THE IMPACT OF CYCLICALITY ON THE PEO MODEL & INDUSTRY

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A common inquiry by investors is the impact of cyclicality on the PEO industry. While every industry is impacted by cyclicality, the PEO industry has historically weathered the shifts better than most. This article will cover the impact of cyclicality on the PEO industry and outline some strategic moves PEOs can make to capitalize on opportunities and mitigate risk.

The PEO industry faces various types of cyclicality. The first is economic cyclicality—the shifting tides between a bull and bear market. The second is insurance cyclicality. This includes medical inflation and the changes between a hard and soft workers' compensation market. The third is regulatory cyclicality. This includes major regulatory changes that impact how business is conducted. Please note that these three types of cyclicality can occur on their own or concurrently.

ECONOMIC CYCLICALITY

If you have been in the PEO industry long enough, you have experienced economic cyclicality. Outside of the pandemic, the Great Recession from 2007 to 2009 was the most recent example of a downward trend. The recession was followed by a prolonged bull market until the pandemic. While the pandemic caused a temporary halt to the bull market, it has since rebounded. Meaning, we have yet to experience a full bear market since the Great Recession.

Statistically, the PEO industry performed well following the Great Recession. As noted in Figure 1, the PEO industry posted an 8.28 percent compound annual growth rate (CAGR) from 2009 until 2020.[1] This growth cycle was accentuated in 2014 when the PEO industry grew by an impressive 21.05 percent year-over-year (Affordable Care Act (ACA) compliance for small and mid-size businesses (SMBs) started in 2014). As noted, the only negative year-over-year growth (prior to the 2020 pandemic) was in 2009 at negative 2.19 percent. In 2021, industry revenues are projected to rebound over 2020 numbers, thus holding the year-over-year revenue decline in 2020 to just one year, just like in 2009. This illustrates that the PEO industry historically has rebounded quickly during down economic shifts.

TYPICAL SHIFTS DURING ECONOMIC CYCLICALITY

There are many factors that play into economic cyclicality. Stock market performance, unemployment rates, interest rates (i.e., the cost of capital), and inflation to name a few. These factors influence economic shifts.

During a robust economy, the stock market typically posts favorable returns, unemployment is low, and inflation is limited. Interest rates may vary,

FIGURE 1. THE PEO INDUSTRY'S PERFORMANCE BEFORE, DURING, AND AFTER THE GREAT RECESSION.

YEAR	INDUSTRY REVENUE*	ANNUAL CHANGE	GROWTH %	
2005	88,572.1	N/A	N/A	
2006	95,983.3	7,411.2	8.37%	
2007	99,464.8	3,481.5	3.63%	
2008	99,715.8	251.0	0.25%	
2009	97536.3	(2,179.5)	-2.19%	
2010	105,838.2	8,301.9	8.51%	
2011	107,426.7	1,588.5	1.50%	
2012	118,597.0	11,170.3	10.40%	
2013	125,210.0	6,613.0	5.58%	
2014	151,569.0	26,359.0	21.05%	
2015	161,841.0	10,272.0	6.78%	8.28% CAGR
2016	179,583.0	17,742.0	10.96%	
2017	203,152.0	23,569.0	13.12%	
2018	213,442.0	10,290.0	5.07%	
2019	216,084.0	2,642.0	1.24%	
2020	197,509.0	(18,575.0)	-8.60%	
2021	*201,945.0*	*4,436.0*	*2.25%*	

* Numbers in the millions.

depending on inflation and supply and demand for capital. If revenue is strong and capital is cheap, SMBs may be growing and reinvesting in their businesses. The war for talent may be competitive due to low unemployment rates. SUTA rates may decline from lower unemployment claims.

During a declining economy, the stock market generally underperforms, unemployment increases, and SUTA rates increase due to higher unemployment. Interest rates may vary, depending on policy, inflation, and supply and demand for capital. Talent is more readily available due to higher unemployment.

There are two additional items to consider. The United States has not seen double-digit annual inflation since Jimmy Carter was president. However, with the recent rising costs of housing, automobiles, travel, etc., inflation could play a material role in the economy in years to come. Additionally, stimulus packages to boost the economy seem to have mixed results thus far. Consumer spending was up earlier this year as was price inflation. Many SMBs are struggling to find entry-level talent, which can negatively impact them. Time will tell if the inflation we are beginning to see is temporary or a sign of inflation to come.

The PEO industry faces various types of cyclicality: economic, insurance, & regulatory.

PEO PERFORMANCE DURING SHIFTING ECONOMIES

The demand for various services within the PEO model may shift during economic cycles. If a PEO is cognizant of these shifts, it can capitalize on opportunities and work to mitigate threats. During a robust economy, SMB revenues are typically up, while unemployment is typically down. SMBs need to focus on their businesses for continued growth and must position themselves appropriately in the war for talent. PEOs that help SMBs focus on their core competencies through administrative support and in the war for talent through technology, HR support, and superior benefits will help their clients operate more favorably in this economic scenario.

Conversely, during a down economy, the market performs less favorably, SMB revenues may be flat or declining, and unemployment and SUTA rates increase. In extreme cases, such as the Great Recession, SMBs may reduce hours, wages, and/or headcounts. PEOs that help clients via HR and workforce management, SUTA mitigation, scaled procurement, vendor consolidation, and administrative support will allow them to focus on their businesses while mitigating potential risks.

INSURANCE CYCLICALITY

While health benefits premiums appear to be on an upward trend, workers' compensation operates in a more traditional cyclical manner. Many are familiar with the terminology of a hard or soft market in workers' compensation—workers' comp rates are higher in a hard market, whereas rates are lower in a soft market. Market changes are on a state-by-state basis.

During a soft market, PEOs may receive pricing pressure from alternative competition, which can cause margin erosion and/or client attrition. A very soft market can also be a hindrance to new client adds. If a PEO does not manage its claims appropriately, a soft market can be problematic, as there is less premium to offset losses. A hard market can present opportunity for the PEO to expand margins, offset administrative fees, and increase new client adds.

While the market may ebb and flow, the key to PEOs mitigating risk and protecting profit during each market is to maintain favorable loss ratios through client selection, client evaluation, risk mitigation strategy, and claims management.

Medical premium inflation has looked more like an incline in recent years rather than a cyclical model. However, PEOs can experience cyclicality in their master policy premiums based on medical loss ratios (MLRs). PEOs can make moves to lessen medical inflation costs and help reduce spikes in renewals. These moves may include a strong evaluation program, wellness initiatives, innovation in product design, risk mitigation strategies, and appropriate premium levels. How PEOs manage their MLR will help determine the volatility of cycles in their plans' healthcare premiums.

REGULATORY CYCLICALITY

Regulatory cyclicality can be more difficult to predict, although there are tailwinds that give us insight into potential disruption and opportunity. For example, the ACA created a phenomenal opportunity for the PEO industry. PEOs were positioned to offer SMBs affordable benefits while simultaneously guiding them through a changing regulatory and compliance environment and

providing support via payroll and reporting to satisfy regulatory requirements. When the ACA compliance initiative finally hit the SMB market, the PEO industry grew by more than 20 percent year over year (see Figure 1).

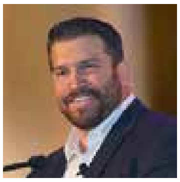
Some regulatory cyclicality is less predictable, as was the case in the recent COVID pandemic. In this scenario, regulatory shifts came in response to an unforeseen global pandemic. The shifts included stay-at-home orders, Payroll Protection Program (PPP) funding, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, loan forgiveness, and SMB shutdowns. These regulatory shifts impacted the way business was conducted. Moreover, the pandemic created a microcosm of a temporary bear market in early 2020. PEOs that pivoted quickly in response to the pandemic and regulatory orders experienced favorable client retention and a renewed SMB appreciation for the PEO model.

SCENARIO PLANNING

Cyclicality can come in various forms. It can be an isolated cycle or a combination of cycles simultaneously. Prepared PEOs can pivot quickly to address the needs of their internal stakeholders, SMBs, and worksite employees.

Preparing for various cycles and scenarios will help position PEOs to shift more quickly. Understanding trends allows PEOs to capitalize on opportunities and mitigate potential threats. Scenario and strategy planning help keep PEOs prepared for expected and unforeseen cyclical shifts. ■

1 IBISWorld Report 56133, "Professional Employer Organizations in the US."



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