Henshaw/Vierra Management Counsel, L.L.C.

Payroll Tribune

Volume 6, Issue 2

February 2014

Disruptive Technology

Happy New Year. While you were working over the last two months on numerous year-end projects from W-2's and new 1099 requirements, balancing statements, getting out employee data for year-end bonus, benefits statements, HR compliance reports…battling for new customers…and, generally working your tail off, the world has moved on. Disruption was everywhere! The East and Southeast has been frozen by sub-zero storms; the West and Southwest have had no rain, the stock market is down 6% in a month, Target had its data base attacked leaving 10 million customers wondering "did I really need that $20 Chinese made doll", the Seahawks have won the Super Bowl, and turning Bitcoins into money has proved to be more difficult than their idealistic and or ideological supporters imagined. 2014 is off and running. Change is everywhere, so thinking about how to plan and execute in this environment is as critical as ever.

For those of you who have known me in the payroll industry over the last twenty years as a payroll company owner, payroll software investor, an advisor to over 50 payroll companies, and an investment management advisor, you know that this is the time of year when I look at what you can expect in the economy and in the business so you can position yourself to grow. For those of you who do not know me, I look forward to meeting you. Here goes:

WHAT I OBSERVED IN 2013 REGARDING PAYROLL AND WORKFORCE MANAGEMENT

- A greater number of companies have devoted more time to using the critical data from payroll in more ways than ever before. This means disruption and more competition, and also more opportunities to gain market share, and to partner with service providers who need employee payroll data like insurance brokers, benefit administrators, HR providers…
- Demand for outsourced payroll services is growing driven by modest growth in the US economy, and aggressive growth in reporting requirements for compliance, healthcare services, retirement plan management…
- The needs of these users of data are becoming more clear…HR requirements/Compliance, Payroll/Tax/ACH/ Reporting…
- Solutions are being presented by well qualified vendors, and by vendors with no qualifications at all in the industry, in software, in managing start-up companies. Payroll providers need a disciplined RFP and review process to examine various "solutions" . It has some expense to it. It takes some time. It may not be a perfect process. But it can help providers assess their own capabilities and see where they need help. It can help expose "vapor ware" and vendors without the experience and expertise a provider will need to review the software, plan it's implementation, staff and client training, monitoring and review. Picking vendors, partners, software are critical steps to competing in the near future.
- Security is a big problem; risk management is mandatory and needs more attention than ever. Security needs to be part of a system's genome, design, and culture. It is much more difficult to enhance security as an after-thought, add-on, or patch. Some vendors "get it", more vendors don't. Providers need to know the difference and demand that security be a key focus in the design of a solution, the resulting operating system, and the working processes and procedures.

WHAT I HAVE OBSERVED IN THE MARKET PLACE WHICH SHOULD AFFECT YOUR THINKING

- Workforce management solutions are changing who the decision maker is. In smaller firms with less than 50 employees with simple to moderate needs, the decision maker remains the owner and/or the office manager. In larger companies, historically, the payroll group was a specialized section inside the Human Resources department and they made either the decision or were very strong advocates of the solution. HR, historically, managed the workforce from organization requirements, to job and skill definitions, to candidate search – interview/examine – hire – on-board – handbook, monitor and score performance, educate, retire or fire. Each of these functions had their own area specialists, data bases, and software.

- Times are changing driven by technology and regulations. Functions are being brought together. Few solutions are being constructed to provide more comprehensive services. A single system of record, primarily the HR core system, is being requested to supply information and services to administrators and employees alike. The decision making is moving from separate specialized sections within the Human Resources department, to a single higher level person or team inside the HR department.
- Alliances are changing. Data users are seeking out data providers directly for two reasons. They need core payroll data for use in their area of specialty more quickly and more seamlessly. And, they are finding that service providers in the food chain are going into each other's business creating competitors, instead of allies.

PAYROLL SERVICE PROVIDERS WILL REMAIN KEY PLAYERS IN A WORKFORCE MANAGEMENT WORLD

- Payroll service providers have several advantages as workforce management systems evolve. Payroll is the source of key data that drives many of the services provided to employees. Payroll processing is complex, getting more regulated each day. Tax preparation and the flow of funds from tax, insurance, benefits administration services require controls, and expertise which payroll companies have. HR management and Payroll Services require that providers have working relationships and access to the national banking system to move customer funds throughout the financial system. Employee services providers generally do not have the same level of access to the system that payroll providers have, and they need that access.

- Technology is moving fast, and in many cases is ahead of providers' subject matter expertise, system of security and controls, and, employees want convenience and immediate multi-platform access to their personal information. Business practices and user practices will need to be revised and in some cases invented, if these requirements are to move out of the Wild West, no rules environment so prevalent today. Core technologies will need to be capable, compliant, controlled, and customer friendly, and probably in that order!

PAYROLL SERVICE PROVIDERS WILL NEED NEW ORGANIZATION MODELS TO DELIVER A FULLER PRODUCT SET

- Employers are driven by complexity and regulation/compliance to find simpler solutions to managing their workforce. Most will want to out-source their requirements to providers with deep subject matter expertise.

- Payroll Providers in many cases have lacked, and continue to lack, the specific segment subject matter expertise in segments other than payroll to provide a single source solution.

- We believe that payroll providers are in a position to re-organize themselves to expand beyond payroll, funds transfer services, and tax and compliance reporting, either as a lead or as a participant in an alliance, in bringing together a broader list of services which require more in-house subject matter experts to use data and information to help their clients. These alliances may often be exclusive, but they don't need to be. Issues like "who owns the customer relationship", the system of record, system level changes, control over data exports, compliance/reporting, security of code and data and access and dealing with breach/damage/loss of data, all are part of what is required in building strong alliances. Just plug and play, poor or no business practices, a lack of rules, accountability, and experience will not work and need to be avoided at all costs if providers really want to position themselves as a trusted and knowledgeable source in the new and quickly changing world of workforce management.

Disruptive Fixed Income Markets and Your Customer Deposit Accounts

MANAGING CUSTOMER DEPOSIT ACCOUNTS IN A LOW INTEREST AND HIGH PRICE BOND MARKET MAY TAKE MORE TOOLS THAN MOST MANAGERS HAVE BEEN USING

- The debris from the wreckage of the 2007/8 collapse of the bond market is still with us. Tools we used to manage customer deposits were broken, some institutions closed down, and many institutions were discredited. The management of customer deposits became more risky and far less profitable.

- To save the economy, the Fed killed savers and investors. To help the pill go down, the politicians focused on demonizing them in the eyes of the population as nasty people unlike them or you or I.

- Savers and investors have turned to what they feel are high quality, liquid paper. In so doing they have driven the prices up and the yields down which meant that they have taken on greater market risk and got paid less for it.

- Five years later, the equity markets have generally recovered to their pre-crash levels, but the fixed income market remains over bought, riskier than ever, and yielding nothing.

- Most payroll providers have taken the direct hit from low rates, and have not raised the price of their tax and other services to offset their income losses or compensate them for the greater risks they have assumed in volatile bond markets.

TWO ACTIONS TO IMPROVE COMPANY EARNINGS AND LOWER THE RISK FROM PROVIDING DEPOSIT SERVICES TO TAX, INSURANCE, AND BENEFIT ADMINISTRATION TO CUSTOMERS AND ALLIANCE PARTNERS

- Managers should do two things: raise the price of providing tax and deposit services to at least cover the cost of offering the services, and two, create an investment policy for the management of these deposits and stick to it.

KEY POINTS TO INCLUDE IN AN INVESTMENT POLICY:

CREDIT QUALITY, MATURITY, LIQUIDITY

- The policy should address the risks the payroll provider faces in investing customer funds: credit quality, maturity, and liquidity. The bond market is huge and basically "efficient". Bond yields are a function of the credit quality of the issuer, the duration or maturity of the bond, and the liquidity or market for the bond in the market place. If a manager gets a higher rate on a bond over like term bonds, they are taking a higher credit risk. If they get a higher rate on a bond over like credit bonds, they are taking a higher maturity risk from taking a longer term. Liquidity is driven by the size of the bond, the strength of the market makers for that bond, and general bond market conditions. When market makers or large money market funds go under, even top quality bonds can lose liquidity for a period of time.
- The policy should also include the criteria for the investment managers and the custodians they deal with; basic credit quality of issuers of bonds they will buy (think terms like investment grade, history of paying interest and principle, how the issuer is managed over time); the maturity of the bonds they buy (they must "match fund"—that means for deposits they hold two days they need investments that are always immediately available at no principle loss to them. For funds that remain on deposit over time, maybe longer duration/maturities will "match" the time they have until they need to use the deposits and the maturity of the bond they use as an investment. The term of a "matched" bond may be from 1 to 3 years.

THE BOND MARKET HAS CHANGED, AND MANAGERS NEED TO CHANGE WITH IT

- The bond market has changed, and with it, liquidity has changed. Few expected that Lehman would fail, the Reserve Fund would not meet its obligations immediately, or that primary dealers in bonds would be shut down. These companies, or others like them, provided a source of bonds for payroll providers directly or to the brokers, money market funds, banks, bond funds they used to manage customer deposits. They provided a market to buy and sell bonds, usually in seconds but in smaller bonds maybe a day or two. They provided the liquidity needed to meet calls on funds by the providers as needed.

- The crash has resulted in a consolidation in the market. The consolidation has contributed to a lack of access by smaller investors to smaller bond lots. It is very difficult to buy bonds in lots smaller than $1 million. Lots of $100,000 can take days or more to find and the dealers charge high fees which basically eliminate the yield on those pieces in this market. When interest rates rise, liquidity will be an even greater issue.

THE BOND MARKETS WILL BE VOLITILE IN 2014. If the U.S. economy grows at 3%+ the fed has shown that it will continue to ease. Other markets around the world are expected to show little or no growth. If that is true, risks in their economies could drive dollar investors back to the U.S. Rates will rise overseas and could fall in the U.S.

RISING INTEREST RATES IN THE US IS NOT A "NO BRAINER". The battle between inflation and deflation is not over. Disruptive technology drives down costs and prices and may or may not support wide gains in employment (score one for more deflation). Trillions of dollars in new US government and corporate debt may one day need to compete with a stronger economy for saver's funds (score one for inflation).

When the winner is announced in the market, it will be too late to act. Act now . Put your investment house in order, put a policy in place, follow the policy, use mutual funds and bankers you can trust, and you will be better prepared to manage your way through the future.

Henshaw/Vierra Management Counsel

Preparing for What's Next * Advising the Board of One

Henshaw/Vierra has been working with the owners and managers of payroll/workforce management companies since 1995. We focus on building better managed companies to give owners and managers a real choice to continue to do what they are doing, grow faster, or sell their company. We have owned and managed payroll service companies and software providers. We have built companies from the ground up. We have managed them. We have sold them. Consider how we might join your team. We are experienced at "Advising the Board of One".