

# The Blueprints for a PEO Start-up

*'Ready-Shoot-Aim' is the modus operandi of most PEO start-up operations. But before you take aim at launching a PEO, an industry consultant advises you to take a good look at the different PEO blueprints, so you can decide which one works best for you!*

**O**n a warm summer day in a sleepy old town, a newcomer rode through on his horse. Wandering along, he noticed the bull's-eye targets drawn on buildings and trees with shotgun holes in the middle of each bull's-eye. Wondering who the town's marksman was, he asked the townspeople and was surprised when they replied, "Oh never mind, it's just Joe."

His curiosity piqued, the newcomer set out determinedly to find Joe, who was not only the expert marksman but the town drunk as well. So he was easily located in the town's saloon. "Oh that," said Joe, after the newcomer inquired about the bull's-eyes. "I get really drunk, shoot up the town, and the next day I draw bull's-eyes around all the bullet holes!"

This is the same story of many PEO start-ups: The owners sign up all their friends and relatives as clients, they then hire someone's nephew to sell marginal, small clients. Three years later they draw a bull's-eye around this hodgepodge and call it PEO market share.

Consultants are then called in to retool the PEO. This often results in a loss of revenue from clients who are terminated because they don't fit the new client profile, there is also an expensive lag time created by changing course. This common scenario begs the question, "Why not determine the target (services delivered and/or client profile) before you start shooting (choosing vendors, hiring internal employees and acquiring new clients)?" And from a PEO consultant's point of view, this mind-set can prevent a lot of problems that inevitably will arise for PEO start-ups.

## Reality Check

The reality we should accept is that PEOs didn't invent anything they are merely a reflection of American businesses today. They provide a vendor consolidation and strategic outsourcing management tool because the government has deemed the American business owner a non-compensated, highly penalized tax collector, provider of workers' compensation and health insurance, plus the redeemer of all social ills.

In other words, we aren't doing anything different, we are just doing it in a different way. Therefore, if we want to be successful, we should focus on studying the trends and needs of the typical American business owners and be at the front of that trend not living in the shadow and picking up the scraps, which has happened in the past.

One of the greatest and free sources of business trends is the Bureau of Labor Statistics (BLS); their Web address is <http://stats.bls.gov>. This government agency collects data from the state unemployment tax (or insurance) reports. They are funded by the federal unemployment tax that all employers pay; the most useful of this data for PEOs is a formerly unpublished chart that was reprinted, exclusively with permission from the BLS, in the September 1997 issue of The ProEmp Journal. In addition, another popular trend predictor is The Popcorn Report's author, Faith Popcorn.

## Top Trends

If you study the BLS statistics, you'll find that there are many different types of businesses: large and small, public and private, least-cost providers and value-added providers, market share and niche players, bottom fishers and snooty companies catering to the wealthy.

There needs to be a variety of PEOs, just as there are a variety of prospects. Basically, three categories of PEOs with several sub-categories exist, and most American businesses can also be pigeonholed into these categories. (Get the picture? You should be mirroring your prospective clients.)

One business trend that all the experts agree is that you cannot be all things to all people; some put it as bluntly as "the middle is dead." So niche marketing is definitely a wave of the future. A message to PEOs: beware or, better put, be aware!

## Category I

The PEOs in this category basically provide payrolling services, which the temporary staffing industry has been providing for many years, long before PEO and even "employee leasing" became popular. Payrolling is defined as providing payroll, payroll tax administration, and workers' compensation to clients. The definition of payrolling, agreed upon by NAPEO and NATSS, is published in the NAPEO position papers.

According to PEO Network, Inc., a PEO consulting firm, 65 percent of worksite employees are delivered this level of service, be it called PEO, payrolling, employee leasing, or administrative employer services. Estimates are based on the actual services delivered, not what is promised in the sales brochure.

## Category II

The majority of PEOs could be classified in the Category II range, some are low IIs and some are very high IIs. Because the PEOs in this category tend to be much smaller than the Category I PEOs, PEO Network estimates 30 percent of the worksite employees receive services delivered in this range.

Services delivered are the same as Category I, plus optional health insurance, reactive (versus preventative) loss control, and very basic HR services. Optional health insurance means several things: taking on clients that do not even offer health insurance, letting the client maintain current coverage, and even letting the worksite EEs adversely select coverage. For example, if during the orientation, only two out of the 20 EEs want coverage, it is provided for the two EEs. Reactive, versus preventative, loss control means that the risk management team is severely understaffed and underfunded, which means they can only put out fires and handle emergencies instead of taking a preventative, pro-active approach to prevent injuries and to create a corporate safety culture at client locations. The HR services delivered in this category are reactive in nature, and the employee handbook, if provided, tends to be a canned software version.

## Category III

A full-service PEO is one that provides payroll, payroll tax administration, workers' compensation, mandatory employee benefits, an array of ancillary employee benefits ("golden handcuffs"), preventative risk management, quality loss control, and a full-service HR department. Less than 5 percent of worksite employees truly enjoy these levels of service for three main reasons: Few PEOs have this level of internal expertise, this service currently can only be delivered at a regional level, and many business owners can only afford a Category I or II PEO. Several key vendors to the PEO industry mentioned they would pursue a Category III if they ever decided to own a PEO.

Unfortunately, a few key players in this industry took a perfectly good Category III-mix PEOs and took them public, using the money to purchase Category II-organic PEOs. This proved the theory that you cannot take a III-mix national, and it also showed everyone the nightmares of assimilating cross category PEOs.

With these brief definitions in mind, peruse the following blueprints of starting a PEO in each category. Remember, define your target, get ready, aim, and then shoot!



Description	Capital Requirement's (through year 3) Timeline (conception to 1 <sup>st</sup> client)	Projected Growth (end of year 3) Equity Team Profile	Sectors Served (by BLS statistics & geography) Pricing Model	Staff-to-Service Ratio (excluding sales) Internal Staff profiles	Sales Compensation & Profile	Vital Vendor & Consulting Relationships	MIS Requirements (hardware & software)
-------------	--	--	--	--	------------------------------	---	--

<b>Category I PEO</b>		\$250,000 to \$500,000 for large deductible program	5,000 to 25,000 EEs	Any company with a workers' compensation meld of more than \$3 is an ideal candidate.	300:1 to 500:1 (can be as high as 1000:1 if payroll and risk management are outsourced.)	Strictly commission (usually a percentage of payroll)	The most important vendors are your team who provide the fronted offshore captive. PEOs in this category who are in large deductible programs are in for a big surprise as the P&C market hardens in the upcoming year.	PC-Based network compromising of a few PCs linked together
	<p>*Workers' compensation aggregator</p> <p>*Least-cost provider</p> <p>*Profits via volume</p> <p>*Uses workers' compensation arbitrage and the long-claims tail to grow the company rapidly</p>	<p>\$500,000-1,000,000 for fronted off-shore captive</p> <p>If you outsource core functions, a start-up can happen in 10 days; however, a typical timeline is 60 days.</p>	<p>The equity/ Management team has an extensive P&amp;C background; they do not understand HR, nor do they wish to provide this level of service. All they are interested in is high growth and providing the most competitive pricing available.</p>	<p>Typically 20-60% discounts off the prospect's current workers' compensation costs plus .50-1.5% administrative fees.</p>	<p>Internal staff is comprised of dedicated stress junkies who are sometimes related to the management team.</p>	<p>Insurance agents tend to comprise this sales force because they understand how to spreadsheet comp and they are used to working as a 1099 independent contractor.</p>	<p>Consulting needs are most critical in the loss control, risk management, and case management areas. The in-house capabilities in these areas tend to be lacking.</p>	<p>*Workstations are Pentium 133 or higher</p> <p>*In-house staff focused on least-cost provision of services</p> <p>*Small array of software platforms, lack of internal support</p> <p>*Internet e-mail accounts</p> <p>*Pricing is usually all done manually or not at all</p>

<b>Bonus: Contract Sales Organization</b>	<p>*Latest trend, as all PEOs are clamoring for organic growth</p> <p>*Great start-up opportunity for disgruntled salespeople who do not have the expertise to start their own PEO or are wary of franchise opportunities</p> <p>*Also appearing as contract-orientation teams</p>	<p>\$10,000 to \$100,000</p> <p>Timeline can be as little as 10 days and as lengthy as 6 months, depending on the number of sales reps and the level of training provided. Captive versus non-captive seems to be a factor as well.</p>	<p>A highly trained "Top Gun" can produce the following in annual new employee production:</p> <p>Category I: 1,000-4,000 EEs per year  Category II: 400-2,000 EEs  Category III: 200-800 EEs</p> <p>Equity team is divided into 3 distinct categories:</p> <ol style="list-style-type: none"> <li>1. mostly ex-PEO sales personnel</li> <li>2. high-end sales executives who cannot get a job with a PEO because they have no industry experience</li> <li>3. P&amp;C agencies</li> </ol>	<p>All PEO sectors can be served by this model. Fees are 30-75% of the negotiated administrative fee.</p>	<p>N/A</p>	<p>Based upon the sector they are trying to attract</p>	<p>The most important vendor relationship is that with the PEOs they are dealing with.</p> <p>The most important consulting need is extensive sales training.</p>	<p>Note: For CSO's</p> <ul style="list-style-type: none"> <li>• Laptop computer for each sales person</li> <li>• Goldmine contact management software</li> </ul>

Description	Capital Requirement's (through year 3) Timeline (conception to 1 <sup>st</sup> client)	Projected Growth (end of year 3) Equity Team Profile	Sectors Served (by BLS statistics & geography) Pricing Model	Staff-to-Service Ratio (excluding sales) Internal Staff profiles	Sales Compensation & Profile	Vital Vendor & Consulting Relationships	MIS Requirements (hardware & software)
-------------	--	--	--	--	------------------------------	---	--

<b>Category II PEO - Organically Grown</b>	<p>* Market-share mind set</p> <p>* Not extremely profitable in any one area</p> <p>* Very diverse in nature, depending on vendor list, internal EE profile, and client base</p> <p>* Majority of PEOs fall into this category Most PEO divisions of temporary staffing companies fall into this category</p>	<p>\$25,000 to \$250,000</p> <p>Depending on distribution system, timeline can be 30-90 days.</p>	<p>200 to 5,000 EEs</p> <p>Typical owner may be: *a "right-sized" professional who reads the hottest trends, typically with no money or HR/RM background *a disgruntled PEO sales representative the #2 person on a PEO management team who has no equity in current PEO *an existing traditional business who decides to start a PEO division</p>	<p>Market-share minded, they write all types of clients; however, 85% of clients have less than 20 EEs.</p> <p>Scattered throughout USA, they do better in less populated areas where unsophisticated buyer who is easier to influence and who does not understand HR.</p> <p>Proposals are presented as a comparison of the current costs of doing business, versus the PEO unbundled bid. Average administrative fees are 1-5%.</p>	<p>100:1 to 150:1</p> <p>Category II of PEOs can only grow to the wingspan of the management team and internal staff. This "Peter Principle" is what makes them easy acquisition targets.</p> <p>The internal staff is a diverse group of generalists. As the PEO grows, the generalists become stretched and specialists are brought in above them. The PEO moves from a decentralized organization to a centralized one, especially after acquisition. These factors make for</p>	<p>Draw against commission of 15-30% of administration fees</p> <p>Sales personnel are as diverse as the client base and internal employee mix.</p>	<p>This category tends to burn through vendors and they rarely utilize consultants</p>	<p>High-end, PC-based network to mid range, server-based network Scaleable network structure</p> <p>*Workstations are Pentium 166 or higher</p> <p>*In-house development staff capable of producing custom reports</p> <p>*Mixture of software packages for internal use</p> <p>*Internet Web site; possibly complete Internet e-mail</p> <p>This type of PEO starts to understand the process of</p>
--	---	---	--	---	---	---	--	---

<b>Category II PEO - Growth by Acquisition</b>					tremendous turnover in all aspects: internal EE, clients, and vendors.			linking pricing and the sales process; not yet fully automated.
	<ul style="list-style-type: none"> <li>*Exit strategy mind set</li> <li>*Profits through consolidation of several PEOs</li> <li>*Centralization of functions such as payroll, accounting, purchasing, vendor negotiations</li> <li>*Publicly traded or heading to Wall Street through venture capital or private equity investment money</li> <li>*High growth</li> </ul>	\$2MM to \$25MM  Timelines are as long as one year and as short as one month, depending on the outcome.	10,000 to 100,000 EEs  The equity team is typically not the management team, unlike the other models. Some factions have earmarked as much as \$100MM for PEO.  Equity Players: *venture capitalists *private equity investors *P&C carriers *P&C agencies *ex-P&C agents *life & health carriers *banks *large, publicly traded companies	Cannibalizing the already fragmented PEO industry by purchasing the organic Category IIs  Currently, there are reports of nightmare assimilation's and poor organic growth results.  Pricing model is an inherited hodgepodge from acquisitions, typically a 2-4% administrative fee (or \$40 per month per EE).	80:1 to 120:1  The equity owners manage the conglomerate utilizing the principles of their former businesses which rarely apply. Therefore, PEO owners that were acquired, are jockeying for upper management positions.  Internal staff is in turmoil due to policy du jour and heavy workloads from consolidation.	Mid-range salary, one-time client acquisition fee, no residual commission  Diverse sales background, due the acquisition process	The most important vendor/consultant relationship is that of a mergers & acquisitions specialist that will stick with you long after the sale is made.	

--	--	--	--	--	--	--	--

Description	Capital Requirement's (through year 3) Timeline (conception to 1 <sup>st</sup> client)	Projected Growth (end of year 3) Equity Team Profile	Sectors Served (by BLS statistics & geography) Pricing Model	Staff-to-Service Ratio (excluding sales) Internal Staff profiles	Sales Compensation & Profile	Vital Vendor & Consulting Relationships	MIS Requirements (hardware & software)
-------------	--	--	--	--	------------------------------	---	--

Category III PEO - White Collar Niche	<p>*Focus on quality HR services</p> <p>*Profits through high administrative fees in 6-10% range</p> <p>*Intranet/Internet provides offsite HR services</p> <p>*Favorite niche markets are IT and venture backed high growth start-ups</p> <p>*Recruiting division brings in cash</p> <p>*Regional, due to lack of integrated MIS systems required for national service delivery</p> <p>*Plans For</p>	<p>\$250,000 to \$25,000,000</p> <p>The white-collar category III PEO's largest capital expenditure is MIS; and a close second is the cost of hiring in house HR specialist. A regional- based PEO in a major market with a list of 1,000 EEs ready to sign through natural market contacts can be started for as little as \$250,000. Timeline average is 3 to 6 months.</p> <p>Start-ups in this</p>	<p>1,500 to 15,000 EEs</p> <p>An organically grown, local PEO can put on 500 EEs per year. Clients tend to be smaller, fees are high, and financial underwriting criteria is strict.</p> <p>National focused</p>	<p>White-collar/major markets</p> <p>PEO rarely services clients with more than 100 EEs with the average being around 30 EEs per client. Economic model accounting with an average administrative fee of 8-10%.</p> <p>This PEO</p>	<p>Currently 70:1 but will skyrocket with a fully integrated and fully utilized MIS system</p> <p>Internal staff reflects the core HR competencies of the owners/management team. Generalist favored over specialists.</p> <p>These staff-to-</p>	<p>Base salary plus percentage of controllable revenue</p> <p>Mature professional with a natural market or circle of influence to network and generate referrals.</p> <p>Recent college</p>	<p>The most important vendor relationships are MIS-related. such as development and maintenance of systems.</p> <p>An</p>	<p>Mid-range to high-end server scaleable network structure</p> <p>*Workstations are Pentium 200 or higher</p> <p>*In-house network engineer</p> <p>*In-house programming/development staff</p> <p>*Web site with full Internet commerce capabilities and complete e-mail functionality</p> <p>*Fully-integrated</p>
---------------------------------------	--	--	--	---	---	---	---	--

	national Acquisition	category with bigger national plans need as much as \$25 million in capital. The money and all three years will be spent entering the race for developing a fully integrated MIS system. Timeline average is 6 to 18 months, from conception to the first client.	full-service PEO's will be attracting small but fast growth firms as well as large companies as the PEO's systems grow and expand. First year projections should be at 3,000 EEs with the second and third coming in at 11,000 each.	category is heading to Wall Street in order to obtain the financing necessary to create the ideal MIS system and to attract the larger clients with a public firm's credibility. Average administrative fees are in the 5-8% range.	service ratio's could skyrocket to 200:1 with the right technology. Internal staff is a conglomerate of specialists who are departmentalized, and there are many things that fall through the cracks with this setup. Technology is the key to fixing this problem and allowing for national delivery of service.	grads with experience at large corporations, knows the decision making process, very professional image.	organizational development consulting firm is the most important relationship to develop. There is a tremendous amount of uncharted water that requires meticulous planning, measuring, and improving. Make sure they have studied under Deming & Drucker.	software package, capable of scaling across a large network platform  *Automated sales process, linked to telemarketing and pricing functions  *Electronic enrollment *Voice-activated health insurance enrollment/selecti on capabilities  *Close relationship with MIS consulting firm
Blue Collar Mix		\$200,000 to	2,000 to 3,000	Light	Will remain	Large base salary	The workers'	

	<p>*Focus on quality risk management programs  *Profits through reducing worksite injuries and fighting fraudulent claims  *60% blue 40% white client mix  *Favorite niche market is light manufacturing  *Flourish in areas of high manufacturing  *Excellent at creating corporate safety culture</p>	<p>\$500,000</p> <p>This category will remain a very profitable small sector of the PEO industry because there is virtually no way to deliver services on a national level. Risk management, loss-control, and corporate safety culture are very personal and regionalized areas. For example, you cannot have a loss-control person from Boston handle a walk through inspection on an Alabama client.</p> <p>Timeline can be a little as 30 days with the right mix of management and internal employees.</p>	<p>EEs</p> <p>The typical III mix equity team is a highly educated mid-level executive, burned out on big corporate.</p>	<p>manufacturing 10-250 EEs</p> <p>Pricing is bundled by workers' compensation code with an administrative fee built in at around 4-8%. The average wage is lower but the margins on workers' compensation are at least 30% of the \$3-15 dollar meld.</p>	<p>between 60:1 &amp; 80:1 depending on core competencies of internal staff  Internal staff is dedicated and there is very little turnover. Several of these PEOs have turned to ESOP as a way to reward their employees. The HR and RM departments are specialists with the client service reps serving as the point person and relaying information to the client.</p>	<p>and quarterly production/retention on bonus</p> <p>Sales personnel are seasoned professionals who sell at the level of a trusted business advisor; typically, they generate most of their business by referrals from CPAs and labor attorneys.</p>	<p>compensation carrier and broker of record are of vital importance.</p> <p>Consulting concerns are ADR and EPLI issues. Also, seek outside advanced sales training. (Risk management and HR tend to be internal competencies.)</p>	
--	---	---	--	--	--	---	--	--

# PEO Network Articles Archive 1998 ()

---

## **What's Missing?**

For those seasoned veterans who are peeking at the chart to determine where you stack up, you might be wondering why there was no listing of a Category III PEO "by acquisition." The answer is simple: A true Category III is a rare gem. They are quite pricey and there are not enough available to grow by acquisition. As the race for a truly integrated PEO software package comes to a close, the Category III PEO will then be able to deliver on a national basis, giving rise to more potential candidates.

The other category that deserves honorable mention is that of global outsourcing PEOs, the companies that offer a client the comprehensive service to "sub everything but your soul." These, again, are still in the development stage.

We would also be remiss in not mentioning the array of PEO franchise opportunities available for start-up ventures. These franchise opportunities vary so much in nature, they warrant their own article and chart, which will be published in a future issue of The ProEmp Journal.

Finally, there is no mention of the number of current PEOs in each category, nor gross revenue figures. This also warrants a separate article because there are many conflicting reports and methods of calculating revenue.

No PEO category is better or worse than the rest; which PEO target you aim for depends on your personal preferences, access to capital, and appetite for risk. Consultants can play a vital role in the planning and implementation of your new venture.

Almost every PEO start-up desires to become a full-service PEO catering to the perfect American business owner, generating 10 percent administrative fees with 500,000 leased employees. But the reality is that many perfect business owners don't operate their businesses with margins sufficient to afford 10-percent administrative fees. We need to focus on the needs of current business owners and, most important, stay on top of the trends for emerging businesses. Do yourself a favor and surf [www.inc.com](http://www.inc.com) on a weekly basis and keep informed. Good luck!

*Carrie Aaron, president of PEO Network, Inc., is a "success coach" to the PEO industry. She can be reached at 888-888-7366 or [www.peonetwork.com](http://www.peonetwork.com).*

**UPDATE by Carrie Aaron 4Q2002:** Market conditions have dramatically affected the PEO industry since this article was published in August of 1998. Due to the hard workers' comp market, Category I PEOs have disappeared. The high Category II and Category III PEOs have flourished. More white-collar clients are utilizing PEOs. For the record, this article was mis-quoted in a recent report by the Center for a Changing Workforce. When I described a Category II PEO as offering "optional" health insurance, it means that the clients can keep their own policy. It does not mean that the employee has to pay for coverage out of his or her own pocket. The paper produced by the Center for a Changing Workforce was trying to prove that PEOs & payrolling firms are an illegal means for business owners to stop paying for their employees health insurance.