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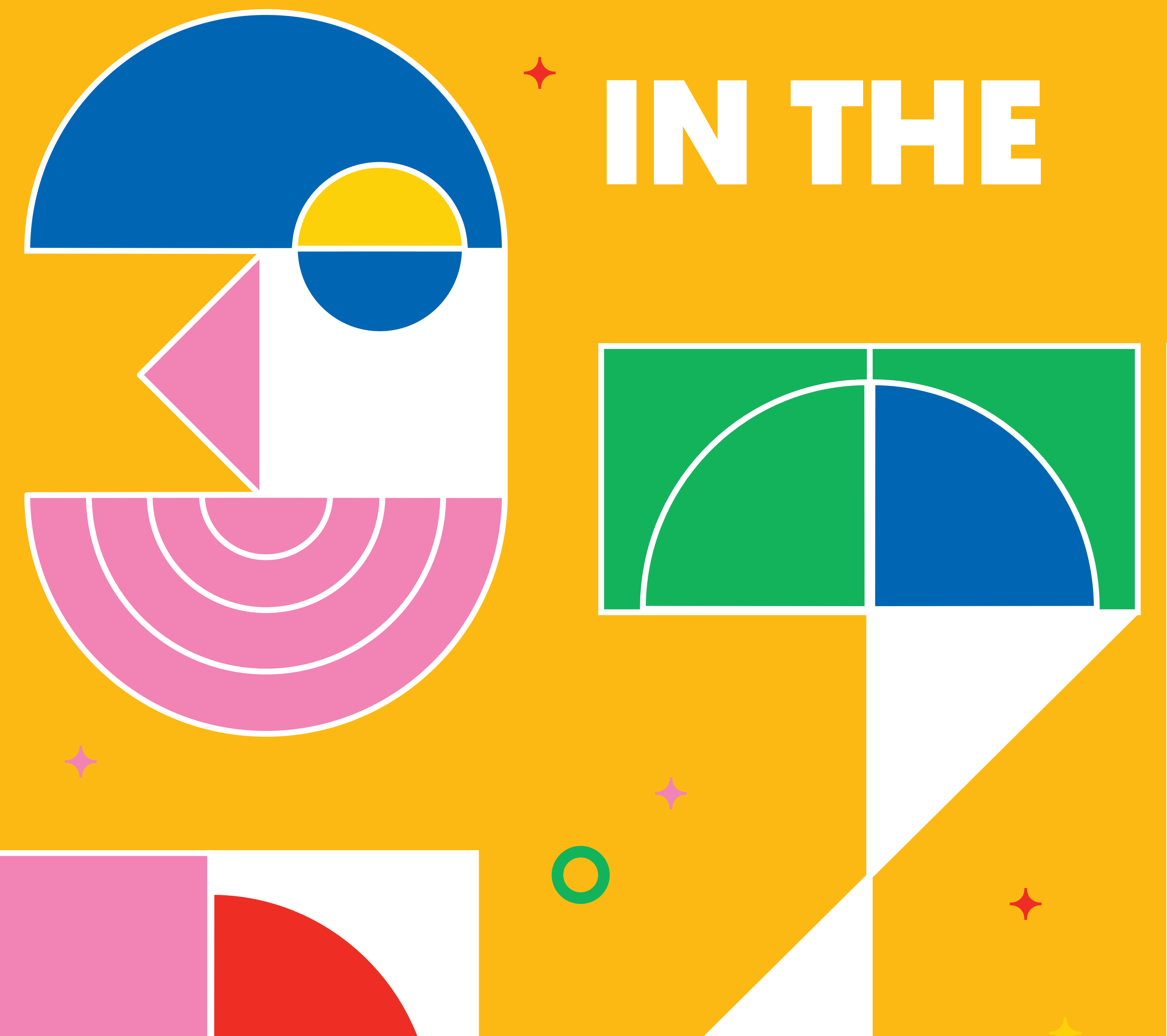

PEO SPACE

MARKET OVERVIEW & BUYER PROFILES

BY ROB COMEAU

The M&A landscape in the PEO industry has been in a state of consolidation for more than 10 years. The COVID pandemic put a temporary halt on many transactions in early- to mid-2020. In Q3 of 2020, deal flow began to rebound, and as of 2021, many deal multiples appear to be at or above pre-2020 levels. The market is very active with a combination of industry veterans and new entrants.

Buyers include public and private PEOs, private equity firms, and family offices (a family office is a privately held company that manages investments and wealth for a wealthy family, with the goal of growing and transferring wealth across generations). As multiples have risen to pre-COVID levels and sometimes beyond, there are a number of variables to look to as drivers behind this recent surge.

Some of these variables include supply and demand issues, increased competition, necessity for capital deployment, increased awareness of the PEO space, industry whitespace (low penetration rate), access to cheap capital, need for scale, and predictable value creation strategies with low revenue volatility for investors.

This article will offer an overview of the common buyers we see within our industry and provide insight into their buying drivers. As we comb through the various buyers, please note one common theme: A buyer is trying to maximize the return on investment post-acquisition. This aim influences deal mechanics (i.e., earn-out provisions, equity rolls, employment contracts, and non-competes), growth initiatives, investment timing, pricing, and post-acquisition strategy.

BUYER PROFILES

The buyer profiles identified at the beginning of this article were public and private PEOs, private equity firms, and family offices. Buyer types have commonalities and differences in their

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approaches. I'll review these potential buyers to gain a clearer insight into drivers and initiatives.

PEO Buyers: Private & Public

PEO buyers may come in the form of private, public, or investor-backed PEOs. I'll review investor-backed PEOs later in this article. For this section, I will focus on private and publicly traded PEO buyers. Often, private non-investor-backed PEO buyers are smaller than publicly traded PEO buyers. Due to the size differential and potential capital restraints, privately held PEO buyers often look for strategic regional acquisitions. Geography often plays a factor in a privately held PEO's acquisition strategy. Neighboring states to the acquirer's headquarters and/or desired emerging markets may, to an extent, dictate the private PEO's search parameters. Once a geography has been identified, the private PEO typically looks for commonality with its acquisitions. Commonality may include client segmentation, insurance platforms, similarity of offering, and technology.

If a privately held PEO identifies a potential target, it often reviews the impact of the acquisition in nearer-term focus, meaning will making the acquisition improve profits, service offering, geographic expansion, sales, or third-party options? If the acquisition will not yield results in the near term, the acquisition may not be consummated. Privately held PEOs may not have the same access to capital as investors and therefore need to ensure that the acquisition will yield a suitable return in an acceptable time frame. Privately held PEO buyers also may be more opportunistic than investors, which means they will only move on potential acquisitions at a time when the deal makes sense. This is in lieu of having acquisition strategies within a specified time frame like the investment horizon of an investment-backed PEO.

Publicly traded PEOs typically have more access to capital than their private counterparts. However, publicly traded PEOs are graded by investors quarterly. Therefore, the publicly traded PEO must balance the long-term strategic advantages of an acquisition with the quarterly impacts the acquisition will have on organizational profitability and shareholder returns. Publicly traded PEOs may choose to make acquisitions for several reasons. Some of these drivers are innovation, geography, scale, higher profit, and synergies. Smaller acquisitions made by publicly traded PEOs often are sought out for innovation or possibly geography, whereas larger acquisitions are typically done for scale, profit, and geographic expansion.

Investors: Private Equity & Family Office

PEO investors typically fall into two categories: private equity and family office. As with any investment opportunity, the acquirers are seeking a suitable return on the capital they deploy. A distinct difference between private equity and family office is the investment horizon. A private equity firm often has a three- to seven-year investment horizon (although we've seen shorter and longer). A family office may have a longer investment horizon.

The difference in timing can be linked to the number of investors within each model. A private equity has many investors within each fund, whereas a family office may have only one or in the case of a multi-family office, several. However, the number of investors at a family office is much smaller than a private equity. Therefore, a family office, assuming the investor(s) agree on an investment horizon, may hold an investment for longer than the private equity. Typically, this means that a private equity investor may be more active with acquisitions in a short amount of time than a family office.

Ultimately, the driver behind activity in the market is led by the return multiple an investor seeks coupled with the performance of the assets under its control. If an investor seeks a four-times return on capital deployed, it can do so through organic growth of its current assets coupled with acquisition growth of new assets. If the asset under control has anemic growth, the investor is forced to grow through acquisition. If the asset under control has strong organic growth, the investor can be more selective with its acquisition strategy. Investment firms answer to their investors. If a private equity wants to raise additional funds, its needs to show a track-record of favorable returns. If a family office wants to satisfy its investor(s), it too needs to show favorable returns.

FINAL THOUGHTS

I hope this article illustrated some of the common drivers behind the different types of investors within our industry. As you will note, while every acquirer desires a positive return post-acquisition, the emphasis on the timing of the return differs based on the investor. A privately held PEO is opportunistic in identifying an acquisition that will improve the acquirer's PEO. A publicly traded PEO buys for various reasons but must be cognizant of the profit timing to satisfy earnings per share (EPS) on a quarterly basis. A private equity buyer answers to a host of investors and needs to illustrate a favorable return in line with forecasted investment horizon parameters. A family office needs to show a favorable return based on its investor's expectations and timing. Understanding the timing of acquirers helps potential sellers understand the potential roadmap for their PEO post-acquisition. ■

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