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Payroll Tribune

Thinking Ahead for the Next 12 to 24 Months

Economy

In January the market was down 16%, by March up 18%, by mid May down, and by July +18%. Unemployment is at a 10 year low but that's counting your children who may be on-demand Uber drivers or contract programmers and not an employee. The economy is awash with cash due to over active and ineffective monetary policy and non-existent fiscal policy. Europe was never committed to being united and is coming apart. Unemployment there is in the teens, and much higher for the 30 and under set. The Swiss and Germans have negative interest rates. In Japan, the Japanese have deflation compounded by a 24 year plus recession. And, it may not be good that we are not alone as elections around the world are putting "non-establishment" types into office.

Can it really be as bad as it looks? Should we care? We need to care because these events drive the general economy in the United States. If the US grows at less than 2% a year, I think that 2 things happen that owners should care about: markets will consolidate and business models will be stress tested.

Industry

Several things are driving the HCM market: technology (sources and uses of data, data management and analytics, saas business models), new capital and new competition (competitors from payroll, human resource management, insurance, and other benefits), and new regulation.

Let's look more closely at HCM and see what's driving markets, so we can figure out how to review our business model to compete and win in the rest of 2016 and beyond. Success in any business requires that you provide a competitive service and a fair price. A fair price is one that clearly demonstrates value to the customer. Value comes from providing accurate, reliable, secure, and we must add convenience, service, data and information, timely to customers who may be resource constrained and are subject to increasing cyber threats and government regulation.

What's driving the market are 1.) large technology / R & D development spends (new technology/software, better hardware and storage, cloud, mobility); 2.) compliance and regulation; 3.) multiple uses for acquired data (H/R, payroll, insurance, healthcare); 4.) user efficiency and costs; 5.) competition (new sources of capital are sponsoring innovation and development and funding of front-end loss producing saas business models which focus on first and fast to market sales wins, and growth or death marketing strategies). These driving forces will increase, until they can't.

Company

Customers want efficient and cost effective human resource management operations, and they are willing to pay at least the discounted pricing they are seeing in the current market place. As a result, they are employing more services from providers. Customers are seeing value in what is on offer and what is coming down the line at them. The value proposition will drive the PEPM higher.

Companies competing in the Industry should build their strategy by thinking about combining three different businesses as the Industry goes through many of the changes listed above: One customer, one data base, one overall interface, three businesses (departments/segments).

This strategy does not really support the tactic of putting limited resources in one business segment at a time, especially into segments which are not core to the original company. The strategy requires thinking about what the customer wants and how best to provide it. The services are complex, generally but not specifically related, and highly regulated. It requires combining subject matter experts, new software and cloud resources in a secure environment, and the capital and management skill to bring them together.

The margins are different for each line of business. All the business segments can be improved by the new technology. All will improve margins through economies of scale. Combining the sales and marketing effort, and building a customer base where customers have multiple potential relationships with businesses which have generally " sticky" recurring revenue streams can improve valuations even down to the retail level. The higher margins will attract competition, some smart, some dumb, some who are not good safe operators, and some who hope to grow fast enough by gaining volumes by cutting prices before their capital runs out. It will take some time before the right business model settles in and margins become predictable, but they will.

it will require a *new organizational structure* to implement and support HCM. The New Organization Chart for HCM will have elements that are common to each of the four business segments: H/R, payroll, benefits administration (workers compensation, healthcare and supplemental personal insurance), and retirement services. The common elements where much of the economies of scale will come from are: administration, finance and treasury services, marketing and brand management, IT, and facilities. The segments do have common functions like on-boarding and customer service, however these functions include very different skill sets, education and training, licensing, and duties. Achieving higher margins and scale will take management focus and skill. H/R and insurance businesses have large compliance service functions. They are highly regulated. They each have elements which are highly labor intensive. Payroll and insurance businesses have significant flow of funds responsibilities to third parties. They require strong cash management services and are dependent upon the provider having access to the banking system. All HCM segments require significantly more security for data, transactions, and storage particularly as customers demand mobility at the company and employee levels.

Populating the new organizational structure with subject matter experts may be done quickly through mergers and joint ventures, through developing a network of alliances with third parties, or by hiring and training new staff members. Mergers bring resources together quickly but pose ownership and capital considerations. Alliances can work but require strong sales incentives and some management commitment. Hiring new staff members is slow. Training staff to be productive takes time. Integrating them into a cohesive team takes strong management skills and time. Mergers and joint ventures may be the fastest route to market, but before undertaking them understand post deal goals and objectives, skills sets and management resources required and available, capital requirements and sources, and the implied exit plan. Mergers and joint ventures fail when business processes are not implemented, and the implementation not managed by capable people. They fail when systems are not integrated well timely, and clear lines of responsibilities are not delineated. Many times combinations fail because the potential partners can't agree upon who "owns" the customer relationship. Here's a novel idea: the customer "owns" the relationship. The potential partners "own" cash flows which come from the relationship. Those "cash flows" have immediate and long term value which can be monetized and divided. Done correctly, all potential service providing partners have an interest in making sure that the customer is satisfied, and that cash flows grow over time.

Competition

The competition is fierce because the opportunity is great. Like you, the competition needs to believe that to succeed they need to understand the market opportunity, develop software and expertise to attract customers, and grab and hold market share as quickly as possible. Established companies with lots of expertise in one or more market segments are going the merger pathway to build up their levels of expertise in new product and service lines. New tech companies are creating new software on new platforms to reach new markets. Both these groups are increasing their marketing and sales efforts dramatically. They use the saas model which emphasizes development and sales spend for growth and market share over cash flow and margin. They are betting that the winner takes all in the market, and the winner is the team with the most customers signed up on long term contracts to provide annuity style cash flows into the distant future. It's a gamble that "disrupts" the market with new product offerings, large pricing discounts, and low entry costs for their customers. It's also a disruption when a majority of these companies fail when they run out of capital and cash before they achieve their marketing goals, and there is no one left to buy them.

How do you compete with smart people who are willing to gamble other peoples' capital? They are willing to spend 35% of their revenues on R & D, and 45% of their revenues on sales, while they offer low/no money down cloud based saas services. You need to look very hard at your business model. You need to offer competitive services, you also need to operate on current platforms which have the back office functionality, controls, and security measures that will allow you to operate in a highly regulated consolidating industry. You should focus on niche markets where expert personalized service matters and is provided by actual employees, not contractors or through remote service centers.

You need to manage your operating cost down, because your IT and selling expenses are going up. Where the IT average costs to revenues ratio was 22%, expect an increase of 15%. Expect cost increases from supporting labor-intensive H/R consulting services, regulatory and compliance management, and higher levels of audit and cyber security costs. Expect your Sales and Marketing costs to increase at least 50%. On the bright side, better and more efficient operations should yield lower operating costs to revenues ratios by 5%. As more customers buy more services on cloud platforms on a per person per month fee basis, your revenues will increase. PEPM will increase because customers will value what is on offer by well-run HCM firms. Today's fair price of $5 PEPM will approach $25 PEPM over the next 2 to 4 years, and go higher later. 20% operating margins should be the goal for firms with less than $10 million in combined revenues. Larger firms can do 50 to 100% better.

Few industries operating in a 2% general environment can even consider achieving these margins and revenue growth rates. There will be disruption as the three market segments come together to grow HCM into the preferred consolidated human capital management system. There will be winners and losers, companies merged and submerged. But there will be opportunity for large and small well run, laser-focused firms in the coming quarters to do markedly better than the US economy in terms of strong growth and increased profitability.

IPPA Conference in New Orleans September 21 – 23

I plan on attending the IPPA Conference in New Orleans. I hope to see you there. I am happy to talk to you about your strategy for taking advantage of the opportunities in HCM

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