

An Acquisition or Organic Growth Strategy?

Dan McHenry and Wanda Silva

DM: As always, it is a pleasure to join you for this article to discuss the age-old question of whether it is better to “build or buy” as a growth strategy for your PEO.

WS: Because you, Dan, are a former PEO operator and I deal primarily on the M&A side of the equation, I presume for this discussion I will focus on the “buy side” and you will take the “organic” side?

DM: Sounds good to me. Because we have limited space and this is a topic we could deliberate for days, why don’t we lay out the basic arguments from each vantage point?

WS: Perfect. I will begin with the following points, outlining some of the potential benefits of an acquisition strategy:

- Accretive to earnings: Improved earnings and efficiency.
- Market expansion: Speed of entry into a new market.
- Competition: Elimination of a competitor.
- Management talent: Acquire human and intellectual capital.
- Economies of scale: Lower operating costs.
- Sales force: Increase business development channel and regional presence.
- New technology: Potentially improve technology in operating platform.
- New products or services: Improve suite of service or product offerings.

DM: Okay, it’s my turn. Here are some of the benefits of an organic growth strategy:

- Reward: The market typically rewards organic growth. Organic growth is cheaper, and if a company is growing organically and profitably, the market has a basis to continue relying on those trends and what the value of the company will be in future years. In a publicly traded arena, growth companies are regarded typically with a higher P/E ratio because of expected growth in revenue and profits.
- Less expensive: Generally, organic growth is less expensive.
- Innovation: Slower growth may ignite creativity.
- Harmony: No clash of cultures.
- Diversification of client base: More likely to build around core products and services because companies that grow organically will likely focus and invest in new products or services to sell and it is cheaper to sell more stuff to existing clients than to get new clients.

- Opportunity: in an organic growth environment, the staff typically has the right to vie for new advancement opportunities due to the expansion of the company before outside talent is sought.
- Less debt: Organic growth normally carries less debt than acquisition growth.
- Less stress: Steady organic growth has less organizational stress.

Wanda, what do you see as some of the concerns associated with an acquisition growth strategy?

WS: There are a number of concerns that must be addressed when you are engaged in an acquisition growth strategy. Here are some:

- Business risk: The acquired company may not perform as expected.
- Financial risk: There may be undisclosed liabilities, risk factors, or contingencies.
- Integration: There may be difficulties in converting/merging technology and processes.
- Retention: Many acquisitions result initially in above-normal levels of client attrition.
- Culture shock: A poorly planned integration and communication plan may cause employee attrition and create a culture of fear.
- Dilution: You may have to give up portion of ownership to finance acquisitions.

Dan, now what concerns do you see with deploying only an organic growth strategy?

DM: I do believe there are a number of concerns associated with deploying a solely organic growth strategy. My concerns would be:

- Speed: A solely organic growth strategy can open a company to be outflanked by a competitor who is an efficient and effective consolidator.
- Human capital: There may be attrition if company is growing slower than developing staff.
- Vulnerability: Smaller companies may spend more time defending their turf (clients) rather than expanding their businesses.
- Capitalization: Slower growth may less likely attract additional investment.

Recently, we have seen another large acquisition with the announcement of the Alpha Staff purchase of Selective HR. How do you see the PEO M&A market in 2010?

WS: I think we will see a wave of continued consolidation as the economic downturn impacts the profitability of PEOs. Valuations are lower than in some “watermark” years—but the numbers hold strong for outsourced business service companies such as PEOs.

DM: Do you see the current market as a buyer or seller market?

WS: I believe the overall market is a seller’s market. Today there are more buying groups than PEO shareholders ready to exit. We are seeing solid PEO companies with well planned and

orchestrated exit strategies receiving multiple offers and therefore leveraged purchase prices based on what the market will bear. There continue to be premiums for profitable and well-managed companies. The market conditions have lowered purchase price multiples, but activity is strong. Many PEO owners have operated their businesses for 15 to 20 years, and it will be time to exit in 2010 and 2011. What do you see Dan?

DM: I agree that there will likely be a spike in M&A activity as many under-capitalized PEOs grapple with the impact of shrinking client payroll, soaring UI rates, and perhaps even a slight tightening of the WC markets. I also believe that many PEOs may elect to revoke previously contemplated exit plans. Many who once considered exits may suspend that strategy, as their expectations may have been set with the high-water profitability marks of 2007.

WS: Do you think PEOs can grow organically in the current environment?

DM: Presuming their pricing and cost of service increase proportionally with the market and there is no abnormal increase in client attrition, then hopefully PEOs will have an expansion in payroll in their existing client bases as the economy recovers. In the current economic climate, I also believe there is a remarkable opportunity for PEOs to approach companies that have never used PEO services, as many small and middle market companies re-assess their approach to business.

WS: Like me, you feel very positive about the future of our industry.

DM: I do. I know many PEOs that have used this “economic time-out” to re-engineer and re-tool their businesses. Providing a PEO is adequately capitalized and has had strong underwriting and risk management, it can emerge from the economic malaise in a strong competitive position. Also, do you think at this point in time in the life cycle of the PEO industry that a PEO can scale profitability on solely an acquisition or organic growth strategy?

WS: In today’s environment, I believe an acquisition strategy complemented by sustainable and consistent organic growth would be ideal.

DM: I am sure you will be amused that I agree with you with a slight modification. I believe that sustained organic sales supplemented occasionally by a strategic acquisition would be ideal.

WS: Ha! Because we are out of time, I am going to leave you with a business quote appropriate for the buyers and sellers out there:

“Let us never negotiate out of fear. But let us never fear to negotiate.”

John F. Kennedy

DM: I think I will close with this one:

“Innovation distinguishes between a leader and a follower.”

Stephen Jobs

[Box]

Typical Costs of Acquisition Versus Organic Growth

DM: Wanda, would you provide a hypothetical scenario showing the costs of an acquisition?

WS: Sure, Dan. If a PEO wanted to acquire 4,000 WSEs, the direct cost would be approximately four times the adjusted earnings before interest, taxes, depreciation, and amortization (EBITDA) of the selling company. To simplify, in today's market the buyer would pay for four years worth of adjusted earnings to acquire a PEO company. Some of this would be paid at close and some would be paid over time, typically in an earn-out. I use the four multiple only as an average—do *not* try this at home. Seriously, the multiple could be lower for a distressed company or higher for a platform.

For example, assume a 4,000-WSE PEO is making \$1.25 million in adjusted EBITDA. The total purchase price over a two- to three-year period would be \$5 million. The indirect costs for the buyer would include advisor, accountant, and attorney fees that are deal-specific as well as the cost to use internal employees to conduct due diligence and to manage the integration of the new company.

Dan, would you do the same for the organic side?

DM: Certainly, Wanda. In my example, I am presuming that an existing well established, profitable PEO with competitive rates in a PEO-friendly geographic market has decided to grow an incremental 1,000 WSEs above the expectation of its existing business development model. I have rounded the assumptions for easy math purposes and those assumptions may be more applicable in better economic times.

In this simplistic example, I assumed the PEO hired an additional three productive salespersons, and for math purposes, I used a combined incremental sales cost of \$200,000 per year over a two-year period. I also presumed the three salespersons between them would collectively produce an additional 500 worksite employees per year.

I also assumed that the average gross profit per WSE is \$1,000 (the 2009 NAPEO Financial Ratio and Operating Statistics Survey (of 2008 data) figure was around \$1,300) and 15 percent attrition. See the following table:

Organic Growth Model

	Year 1	Year 2	Total
WSEs			
Beginning	-	425	-
+ Additions	500	500	1,000

- Attrition	(75)	(139)	(214)
Ending	425	786	786
Average WSE	213	606	
Gross profit	\$212,500	\$605,625	\$818,125
Business development costs	\$(200,000)	\$(200,000)	\$(400,000)
Incremental cash flow	\$12,500	\$405,625	\$418,125

In this simplistic example, the PEO produced an additional 1,000 WSEs for \$400,000, an average of \$400 per WSE over a two-year period. But just like any type of forecast, it is a matter of whether the assumptions will hold up, including whether a PEO wishes to front the costs of the ramp-up time before any new salespersons become productive.

Dan McHenry is president of McHenry Consulting, Tampa, Florida, and Wanda Silva is president of Silva Capital Solutions, Inc., Kennesaw, Georgia. They have been professional peers in the PEO industry for 15 years and hold tremendous respect for each other.