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The State of the PEO Industry 2016: Markets, Value, and Trends

By Laurie Bassi and Dan McMurrer
McBassi & Company

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The State of the PEO Industry 2016: Markets, Value, and Trends

This report on the state of the PEO industry in 2016 is the fourth in NAEPO's series of white papers designed to help the general public and small business owners better understand the economic impact and value of the PEO industry. It explores three main topics: the market for PEO services, the value that PEOs create for their clients, and trends currently shaping the PEO industry. It uses a variety of sources, including external data (from governmental and non-governmental sources), econometric analysis, and interviews with industry experts by the authors. It also draws on key articles, laws/regulations, surveys, and reports.

Quick Summary

The Market for PEO Services

- There are 1.1 million businesses in the United States that have between 10 and 99 employees, which represents the target market for most PEOs (the average PEO client has 22.5 employees).
- As of 2013 (the most recent year for which data are available), the number of small businesses in the U.S. was still 7 percent below its pre-recession peak.
- Small business optimism has recovered significantly since the recession, but is still approximately 4 percent below its 42-year average, according to the National Federation of Independent Business (NFIB).
- Healthcare, taxes, and regulation—exactly the issues that PEOs help clients address—are consistently reported as the top concerns of small businesses.
- In 2015, up to 14 to 16 percent of small businesses (with 10 to 99 employees) were PEO clients.

The Value PEOs Create for Their Clients

- PEO clients grow faster, have lower rates of employee turnover, and have higher rates of business survival than other comparable small businesses.
- PEOs provide access to a broader array of HR services than small businesses have, but at a lower administrative cost per client.
- PEO clients are more likely to provide employer-sponsored retirement plans and other employee benefits, which helps them attract and retain their employees.

Trends Shaping the PEO Industry

- Factors currently fueling the growth of the PEO industry include the growing complexity of state-level HR mandates, the Affordable Care Act (ACA), and the Small Business Efficiency Act (SBEA).
- The HR environment is becoming increasingly complex in many states, with more changes likely on the horizon.
- Technology-heavy HR Software-as-a-Service (SaaS) companies represent a potential disruption to the PEO industry.
- Recent valuations in the PEO marketplace now slightly exceed their pre-recession peak, although the premium in valuation that publicly traded PEOs commanded 20 years ago has (or soon will have) disappeared.
- The PEO industry may be entering a new, more mature phase from an investment perspective, reflecting a more conservative approach among institutional investors.

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Section 1. The Market for PEO Services

The vast majority of PEO clients are small businesses: in 2015, the average number of worksite employees per client was 22.5.¹ This varied by PEO size: the largest PEOs reported an average of 25.3 worksite employees per client, while the smallest firms reported 12.7.

The state of the PEO industry is thus closely linked to the state of small business within the United States. This section explores the small business sector in detail, focusing on a variety of elements of particular relevance to the PEO industry:

- The size of the small business sector
- Growth rate of the small business sector
- Geographic and industry composition distribution of small businesses
- Distribution of small businesses in comparison to PEO concentration
- Small business owners' views and outlook
- Primary pain points that small business owners experience in growing their businesses

The Size of the Small Business Sector

The Small Business Administration (SBA) applies two primary standards to define a small business: for most manufacturing and mining industries, firms with 500 employees or fewer are considered small businesses, and in many non-manufacturing industries, small businesses are those with less than \$7.5 million in average annual receipts.² By this broad definition, the vast majority of the 5.8 million businesses in the United States (approximately 99.7 percent) qualify as small businesses.³ Almost 90 percent of those have fewer than 20 employees.

Table 1. Measures of Small Businesses (10 to 99 employees) as a Percentage of the Economy, 1998 to 2013

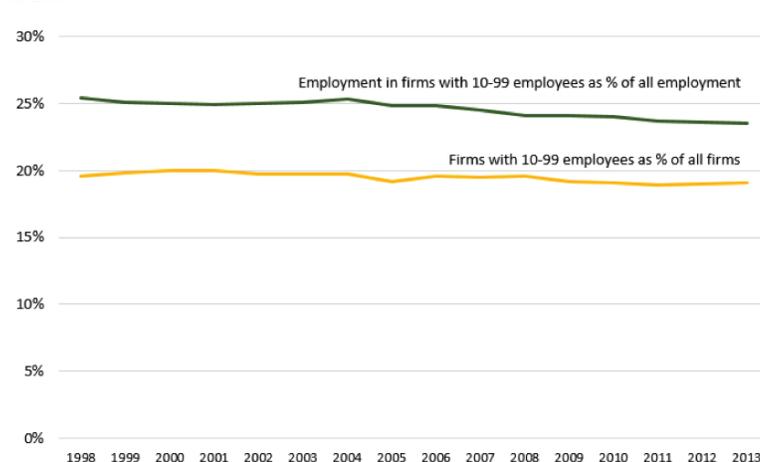
	% of firms with 10-99 employees	% of employment in firms with 10-99 employees	# of firms with 10-99 employees
1998	19.6%	25.4%	1,094,524
1999	19.8%	25.1%	1,107,541
2000	20.0%	25.0%	1,133,064
2001	20.0%	24.9%	1,134,322
2002	19.7%	25.0%	1,122,129
2003	19.7%	25.1%	1,135,443
2004	19.7%	25.3%	1,159,037
2005	19.2%	24.8%	1,150,843
2006	19.6%	24.8%	1,182,681
2007	19.5%	24.5%	1,177,233
2008	19.6%	24.1%	1,159,448
2009	19.2%	24.1%	1,106,450
2010	19.1%	24.0%	1,092,214
2011	18.9%	23.7%	1,074,459
2012	19.0%	23.6%	1,087,811
2013	19.1%	23.5%	1,103,584

To maximize relevance for the PEO industry, we focus the remainder of the discussion in this section on a smaller slice of small businesses: **those with between 10 and 99 employees, which we define for purposes of this report as the primary target client market for most PEOs.** While some PEOs certainly target smaller or larger firms as well, companies with 10 to 99 employees represent the “sweet spot” for most PEOs, based on the 2015 NAPEO Financial Ratio & Operating Statistics (FROS) survey data on average client size. A 2016 report by PrismHR, a service provider to the PEO industry, found that, among those PEOs and ASOs that have a specific target company size, more than 85 percent report targeting potential clients with between 16 and 100 worksite employees.⁴

Growth Rate of the Small Business Sector

As a percentage of the overall economy, the small business sector has remained fairly steady over time (see Figure 1, with detailed numbers included in Table 1). From 1998 to 2013 (the most recent year for which data are available), firms with 10 to 99 employees have declined slightly as a percentage of all firms (19.6 percent in 1998; 19.1 percent in 2013). Viewed from the perspective of employment, there has been a more notable, but still modest, decline in the percentage of all employed individuals who work in firms with 10 to 99 employees (25.4 percent in 1998; 23.5 percent in 2013).

Figure 1. Small Businesses (10 to 99 employees) as a Percentage of the Economy, 1998 to 2013



Because the economy has been growing, the absolute number of firms with 10 to 99 employees has remained almost constant, despite its slight decrease as a percentage of all firms and employment. In 1998, there were 1.1 million businesses with 10 to 99 employees, and in 2013, there were again 1.1 million such businesses.

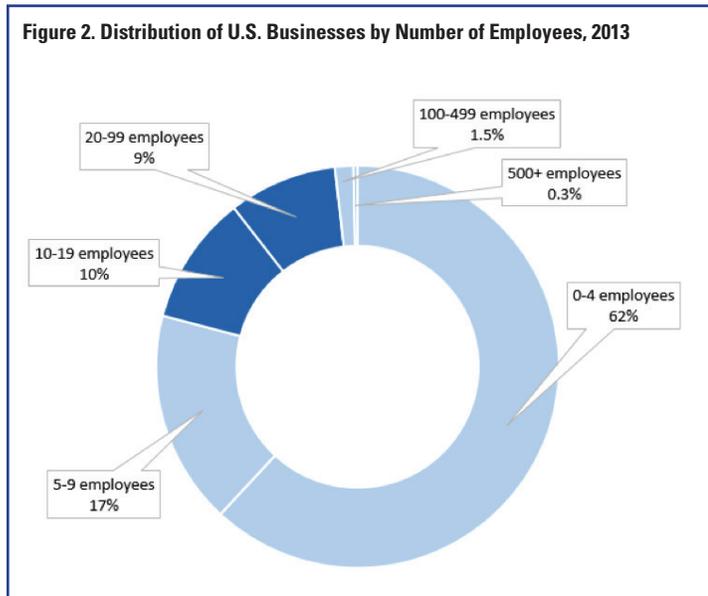
- 1 See NAPEO 2015 Financial Ratio & Operating Statistics Survey (FROS), page 31.
- 2 <https://www.sba.gov/contracting/getting-started-contractor/make-sure-you-meet-sba-size-standards/summary-size-standards-industry-sector>.
- 3 https://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf.
- 4 PrismHR, “2016 Human Resource Outsourcing (HRO) Trends Report,” <http://www.prismhr.com/blog/2016-human-resource-outsourcing-hro-trends-report/>. Consistent with this finding, a 2015 survey of PEOs by Brown Gibbons Lang (“Business Services Insider: Spotlight: The Breakout of the PEO Industry”) found that the two client size groups cited as the best fit within the PEO model were those with 25 to 50 and 50 to 100 employees (those with 25 or fewer were also cited by most respondents as a strong fit for PEOs).

There are three notable implications of these statistics for PEOs, which are:

1. The PEO “sweet spot” contains a large number of businesses: 1.1 million, or more than 20,000 such businesses per state, on average.
2. That number is not growing; it’s remaining remarkably constant (or declining very slightly) over time based on any one of a variety of different measures.⁵
3. As seen in Figure 2, there are almost as many businesses with five to nine employees as there are businesses with 10 to 99. That suggests that any PEOs seeking new markets might do well to consider looking to smaller firms (if they are not already doing so), if they can adjust their product offerings to be cost-competitive at that size.

Geographic Distribution of Small Businesses (10 to 99 Employees)

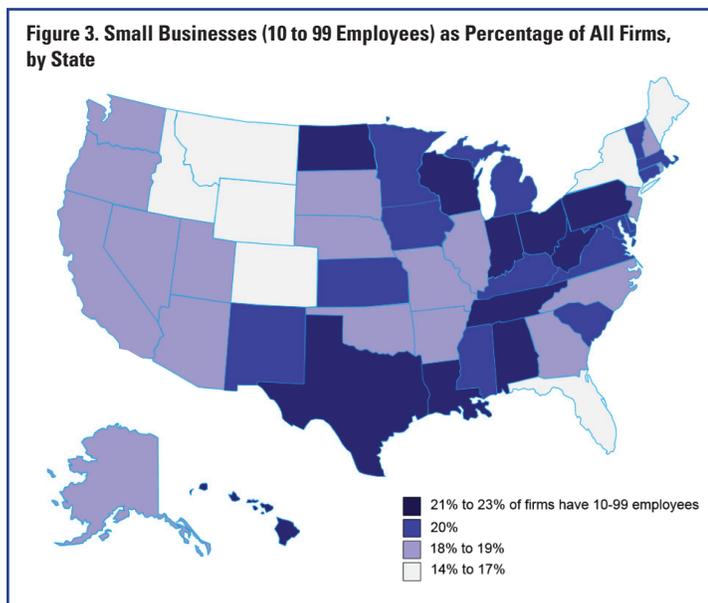
Another factor for PEOs to consider is the geographic distribution of potential clients. Small businesses, not surprisingly, are most heavily concentrated in the most populous states. California, Texas, New York, Florida, and Pennsylvania comprise the five states with the largest number of small businesses, with more than 400,000 businesses with 10 to 99 employees among them.



But when firms with 10 to 99 employees are viewed as a percentage of all firms in a state, a somewhat different picture emerges (see Figure 3). It is still the case that percentages across states are fairly comparable, with 46 of the 50 states having a percentage between 17 percent and 22 percent, but there are some variations. The largest percentage is in Ohio (23 percent), and the lowest in Florida (14 percent). Many of the highest percentages can be found in the Midwest and South, while lower percentages are found in many of the western states. It is notable that some of the largest states have high percentages of firms in the PEO target range (Texas, Pennsylvania, Ohio), while others have among the smaller percentages (New York, Florida).

Small Businesses (10 to 99 Employees) by Industry

There is also wide geographic variation in the industry composition of small businesses. Table 2 summarizes which states have the highest concentration of small businesses (10 to 99 employees), broken down by industry.⁶ Wisconsin and Michigan have the highest concentrations of their small firms in manufacturing; Virginia and Maryland have the highest concentrations of small business in professional, scientific, and technical services. Many smaller states (such as Vermont, Maine, and South Dakota) have a disproportionately high percentage of their small firms in retail trade.



In almost all states, the highest percentages of businesses with 10 to 99 employees are in accommodation and food services. These firms include restaurants, hotels, motels, and inns. The second-highest percentage in many states is healthcare and social assistance, an industry that includes hospitals, nursing homes, residential care facilities, offices of health practitioners, rehabilitation service providers, and daycare centers.

For most states, more than half of all firms in the 10 to 99 employee “sweet spot” for PEOs do business in one of the six industries listed in Table 2, on page 5. While the pattern varies somewhat across different states, these industries would thus be expected to represent the key target industries for most PEOs seeking new clients.

PEOs are more heavily penetrated into certain industries, with a 2015 Brown Gibbons Lang (BGL) report⁸ indicating the three industries that make up the bulk of PEO clients are computer and IT, finance, and management/administration/consulting.⁹ (Many PEOs, of course, service a combination of industries, including white-, gray-, and blue-collar.) Although that report

5 Of course, this absolute number is a net amount; it does not reflect the dynamics of firms that come into being, grow into a new size category, or go out of business in any given year. It does indicate that the net effect of such changes is close to zero.

6 The table shading indicates the top three industries, by percentage of small businesses, in each state, with the darkest blue shading indicating the highest industry, second-darkest blue the second-highest, etc.

7 The top three industries by state are shaded in blue, in descending order from dark shading to lighter shading.

8 Brown Gibbons Lang, “Business Services Insider: Spotlight: The Breakout of the PEO Industry,” July 2015, p. 2.

9 The report lists the PEO client industry segmentation percentages as follows: computer/IT: 22 percent; finance/insurance/real estate: 19 percent; management/administration/consulting services: 15 percent; retail/wholesale trade: 13 percent; professional services: 8 percent; manufacturing: 7 percent; construction/engineering: 6 percent; other: 10 percent.

uses a somewhat different industry classification structure than the data in Table 2, it is clear that the overall distribution of PEO clients does not mirror the general distribution of small firms in the U.S. This indicates a higher-than-average PEO penetration rate in those industries (relatively small in number) that are highly represented among PEO clients.

While this could suggest potentially lower opportunity levels in more highly penetrated industries, overall penetration rates are still relatively low and suggest good opportunity for PEOs to continue penetrating the small business market. It is likely that larger-than-average opportunities exist in those industries listed in Table 2 for those PEOs that can be creative and agile in seeking clients in less-commonly targeted industries.

Small Business Owners' Views and Outlook

There are multiple measures of small business owners' sentiment. The Wells Fargo/Gallup Small Business Index is a measure of small business owners' ratings of the current situation of their businesses and expectations for the next 12 months. It has varied significantly since its inception in 2003 (see Figure 4). Wells Fargo and Gallup interpret the current score of +64 as follows: "After steadily improving from the lows found during and after the 'Great Recession' of 2008-2009, small business owners' optimism has leveled off over the last year and a half. The current index reading of +64 is more than 90 points higher than at points in 2010, but still well below readings for the years prior to 2008. The question remains as to whether small business owners' optimism will eventually return to the more positive levels seen before the recession or whether that trauma ushered in a new normal of sorts, such that owners' optimism may never fully recover."¹⁰

Meanwhile, an alternative measure, the NFIB Small Business Optimism Index (see Figure 5 on page 6), also suggests that small business owners' optimism (currently 93.6) still has not returned to its pre-recession levels. Nevertheless, it stands only modestly below its 42-year historic average of 98.¹¹

Taken together, these two major small business indices reflect a slow but steady increase in optimism since the last recession in 2008-2009. While they have both been higher in the earlier part of the 2000s, they are indicative of a cautious sort of optimism, especially in light of the fact that 2016 is an election year. Recent research suggests that this likely explains some of the current "below average" level of optimism among small business owners. Elections create uncertainty, and uncertainty creates economic turbulence.¹² Further, analysis by Bank of America Merrill Lynch Global Research finds that the turbulence caused by election years is particularly pronounced in years in which the incumbent president is not seeking re-election, as is the case in 2016.¹³ Almost half of all

Table 2. Percentage of Small Businesses (10 to 99 Employees) in Various Major Industries, by State⁷

State	Accommodation and Food Services	Construction	Health Care and Social Assistance	Manufacturing	Professional, Scientific, and Technical Services	Retail Trade
Alabama	14%	10%	14%	8%	8%	13%
Alaska	17%	10%	16%	3%	8%	13%
Arizona	18%	11%	14%	6%	9%	9%
Arkansas	18%	9%	13%	7%	6%	13%
California	17%	9%	12%	9%	10%	9%
Colorado	19%	10%	12%	6%	10%	10%
Connecticut	17%	7%	14%	10%	8%	10%
Delaware	16%	10%	16%	4%	10%	10%
Florida	17%	10%	14%	5%	10%	10%
Georgia	18%	8%	14%	6%	9%	9%
Hawaii	21%	11%	9%	4%	8%	10%
Idaho	17%	11%	15%	7%	7%	13%
Illinois	16%	7%	13%	9%	9%	9%
Indiana	16%	9%	11%	11%	7%	11%
Iowa	18%	9%	12%	8%	7%	14%
Kansas	15%	9%	13%	7%	7%	12%
Kentucky	17%	9%	14%	7%	7%	13%
Louisiana	16%	9%	14%	5%	8%	12%
Maine	19%	8%	13%	8%	7%	17%
Maryland	15%	12%	13%	4%	12%	9%
Massachusetts	18%	7%	12%	8%	10%	10%
Michigan	17%	6%	14%	12%	8%	11%
Minnesota	16%	7%	12%	9%	8%	12%
Mississippi	17%	8%	14%	7%	6%	15%
Missouri	17%	9%	13%	8%	7%	12%
Montana	24%	8%	11%	5%	6%	14%
Nebraska	16%	10%	14%	6%	7%	13%
Nevada	17%	11%	13%	5%	9%	10%
New Hampshire	19%	8%	11%	9%	9%	13%
New Jersey	14%	7%	15%	7%	10%	9%
New Mexico	18%	11%	14%	5%	8%	11%
New York	17%	8%	12%	6%	9%	10%
North Carolina	18%	10%	15%	8%	8%	10%
North Dakota	17%	11%	10%	5%	6%	15%
Ohio	16%	8%	14%	11%	8%	9%
Oklahoma	15%	10%	14%	7%	7%	12%
Oregon	20%	8%	12%	8%	8%	11%
Pennsylvania	15%	8%	14%	9%	9%	11%
Rhode Island	21%	7%	13%	11%	8%	9%
South Carolina	20%	10%	13%	7%	7%	11%
South Dakota	19%	9%	11%	7%	6%	16%
Tennessee	17%	9%	13%	8%	7%	11%
Texas	16%	9%	14%	7%	9%	9%
Utah	15%	11%	12%	9%	9%	12%
Vermont	19%	8%	13%	8%	7%	18%
Virginia	16%	10%	13%	4%	13%	10%
Washington	18%	10%	13%	7%	9%	11%
West Virginia	16%	9%	16%	6%	7%	14%
Wisconsin	18%	7%	12%	12%	7%	12%
Wyoming	19%	12%	12%	4%	7%	13%

Figure 4. Wells Fargo/Gallup Small Business Index, 2003 Q2 to 2016 Q2



Source: Wells Fargo/Gallup Small Business Index, <https://wellsfargoworks.com/File/Index/J6WCK2WHn0yd-wrTX8btvA>.

10 <http://www.gallup.com/poll/191417/small-business-owners-optimism-levels-off.aspx>.

11 <http://www.nfib.com/surveys/small-business-economic-trends/>.

12 Canes-Wrone, Brandice, and Jee-Kwang Park. "Elections, Uncertainty, and Irreversible Investment." *British Journal of Political Science* 44, no. 1 (2014): 83-106.

13 <http://www.nytimes.com/2016/05/17/business/dealbook/election-years-are-steeped-in-markets-least-favorite-thing-uncertainty.html>.

employers with 20 to 99 employees reported that the upcoming U.S. presidential election is affecting their decisions about whether to increase wages and whether to add staff.¹⁴

This suggests that small business owners will need guidance to help address the uncertainties that accompany election years. PEOs are in position to help in this area. For example, by helping their clients seamlessly comply with changing regulations and taxes, PEOs can provide much-needed peace of mind and stability in a period of above-average economic uncertainty.

Primary Pain Points in Growing Small Businesses

A variety of recent surveys of small and mid-sized businesses provide current data on the primary challenges that those businesses face.¹⁵ While the rankings vary somewhat from one survey to the next, the main takeaways across the surveys are quite consistent. At the top of many of these lists are concerns about healthcare, regulations/taxes, and being able to hire the right people. Other factors frequently cited include growing the size of the business, the state of the economy, and the effectiveness of government leaders. Table 3 summarizes many of the top concerns of small business owners that emerged in seven recent surveys.

These findings suggest that the issues of primary concern for most small business owners are the types of issues that PEOs can help solve. By focusing communications on their ability to facilitate new hires, handle healthcare administration, and cope with the complications of new regulations and taxes, PEOs can help small business owners understand that their services are targeted at their primary pain points. Further, by addressing some of those major concerns, PEOs leave small business owners more time to spend on other key concerns that they are best-equipped to tackle, like growing their businesses.

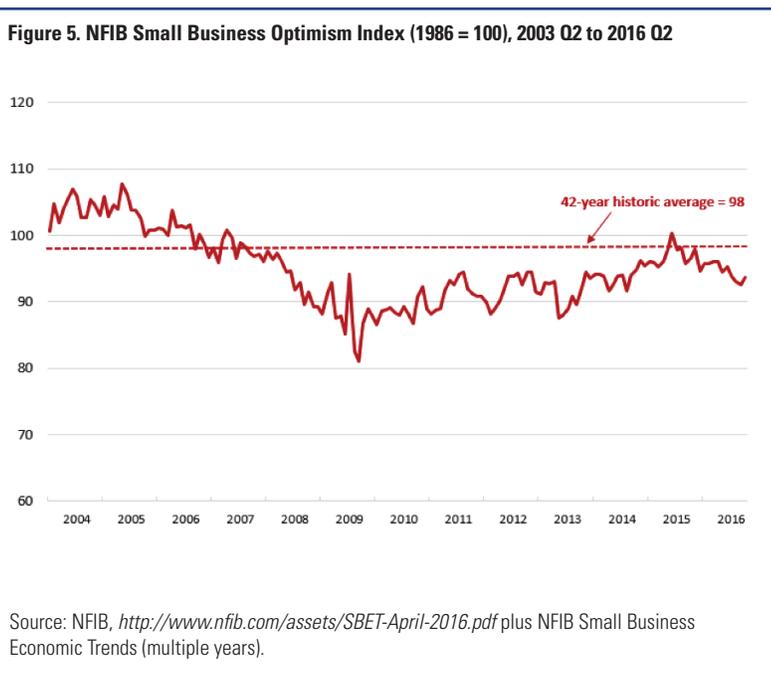


Table 3. Small Business Owners' Top Concerns, Based on Various Surveys

Survey	Hiring New Employees	Healthcare	Taxes/Regulation	Attracting New Clients	Economy/Stock Market
Bank of America ¹⁶		X			X
American Express ¹⁷	X				
NFIB ¹⁸		X	X		X
Wells Fargo/Gallup ¹⁹			X	X	X
Dealstruck ²⁰		X	X		
Forbes ²¹		X	X		
Waspbarcode ²²	X	X			

14 48 percent of all employers said it was affecting their decisions about increasing wages, and 42 percent about adding staff. Paychex, "Paychex Small Business Snapshot: The Election's Impact on Hiring and Wage Decisions," July 21, 2016. <http://media.paychex.com/paychex-small-business-snapshot-elections-impact-hiring-wage-decisions/>.

15 We focused on surveys that were conducted in late 2015 or early 2016.

16 <http://newsroom.bankofamerica.com/press-kit/bank-america-small-business-owner-report>.

17 <https://www.americanexpress.com/us/small-business/openforum/articles/what-matters-most-to-small-business-owners-new-survey-reveals-top-concerns/>.

18 <http://www.nfib.com/content/resources/economy/infographic-top-small-business-issues-in-2016-72233/>.

19 <http://www.gallup.com/poll/191417/small-business-owners-optimism-levels-off.aspx>.

20 https://www.dealstruck.com/press_release/dealstruck-survey-taxes-and-health-care-top-small-business-concerns-this-election-season-while-the-minimum-wage-is-of-little-consequence/.

21 <http://www.forbes.com/sites/thehartford/2015/12/11/5-hot-button-issues-for-small-business-owners/#226cd9b34064>.

22 <https://www.waspbarcode.com/small-business-report>.

Section 2. The Value PEOs Create for Clients

In previous NAEPO white papers, we examined the impact that PEOs have on their clients. Most tangibly, they offer notably better services and/or benefits for clients and for clients' employees. Beyond that, we also found clear statistical evidence that small businesses in PEO arrangements have higher growth rates, lower employee turnover rates, and higher rates of business survival. This section reviews those findings and updates the data whenever possible.

A company's ability to survive and profit increasingly hinges on the degree to which it can manage its employees more effectively than its competitors can manage theirs. As traditional sources of competitive advantage have eroded in the face of globalization and technology change, the importance of a company's people has steadily increased. People—including their skills, knowledge, creativity, and motivation—represent a critical asset on which a company must depend for success in today's competitive marketplace. Numerous research studies have found that those companies best at managing their people are subsequently more likely to enjoy success in the marketplace and have a greater appreciation in their share price than their competitors.²³

Achieving sustainable competitive advantage through better management of employees is a huge challenge for even the largest and most sophisticated companies, but that challenge is even greater for small and mid-size organizations. PEOs help their clients tackle this by managing the "people side" of their businesses more effectively, avoiding compliance pitfalls, and creating key benefits for the business and its employees while simultaneously freeing up time for owners and executives to concentrate on growing their businesses by focusing on operations, strategy, and innovation. The existing evidence confirms this: PEO clients offer better benefits to their employees, offer a wider array of employee-related services, and are able to do this while saving money (money that can then be redirected toward business growth).

Most smaller organizations usually have only a "bare bones" HR functionality, which typically focuses on the most basic HR needs. Even these basics can be time-consuming, distracting, and fraught with potential for error. PEOs typically take over these key HR responsibilities for their clients, administering employee payroll and benefits, personnel management, workers' compensation services, and monitoring and managing risk in these areas. In addition, PEOs make available to their clients a broad array of additional employee-related services and hands-on expertise, including the ability to advise on issues such as workplace diversity, employee retention, and up-to-date information on changing employment laws that may affect clients. Each of these other services generates advantages for the business and/or its employees.

Services and Benefits

Retirement Benefits

One of the most important potential benefits of PEOs is increased access to employer-sponsored retirement plans, such as 401(k) or similar offerings. Such plans are far more likely to be available to a company that uses a PEO than a comparable company that handles all HR functions in-house. This generates a variety of benefits that accrue to both the company and its employees.

While PEOs make possible a range of benefits, including robust healthcare coverage, we choose to focus the analysis below on retirement benefits for two reasons. First, high quality data exists measuring the availability of retirement plans both within the PEO environment and for smaller businesses overall, making it possible to accurately compare across the two populations of companies. Second, retirement plans create key benefits across a range of stakeholders that include both the employer and the employee. While the data do not allow for similar quantitative comparisons between PEO clients and others for numerous other available services, it is reasonable to expect that similar patterns prevail for many of those services as well: greater availability for PEO clients, with significant benefits that accrue to both employers and employees.

For employers, retirement benefits play a crucial role in successfully navigating one of the most important people-related challenges: the ability to attract and retain employees. A 2013 Towers Watson survey found that 45 percent of employees cited retirement benefits as an "important" reason to stay with their current employers, and 29 percent of employees viewed retirement benefits as an important reason they decided to work for their current employers in the first place.²⁴ Retirement plans were ranked third, behind only health insurance and prescription drug coverage, as must-have benefits among employees of small businesses.²⁵

Nevertheless, retirement benefits are rare among most small businesses. The availability of retirement plans represents a major difference between PEO clients and other small businesses. Nearly all PEOs (97 percent) offer some type of retirement plan to their clients (although not all clients choose to take advantage of these services).²⁶ In contrast, in 2013, in the U.S. economy as a whole, only 13 percent of all employees of the smallest companies (those employing fewer than 10 workers), 32 percent of those at companies with 10 to 49 employees, and 36 percent of those at companies with 50 to 99

23 See, for example, the outperformance of Glassdoor "Best Places to Work" relative to the S&P 500, Andrew Chamberlain, "Do Satisfied Employees Impact Stock Performance?" March 2015 (<https://www.glassdoor.com/blog/company-culture-pay/>) and Theresa Welbourne, "Want to Make Money on IPOs? Learn About Companies' HR Management Strategies," *Workforce Management* (September 2010).

24 These questions were asked in 2009, 2010, 2011, and 2013. Overall, retirement benefits have become more important since the 2009 survey (attracting employees: from 24 percent in 2009 to 29 percent four years later; retaining employees: 38 percent in 2009 to 45 percent four years later), although the importance for both attracting and retaining employees declined since 2011 (attracting: 35 percent in 2011; retention: 47 percent in 2011). Jonathan Gardner and Steve Nyce, "Attracting and Keeping Employees: The Strategic Value of Employee Benefits," *Towers Watson Insider* (May 2014), p. 1. <https://www.towerswatson.com/DownloadMedia.aspx?media={FD628608-2EB0-45C7-864D-F4617DEC5F54}>.

25 Jim Hardman and Geoff Vandal, "Emerging Insights into the Benefits of Benefits," MetLife presentation, July 12, 2016. <https://www.napeo.org/docs/default-source/lcf-uploads/metlife—insights-into-benefits.pdf?sfvrsn=2>.

26 NAEPO, 2015 Financial Ratio & Operating Statistics Survey.

Table 4. HR Service Offerings by PEOs, Percentage Offering, 2010 and 2015²¹

HR service offering	2010 % of PEOs offering service	2015 % of PEOs offering service
Compliance assistance on HR-specific regulations such as EEOC, FMLA	97	96
Retirement plans for employees	98	97
Assistance with job descriptions	95	95
Paid time off (PTO) tracking and reporting	97	97
Customized employee handbooks	99	99
Telephone consultation re: HR and personnel matters	99	96
Employee exit interview assistance	91	88
Wage and salary compensation planning assistance	78	78
Performance review assistance/tracking	83	85
Recruitment/job placement	58	64
Employee surveys	58	65
Online training services for supervisors and employees	51	65
Personality testing	46	57
Turnover analysis and reporting	57	65
Professional licensing and certification tracking	38	42

employees work for companies that sponsor some type of retirement plan, according to the Employee Benefit Research Institute (EBRI).²⁷ Roughly two-thirds of all workers who lack access to a retirement plan work in small businesses.²⁸

Similar numbers were cited in a recent Government Accountability Office (GAO) study,²⁹ which found that the primary obstacles cited by small businesses in sponsoring retirement plans included confusion regarding the number of plan options, plan administration requirements, and fiduciary responsibilities. Others cited lack of financial resources, time, and personnel.

In addition to providing key benefits to businesses in terms of employee attraction and retention, the greater ability to participate in retirement plans naturally provides major benefits to employees as well. A large body of research shows that having accessible retirement savings options at work has a significant impact on people's ability to save for their futures. For example, a 2015 survey found employees in companies more likely to offer access to employer-sponsored retirement plans are significantly more confident about being able to retire comfortably and to believe they are building a large enough "nest egg."³⁰

By making it much easier for the under-served small and mid-size employer population to provide retirement plans to their employees, PEOs provide a service that creates value for employees and for our broader society. In so doing, PEO clients reap key benefits in turn—being able to attract and retain higher-quality employees enables them to grow faster (as described in additional detail below).

Broad Array of HR Services

In addition to retirement plans, other PEO-provided services fall into a wide variety of categories. Table 4 provides a detailed summary of the extent to which a wide range of services are provided by PEOs to their clients, including comparisons with 2010. Like retirement plans, many of these services are likely available to a much higher percentage of PEO clients than to other businesses, especially among the smallest employers. For most of the services, there has been little change from 2010 to 2015 in the percentage of PEOs offering such services; this is likely because many of them are offered by the vast majority of PEOs. The four categories with the largest changes are all a bit less commonly offered, and all saw increases since 2010: online training services for supervisors and employees (percentage of PEOs offering now 14 percentage points higher); personality testing (+11); turnover analysis and reporting (+8); and employee surveys (+7).

More Services at a Lower Price

Despite this broad array of offerings, PEOs are able to provide these services at a lower cost than their clients would have to pay for more basic HR administrative services. For example, in FY 2014, PEOs' gross profit margin was \$1,295 per worksite employee; this figure represents the revenue remaining after all direct employee-related costs (salaries and wages, health or medical, FICA, etc.) have been paid. Out of its gross operating margin, a PEO must pay all of its own operating expenses. So, in essence, the figure of \$1,295 represents the amount PEO clients are paying for HR administration and all other services offered by their PEOs.

Although there are no strictly comparable numbers available for non-PEO clients, we've identified two different relevant statistics in recent publications, and averaged them in order to develop a comparison for the cost of HR administration for PEO clients:

- Bersin by Deloitte puts HR spending at \$2,112 per employee within companies at the lowest "maturity level"—those with just a compliance-driven focus in their human resources. Such HR departments are likely found disproportionately among small- and mid-size companies, of the sort that ultimately choose to hire PEOs. (Companies at higher levels of maturity have HR expenditures per employee that are up to twice as high as that lowest level of maturity).³²

27 Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2013," *EBRI Issue Brief* (October 2014, no. 405), p. 11. https://www.ebri.org/pdf/briefspdf/EBRI_IB_405_Oct14.RetPart.pdf.

28 National Institute on Retirement Security, "The Continuing Retirement Savings Crisis," March 2015. http://www.nirsonline.org/storage/nirs/documents/RSC%202015/final_rsc_2015.pdf.

29 U.S. Government Accountability Office, "Challenges and Prospects for Employees of Small Businesses," GAO-13-748T, July 2013. <http://www.gao.gov/assets/660/655889.pdf>.

30 Transamerica Center for Retirement Studies, "16th Annual Transamerica Retirement Survey of American Workers: A Compendium of Findings About American Workers" (August 2015), https://www.transamericacenter.org/docs/default-source/resources/center-research/16th-annual/tcrs2015_sr_16th_compendium_of_workers.pdf.

31 NAPEO, 2015 Financial Ratio & Operating Statistics Survey.

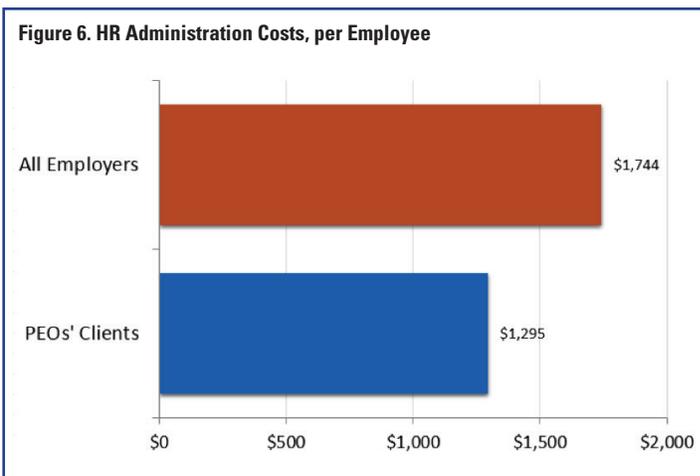
32 Bersin by Deloitte, "HR Factbook 2015: Benchmarks and Trends for US HR Organizations," January 2015 Whatworks Brief, <http://www.bersin.com/uploadedFiles/011415-hr-factbook-wwwb.pdf>.

- Bloomberg BNA reports that median budgeted HR expenditures per employee were \$1,375 in 2015, averaged across all firms regardless of size.³³

The average of the two numbers is \$1,744. Given considerable economies of scale for larger companies (because they can take advantage of their larger size to spread fixed costs over their entire employee populations), this average almost certainly underestimates the cost for very small businesses which, as noted above, represent the primary clients of PEOs. For example, a 2011 *Human Resource Executive* article cited figures indicating that per employee HR expenditures at firms with 10,000 or more employees are half of the amount spent by firms with 1,000 or fewer employees.³⁴

This suggests PEO clients enjoy a 35 percent savings on HR administration (see Figure 6), even as they enjoy a significantly higher level of services.

Considering both the broader services available and the cost savings realized from small businesses outsourcing their HR responsibilities, Peter Cappelli of the Wharton School at the University of Pennsylvania remarked: “This is one of those rare instances that is both cheaper and better. It’s a big burden on a local HR manager to know everything.”³⁵ Noted management consultant Peter Drucker agreed, observing approvingly that “PEOs free up managers to focus on the business rather than employment-related rules, regulations, and paperwork.”³⁶



PEO Client Growth Rates

Evidence shows the number of workers employed by PEO clients has grown more quickly than comparison groups (U.S. small business employment as well as overall U.S. non-farm employment). This is consistent with the expectation that small business owners that use PEOs and are thus relieved of major administrative burdens associated with HR are better able to focus on their businesses, reflected in the higher employment growth rates for PEO clients relative to their competitors.

These findings are based on the PEO Employment Index, which was developed in 2004 by Slavic 401(k), together with Florida Atlantic University professor Dragan Radulovic. The index, the best available evidence on PEO employment, has tracked changes in employment levels across thousands of PEO clients since December 2004. It is designed to reflect the overall industry mix in the United States and is weighted by geography to also reflect the geographic distribution of U.S. companies. It is calculated based on employment at the company’s PEO clients that offer 401(k) plans. As discussed earlier, virtually all PEOs (97 percent) offer some form of retirement plan, so this PEO Employment Index can be seen as representative of the broader population of all PEO clients.³⁷

Because most PEO clients are small businesses, the best comparison for the PEO Employment Index is a measure of small business employment growth in the United States overall. The most timely source of comparison information³⁸ is the Paychex/IHS Small Business Jobs Index, which was launched in April 2005.³⁹ It measures employment for the approximately 350,000 businesses in the Paychex client base that have fewer than 50 employees,⁴⁰ using “same-store” analysis methods to assess trends over time.⁴¹

33 Bloomberg BNA, HR Department Benchmarks and Analysis 2015-2016, Executive Summary, http://www.bna.com/uploadedFiles/BNA_V2/HR/Products/Surveys_and_Reports/HR%20Department%20Benchmark%20and%20Analysis%202015-16_Executive%20Summary.pdf.

34 Karen O’Leonard and Stacey Harris, “Maximizing Your HR Spend,” *Human Resource Executive Online* (June 2, 2011), <http://www.hreonline.com/HRE/view/story.jhtml?id=533338466>.

35 Adam Skolnick, “HR: Big Savings for Small Business,” *The Fiscal Times* (July 23, 2013), <http://www.thefiscaltimes.com/Articles/2013/07/23/HR-Big-Savings-for-Small-Business.aspx>.

36 Peter F. Drucker, “They’re Not Employees, They’re People,” *Harvard Business Review* February 2002. <https://hbr.org/2002/02/theyre-not-employees-theyre-people>.

37 Slavic 401(k) is a third-party administrator of retirement savings plans that specializes in offering plans for the PEO environment. Its index includes approximately 1,500 companies, each of which has between two and 99 employees, with an average size of approximately 20 employees. Additional information about the PEO Index is available at <http://www.slavic401k.com/peoindex/publication/index.html>.

38 There are additional governmental sources of data about employment change for small businesses, although they reported with significant delay. The Bureau of Labor Statistics (BLS) reports gross employment gains and losses, by firm size, through its Business Employment Dynamics (BED) data on a quarterly basis with a seven-month delay. Combined with data on overall employment by firm size from the Current Employment Statistics (CES) survey, the BED data yield a trend for small businesses in the PEO “sweet spot” (10 to 99 employees) that looks similar to the trend for the overall nonfarm economy as it is seen in Figure 8, on page 10 of this paper (and higher than the small business index in Figure 7, also on page 10 of this paper), with a 10.8 percent overall increase in employment from December 2004 to September 2015 (the most recent data available), even as the number of those firms has remained fairly constant (as indicated in the discussion regarding Table 1 and Figure 2 in this paper).

39 In our 2013 analysis, we compared PEO clients’ employment trends to the Intuit Small Business Employment Index, which no longer exists. The trends in the Paychex/IHS data are quite similar to those in the Intuit index (up to the point at which the Intuit index was discontinued).

40 A technical note: given the different sizes of companies in their employer population, the PEO Employment Index (two to 99 employees) and the Paychex/IHS Small Business Jobs Index (fewer than 50 employees) are not strictly comparable because the PEO index includes larger companies.

41 A more detailed description of the Paychex/IHS Small Business Jobs Index methodology is available at <http://www.paychex.com/jobs-index/understanding-the-index.aspx>. Because the Paychex index launched months after the PEO Employment Index was created in December 2004, it is not possible to make a small business comparison back to the inception of the PEO index.

The comparison in Figure 7 shows notably stronger employment growth among PEO clients than among small businesses generally since 2005.

Comparing the PEO index to a broader measure, (non-farm) employment growth in the United States as a whole,⁴² yields a similar conclusion: PEO clients show stronger employment growth in comparison to the U.S. economy overall (see Figure 8).

The six years since employment “bottomed out” following the end of the recession are particularly notable in both comparisons, with employment growth among PEO clients significantly out-pacing other measures of employment growth in the small business sector and in the U.S. economy overall.

Employee Turnover and Business Survival

In 2014, we examined employee turnover and business survival rates for businesses using PEOs compared to national data available from the Bureau of Labor Statistics. For both measures, we applied multiple data specifications and consistently found that PEO clients have lower employee turnover rates and lower rates of business failure than comparable national averages, after controlling for factors including industry, size, and state location.

Employee Turnover

Specifically, the employee turnover rate for PEO clients is 10 to 14 percentage points lower per year than it is for comparable companies in the U.S. overall: 28 to 32 percent annual employee turnover for companies that used PEOs for at least four quarters, compared to approximately 42 percent for all companies.

Business Survival

In addition, we found that businesses that used PEOs for at least four quarters are approximately 50 percent less likely to permanently go out of business from one year to the next when compared to the overall rate for similar private businesses in the United States.

By Industry

Industry breakdowns indicated that the three industry categories that benefit most from PEO services are: professional, scientific, and technical services; construction; and finance and insurance. These industries stood out in terms of both lower-than-expected employee turnover among PEO clients and lower-than-expected business failure rates.

Overall, the combined evidence from various data analyses suggests PEO services yield a range of high-level advantages to their clients: they enable faster client growth, lower rates of employee turnover, and higher rates of business survival. These advantages can be attributed to a variety of PEO-related services discussed above: PEO clients have access to a broader array of HR-related benefits and services yet spend less on HR administration than peers. The greater availability of employer-sponsored retirement plans (and other employee benefits) helps businesses attract and retain their employees. Freed from many HR administrative burdens, executives and managers of PEO clients can focus more of their time on strategy and growth, with the results being higher growth rates and higher likelihood of survival year in and year out.

Figure 7. Employment Growth, PEO Clients versus Small Businesses Overall, April 2005 (date of Paychex index inception) = 1000

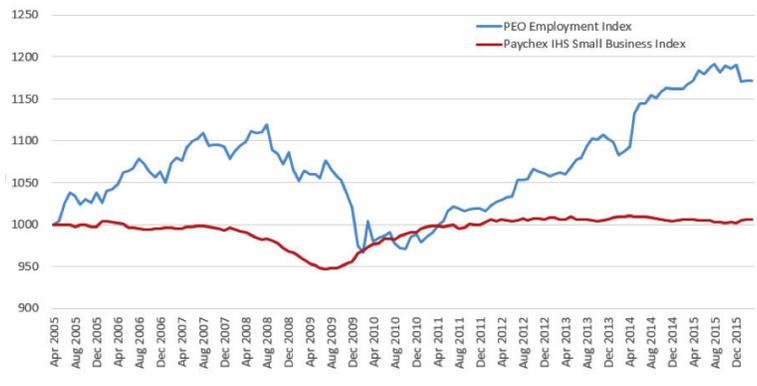
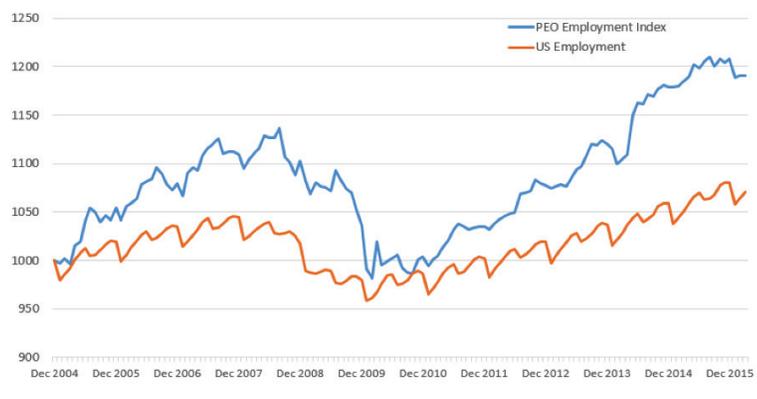
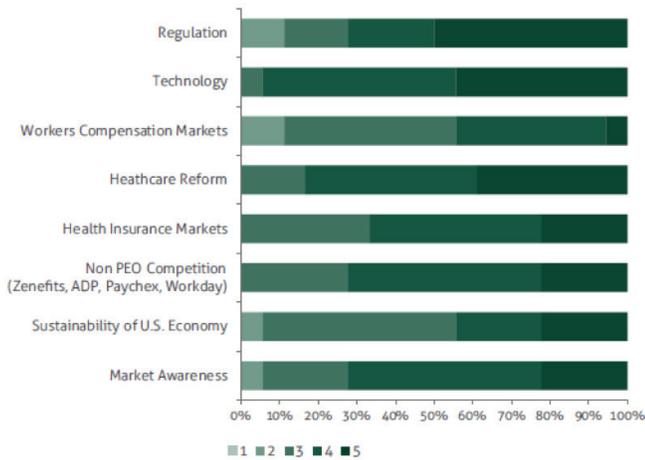


Figure 8. Employment Growth, PEO Clients Versus U.S. Employment Overall, December 2004 (date of PEO index inception) = 1000



⁴² The overall U.S. growth rate of employment is derived from BLS Current Employment Statistics survey data on total nonfarm employment (not seasonally adjusted, to improve comparability with the PEO index). See <http://www.bls.gov/ces/>.

Figure 9. Most Significant Issues Facing the PEO Industry Ranking (1 to 5, 5 being the highest) of the Significance of Each Issue Faced by the PEO Industry



Source: Business Services Spotlight: The Breakout of the PEO Industry, Brown Gibbons Lang, July 2015.

Table 5. Key Facts About the PEO Industry⁴⁴

Total size	\$136 billion to \$156 billion (clients' payrolls plus PEO fees)
Worksite employees	2.7 to 3.4 million
# of PEO clients (organizations)	156,000 to 180,000
Internal employees	21,000 to 27,000
# of PEOs	780 to 980
% Female-owned	15%
% Minority-owned	5%
States with most PEOs	Florida, Texas, California, New York, Michigan

However, there is plenty of room for growth. With 156,000 to 180,000 businesses as PEO clients in 2015, only 2.7 to 3.1 percent of all employers in the United States use PEOs.⁴⁶ Within the usual PEO target population of employers with 10 to 99 employees (as discussed in Section 1), PEOs capture as much as 14 to 16 percent of these firms as clients.⁴⁷

Regulatory Trends

State-Level Regulations Affecting Small Businesses

Looked at from most any angle, the regulatory environment continues to grow more complex for small businesses. According to the Workplace Policy Institute, "While the U.S. Congress has been predictably stagnant this election year, state legislatures have enacted over 100 labor- and employment-related bills during the first half of 2016. At least 20 employment bills were signed into law at the state level in June alone. These new laws impose new

Section 3. Trends Shaping the PEO Industry⁴³

The discussion in the previous section indicates that the PEO industry has already evolved into a significant force in the U.S. economy. With the passage of the Small Business Efficiency Act (SBEA) in 2014, and the important codification of the industry that it represents, the industry may be positioned to grow significantly in the near future. However, other developments, perhaps especially the emergence of potentially disruptive technology, could represent a significant challenge to those PEOs that are not well positioned to adapt to rapid changes in the marketplace.

For example, the findings from a recent survey of PEOs conducted by Brown Gibbons Lang found that technology and regulation are the two most significant issues currently faced by the PEO industry (see Figure 9).

This section discusses a number of issues that are among the most likely to affect PEOs' ability to grow in the future. It begins by taking stock of the current size of the PEO industry itself.

The Size of the PEO Industry

For 2015, the most recent year for which data are available, we calculated the size of the PEO industry using multiple measures. Measured in gross revenues (which includes clients' payrolls as well as the fees charged to clients), the industry's size is between \$136 and \$156 billion. The estimated 780 to 980 PEOs provide services to between 2.7 and 3.4 million worksite employees for 156,000 to 180,000 clients. Table 5 summarizes the full set of key statistics that emerged from this industry analysis.

These numbers indicate the PEO industry has grown significantly since the PEO concept first began to take hold three decades ago. In each of the last 30 years, the industry has added, on average, roughly 100,000 worksite employees and 6,000 net new clients. For perspective, that means that every five years, the PEO industry has added the employment equivalent of the entire utilities industry in the United States.⁴⁵

⁴³ We are grateful to the following industry experts who provided us with their insights and analysis on which this section is based:

- Bradley Buttermore, Managing Director & CFO, Capital Alliance Corporation
- Matt Claus, M&A Group Practice Leader, McHenry Consulting
- Neal England, Managing Director, HCM Practice Leader, Capital Alliance Corporation
- Bill Kramer, Policy Director & Counsel, Council of State Chambers
- Daniel McHenry, Business Advisory Group Practice Leader, McHenry Consulting
- Dev Navare, Segment Lead, HR Software and Services, KeyBanc Capital Markets
- Wanda Silva, President, Silva Capital Solutions, Inc.
- Clifford Sladnick, Managing Director, Brown Gibbons Lang

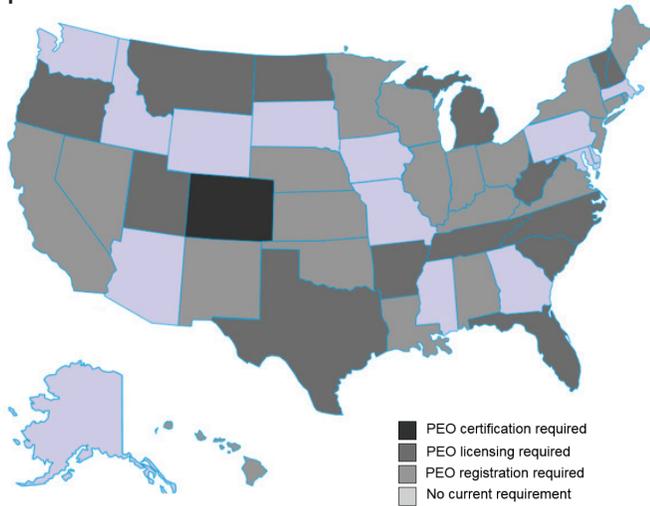
⁴⁴ "An Economic Analysis: The PEO Industry Footprint," Laurie Bassi and Dan McMurrer, NAPEO white paper, 2015.

⁴⁵ Bassi and McMurrer (2015).

⁴⁶ U.S. Census Bureau, Statistics of U.S. Businesses Employment and Payroll Summary (February 2015), reports that there are 5.7 million businesses in the U.S.

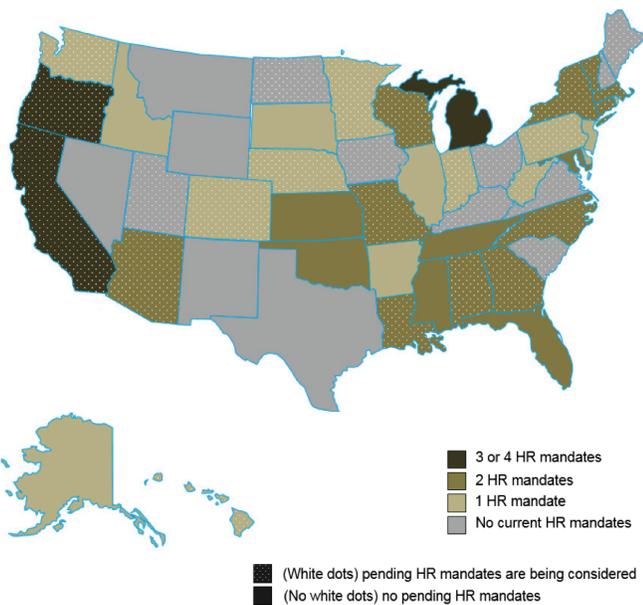
⁴⁷ This calculation divides the estimated total number of PEO clients by the total number of U.S. companies with 10 to 99 employees. Because some PEO clients are larger or smaller than this, the actual percentage of 10 to 99 employee companies that use PEOs is somewhat below the 14 to 16 percent estimate cited, although it is not possible to know exactly how much lower it is.

Figure 10. States with PEO Licensing, Certification, or Registration Requirements



Source: Summary of state regulatory information provided by NAPEO.

Figure 11. Current and Pending State HR Mandates (Minimum Wage Increases, Paid Sick Leave, Retirement Program Requirements)



Source: Summarizes presentation by Bill Kramer, Council of State Chambers, Minimum Wage & Paid Sick Leave: State & Local Overview, NAPEO Mid-West Leadership Council Forum, June 2, 2016.

I have been in the industry since 1990 as a PEO operator, client, or consultant. During that time, I've seen many peaks and valleys along the way. However, I must say that I have never been more bullish on the industry and where it's going than I am at this time. There are two primary drivers that have accelerated the visibility and interest in the PEO industry from a new entrant standpoint and for consumers of PEO services.

The first is the Small Business Efficiency Act (SBEA). This codification of PEOs in the Internal Revenue Code (IRC) has really advanced the visibility of PEOs in the marketplace, and more private equity companies have been taking notice.

The complexity and the growing regulations over the past few years, coupled with the Affordable Care Act (ACA), have created an increasing demand from small- and middle-market-sized businesses that have an interest in PEO services.

There have also been a number of other industry sectors that have identified the PEO market as an excellent diversification strategy. These successful and well capitalized groups have included benefits brokers, staffing companies, payroll companies, and a growing interest from insurance carriers. These new entrants have been either deploying an organic growth strategy, an M&A strategy, or at times both, as an entry point to the PEO marketplace.

Daniel McHenry
 McHenry Consulting

requirements related to background checks, pregnancy accommodation, and paid sick leave, among other hot legislative topics. In addition, the looming general election has spurred several ballot initiatives that seek to place the adoption of new employer obligations in the voters' hands."⁴⁸

Figure 10 displays states based on their current and pending levels of state mandates that affect certain key aspects of HR administration. The color shading in Figure 11 is based on how many mandates apply in each state from the following list:

- Paid sick leave
- Recent minimum wage increase
- Mandated retirement plan
- State preempts local minimum wage laws
- State preempts local paid leave laws

While some mandates do not apply to businesses with under a certain threshold of employees, they each make the regulatory environment for businesses more complex (with the associated administrative burdens often falling disproportionately on small businesses). Thus, states with the darkest shading have the most complex current environment on the aspects of HR administration noted above, while those with dotted shading (those considering new mandates) are those where the environment may become more complex in the near future.

Because one of the primary value propositions of PEOs is that they provide relief from the burden of complying with complex and ever-changing regulations, the current environment is a favorable one for those PEOs positioned to effectively address this pain point for small businesses, and those businesses in states with the most complex environments are most likely to benefit from the services offered by PEOs.

Table 6, on page 13, displays detailed information for those states currently considering new HR mandates in the policy areas mentioned above, with those states being the most likely to see increased complexity in HR administration for businesses in the near future.

Table 6. States Considering New HR Mandates

State	Minimum Wage (vote pending)	Mandated Retirement Program (formal study committee)	Mandated Retirement Program (legislation introduced)
Alabama	X		
Arizona			X
California	X		
Colorado	X		X
Connecticut		X	
Georgia			X
Hawaii			X
Indiana			X
Iowa			X
Kentucky			X
Louisiana			X
Maine	X		X
Massachusetts			X
Minnesota	X	X	
Missouri	X		
Nebraska			X
New Hampshire			X
New York		X	
North Carolina			X
North Dakota			X
Ohio	X		X
Oregon	X		
Pennsylvania			X
Rhode Island		X	
South Carolina	X		X
Utah			X
Vermont		X	
Virginia		X	
Washington	X		
West Virginia		X	
Wisconsin			X

Source: Presentation by Bill Kramer, Council of State Chambers, Minimum Wage & Paid Sick Leave: State & Local Overview, NAPEO Mid-West Leadership Council Forum, June 2, 2016.

States are introducing more and more HR legislation. For small businesses, it's death by a thousand cuts.

Bill Kramer
Council of State Chambers

The ACA and the SBEA transformed the PEO industry; regulation is keeping us relevant, and technology is broadening our scope of delivery.

Neal England
Capital Alliance Corporation

The Affordable Care Act

The Affordable Care Act (ACA) represents one of the most significant regulatory overhauls to the U.S. healthcare system in the past five decades. It has added to the complexity of the regulatory environment for those small businesses with 50 or more employees that must comply with the ACA or face penalties.

Because small businesses don't have the economies of scale of larger businesses, their per employee cost of ACA compliance is higher. Not surprisingly, PEOs are responding by expanding their services to include advice and guidance about how to comply with the ACA.

However, in states where the health plan marketplace operates relatively efficiently, the advent of Obamacare may actually be reducing small business' need for expert guidance on healthcare coverage for their employees. Moreover, the emergence of technology companies such as Namely (see below) reduces the costs to small firms of finding competitive health plans that comply with the ACA.

So the net impact of the ACA, taken together with rapidly evolving technology in the HR space as discussed below, makes it unclear whether the ever-changing healthcare landscape will have a positive or negative impact on the demand for PEOs.

Regulation of PEOs

This year's implementation of the Small Business Efficiency Act (SBEA) represents a major watershed for the PEO industry—it is the first codified federal recognition of PEOs. It has generated increased awareness of the industry and resulted in an influx of private equity capital.

The most important result of the passage of the SBEA and the creation of the IRS PEO certification program is that it provides assurances and certainty to small business owners that may make them more confident in the legitimacy of the industry and therefore more likely to use a PEO for their HR outsourcing needs.

Key Provisions of the SBEA for PEOs

- Certification: The SBEA creates a voluntary certification process within the IRS for PEOs and criteria for PEO certification, which include:
 - Bonding: A certified PEO (CPEO) must maintain a \$50,000 bond, or, if greater, a bond in an amount that is equal to 5 percent of the CPEO's federal employment tax liabilities for the previous year (not to exceed \$1 million).
 - Annual audits: A CPEO must prepare and provide the IRS with annual independent financial statement audits prepared by a CPA.
 - Quarterly CPA attestations on employment taxes: A CPEO must provide quarterly assertions to the IRS regarding payment of all employment taxes, accompanied by an examination level attestation by an independent CPA with respect to each such assertion.
 - Annual fee: The CPEO must pay an annual fee of up to \$1,000 per year to be (and remain) certified.
- PEOs recognized under federal tax law: CPEOs will have clear statutory authority to collect and remit federal employment taxes under the CPEO's EIN for wages the CPEO pays to worksite employees.
- Customer eligibility for tax credits confirmed: The SBEA expressly codifies that customers of CPEOs will qualify for specified federal tax credits that the customers would be entitled to claim if there were no PEO relationship.
- CPEO gets federal tax credit for SUTA taxes paid: If a CPEO (or a customer) makes a contribution to a state unemployment fund with respect to wages paid to a worksite employee, the CPEO receives the federal (FUTA) tax credit with respect to that contribution.
- Potential double taxation eliminated: The FICA and FUTA wage bases will not restart when a customer joins or leaves a certified PEO mid-year.

Source: NAPEO, <http://www.napeo.org/advocacy/what-we-advocate/federal-government-affairs/irscertification/background-on-sbea>.

In addition to federal regulation of the PEO industry, state registration and certification requirements for PEOs have been steadily increasing. In 1991, only four states required registration or licensing of PEOs.⁴⁹ Now more than 30 states have a licensing, certification, or registration requirement (see Figure 11 on page 12).

Technology Trends

Every industry of any significance in the U.S. economy is being transformed by the rapid pace of technology change—and the PEO industry is no exception.

Companies such as Namely and Gusto are among the current emerging players that have captured the attention of the PEO industry due to their innovative application of new technologies in the payroll, HR, and talent management space.⁵⁰ (Until recently, Zenefits was also receiving significant attention from those who closely track the PEO industry, but it has since hit a rough patch that has significantly reduced its business momentum.⁵¹) Many of these companies offer some form of HR Software-as-a-Service (SaaS), a model in which software is licensed on a subscription basis to client organizations.

There is significant venture capital money behind some of these firms, which increases their staying power along with the probability that they will emerge as a disruptive technology—a development that has the potential to disintermediate PEOs.

This development is worthy of the attention of all PEOs—large and small. Among the implications of this change is the need to consider whether or how to compete with—or partner with—these highly efficient, low-cost, flexible, user-friendly offerings. The ultimate consequences of this rapid technology (r)evolution are likely to vary, depending on the specifics of any given PEO's business model.

Merger and Acquisition Activity

Industry experts seem to concur that the convergence of the regulatory and technology changes outlined above have set the stage for ongoing consolidation in the industry over the next six to 18 months. Both separately and together, these meta-forces are making it increasingly challenging for smaller PEOs to compete, thereby creating an environment ripe for mergers and acquisitions to occur. At the same time, an influx of private equity funds, attributable at least in part to the increased attention the industry has received as a result of the SBEA, has created a very dynamic environment.

This has generated considerable interest in and speculation about the purchase price that is being paid by buyers. Capital Alliance Corporation's Bradley Buttermore has compiled an analysis of 29 (out of a total of 72) PEO valuations from 2003 to 2015, based on sources that he believes to be trustworthy. His analysis (see Table 7) indicates that PEO valuations have recovered from their decline during the past recession and have recently exceeded the levels experienced from 2003 to 2007.

M&A experts in the industry (including Buttermore), however, counsel caution for PEO owners who are hoping to receive record-high valuations:

- Bradley Buttermore, Capital Alliance Corporation: I believe there will be plenty of acquisition activity near the end of this year, but bigger firms are becoming more selective in their acquisition criteria. Smarter and more strategic investments are where investors are now. The value expectations of the smaller PEOs are still very high, but they will adjust as the need to merge continues to increase. We believe valuations remain high by historical standards, but the lofty valuations are not likely to be available to the average PEO.
- Clifford Sladnick, Brown Gibbons Lang: My firm is engaged by a number of PEOs right now. The PEO M&A market is very active, but potential buyers are being conservative. Valuation multiples are primarily driven by the size of the target PEO, but are also driven by growth rates, profitability, client quality, and risk profile.

The proliferation of HR SaaS is the biggest competition that PEOs face. These technology companies are going after the small- and medium-size business market directly. PEOs need to become more nimble to remain competitive, by adding HR tools and going to the left and right of just payroll and benefits.

Dev Navare
KeyBanc Capital Markets

Tech savvy HR start-ups have the potential to disrupt the PEO industry. We believe this will result in the pie becoming bigger for everyone, but it might also take some market share from the PEO industry.

Bradley Buttermore
Capital Alliance Corporation

Table 7. PEO Industry Valuation

Time Period	Sample Size	EBIDTA Multiple (Median)	Gross Profit Multiple (Median)
2011 to 2015	12 of 36	7.2x	2.0x
2008 to 2010	5 of 20	4.8x	1.2x
2003 to 2007	12 of 16	7.0x	1.6x
2003 to 2015	29 of 72	6.6x	1.5x

The industry has fewer players today than it did 20 years ago. In the future with SBEA, the industry is poised to be extremely strong. The CPEO process seems complex and there is concern that smaller PEOs may choose not to get certified. More consolidation is coming.

Wanda Silva
Silva Capital Solutions, Inc.

49 Brown Gibbons Lang, Human Capital Management Outsourcing: PEO Industry Update, April 2016.

50 The field seems to be filling quickly and also includes companies such as BambooHR, Deputy, GoCo, and Maxwell Health.

51 <http://www.nytimes.com/2016/02/18/technology/zenefits-scandal-highlights-perils-of-hypergrowth-at-start-ups.html>.

People ask me all the time if we're ever going to have all large PEOs and eliminate the small ones. I think that will never happen. Small PEO business owners have local and regional relationships that only local business owners can keep, cultivate, and grow.

Wanda Silva
Silva Capital Solutions, Inc.

We are seeing a lot of private equity firms showing appetite for smaller PEOs to invest in as platforms for future growth, whereas in the past, it was really only the mid-to-large PEOs that were taken out by PE funds.

Dev Navare
KeyBanc Capital Markets

- Matt Claus, McHenry Consulting: The majority of new entrants have been private equity and strategic buyers intending to attain synergy with their core business model. The industry lifecycle has advanced significantly, with several entities traded multiple times within the private equity segment.

Valuation of Publicly Traded PEOs

Figure 12 provides an alternative perspective on how the market views the PEO industry. It shows a two-decade trend in a key valuation metric, the price-to-earnings (P/E) ratio,⁵² for an index of the five publicly traded PEOs.⁵³ For comparison purposes, the P/E ratio for the S&P 500 is also included.

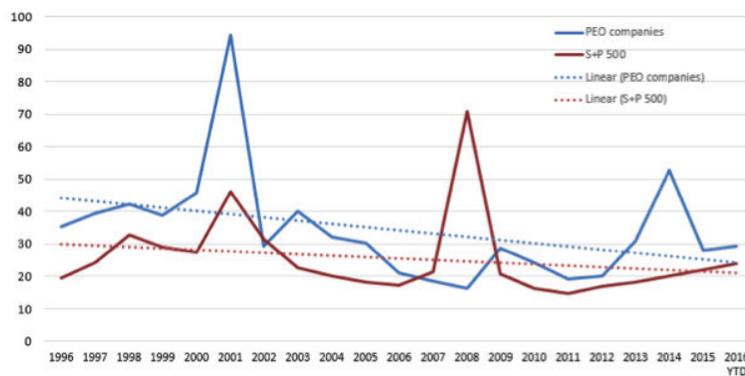
The P/E ratio for both the PEO and the S&P 500 has tended downward over the course of the past 20 years, as evidenced by the linear trend line fitted to both, but the downward trend of the PEO P/E ratio has been more pronounced than that of the S&P.⁵⁴

This indicates that the premium PEOs earned in the marketplace 20 years ago has (or soon will have) disappeared. A possible explanation behind this convergence of P/E ratios is that the PEO industry, taken as a whole, is entering a new, more mature phase from an investment perspective. This also reflects the caution expressed by institutional investors cited earlier in this section.

Conclusion

With penetration rates of only 14 to 16 percent of its primary target market (firms with 10 to 99 employees), the PEO industry has ample room for continued growth. For those PEOs that are able and willing to provide cost-effective solutions to very small firms (those with fewer than 10 employees), that market is significantly larger still—with a current PEO penetration rate of only about 3 percent.

Figure 12. Price to Earnings Ratio of PEO Industry, Relative to S&P 500



Beyond the sheer size of the potential market for PEOs, there are a variety of factors that both separately and together are creating an environment that is favorable to the ongoing growth of the industry. This year's implementation of the Small Business Efficiency Act will almost certainly prove to be beneficial to those PEOs that have the wherewithal to meet the SBEA's voluntary certification requirements. That, coupled with the increasing complexity of HR-related mandates in many states and continuing concerns among small businesses about their ability to attract and retain employees, healthcare, regulation, and taxes should combine to ensure that demand for PEO services remains strong among both current clients and other firms that have never before used PEOs.

Section 1 of this paper notes those states and industries where small businesses are currently most under-served by the PEO industry. The most successful PEOs will be those that are able to penetrate these under-served segments of the small business community and capitalize on the trends that are creating an environment favorable to growth of PEOs.

At the same time, other developments may have a more negative effect on certain PEOs. In particular, the emergence of potentially disruptive technology change may present a major challenge to those PEOs that are poorly positioned or late to adapt to rapid changes affecting the PEO landscape.

⁵² This is calculated as the stock price of a company divided by its earnings.

⁵³ Not all five of the companies (ADP, Barrett Business Services, Insperity, TriNet, and Paychex) have been publicly traded for the entire period examined. It should also be noted that PEO services represent only a small percentage of the offerings of ADP and Paychex, so it would be expected that their stock performances are being influenced by non-PEO elements of their businesses as well.

⁵⁴ In fact, if TriNet, which went public in 2014 and accounted for the PEO industry's P/E spike that year, were removed from the index, the PEO index would have achieved parity with the S&P index in 2016.

About McBassi & Company

McBassi is an independent analytics and research firm that helps clients create consistently profitable and enlightened workplaces. McBassi uses the language and tools of business—metrics and analysis—to build successful organizations by optimizing the power of their people. McBassi's principals (Dr. Laurie Bassi and Dan McMurrer) are co-authors of "Good Company: Business Success in the Worthiness Era" (winner of the 2012 Nautilus Gold Award for Business/Leadership) and the "HR Analytics Handbook."

About the Authors

Dr. Laurie Bassi is CEO of McBassi and a global leader in the field of applying analytics in the world of HR. Laurie is the author of more than 90 published papers and books and was previously a tenured professor of economics and public policy at Georgetown University. She holds a Ph.D. in economics from Princeton University.

Dan McMurrer is the chief analyst at McBassi. An analytics expert, Dan focuses on researching the relationship between organizations' work and learning environments and their business results. He holds an M.P.P. in public policy from Georgetown University.



**National Association of Professional
Employer Organizations**

707 North Saint Asaph Street
Alexandria, VA 22314

703/836-0466

www.napeo.org