controls. When focused on both the top line and bottom line simultaneously, the PEO will recognize the drivers to optimize operations and realize superior market penetration. A PEO that masters this dual focus will achieve superior working capital, increased cash flow from operations, and higher EBITDA. Combined, these elements create increased security for the PEO and position the company favorably if it chooses to partner with investors or make acquisitions.

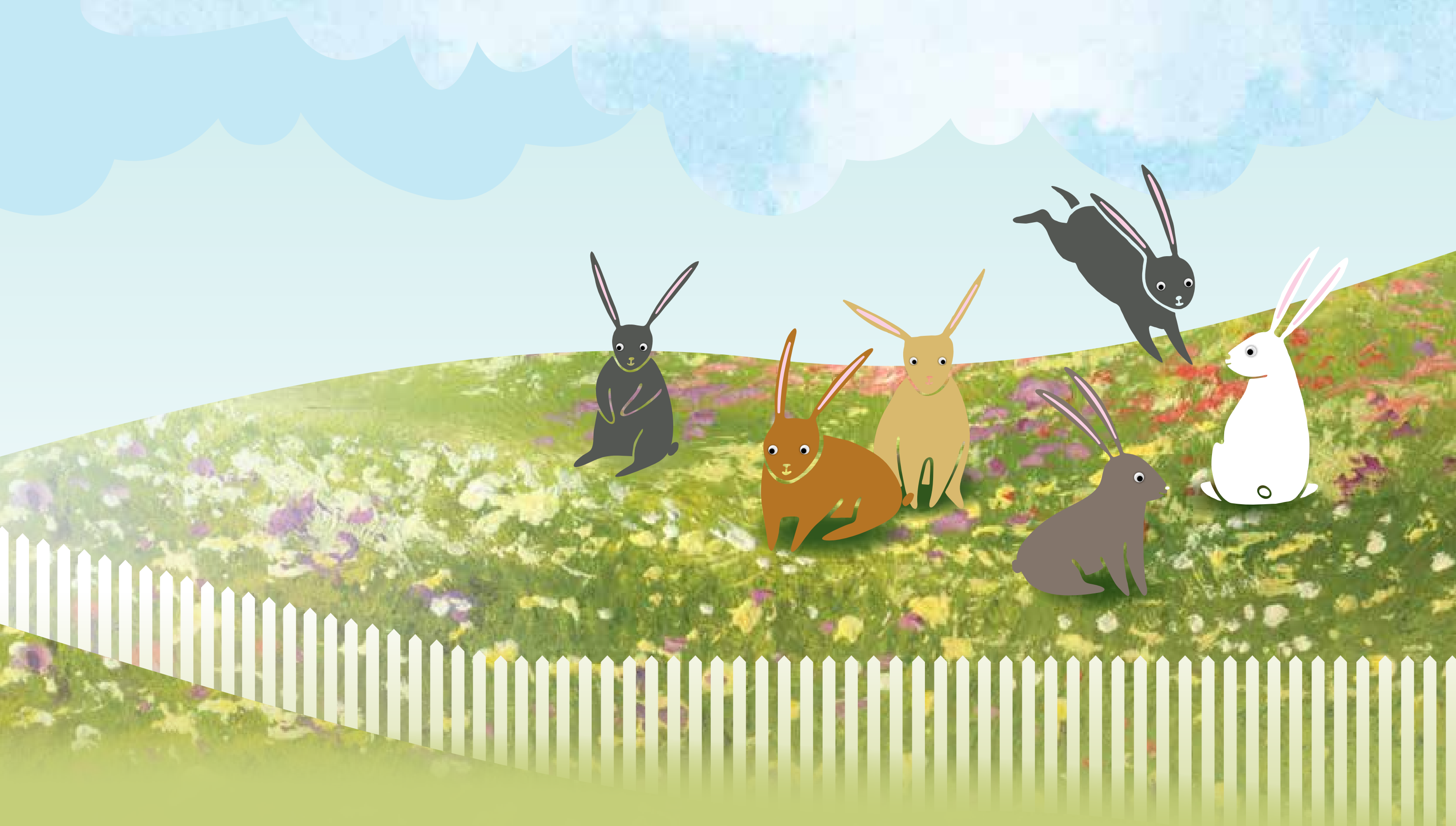
A PEO should be cognizant of its revenue growth rate in relation to industry averages. If the industry's year-over-year growth is 5 percent and a PEO mirrors that growth, it is simply keeping up with industry averages. A lower-than-industry average growth rate is underperformance compared to peers and a loss of market share. A higher-than-industry average growth rate is out-performing competition and capturing increased market share. With larger PEOs, the year-over-year growth percentages will likely decrease over time. This may not be due to slowed growth, but to new client growth being applied to a larger existing client base, which will reduce the year-over-year percentage. A good source for these industry statistics is the NAPEO Financial Ratio & Operating Statistics Survey.[1]

External Drivers

A notable external driver several years ago was the Affordable Care Act (ACA). In 2014, when ACA compliance requirements took effect, the PEO industry grew by 21.25 percent.[2] In the

1 *www.napeo.org/peo-resources/publications-products/online-store/napeo's-financial-ratio-operating-statistics-survey-report*.

2 *IBISWorld Industry Report* 56133, Professional Employer Organizations in the United States.



five years leading up to 2014, the average industry growth rate was 3.50 percent annually. PEOs positioned to capitalize on regulatory changes in 2014 experienced significant year-over-year growth. This included PEOs that designed suitable health benefits platforms, understood regulatory requirements, and possessed technology to track employee eligibility hours. Due to high industry retention rates, many of the clients obtained during that growth spurt remain clients today.

Another macro external driver that influences PEO growth is the economy. During a flourishing economy, there is normally a bullish stock market, low interest rates, and high small business productivity. This means money is making money, companies have access to cheap capital, and clients are growing. All three elements bode well for growth within the PEO sector. During a sluggish economy, interest rates generally increase and the stock market is bearish. This stalls client expansion and may result in worksite employee (WSE) hour reductions or layoffs. New business growth should occur during down economic times, but same store sales (existing client revenue) will likely decrease. The PEO industry experienced this scenario at the start of the great recession—year-over-year industry revenues in 2009 were -3.91 percent.[3] Small businesses look for efficiency during a sluggish economy. This creates an increased demand for PEO services. A PEO that increases its client base during a down economy will help offset same store sales reductions and experience a significant revenue increase once the economy flips.

Internal Drivers

Internal drivers are controllable. They are the elements that allow a PEO to drive revenue and profit forward. This article will separate internal drivers by revenue and profit growth. While there is overlap between the two, separating them will provide greater transparency into areas that can drive progress in each category. This article will also review drivers common to all PEOs and those that are more influential based on client segmentation.

Common Internal Revenue Drivers

Common internal revenue drivers include client referrals, channel partner alignment, associations, compliance, talent, business development, and value proposition. The value proposition is the place to start. A PEO should only sell what it consistently delivers. Not doing so will result in unsatisfied customers, low client retention, poor brand equity, and stifled growth. Once a PEO designs an appropriate value proposition, it should ensure it employs the talent to execute its vision. Optimal growth relies on skilled talent executing an appropriate value proposition. Once the value proposition and talent are in place, a productive go-to-market strategy is required. An often-underused prospect entry point is existing client referrals. An existing client can speak to the value of the PEO better than any sales pitch. Beyond client referrals, a PEO must decide whether it will use a direct, channel, or hybrid sales approach. There are pros and cons to all options. Many PEOs use a hybrid approach of direct and channel. If a channel approach is part of the strategy, a PEO can cast a wider net while maintaining lower selling, general, and administrative expense (SG&A). If the PEO chooses a channel strategy, it should have an employee who is client-facing during the sales process. A PEO must analyze prospective clients and convey the

3 *Ibid.*

expectations of the relationship. Lack of doing so often results in lower client retention and disjointed client implementation.

Common Internal Profit Drivers

Common internal profit drivers include scale, organizational design, risk mitigation, technology, and insurance. As discussed earlier in this article, the aim is for profit increase to outpace revenue increase. When profit growth outpaces revenue growth, it indicates achieving internal efficiency while capturing market share. For optimal results, both revenue and profit growth must coincide. Without revenue growth, the profit yield on efficiency has a limit. In other words, there is only so much water one can wring out of a rag unless more water is added.

A metric common to the PEO industry is the WSE to internal employee ratio. It is used to determine the PEO's scale for profit increase. Common methods to increase this ratio include technology and organizational design.

Technology allows a PEO to scale certain functions within the PEO model such as payroll, HR, and personnel management. Organizational design is another function used to scale. Some PEOs use a branch and regional operating structure. This allows client-facing personnel to remain local to clientele, while consolidating functions like payroll, claims management, and benefits administration in a regional center. The combination of scaled technology and efficient organizational design yields an increased WSE to internal employee ratio and subsequent profit increase.

Insurance and risk mitigation are pivotal factors in profit increase. A good client selection and risk mitigation strategy will often produce favorable insurance results. This combination helps mitigate unnecessary increases in collateral requirements and premium remittance. The result is higher profit due to managed expenses.

Niche Internal Revenue Drivers

Some internal drivers depend on client segmentation. There are micro and macro niche drivers. On a micro level, a PEO may focus on a small number of industry verticals. It specializes in these industries to increase market share. Drivers for a micro niche focus include industry recognition, industry-specific knowledge and talent, association alignment, industry sponsorship, and networking.

On a macro level, PEOs often select a client segmentation to service, i.e. white-, gray-, or blue-collar industries. Based on the selected segmentation, the PEO will likely have an increased focus in certain value proposition mechanics. For example, a white-collar-centric PEO may have an increased focus on technology, human resources, and health benefits, whereas a blue-collar-centric PEO may focus on risk management, human resources, and workers' compensation. This does not suggest that PEOs should not execute upon all aspects of their value propositions. Rather, it illustrates nuances of the model that may be emphasized based on what each macro client segment values. Moreover, a PEO must identify where it should focus to drive optimal profit. A white-collar-centric PEO with poor technology, HR, and benefits may be ignoring what is most important to its customer base. A blue-collar-centric PEO that does not emphasize risk, HR, and claims management may not be aligned with client requirements.

A PEO that stimulates appropriate internal revenue and profit, while remaining prepared to capitalize on external drivers, will be positioned for growth, sustainability, and profit increase. ●

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