William Blair

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Andrew Nicholas, CPA +1 312 364 8689
anicholas@williamblair.com

Daniel Maxwell +1 312 364 8733
dmaxwell@williamblair.com

Tom Roesch +1 312 364 8376
troesch@williamblair.com

Insperity, Inc.	
NSP (NYSE)	$114.03
Stock Rating:	**Outperform**
Paychex, Inc.	
PAYX (NASDAQ)	$120.53
Stock Rating:	**Market Perform**
TriNet Group, Inc.	
TNET (NYSE)	$92.80
Stock Rating:	**Outperform**

PEO Pulse

Takeaways From PEO Industry Association's New Podcast

In a break from our typical quarterly cadence, this version of William Blair's *PEO Pulse* highlights key takeaways from a newly-established podcast from the National Association of Professional Employer Organizations' (NAPEO's), which features NAPEO President and CEO Pat Cleary interviewing industry experts across the sector. Topics of discussion are relatively consistent between episodes, primarily addressing each guest's experience in the PEO industry and their outlook for their company's and the industry's future. Guests range from industry pioneers to relative newcomers, varying in geographical exposure and relationship to the industry. We highlight the following key takeaways from the 14 episodes that have been released so far:

- **The value proposition of PEO is constantly changing.** The PEO industry is structured to benefit from changing rules and regulations that make running a business more complicated. When laws become more stringent or difficult to interpret, having a partner to help navigate these complexities increases significantly; small businesses expanding into new states is the most common example and driver of this dynamic.
- **"If you've seen one PEO, you've seen one PEO."** This phrase is popular among industry leaders and solidifies the idea that each PEO has its own unique value proposition, even across the most closely comparable public competitors. Smaller PEOs tend to differentiate themselves through their service, customer relationships, and/or through their focus on a specific industry or geographic market.
- **The industry will continue to consolidate alongside continued interest from private equity.** Interviewees were experienced with the interplay of private equity and PEOs on both sides of past transactions. Private equity has helped grow the industry significantly and has increased awareness of the model. Interest has grown over time as well-run PEOs have proven profitable cash generators with economic resiliency.
- **The outlook for PEO is overwhelmingly positive, but leaders remain wary of potential threats.** Unsurprisingly, every interview was very complementary of the model and bullish on the industry outlook. Current industry trends including technological advancement and increased regulatory complexity simultaneously represent opportunities and threats, whereas increasing awareness and penetration of white space remain clear tailwinds for PEOs.

Throughout the podcast episodes, it was clear that the PEO industry has transformed significantly since its inception in the late 1980s. Current leadership at NAPEO and across the industry remains committed to improving the landscape for all industry participants and has proven to be highly adaptable to an evolving operating environment. All told, these interviews further enhanced our conviction in the long-term value proposition of the PEO model, as discussed in detail in our deep dive report, PEOs: Ideal SMB Partners – A Detailed Review of the Professional Employer Organization Market.

Industry Evolution

As several interviewees have been part of the PEO industry since its inception, they were able to offer insight into how the industry has changed over the years. When the PEO model was first established, the industry was largely in "survival mode," with leaders primarily focused on making sure regulators and clients were comfortable with the legality and sustainability of the model. The biggest challenge in the early stages was educating governments, insurance brokers, and clients about its legality and cost efficiency. In the late 1990s, Wall Street became interested in the model and capital flowed into the space, increasing credibility and awareness. While education remains a top priority for NAPEO and the rest of the industry, significant strides have been made in both awareness and adoption of the model among SMB owners.

As PEO education has progressed, the sales pitch has shifted from being almost entirely focused on workers' compensation and benefits to also including conversations about a PEO's technology and ancillary service offerings. As SMBs have adopted the model, PEOs have steadily added capabilities; examples include the incorporation of state-mandated retirement plans and Medicare and the administration of the Employee Retention Tax Credit (ERTC) and Paycheck Protection Program (PPP) loans. As regulations become more complicated, the PEO value proposition resonates even more, as they can help small businesses navigate these complexities in the absence of in-house expertise. The PEO industry has proved adaptable and resilient to change throughout its history, navigating the early questions of the structure's legality through modern crises including the COVID-19 pandemic and the failure of Silicon Valley Bank.

Today, PEO leaders are competing more frequently against other PEOs than they had historically when the focus was primarily on increasing awareness of the PEO model (one interviewee commented that the PEO was selling to clients who "couldn't spell PEO" at the beginning) and displacing in-house solutions. There is still significant white space to penetrate, but it seems that head-to-head competition has become more prevalent. PEOs are also competing against other outsourced HR models such as the ASO offering, which is most concisely described as "PEO without benefits." As PEO clients become more geographically diverse (i.e., hiring across multiple states), the level of regulatory complexity increases meaningfully, enhancing the PEO value proposition. PEOs, in turn, have expanded into new markets alongside their clients, which is one explanation for increased head-to-head competition, in our view. Still, there is a long runway for growth in this industry, and industry members are convinced that every SMB stands to benefit from working with a PEO. The more complicated the external business environment becomes, the more PEOs can help clients and prospects comply with regulations while also offering competitive benefits to employees.

Competitive Differentiation

Many of the interviews were conducted with the founders or current leaders of small, regional PEOs. A common theme among these interviews was the importance of differentiation in their company's ability to grow and/or maintain market share. Concepts of differentiation varied but were often centered on the PEO's go-to-market strategy or service level (i.e., offering high-touch service). It is interesting to note that technology does not seem to be viewed as a major differentiator, but rather is a hurdle to participation in the industry. Multiple interviewees mentioned that having a competitive technology platform is seen as a bare minimum requirement due to the need for integrating with other systems that clients already have in place. We believe this is partly a function of the fact that the vast majority of smaller PEOs are leveraging the same technology platform (i.e., PrismHR).

Even among the largest industry players—TriNet, Insperity, ADP (ADP $227.16), Paychex, Vensure, Barrett (BBSI $86.77)—the go-to-market approaches and service levels vary. For example, TriNet and Insperity offerings are usually more expensive on a per-employee, per-month basis but come with higher-touch service. For smaller PEOs, it can be a challenge to keep up with rapidly changing laws and technology. By emphasizing high-touch service and focusing on long-standing client relationships, smaller firms can offer a more personal touch. Given the low levels of industry penetration, we believe there is ample opportunity for both large and small PEOs to grow in the space, with a range of service models available for each client's specific needs. Small PEOs and start-ups can also compete by carving out an industry niche. Samuel Hale, for example, focuses on offering PEO services to staffing companies in California with a heavy emphasis on workers' compensation and related legal issues.

Private Equity Involvement and Industry Consolidation

Private equity has played a significant role in the PEO industry's growth. A notable example is Oasis Outsourcing, which worked with five different private equity sponsors before eventually being sold to Paychex in 2018. PEO industry leaders have embraced the presence of private equity, leading to faster growth and increased awareness of the model. The podcast episodes incorporated the perspectives of both the private equity side and the PEO side of these deals. From the private equity investor side, the primary considerations when evaluating a PEO investment include the management team, the firm culture, and offering a differentiated model. This offers further evidence that as the model becomes even more prevalent, new entrants need to find a way to differentiate their offering to attract investors and clients.

Another notable example of private equity's influence on the industry is the rapid rise of Vensure. After years of strong organic growth led by CEO (and podcast guest) Alex Campos, Vensure took its first private equity investment in 2012 and significantly accelerated its M&A strategy. When it came to market in 2021 for additional private equity funding (ultimately landing with Stone Point), Campos noted there were "13 or 14 interested suitors," demonstrating the conduciveness of the PEO industry to consolidation (as we described on pages 16-18 of our PEO primer, PEOs: Ideal SMB Partners – A Detailed Review of the Professional Employer Organization Market). According to Campos, Vensure has made nearly 60 acquisitions over the last five years and stands at roughly 850,000 worksite employees, the latter of which would make Vensure the largest PEO in the country (ADP had 704,000 worksite employees as of March 31).

Even barring the influence of private equity (albeit intertwined), nearly every interviewee expects consolidation to continue in the industry. With so much available white space—one guest estimated 15% penetration—there is an obvious race to add as much market share as possible.

Opportunities

As PEO owners, founders, and investors, it comes as no surprise that podcast guests were bullish on the future of the industry. Every guest was asked about the outlook for the industry, in terms of both opportunities and threats, which oftentimes overlapped. While we have discussed some of these factors previously, we highlight the following key opportunities for PEOs going forward:

- **Fear, uncertainty, and doubt (FUD) factors work in favor of PEO.** As legal and regulatory complexity increases, small businesses can turn to PEOs as a resource for maintaining compliance. Beyond offering attractive benefits, PEOs have been successful helping clients access government credits and navigating choppy economic environments. In recent history, PEO lobbyists played a pivotal role in extending the PPP to PEO clients, helping thousands keep their businesses open through the pandemic.

- **Low SMB penetration leaves plenty of room for growth.** As highlighted previously, one guest estimated that only about 15% of SMBs use a PEO. The PEO industry is highly collaborative as there is plenty of market share to go around, and all PEOs stand to benefit from further education of prospects and penetration of the remaining market.

- **New entrants can bring innovative products to untapped market segments.** Podcast guests highlighted the necessity of differentiation, especially for smaller PEOs. Both existing PEOs and new entrants to the industry can access untapped markets and stake their claim. As government regulation steadily increases, opportunities will arise to claim various niches, offering new products and services. In addition, there are opportunities to *serve* the industry as well; for example, Slavic401k's retirement savings solutions serve close to 150 PEOs today.

- **Government regulation will continue to increase in scope and complexity.** For PEOs, "when things get worse, things get better." The more complicated laws become, the harder it is for SMBs to maintain compliance, especially when expanding to new geographies. PEOs help clients navigate these complex environments, allowing companies to hire and pursue clients wherever the most attractive opportunities are.

Threats

Many of the tailwinds for PEOs can alternately be interpreted as threats. For example, increasing government regulation also makes it more difficult for PEOs to remain in compliance, and the mistakes for not doing so can be catastrophic. Since the beginning, the PEO industry has continuously dealt with the issue of awareness. Informing business owners about the model and overcoming their concerns (frequently cost) leads to a more difficult, elongated sales process than that required to sell a pure payroll or even ASO solution.

While technological advancement allows PEOs to offer more products and services, keeping up with technology and cybersecurity can be challenging for smaller PEOs in an industry that tends to reward scale. As technology improves, the industry also has a greater threat of outside entrants offering platforms that look similar to the PEO offering. Some leaders voiced concern over getting "out-PEO'd" by another model, whether that is a client preference for ASO or a new entrant that offers similar services. TriNet's acquisition of Zenefits and Vensure merging with PrismHR and Namely are the most obvious examples of the convergence of ASO and PEO model; for additional color on this topic, see page 3 of our report, PEO Pulse: Third Quarter 2022.

While consolidation is bound to benefit some PEOs, it will inevitably push others out. Particularly for small PEOs, it may eventually become difficult to compete if they are unable to keep up with rapid advances in technology and the breadth of services large firms can offer. Small PEO leaders believe their value proposition will continue to resonate as a result of superior service or other factors, but also acknowledge the importance of scale and technology to clients.

Podcast Guests

Through July 11, NAPEO had published 14 podcast episodes in the *People Pat Meets* series. A list of each podcast guest, his/her company, and relevant company details are included below:

PEO Industry
People Pat Meets' Podcast Guests

Podcast Guest	Company	Company Details
Lee Yarborough	Propel HR	South Carolina-based PEO with worksite employees across 47 states
Kirk Flagg	Samuel Hale	California PEO focused on resolving workers' compensation disputes for blue collar workers
Alex Campos	Vensure Employer Services	Highly-acquisitive, private equity-backed PEO; among largent PEOs in the country
Mark Perlberg	Nautic Partners (Former Oasis CEO)	Private equity firm focused on healthcare, industrials, and services
Celeste Johnson	The Applied Companies	CEO-owned regional PEO and staffing company based in Nevada
Clay Kelley	claykelley.com	Salesforce training organization focused on HRO and PEO sales
Melissa Viscovich	NAPEO	Industry association focused on promoting PEO growth and awareness
Kristen Appleman	ADP	Operates one of largest PEOs in the country, with over 700,000 WSEs
Brent Tilson	Tilson HR	Founder-led PEO based in Indiana and operating in 48 states
Brian Fayak	Nextep	Oklahoma-based, white collar-focused PEO with roughly 20,000 WSEs
John Slavic	Slavic401k	Retirement plan provider that partners with PEOs to provide pooled retirement savings plans
Britt Landrum III	LandrumHR	Industry-pioneering PEO based in Florida with over 1,800 client companies in 44 states
Norman Paul	SWBC PEO	PEO with ~20,000 WSEs embedded within a Texas-based financial services company
Tara Conger	Tandem HR	Private equity-backed, midwest PEO headquartered in Illinois

Sources: NAPEO's 'People Pat Meets' Podcast, company w ebsites, and William Blair Equity Research

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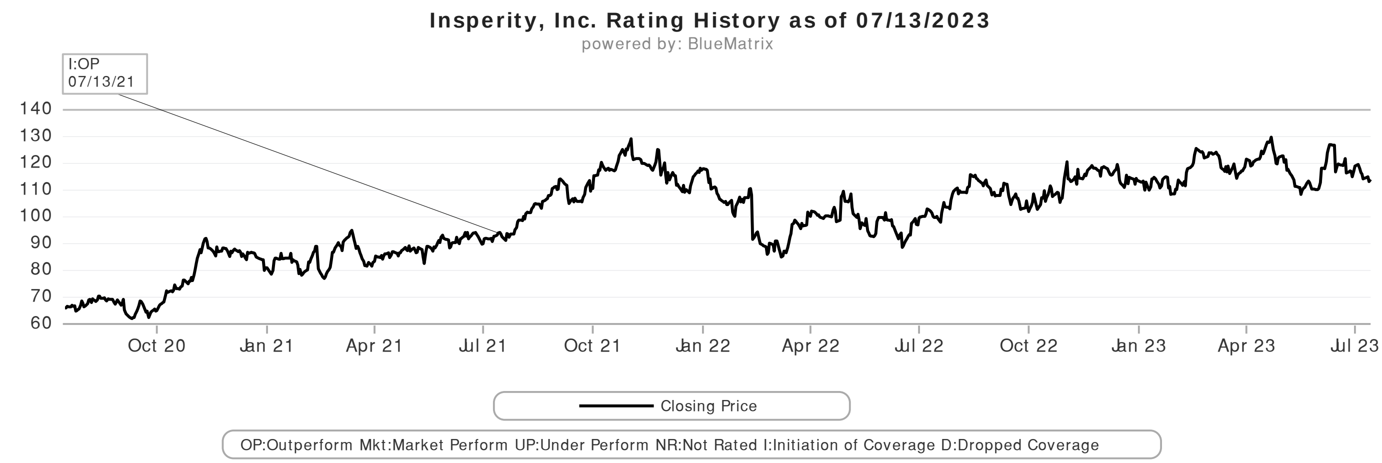
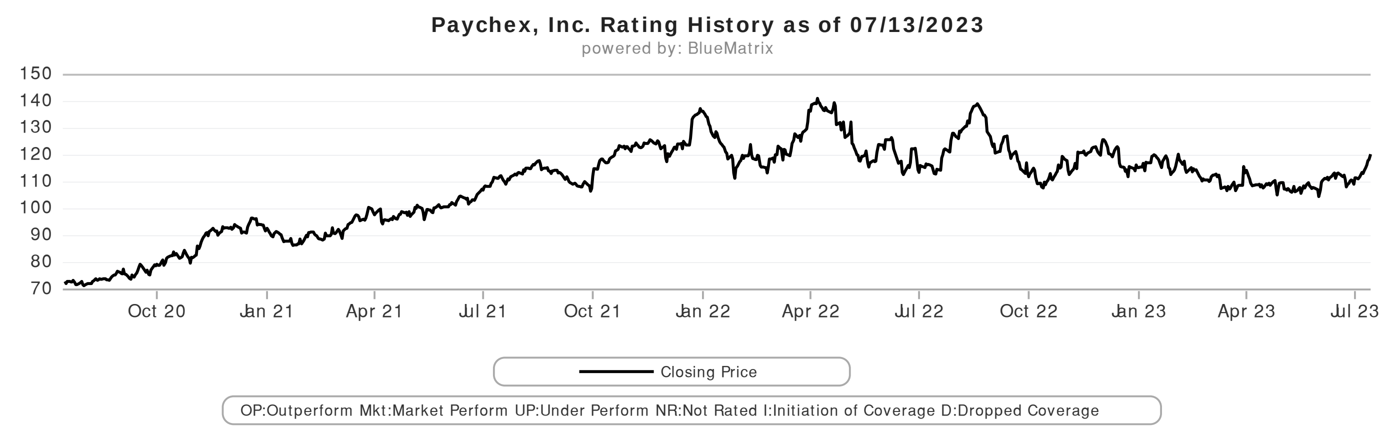
DOW JONES: 34347.40
S&P 500: 4472.16
NASDAQ: 13919.00



Source: FactSet & William Blair



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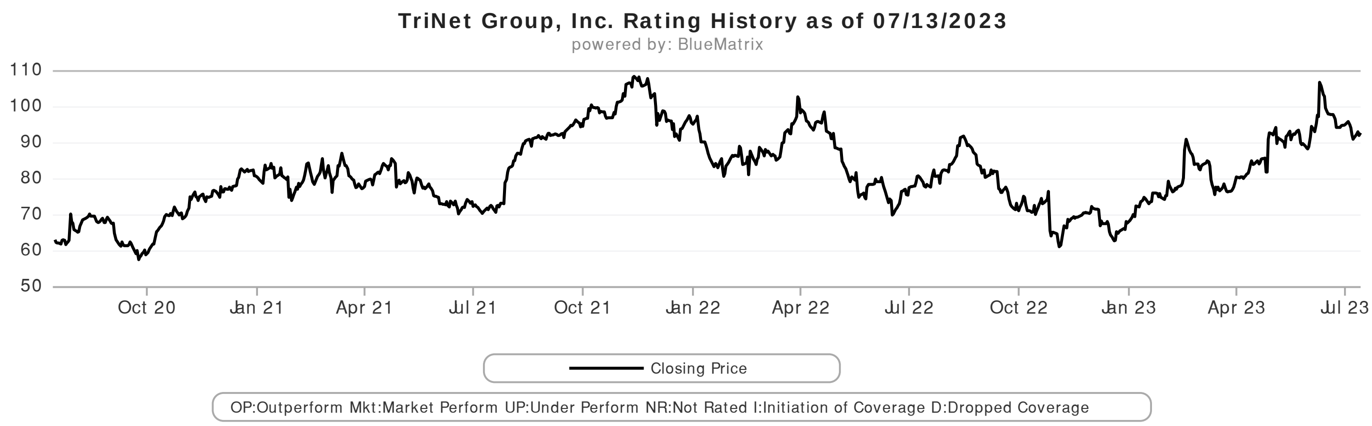

Source: FactSet & William Blair

Additional information is available upon request.

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Outperform (Buy)	74	Outperform (Buy)	8
Market Perform (Hold)	26	Market Perform (Hold)	3
Underperform (Sell)	1	Underperform (Sell)	50

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