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Good Morning. I am happy to be here, and to see you again. I have worked on boards of payroll companies, owned a payroll company, financed software companies, consulted with over 50 service bureaus over the years, and spent my youth in commercial banking.

The markets have changed a lot since IPPA was founded in the late 90's. This morning I will take a few minutes to run through the general environment that the HCM industry finds itself in, and take the Pulse of the Industry. I am willing to take a few questions at the end.

Pulse of the Industry

State of the Economy

- There is a pulse: shock of Recession not easily forgotten, near financial melt-down, greed-avarice-incompetence, lost wealth and purchasing power
- Lessons taught but not learned: the dollar is the reserve currency of the world, monetary policy is about managing money. It is not a substitute for lack of fiscal leadership
- US is growing, at 2%, get used to it, it's way ahead of our long term competitors
- Growth is being driven by increased productivity, technology, value creation, and you are right in the middle of it

What is happening TO the industry?

- Technology is changing the environment: data (storage, retrieval, functionality), system design increases applications and flexibility, communications and mobility, analytics (stochastic and predictive), and management strategies (lean operations and precision marketing)
- Human Capital Management has become real from organizational design, to hiring, to taking care of, and retiring employees.
- One base of data, multiple touch points and applications, strong value add for employers and employees
- Not done yet, major gap in the technology and process is cybersecurity: application design, program review, weak points within local systems, internet, mobility, real focus
- Data and flow of funds will draw significant regulations and compliance requirements to the industry. Don't fight them over regulations, write them. To date the industry has operated as a shadow banking industry, and unregulated insurance and securities brokerage.

What is happening IN the industry?

- Early adopters are gaining market share using technology to make financial services more effective and efficient in the use of employer and employee data and the movement of personnel related funds
- They can be a threat to established incumbents

- Incumbents are: financial service providers like banks, insurance companies, wealth managers, and payroll providers
- Technology changes the speed of change, the cost of change, the need for organizational change, and customer preferences
- Player management teams must learn to be nimble, realistic, and adaptive
- Capital is needed to pay for development and marketing on a scale, and at a cost many players have not seen before
- Larger customers are more sophisticated and demanding. Service providers dealing with large customers will come under increasingly heavy regulation to meet their customers' requirements. Businesses will demand more effort in building and maintaining strong relationships with these customers. This will be capital intensive and require highly specialized knowledge in human resource management, benefits administration, and treasury management.
- Smaller industry providers will need to consider either entering into partnerships that provide specific solutions and capital to compete, or recognize that they will need to enhance their own capabilities and resources significantly.

What does it mean to you?

- The good news is that the market needs these services to increase their efficiency and to allow them more time to focus on their business
- They want to out-source these tasks: to become cost effective, to buy deep knowledge in complex services, to buy regulatory

expertise, and, frankly, to partially transfer responsibility and liability

- These are great businesses when done correctly: strong positive cash flows, recurring revenues, service/relationship driven
- Industry trends are positive and in transition. Some public and privately held players have attracted huge amounts of capital and carry high multiples against meager bottom-line performances. It is not unusual to see 25 to 35% of revenues spent for development and another 30 to 40% spent on sales and marketing expenses, and with no immediate hope of a bottom-line. The investors are betting that their ideas will capture a lion's share of a "winner take all" market strategy
- There are less risky paths to take

What can you do about it?

- Take a broader view of data that you share within HCM related services
- Hire or develop more In-House "subject matter expertise". Markets and regulators demand it. Markets will pay for it. Key areas of needed expertise are: Payroll, HR, insurance (workers' comp and healthcare, some life/disability); treasury management of flow of funds (data and money transfers, fraud, money laundry), data and cyber security
- The new environment will change your organization, your management needs, and your margins

- Where firms tend to under invest: planning, training, sales and marketing, and customer service
- The market is already demanding HCM services, it's the players who are trying to figure out whether they can or want to be single source providers.
- The market is OK with PEPM pricing. Core services are already being sold at $25 PEPM and going to $50+, quickly
- Retain capital and build your organization to compete

What happens to valuations as the industry moves into the next generation?

- You don't compete in a vacuum. Competitors define much of your reality
    - The big guys historically run a disciplined and focused operations and income statements
    - New tech companies have adopted winner take all, high risk strategies, many are betting outside investor money on gaining disproportionate market share at the cost of high capital burn rates
    - IPPA members are generally focused on smaller target markets where personal service matters…use Tech to get personal.
- For those who want to sell:
    - Asset sales are a normal way to go for smaller private companies: are attractive to Buyers because they contain liabilities for them, and allow integration into their structures. The more the seller documents, the better the integration, the higher the seller's net

    - Think like a shareholder and less like an owner as you plan for an asset sale
- For those who want to stay:
    - Revenue will be a key driver in valuation, EBITDA may be more important for the seller's net
    - Revenue considerations: make it sticky, make it last. Track customer relationships. As acquisition cost raise, it is mandatory to think about doubling the average life of your customer base. Design your firm for a $50+ PEPM world. Change the way you think about measuring your performance. It's not about checks any more
    - Push efficiency through out your organization: be lean, understand the flow of work and the required levels of expertise needed to service "sticky" customers and their employees. Economies of scale matter in payroll, HR data services, benefits administration, and insurance sales and servicing. Put budgets in place, and manage to your budgets
    - Plan to grow Revenues 10%, Expenses 5%, and build margin to 20% if you want to generate the capital you will need to remain independent.

The pulse of the Industry is strong, and the forecast for the fittest, healthy. If you need help, get a personal trainer so you can live long and prosper.

I am happy to take **questions; I may not be able to answer them. Thanks for your time.**

Questions

1. Growth

a. US at 2% how can I grow 10% or more than that over time?

i. You are in one of the few fast moving sectors in the economy, blessed by tech focus, value-add products and services customers want and will pay for.

ii. If you are not spending 15% of your revenues on sales and marketing today, do so because you heard earlier what some of your wealthy competitors are spending. Put together real performance standards for your sales team.

iii. Put systems, and processes, and skilled people in place to broaden your product offering. This processes run from market research, to product development, to the control and operating environment, to marketing/pricing/promotion/channels, to conversion and implementation, to ongoing customer service, to long term customer retention. Think lean, manage by the numbers.

iv. Increase your prices 3% a year without fail

b. Competitors use predatory prices and have capital to burn, how do I compete?

i. Match your product to your targeted market, use value pricing, and really provide top notch highly trained and motivated customer service people. Understand and track how you make money: some price/cost times volumes for each line of the budget;

compare your actual result against your budget for every line of your Income Statement; understand the variance and determine the amount contributed by price/cost and by volume variances.

2. **Where do I get the technology?**
   a. Write it yourself: if you do, start with a small group of, smart, trained and experienced developers who have deep subject matter expertise in each of your market segments. Development isn't cheap. Great developers who have industry backgrounds and expertise are hard to find and expensive. Development never stops, particularly in a competitive saas world. You need economies of scale to spread the costs either big volumes or high prices. That's the thinking behind the "winner take all" strategies.
   b. Venture backed software companies can spread costs over a wider base.
   c. Build it: Super API, best of breed (see 2 a above)

3. **Fight regulation: don't**
   a. Know your customers: are they real, how sophisticated are they, do they employ knowledgeable staff, are they professional, do they "get" security, do you and they understand the risks in HCM
   b. Insurance is a sophisticated and highly regulated business
   c. The banking system is highly regulated and the regulators will one day turn to review the risk your undercapitalized

business represents; without access to ACH you are out of business.

d. I have shaken my head at CEO's in regulated businesses that fight with and degrade regulators. It is a totally losing proposition. Regulators most often are just doing their job. If you are responsive and prepared, they will react to your level of co-operation in most cases. Trust flows two ways. They know the rules, often better than you and your lawyers do. They can get you fired and your company closed down. They are often, however, willing to listen and learn if they can trust you, and you have ideas that make the industry work better.

4. **Incumbents are friends and potential partners as well as competitors**
   a. **Most incumbents only have parts of the product offering, but they can bring deep subject matter expertise. Insurance companies have the margins to play in this game. Benefits administrators are seeing major parts of their business under attack. HR companies have been focused in larger segments, or didn't have the scale. They are seeing tech open markets but need expertise. You know all about what payroll companies are looking at.**

5. **Where do I find expertise in payroll, HR data services, HR consulting services, insurance, and wealth manage?**
   a. **Partners, acquisitions, your community business contacts**

   i. **I am not a big fan of casual referral relationships – not enough effort or follow through**
   ii. **Joint Ventures can work – form a separate LLC, put some capital in place, need to make sure that partners agree on the vision of the LLC**
   iii. **In coming together remember that different partners are in businesses that carry different multiples: payroll companies as a base; HR Consulting and staffing companies and insurance brokerages have half the multiple of payroll; HR data services are new but can match payroll multiples; wealth managers doing 401 (k) administration try ¾ of payroll; wealth management running money (highly regulated) trade at 1 to 4% of asset under management.**

6. **How does this change my organization?**
   a. **Silos and other inefficient structures (leaders are those who have been there the longest; data, process, and relationship hoarders)**
   b. **Lean management systems: know what is needed, what enhances productivity, workflow analysis and design, and use full on risk management analysis**
   c. **You will spend more time managing experts, and managing risks**
   d. **Customer Service Teams: serious training, strong customer service software, seamless hand-offs between product service teams. (USAA model)**

7. **In selling, what do you mean "the more you document, the better the integration, the higher the net"**
    a. **Algorithms are changing conversions, but the more you customize the bigger the algorithms, the less the documentation the greater the carnage, the greater the carnage, the lower the net**

8. **In selling, what do you mean by "think like a shareholder and less like an owner"**
    a. **Shareholders want a strong business, strong Balance Sheet, repeatable Income Statement. Outside shareholders look at revenue growth, cash flows, and EBITDA**
    b. **Owners want good long term relationships for recurring income, but they don't manage their Income Statements any more than they have to, and they like to manage their Balance Sheets to reduce cash and retained earnings. Shareholders hire managers at market rates. Owners are in some cases very well rewarded.**

9. **Why only 10% revenue growth?**

    For three reasons: I look long term; fast growers need great resources, what happens to valuations.

    a. **I look long term.**
        i. **Sometimes you can grow 20%+ if you are well prepared to grow at those rates. You will need to manage your margins and EBITDA even if you are not a public company. If you are a private company**

looking for private equity, that focus will be mandatory.

ii. **Sometimes market disruptors' focus on your market and you are glad to just hold on which means some good years and some less good.**

iii. **10% will double your revenues in 7.25 years. Imagine your company today. Double it. What did it cost you? What does your company look like? What was your staff turnover like? Did your projections for your Operating Plan, Marketing Plan, and Financial Plan hit the marks you set?**

iv. **Growth is hard. You need to go to work every day, all day. It takes energy, capital, and taking more risks. So I look long term.**

b. **Fast growers need great resources: capital, management, staff. History is littered with the bankruptcies of fast growing companies, and of companies which could/would not change as markets changed. Today there are only 3 AAA rated companies in the US. The Dow has less than five companies still on the list from 1945. Index funds have 100%+ annual turnover rates. Private investor pools have 7 year holding terms, and that is a long time in today's world. Warren Buffet buys companies for life. He is tough but fair. He wants strong and consistent performance, strong cash-flows, creative management teams, teams that are fair to employees and customers, and teams who do what they say they are going to do. As generally long term holders, why would you ask anything less of yourself?**

c. **Valuations in a 10% world: Let's take an example of a $5,000,000 Revenue company**

   i. **Classic case: Revenue multiple 1.75 to 2.25; EBITDA multiple 5 to 7. Let's use the mid-points to illustrate. The $5 million in revenue may be worth $10 million, if EBITDA is $1.667 Million, which implies that the margin is 33%**

   ii. **Current case for HR Outsourcing may look more like revenue multiple of 2.4, EBITDA of 13, a worth of $12 million if the EBITDA is $.925 with an implied margin of 18.4%**

   iii. **For a small class of payroll "saas" companies in the public market, the jack pot has been hit because investors are hoping that one or two of the companies will take a disproportionate share of the market, the market is looking at margins of 19.7%. Most, not all, are losing money. They are betting all on green that they can generate revenue growth through gaining disproportionate market share growth (by discounting), and cut their very large spend rates on development and sales and marketing at some point in the future. As long as their investors see their prospect for market domination great, they will get more capital. If the investors run out of time, capital, or patience before the goods can be delivered, there will be interesting tremors in the market forces.**