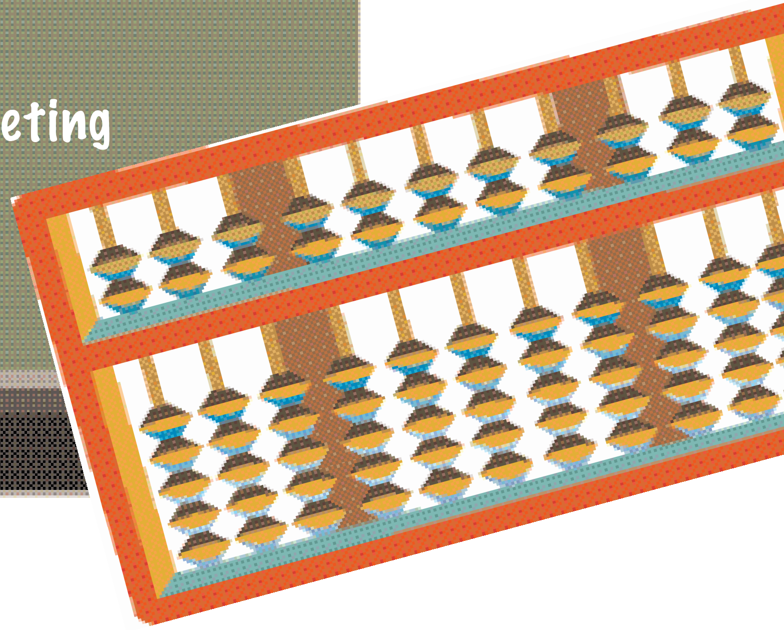
Build Versus Buy

Should Your 2005 Sales and Marketing Plan Include Organic Growth, Acquisition, or Both?



Carrie Aaron

Sandra Dickerson says her boutique PEO in Southern California has only done one acquisition, but she probably would not do it again. "Even though the owner of the PEO we purchased had been in the industry a very long time, we found the clients had not been serviced to our standards," Dickerson says. "Employees terminated for a year were still on health plans and others did not have sufficient 1-9 documents. That meant the cost of acquisition was very high when we factor in the year of intensive work to get everything caught up and cleaned up," she adds.

Fortunately, Dickerson notes, "It's a great credit to our staff at YPP that none of the clients terminated services and instead were thrilled to be with a PEO that serviced them so well." Dickerson's acquisition turned out well compared to some. When properly done, an acquisition may advance your growth more rapidly than possible through sales alone; but, it can just as easily stall your progress if you do not take proper precautions.

Don't Try This at Home

That leads Howard Winters, CEO of Payroll Solutions in Las Vegas to suggest, "It's the stupidest thing any PEO could think about doing. Look at Team America, who touted itself as the 'Premiere PEO Consolidator in America.' (Author's note: Team America went bankrupt.) In almost every market, PEOs have barely scratched the surface of market share. Why would you ever try to buy market share? When it comes to mergers and acquisitions, the only piece that most PEOs could get right is the acquisition part. And most of them do not get that right either, because they ultimately pay too much for the book of business — regardless of the price.

"If this industry ever gets to a point in a market where there is significant penetration (like 25 percent or more), then maybe you could make a marginal case to grow by acquisition. But you still have all the integration challenges that I think outweigh any benefit you could ever hope to achieve by acquisition," Winters concludes.

Growth by Acquisition

Yet, a larger PEO in the above-10,000 range has grown successfully through acquisition in tandem with healthy organic growth. It completed six acquisitions in the last five years with an average cost of acquisition at $850 per WSE. During the

Figure 1.

Advantages of Growth by Acquisition

- Gain clients who otherwise would not switch from one PEO to another
- Gain management team with PEO experience
- Absorb existing idle capacity
- Spread corporate overhead over larger revenue base
- Gain attributes of acquired company that are favorable to your own, e.g., better insurance rate/carrier or state unemployment experience, superior software/hardware, better sales force
- Opportunity to apply your own favorable attributes (as per above) to the clients of the acquired company
- Entry into new geographic market
- Elimination of competitor

Disadvantages of Growth by Acquisition

- Poor integration and client cancellation
- Top management talent moving on to other acquisitions/not paying enough attention to integration
- Over-estimate of the value of synergies
- Corporate culture clashes
- Inadequate resources devoted to integration effort and these synergies are not realized
- Poor due diligence prior to completing the acquisition and these assumptions were incorrect

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same period, organic growth averaged $700 per WSE. Both organic and acquisition growth costs appear within similar ranges for this company. But the pros and cons of acquisition have to be carefully considered on a case-by-case basis, or you could find you've expanded your workload more than your bottom line. See Figure 1 for an overview of those pros and cons.

Rules of the Road

One very sharp PEO owner insists that the only reason to acquire another PEO is to gain entrance to a new geographic market, gain a superstar sales force, or obtain a software license. A former PEO owner who handled double-digit acquisitions, and is now an investment banker, says that savvy PEO acquirers should:

- Incorporate integration planning into your due diligence activities;
- Corporate culture matters — avoid acquisitions that will create culture clashes; perform cultural due diligence;
- Treat the integration of each client as an independent event;
- Get rid of unwanted clients from each acquisition quickly;
- Communicate with key vendors to understand how each will treat the acquisition for experience rating purposes and what you can do to improve the outcome (see above); and
- Don't pay more than you can justify based on the strategic objectives of the acquisition (e.g., entry into a new geographic market).

An example of the build versus buy saga plays out between the two largest publicly traded PEOs, Administaff (ASF) and Gevity HR (GVHR). Administaff is adamant that it will grow organically only and will never contemplate an acquisition. Conversely, Gevity HR has managed to grow lately through acquisition. Last year, Gevity bought two large competitors, EPIX and TeamStaff, and another major acquisition is on the horizon. It is very difficult to unpack the numbers of these two public PEOs. My guesstimate is that organic growth is coming in right around the $1,000 per WSE mark, and acquisition growth is slightly higher at $1,200.

Figure 2.

Retention	Years with client
95%	20
90%	10
85%	7
80%	5
75%	4
70%	3

Build it One Client at a Time

Most studies and research seem to indicate that growing organically is the best choice for PEOs. However, opinions on the cost of organic growth differ, as do the calculations of capturing this cost. Estimates vary from as low as $300 per WSE to as high as $2,000 per WSE.

One PEO uses a complicated three-year formula for calculating organic growth. A senior manager from this company shares this more simplistic version for smaller PEOs: "The formula to calculate organic growth equals the sales salaries, including burden, plus marketing costs (marketing material, advertising, proposal production). Now add the cost of underwriting (risk, financial, and legal departmental costs to negotiate the contract), and the time the service staff spends assisting on appointments (about 20 percent), divided by the number of new WSEs."

To make this work, the senior manager warns, "This should be compared to gross margin and spread over a three-year period. This calculation only gives you the cost of getting them to contract, and the real cost is getting them to the first payroll."

Additional Points to Ponder

You should also consider accounting and tax issues when deciding whether to grow organically or through acquisition. Costs of internal growth, called "periodic expenditures," are current expenses deductible on income taxes. "Goodwill" costs such as those associated with acquisitions, however, have to be written off over a period of years. Your choice can really affect earnings.

Regardless of your growth model, all experts agree that taking clients from contract to the first payroll is both costly and mission critical. This on-boarding process has to take place for any new client due to the co-employment nature of PEOs.

One manager says that the retention of organically grown clients is much higher than acquired clients because many clients tend to view the acquisition of their chosen PEO as an open invitation to shop their business around to other PEOs. Smart buyers with superior integration plans will treat the integration of each acquired client as an independent event — similar to an enrollment of a new client gained via traditional sales effort. When added to conventional integration costs such as merging accounting systems, merging staff, merging benefit plans, training, etc., the resulting total integration costs can be surprisingly high.

Show Me the Money

So, it doesn't matter how you get the business; what matters is if you keep the clients over a long period. Net present value calculations of a PEO client suggest that profits do not surface until the third year. Acquisition retention hovers in the 70 percent range, so minimal profit is realized at three years, as outlined in Figure 2. Standard retention rates in the 80 percent range equal client tenure of five years, while client retention rates around 90 percent equal client tenure of 10 years.

A large Midwest PEO agreed that acquisition pricing must carefully take into account customer loyalty because conversion and retention highly impact the value of a PEO's biggest asset — its book of business. As a final thought: be slow to bring on clients but quick to fire them if necessary. Several of the companies we talked with mentioned that dropping clients who don't fit your culture should be done quickly. For example, Sandra Dickerson, of the small Southern California PEO that survived a less than perfect acquisition, says one of the things they did to make it work was terminate two of the acquired clients early.■

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