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

# Payroll Tribune

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## SOME THOUGHTS ABOUT THE FUTURE OF PAYROLL

I went to a couple of payroll conferences this year and was struck by two conversations I had, one with a smart old banker and one with the founder of a well-run and well-respected regional payroll company.

The banker and I talked about industry trends – product expansion into HR services, benefits administration, retirement plan administration, changes in software and hardware, and competition. Because we are bankers we also talked about what it will take to win in the next stage of our industry's development: what kind of leadership a company needs, where to find the talent to manage the changes in technology, and what amount of capital will be required to compete. I came out of that discussion knowing that the future for outsourcing human resource services is bright.

My view coming out of that discussion is that technology is currently driving the changes in the industry to provide customers responsive service, quality products, and comprehensive solutions. Companies will face challenges in bringing together leaders with a broader base of knowledge of diverse businesses like accounting, payroll, insurance, benefits administration, and retirement administration. The survivors will grow or form syndicates to bring human resources together.

The hardest issue coming out of the conversation was where the capital will come from. The capital needs for technology, human resources, conversions, starting up new operations will be significant. Most independent providers are S Corps and LLCs. They distribute much of their free cash flow annually in the form of salaries and distributions. Their balance sheets show few reserves and retained earnings. Without retaining capital these providers will find it difficult to make the investments which will be required to remain competitive. Their choices will be limited unless they begin today to plan for their capital needs.

Workday (WDAY) went public recently. To me, at least, it shows that well lead companies can, and in their case certainly did, attract investor capital. They priced their stock at $28 a share, giving themselves something north of $500 million of new capital. The shares opened at $48 a share, and a week later were trading at $53 a share, giving them a market valuation of $7 billion. That is pretty good for a company with less than 200 customers and is currently losing money! I bring this up because it shows that larger well run workforce management companies with well thought out business plans can attract attention. And, I know that some of you get approached by private equity buyers who "run the numbers" on your company and "can't possibly offer you more than 5 to 7 times EBIT". Of course they may be planning on "rolling up" your assets with others and re-selling the assets, maybe not at what Workday got, but closer to what Workday got than what they are offering you. You might want to see if they will let you ride along with them, instead of just completely buying you out. If not, you might want to keep shopping.

My conversation with the successful founder made me think more about change. He is generating the free cash flow he needs to make the proper investments in technology, leadership, and marketing. What he asked me was why I always repeated the same old song about the fundamentals of managing a business. These are changing times he told me. Catch up. Get current. Tell me something I don't know he asked. I think I told him that it was nice to see him too, as I fell into thinking about whether things were really different, was there really a new world, or can you rely on the old time religion to become a master of this next universe. I decided that it is important to keep repeating the basic elements that go into building a successful payroll processing and human resource service company.

### The fundamentals matter and I see too few managers using them, so here goes.

Since it's time to think about your 2013 business plan, the old time religion bears repeating:

To build a plan you need to know what your customers value and how you are going to provide to them and at what price. Your marketing plan should consider the products and services your customers want, the prices you need to charge to be competitive and make a profit, and how you are going to communicate to your customers and prospects.

# THE FUTURE OF PAYROLL (CONT.)

Your operations plan should detail what a "right sized" organization looks like, the leadership you need, the equipment and technology required, how you will use technology and your staff to deliver your services, and space you need.

Your capital plan needs to take the marketing plan and operations plan together to determine the investments in technology and equipment.

Finally, with these plans in mind and lots of historical data on the rates and volumes of services you have provided and plan to provide you can build your financial plan. With your historical cost information and the following operating ratios (operating margin target of 15%+, mis/it/operation to revenue ratio of 20%, customer service team costs to revenues of 30%, sales and marketing expense of 10%+, and G&A to revenues of 25%), you can complete your budget. It really, really helps to collect these numbers monthly and to group them as I have so that you can compare your outcomes to the industry. If you can compare yourself with the industry, you can improve yourself.

**Just in case you were wondering if the old time religion works, a certain industry leader has an operating ratio of not 15%, but 38%. And, they are planning the following growth rates for the following lines of business: payroll (3 to 4%) and HR services (9 to 11%). I imagine Workday will do even better.**

So, your challenges as you think about the future of payroll:

- What business are you in, what is the amount of capital you need to be in it, and what do you need to change about what you are doing now with your free cash flow to raise the capital, if you can.
- Will you put a budget and business plan together for your company this next year, will you gather the data you need, will you use analysis that is time tested to build your financial models, and will you critically analyze monthly variances to improve your outcomes?

This is old time religion. Nothing fancy. Nothing new.

# WHAT TO THINK ABOUT WHEN SELLING

I received several phone calls after my last Payroll Tribune where I wrote about selling a payroll company. It seems like there is quite a bit interest out there. The motivations for selling differed from owner to owner. Some were thinking about retirement, some about the cost of new technology and other changes, some about the competition, and some just wanted to know what was going on in the market. I enjoyed talking to most of them.

In my experience when owners begin to think about the issues above, they need to change their mind set and need to have a plan to manage their company in a way to make it an attractive candidate for sale. Few are in a position to sell their company at the drop of the hat. Most need to prepare, get organized, and get focused. This may take some time, cost a bit of money, but it is time and money will spent in terms of helping to make good decisions, protecting the company and the owners, and getting a fair outcome.

Let's go over the basics.

As an owner you have three options of what to do with your company. You can maintain it. You can grow it. You can sell it. All are very good objectives. I believe none of them happen unless you plan for which ever option you take.

Let's look at a few examples of choices you can make that make a difference in how you manage your company depending upon which option you want to take: pricing and discounting, tax account management, and documentation.

As an owner maintaining or growing your client base you may take to a strategy that you are competing very hard for customers and that the customer is always right, both of which are not bad assumptions. You customize or discount your price. You don't change the customers' pricing for years. You may customize reports to meet the customer's needs. Or maybe you're a bit understaffed and you manage your tax account by looking at the bank statement from time to time, and investing the escrow funds by buying some notes or short term bonds you may not fully understand but your broker recommends.

These actions are all common practice among independent payroll providers. They all have risk implications with which most owners are willing to live.

But, when you go to sell the company, you may want to look at these practices not through the eyes of an owner who has already accepted these risks, but through the eyes of a buyer who is looking at buying a predictable and repeatable stream of income from a customer base they wish to purchase. The customer base may no longer be serviced by you and some or all of your current staff.

# WHAT TO THINK ABOUT WHEN SELLING (CONT.)

Multiple pricing tables, customers with implied fixed prices, undocumented custom reports, escrow accounts not reconciled at the customer level, unsecure links to small unknown and under-capitalized third party software providers, and possibly risky investments in the escrow accounts, need to be thought about prior to putting the company up for sale, if the owner wants to get a strong bid with few contingencies.

Selling your company requires that you put in place a plan to sell and take actions prior to the time you begin to shop your company.

The first thing you should understand before you start is that selling your company is an emotional experience. Be prepared for that, particularly because it is not an emotional experience for the buyer. When we work with clients, we spend more time than they can imagine on talking through the emotions. Selling a company, particularly if you founded it, is hard. If you are not fully committed to the project and plan, back away. You are not ready. If you don't, you may end up wasting your time, and showing your company to potential buyers/competitors that you can't work with. Jumping in and out of the market can reduce your sales price and give competitive information away.

Once you are committed to a selling plan, here are some steps you should consider.

- Determine what you have to sell
  - Most deals are asset sales, where you sell customer relationships, and you keep any liabilities. You need to know specifically how you produce revenue and how stable that revenue has been and will be. You need to know that your historical numbers are right.
- Get the company ready to sell
  - Full disclosure
  - Lock down the numbers
  - Find the documents and files
  - The electronic deal room
- Understand how to qualify a buyer
  - Honest
  - Judge the buyer by the company he/she keeps
  - Financially capable
  - Understands your business and industry
  - Understands the sales process
  - Knows what they want and understands valuation in today's market place
- Get some help in understanding the selling process
  - Prepare the company
  - Market the company
  - Define an offer
  - Accept an offer
  - Define and control the due diligence process
  - Elements found in most definitive agreements to purchase assets
  - Representations and warrantees in many definitive agreements
  - Close
  - Post Close
- Learn what is required to close a transaction
  - Company deal team: advisor, attorney, accountant
  - Term sheet
  - Definitive Agreement and Exhibits
  - Payment
  - Escrows

Most sellers have never sold a company before. Common mistakes are casually talking about selling before you are ready, not screening buyers to see if they are qualified, taking the company on and off the market, underestimating the time to prepare to close quickly, and being unprepared to prepare for the representations and warrantees buyers will require.

As an owner you have three options of what to do with your company. You can maintain it. You can grow it. You can sell it. All are very good objectives. Oh, did I tell you that selling your company is an emotional experience? With some planning and preparation, however, the stress can be managed and a fair outcome achieved!

## HENSHAW / VIERRA MANAGEMENT COUNSEL, LLC

Henshaw / Vierra Management Counsel LLC has helped the owners of payroll service companies maintain, grow, and sell their companies for over 15 years. We have owned and managed payroll service companies and software providers ourselves.

We work with our clients to help them consider their strategic alternatives. We help them prepare their companies for success in the strategy they select, and to prepare them for what's next. If you are thinking about selling your company at some time in the future, we can help you prepare now and we can work with your advisory team to design a selling plan and help you manage the selling process when the time is right. With our direct experience in the industry, we can "even up the sides" in dealing with buyers.

When you are thinking about selling your company, we are on your side.

Call Guy R. Henshaw at 510-749-3225, or e-mail guy@henshawvierra.com