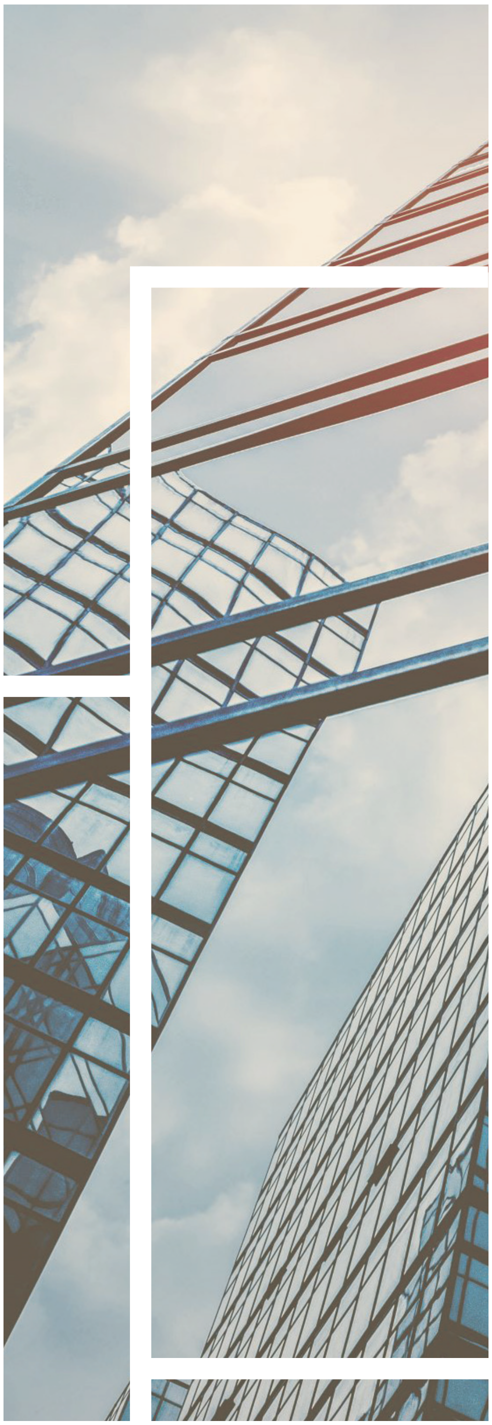
PEOs and EORs: U.S. Employers Turn to Human Resources Outsourcing to Maximize Organizational Agility



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While global competition, technology disruption and workforce demographic changes have moved many organizations to prioritize organizational and workforce agility, the COVID-19 crisis has kicked those efforts into overdrive. Since the onset of the crisis in the United States, employment levels within the economy have experienced a rapid V-shaped recovery with **unemployment levels hitting 14.7% in April before recovering to 6.9% in October**. Many businesses needing to contain costs or scale their businesses to meet demand during the pandemic have lost or added headcount at a rapid clip.

Additionally, **close to 80% of organizations surveyed by 451 Research said they implemented or expanded universal work-from-home policies as a result of COVID-19, while 67% expect these policies to remain in place either permanently or for the long-term**. Working from home rapidly created a new set of requirements for employers to effectively administrate and engage their existing workforces. New technology tools and benefits were needed immediately, which the scale of an outsourcer can best address.

To cope with the fluidity of the crisis, as well as with the longer-term war for talent and skills gaps that exist within the economy, businesses have increasingly sought to deploy outsourced human resources (HR) models. Two of the most widely deployed outsourcing provider types, professional employer organizations (PEOs) and employers of record (EORs), have existed for many years but remain opaque to some. These service providers allow employers to shorten reaction times, ensure legal and tax compliance and gain access to technology and services to enhance employee experiences at scale that they cannot practically provide on their own.

The pandemic has been uniquely difficult for small- and medium-sized businesses, which are turning to PEO models to compete with larger organizations and free up precious management time. Meanwhile, many larger organizations have committed to increasing their use of contingent workers to increase flexibility and resilience—but need the help of an EOR to manage the complexity of administrating varied contingent arrangements alongside permanent employee programs.

As investment candidates, PEOs and EORs check many of the key criteria for attractive targets. They pose strong value propositions to clients and benefit from attractive long-term secular trends, while being highly cash generative with controllable risks.

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While PEOs and EORs share numerous similarities, they are also quite different in many of their business model attributes. Below, we have outlined some of the key business model advantages and risks of both PEOs and EORs, as well as our perspective on how private equity and strategic investors can capitalize on these trends.

	PEO	EOR
TARGET CLIENTS	Entire workforce for small- and medium-sized businesses.	Contingent workforce for businesses of any size that have complex workforces, including seasonal workers, independent contractors (ICs), project-specific hires, out-of-state/country employees, etc., serve end clients directly as well as in partnership with staffing providers.
EMPLOYMENT ARRANGEMENT	Co-employer with client.	Legal employer of record.
KEY VALUE PROPOSITIONS LARGE ADDRESSABLE MARKETS	Pooling of clients' workforces allows PEOs to procure and offer clients employees benefits, services and insurance coverages on par with much larger organizations. PEOs provide employers with a fully outsourced solution ensuring efficiency, cost savings and compliance across payroll, benefits administration, taxes, workers comp, health insurance and claims management, staff onboarding, reviews and terminations.	Large scale employers can move their contingent workforce to an EOR, thus outsourcing a significant burden on HR—while delivering efficiency and compliance particularly with frequent on-boarding/off-boarding and multiple suppliers of talent. This allows HR departments to focus on delivering strategic value to their organizations. Migrating contingent workers to an EOR often allows employers to give these employees a different set of benefits, reducing costs to the firm overall. EORs also reduce regulatory risk around independent contractor classification. Because the EOR becomes the legal employer, they can administrate employees in expansion areas where the client does not yet have legal registration.
KEY SECULAR TRENDS (continued next page)	Small businesses are often called the backbone of the American economy. They account for 99.7% of all employers in the U.S., employing nearly half (47.3%) of all private sector workers and are responsible for bringing 2 in 3 net new jobs to the U.S. economy, according to the U.S. Small Business Administration.	Ardent Partners' market research indicates that 40% of today's total global workforce is comprised of non-employee talent, including independent contractors, freelancers, professional services and temporary workers. It is important to note that these are not augmentative, supplemental workers, as today's non-employee workforce plays a critical role in how mission-critical work is handled, addressed, managed and completed.

	PEO	EOR
KEY SECULAR TRENDS	**Expanded Cost of HR Regulatory Compliance:** According to the Small Business Administration, federal regulations alone are estimated to cost the American economy as much as $1.9 trillion a year in direct costs, lost productivity and higher prices. These costs historically fall disproportionately on small companies; the average small business owner spends at least $12,000 every year on regulations; 44% also spend more than 40 hours of their own time each year on federal regulation, according to the NSBA Small Business Regulations Survey. **Increased Need for Access to HR Technology:** HR Technology change has accelerated through HR processes like hiring and recruitment, leadership, talent management, payroll and legal and compliance. A recent PwC survey found that three in four companies planned to increase spending on HR tech in 2020. Half of PwC's respondents already buy from multiple HR tech vendors and nearly two in five plan to increase the number of vendors they work with. This investment level in HR tech is often not as feasible for smaller companies. **Greater Need for Cost Savings:** Many small businesses across sectors came into the COVID-19 crisis with low financial resilience. Among respondents to a McKinsey survey, close to a third were operating at a loss or breaking even prior to the crisis. The research found that balance sheets for small businesses in manufacturing, retail and restaurants also lack flexibility, since a significant portion of the costs for small businesses in those three sectors are relatively fixed. PEOs allow small business clients to save on HR and benefits costs as well as business owner time, by providing bargaining power, compliance know-how and access to both a wider array of benefits and HR technology.	**Increased Scrutiny of Employee Classification Compliance:** One of the most significant (and riskiest) challenges for business may be correctly categorizing contingent workers. Reclassifying a full- or part-time employee as a contingent worker can be fraught with legal pitfalls. Because of the tax implications, the IRS has specifically delineated who can be considered an independent contractor. To add complexity, the variation of an independent contractor or contingent worker can vary between states. **Expanded Risk Around Contingent Procurement Practices:** Another challenge for many businesses is the "off book" status of many of the growing number of contingent workers. Department heads may take on temporary or contract workers through their own budgets, bypassing HR altogether. This can mean contingent workers aren't screened, onboarded, or off-boarded through normal processes. The impact on culture, headcount projections and actual staffing costs can be significant. **Competitive Importance of Employee Experience:** 2019 marked the first time in history that five different generations worked together at the same time, and 2020 will be the fourth year that millennials constitute the largest generation in the labor force. Yet employers are still failing to implement policies that meet their demands. In 2017, 75% of U.S. millennials wanted their work environment to be flexible and fluid, yet Deloitte's Global Millennial Survey found that only 39% viewed their work environment as such. This desire for flexibility is not just about the option to work-from-home and enjoy flexible hours (which many companies have adopted due to the pandemic), but also the ability to move from project to project and company to company.

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	PEO	EOR
FINANCIAL MODEL BENEFITS	Just 14-16% of small businesses have worked with a PEO, according to the National Association of Professional Employer Organizations, leaving significant room for market penetration Recurring revenues with high visibility The ability to grow with clients due to the per/employee, per/year nature of the service Low concentration given the focus on SMB Asset-light with cap-ex mostly focused on technology and low working capital intensity given client pre-funding of payrolls	Secular growth driven by contingent worker penetration into the overall workforce and penetration of EOR services among clients that had previously in-sourced Low customer attrition and receivables credit risk given focus on larger clients Highly scalable with ability to operate across all states and internationally once business registrations are obtained Attractive margins as a result of ability to mark up the full suite of services to clients, including insurance provision
RISK FACTORS	Investors in the space should be aware of: **Employee Turnover:** 50% of small businesses shut their doors after 5 years in business. The conditions for small business survival have only worsened amid COVID-19. Since the revenue models of PEOs are based on total number of work site employees, the amount of churn inherent to small business creates the need to replace revenue at a more rapid rate than businesses serving large company employee bases. **Potential changes to Healthcare Insurance:** ACA compliance challenges for small business have aided in the growth of the PEO industry since its enactment. With the Supreme Court's demonstrated willingness to review the ACA and the ongoing potential for changes in party balance in Congress, there is, on one hand, a risk that the ACA is overturned or, conversely, a that there is a future move away from employer-sponsored healthcare towards a single payor system. Changes to the current system could undermine some of the PEO value proposition. However, given the multitude of other efficiency and compliance benefits of the PEO model, the impact would likely be slight.	Investors in the space should be aware of: **Downturn Sensitivity:** Because EORs are used to manage contingent workers, they are more susceptible to larger percentage changes in work site employees than outsourcing models focused on the entire workforce. However, a significant portion of negative cyclical pressure on overall employment is often offset by continuing penetration of contingent workers as employers seek flexibility. **Changing regulation related to ICs:** Early in 2020, California passed a new Gig Economy Law (AB5), seeking to protect contract workers by reclassifying them as employees. To the extent that there are fewer independent contractors recognized by states, some of the classification protection that EORs provide may decline. However, while new legislation may seek to protect low wage gig economy contractors, the expectation is that white collar and higher-skilled blue collar employees will continue to migrate toward IC arrangements.

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Given the inherent economies of scale of ever larger employee bases, the incentive for PEOs to grow via M&A has been and remains strong.

Key drivers of M&A opportunity include:

Because PEO regulation has differed from state to state historically, the market remains highly fragmented with nearly 1,000 smaller, largely sub-scale competitors. With larger players attracting premium valuations, add-on acquisitions present opportunities to increase PEO value.

As PEOs look to expand their footprint into additional states, they need the business registration and infrastructure to be compliant to local laws on day one in a new market. This makes M&A the preferred option for geographic growth, rather than de-novo startups.

By growing their pool of employees on the group healthcare and workers comp insurance plans, PEOs gain additional bargaining power with insurance companies. Further, with broader diversification risk, PEOs can move to self-insured or captive-insured models allowing them to generate additional margin while increasing their value proposition to current and prospective small business customers.

With contingent employee relationships projected to continue to grow more quickly than traditional working arrangements in the future, investors will likely be eager to gain exposure to this secular growth opportunity through EORs.

Key drivers of M&A opportunity:

Whether serving end clients or staffing companies, EOR relationships tend to be with larger, more complex organizations. As such, there is inherent need to build scale in order to reduce customer concentration more quickly.

Platform organizations will seek to add vertical market industry expertise and diversify "essential" with "non-essential" industries to mitigate business cycle risk and insurance risk.

Those EORs that are focused on helping clients globalize will seek acquisitions in geographies of interest, helping clients expand into new markets with knowledge of the geographic-specific compliance nuances.

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