# Consolidation in the PEO Industry Continues to Accelerate

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Consolidations in the human capital management sector continued to accelerate in 2018 as professional employer organizations (PEOs) experienced sustained interest from institutional and strategic investors. As this article offers a view of what is happening and why, it does not try to discuss in detail the reasons why one particular company bought or invested in another. Let's begin with a look at the source of capital.

## Where Does the Investment Capital Come From?

The United States is blessed with arguably the best capital development engine in the world, combined with an economic system that encourages new business formations. Investor types and styles change over time, but for most industries, there are venture capitalists that back start-up and pre-sales/pre-profit organizations, private equity investors that traditionally support profitable and growing organizations, and the ultimate capital and liquidity providers, which are the various public stock exchanges (NYSE, NASDAQ, and others). Of course, there are many types of private equity funds, but that is an extensive topic that can be addressed at another time and place. However, there is a type of private equity investor that I want to point out because it is participating in the consolidation of the PEO industry. In the past few years, we have seen a proliferation of a variant of the private equity fund known as a family office, where private-equity-type professionals are responsible for investing the wealth of particular families. Finally, there are strategic acquirers/investors that invest to expand or diversify their services. An old but good example would be the ownership of Strategic Outsourcing, Inc. out of North Carolina (now part of the TriNet Group, Inc., out of California) by Union Planters Bank, long before Clarion Capital invested in that company. Union Planters thus decided to deliver small-business-type services not otherwise offered by a banking institution to its small business client base. A more recent example would be the acquisition of Merit Resources, an Iowa-based PEO (now Aureon and part of Oasis Outsourcing, based in Florida), by the Independent Network Services (INS) company (a rural telephone exchange and fiber optic network company). INS chose to offer PEO services to its small business client base while diversifying its client base by acquiring a whole new class of customers.

## A Short History and Modern Drivers of this Consolidation Trend

Earlier in this decade and as far back as the 1980s, talented management teams and a few investors created some of the very large PEOs that we know today. For example, the private equity fund General Atlantic backed the team that grew TriNet from a relatively small PEO to a national firm today. After many acquisitions, it achieved the ultimate return on investment through an initial public offering (IPO) in 2014. Other successes, such as Insperity (formerly Administaff), based in Texas, led the early growth years, mostly backed by private equity capital and ultimately the public capital markets.

The difference today is the number of private investors and the speed at which they are supplying capital into the PEO industry.

The genesis for this recent consolidation movement, which we expect to continue in 2019, began sometime after the recession of 2008-2009. Several developments came together to drive the exposure of the PEO industry to small businesses and, more importantly, to the capital markets that drive the business of this country:

- Increasing government regulation placed a significant burden on employers, especially small employers. PEOs seized the opportunity to provide solutions for this burden.
- The extensive amount of capital available in the U.S. and the recurring revenue model that PEOs offer is very attractive to institutional capital.
- NAPEO's long-term objective of having the industry recognized at the federal level became law in 2014 with the passage of the Small Business Efficiency Act (SBEA), a move that ultimately brought new awareness of PEOs with a stamp of government approval via the IRS certification process.
- I believe that NAPEO's efforts to drive industry awareness—including a series of white papers that not only explained the industry, but also

offered valuable industry statistics about the size of the market and quantified the value proposition that small businesses can achieve by using a PEO service provider—contributed significantly to industry growth and awareness. NAPEO's annual Financial Ratio & Operating Statistics (FROS) Survey report also helps the investing community and operators compare and evaluate performance against peer groups.
- Technology plays a key role, as it is critical to successfully scaling the PEO business. The available technology offers old and new PEOs the ability to differentiate their service offerings. There are competing technologies, from custom software applications written in-house to industry standard software and, in most cases, a combination of the two as software is purchased and customized for specific audiences and applications.
- The explosive growth in business owners' confidence after the 2016 election continues today, according to the National Federation of Independent Business (NFIB.) This confidence helps to accelerate the growth of small businesses, the lifeblood of the PEO industry and, some would argue, also of the U.S. economy. Revenue growth for the industry in 2018 should show significant increases, much of it the result of the positive business environment in the U.S. Increased employment should yield organic growth for the PEO industry.

## Capital Investment and its Effect on Industry Growth and Consolidation

Providing an impressive but small sample of transactions, we get a glimpse of how capital inflows can influence the growth of an industry. The following transactions have all occurred in just the past few years, many since 2014.

Reviewing the transactions below, think about how each transaction carries an expectation of profit or return on investment. Each turn of the former investor's position can drive valuation higher and terms more agreeable to the seller. *More to the point of this article, any time substantial amounts of capital investments flow into an industry, there will be growth in that industry, principally because the required return on that capital demands it.*

- Tenex Capital Management acquired PEMCO (Progressive Employer Management Company, Inc.), based in Florida, from Palm Beach Capital in 2015. It sold its investment in PEMCO to CoAdvantage, also based in Florida, (principally owned by Morgan Stanley) in 2017.
- Morgan Stanley's platform acquired CoAdvantage, which was a combination of the original CoAdvantage PEO, combined with Odyssey One Source, based in Texas and Global Employment Solutions PEO, out of Colorado. This consolidation began with an investment by Madison Capital Funding, which one year later sold its position to CIP Capital Fund, which one year later sold its position to Morgan Stanley, each acquiring one or two more PEOs along the way. Morgan Stanley continues this growth with the 2017 acquisitions of PEMCO and Total HR Solutions out of California.
- Clarion Capital sold its investment in Strategic Outsourcing to TriNet in 2012. It returned to the PEO industry with the acquisition of HROI out of Georgia and followed that with the acquisition of Fortune Financial Group out of Florida. Clarion then sold its position to Paychex in 2017.
- Oasis Outsourcing has been owned by private equity for many years, but two new groups have acquired that business from the earlier investors. This capital is driving a very aggressive acquisition program, with Oasis acquiring Doherty Employer Services (Minnesota), A1 HR (Florida), Fortune Industries (Tennessee), and the recent acquisitions of Staff One (Texas) and Aureon.
- GPB Capital, a substantial New York-based investment fund, made its initial investment into the PEO industry in 2018 with the acquisition of MatrixOneSource out of Florida.

These large, merged companies now have substantial footprints in almost every state. As our economy returns to a normal growth track after a decade of low interest rates and nominal GDP growth, these large public or private equity-backed operators have brought large professional salesforces to expand organically in addition to selective acquisitions. In turn, the growth of the industry has attracted new investors to the industry, as in the case of GBP Capital and others.

As we close out 2018, the institutional backing of the PEO industry remains strong. We believe more merger and acquisition (M&A) activity is on the horizon as the majors look for regional

players to scale their businesses and to fill in needed service offerings, geographic diversification, and technology needs.

## Regional Market Participants Will Need to Bulk Up

There will be some challenges, to be sure, as regional participants will need to bulk up via M&A activity in addition to their organic growth to make themselves more attractive to clients and industry leaders that now have considerable heft. These bulked-up majors will forego the smaller acquisitions they might have considered two or three years ago to focus on more sizable deals, often leading them to the regional participants.

Regional PEOs partnering with or acquiring other smaller PEOs is not a new trend, but it does seem to be accelerating. These firms are building buying power for better benefit plans, expanding geographical coverage, and diversifying their revenue-producing client bases. For example, in 2017 Aureon, seeking a foothold in the Mountain West region, acquired Peliton, a Denver-based PEO. We saw it again with the acquisition of Sequent, Inc., an Ohio-based PEO, by Resourcing Edge, Inc., a Texas-based PEO that continues to expand its geographical footprint. There are so many other examples, but these two illustrate my point about regional participant growth activity.

Smaller, more local PEOs face several challenges, but they too have a strong economy as a tailwind. For them, the key is high-touch and low-to-moderate growth. However, those with good clients and reasonable profitability should be able to partner with other PEOs seeking to hit the level of profit necessary to fund more internal growth and operating initiatives such as new technologies and investments in sales programs and personnel to enhance organic growth. Perhaps they may be able to raise enough capital to do some small but strategic acquisitions.

## What are the Former Owners of Acquired Companies Doing?

Private equity investors offer some owners a unique and rewarding future because they are investors, not operators. Often, they first invest in the people, and then in the business. If you have much of your net worth locked up in your PEO, then a private equity partner not only provides liquidity to much of that net worth, but often gives you the ability to continue to do what you love using someone else's capital to grow. Additionally, many investors prefer that you reinvest a portion of your sales proceeds and help them lead the future growth of the business, for which you can recognize a future gain when they decide to sell the business (usually within three to seven years). This investor class offers leadership and professional guidance and development as part of the investment. However, investors are investing what I refer to as "OPM," other peoples' money. They can be a bit demanding and challenging for the business owner used to calling all the shots and, therefore, they are not for everyone. Those who determine that working for private equity investors is not desirable can retire, consult, or move on to their next opportunity in life, having substantially *reduced their financial risk and improved the liquidity of their nest eggs.* The caveat for these owners is that they must have a strong management team below them that can operate the company day-to-day and have some leaders in that group to help take the company forward with guidance and leadership from the investor group.

## Conclusions

I believe PEOs with attractive fundamentals will continue to be approached with the possibility of merger or acquisition. Owners and investors that are growing, profitable, and looking to manage their financial/retirement risk will be prime M&A candidates. I have offered a very condensed view of the types of investors in the marketplace and a glimpse at some ways owners can take advantage of partnering with them. As the industry continues to grow and mature, I forecast additional M&A activity, including continued private equity investment for 2019. However, I believe our economic cycle is closer to a pause or downturn than it is to a major upturn. None of us knows when it will slow, but merger and acquisition transactions (for the sellers) are rarely as profitable when the trend line begins to fall. ●

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