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Payroll Tribune

New Year, New Hope, New Challenges

Special points of interest:

- Payroll is now part of the human resources solution
- Pricing is moving to per person per month
- Security is serious, but development firms don't seem to think so
- Payroll industry is consolidating and bringing in new financial partners

2014 is over, but it left several impressions with me: payroll has grown and is now a part of the human resource solution, pricing is moving from per check to per person per month, security is serious but most development firms are not serious about it, and the industry is consolidating and bringing in new financial partners– equity from several IPO's and private equity through several acquisitions.

2015 is here, and will pose both opportunities and challenges, thank goodness. Out sourcing of key business administrative tasks is growing faster than the economy is growing because it offers customers the opportunity to provide its employees core service, more options, and more control than ever before. New technology from open stack, "business analytics", mobile devices, cloud applications and data storage can make this possible at a lower cost for business owners. Several areas of expertise, payroll and funds transfer, human resources, benefits administration, and insurance brokerage are coming together in combinations which are still being defined. Successful service providers will need software and subject matter expertise in each of these areas.

The challenges will come in several forms, but two come to mind immediately: pricing tactics in a competitive market and technology. Product packaging and pricing are a Wild West Show. Some players are using 1990s style pricing of "grabbing market share by giving away services". Since payroll provides key data for benefits administrators and insurance sales forces, it is being used as a pawn in their growth strategy. It is a foolish and wasteful tactic. Giving away services positions them badly in the eyes of the customers, and weakens or destroys margin, EBITA, and value. Victory will go to the companies who provide customers a focused and well supported set of services priced at a level which gives value to customers and generates free cash flow to providers.

Technology is certainly driving part of the change which will again be a very important factor in 2015. To me, the payroll business has always been about the care and feeding of data. The technology is and will be the gathering, storing, cleaning, filtering, and analysis of data. To date, the discovery, development, and sale of technology has been at the expense of data security. The neglect of the security of data and data systems is callous, calculated, and dangerous. Imagine building infrastructure without proper engineering, design, controlled development, and rigorous series of inspections. Water systems, sewage projects, highways, cities, railroads, ports built the way our technology systems have been would collapse or wouldn't last. Today there are few CIOs who could claim that their systems could not be taken down, by internal players, former employees/ contractors, or outside parties like competitors or general predators. Few CIOs of banks, insurance companies, employee benefits companies, data processing and management firms would admit that they could not be hacked. In 2015 we will see major changes begin to take place regarding security of data, systems and infrastructure. There will be serious regulations beginning to be put in place. Players who cannot or will not take security seriously will begin to be excluded from markets. The first movers will be the Federal Reserve System enforcement actions around banks and their customers, then the consumer protection agencies moving against retail and healthcare providers and government contractors on behalf of consumers who are more than just 'inconvenienced' by cavalier technology providers.

HR support data will be on the increasingly reviewed and possibly regulated target list. Take active steps in 2015 to integrate more technology into your service offering, but use commonsense in reviewing in-house development projects and purchased software. Incorporate initial and on-going security reviews. Understand the 'cycle of security' of actions to take and vendors to use before, during, and after a 'security incident'. Regular penetration tests are just the beginning of

Interest Rates: More to Think About in 2015

- ***Interest rates*** *will rise again in the U.S…* ***Bond Prices*** *will fall*
- ***Risks****: Credit and Liquidity*

- ***Be careful*** *with money market and bond funds*
- *Do your homework*
- ***Markets*** *could move quickly."*

It's time again to think about the financial markets, interest rates, and how to manage customer tax deposits and other payments. As we move from payroll to work force management those flows of funds have gotten and will continue to grow, along with the opportunities and risks of managing those cash flows while the funds are under your care.

Prior to 2007, payroll companies, insurance brokerage firms, and third party administrators made up to 10% of their gross revenues on earnings off customer deposits. Interest rates were from 4 to 6%. With the collapse of the financial system from 2007 to 2010, markets froze, some money market funds basically collapsed, depositors were denied access to funds, some very risky players were bankrupted and the Federal Reserve had to undertake untested policy moves to provide the system with liquidity. Between the crash and the Fed's quantitative easing (QE) the Fed became the major buyer in the bond markets. They drove up the price of government bonds to historic levels, and by doing so, influenced all debt markets and pushed interest rates to near zero. Workforce management companies saw 10% of their revenue stream disappear.

Today we find an over-bought bond market, lower than normal spreads between the best and the lowest quality credit issuers, a boom in unregulated "financial" institutions issuing untested investment "securities and deposit instruments", and interest rates on the verge of going negative (in Switzerland rates on bank deposits are already negative 2 to 3%).

Interest rates will rise again in the United States, possibly in 2015. Savers will not long tolerate for-going massive amounts of income to support unhealthy monetary policies, and the lack of leadership and direction from a dysfunctional Congress. As rates rise, bond prices will fall. For example, if you owned a bond with a 4% coupon which you bought on a yield to maturity basis of 3.5% with 10 years to run at $104.19 and interest rates rose 1% for that bond to 4.50%, in a stable market the price would fall to $96.01. Your loss would be $8.18 per $1,000 bond, or 7.9% of your investment. That is the level of lost on a 1% move in the market. Do the calculation on a 4% move after lunch, you will feel better then.

If the borrower who wrote the bond cannot afford to pay the new market cost of money, it could lose its credit lines; its working capital could decrease, and they may need to reduce their plans for growth and expansion. Some will fail. If you own those bonds, your losses could be more. In the past 20 years, the investment bankers have created a vast number of debt instruments which were never really tested for liquidity in extreme markets, where there was just no market for their instrument. The issuing company often is not in a position to buy them "in" at any price. The bankers have taken their fees and left the scene long ago. In 2008 the only market maker left was the Fed. It bought the good, the bad, and the ugly. It made the "markets". It had to push interest rates down to record low levels to do it. It re-established the markets and turned the economy around while Congress became leaderless and dysfunctional, the investment bankers joined the "1%", and the over compensated management teams of some of the greatest issuers left their firms in limbo and got even higher paying jobs somewhere else. But, I digress.

You and or your company normally don't own these bonds directly. Banks, insurance companies, mutual funds, and others you use hold the bonds, directly or indirectly. They will see the price of the bonds fall for two general reasons: the supply of bonds will exceed the demand for bonds, and many bonds will become illiquid for some period of time as everyone heads to the door at the same time.

What we could see, as interest rates rise and bond prices fall, is greater illiquidity in the largest holders in the market place, not just the little guy. Do not think that your giant bond mutual fund company will automatically be the safest place for you to be in this market. In 2008/2009 the oldest, best, and most trusted money market mutual fund became illiquid. The President of the United States, on day after the event, had to go on national TV and announce that all fund balances would be "guaranteed". He saved the markets from a massive run.

So, be careful. Do your homework. Rates will increase. It will be messy, and it is necessary. Use several mutual fund vendors instead of just one. Many of the funds today know the issues I have outlined

Interest Rates Continued

and are taking active steps to reduce their exposures. They will be using their preparation as a selling tool. Start looking now for those firms.

Fed is hoping that the return to more normal interest rates can be done slowly over many quarters. The "Street" which thinks in nano-seconds and rarely the long term, will try to jump and gun and will over react. They will push the change faster and further than necessary. I have a friend who is a former Governor on the Federal Reserve Board. He recently reminded me that none of the current members of the Board have ever had to raise interest rates, because they are relatively new to the board. They are people who have a difficult task to perform, basically on their own because Congress is not up to it.

We will get through this because it will happen and we have no choice. Start working on it now to either get out of the business of managing customer funds, or by doing your homework to find the best groups to work with.

Reasons for Optimism

There is a lot to be optimistic about for 2015: the economy is still on an upswing, more and better technology, market share and margins will go to the swift, 2014 IPO's have done well and will help to continue to attract capital and new buyers, and consolidations will continue. Well run and well positioned companies should prosper in this environment.

The business environment can support 3 to 3.5% GDP growth meaning that existing business can expand and new start-ups will increase during the year. That means more employees to service and more companies to employ them. Capital will be available to support some more IPO's for companies on the larger end, and more acquisitions across the board.

The rules for participation have not changed. For service providers, value will go the companies which can demonstrate revenue growth and consistent market leading margins over time. Growth targets of 10% plus revenue and normalized operating margins of 20% or more are hurtles for getting into the mix. If you are operating below those numbers, 2015 will be a year where it will be worth your time and trouble to get to those numbers by setting up predictive budgets and understanding what drive your revenues and margins.

Players in payroll, HR Services, Benefits Administration, and insurance brokerage who wish to lead consolidation acquisitions will need to have access to capital, will need to have revenues of over $50 million and revenue growth over 25%, and margins over 30% to attract the best opportunities. Those few seeking the IPO market may have one more year before higher interest rates force the market gates to narrow. These deals are usually driven today by companies with sophisticated investors on the board of the companies to guide them through creating strong revenue growth strategies and management

- **GDP Growth**
- **Work force manageme nt services in strong demand**
- **Lots of capital around to support growth**

Optimism Continued

enhancements to make them attractive to the institutional investors in the public markets.

2015 will be a good to prepare for this competitive but exciting future. Growing through acquisition or being a successful candidate is a process. It takes an ownership which understands how their company makes money specifically, understands value from the viewpoint of the new partner or buyer, has a history of providing good customer service and has developed customer loyalty, and has a management team in place which can assist in the development of a new and broader enterprise. Buyers will be interested in 12 to 24 month histories of results. New partners will want 3 to 5 years of history, and a deep dive of the current situation. If you have software, they will want clear use, if you have written, developed, modified, copied your own or other's software, buyers will do up to line by line due diligence of the software to establish ownership or authorship, and require escrow accounts or more. 2015 will be a good year for companies seeking these kinds of changes. And the time to prepare is now because it takes time to plan for and organize for a future which may depend on these types of transactions. Get help from people who have been successful at preparing companies for their future. Deals are hard to do, and are very emotional for most parties involved. Plan ahead and know where you are going.

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