Barrett Business Services, Inc. Second Quarter 2023 Earnings Call

Good afternoon, everyone, and thank you for participating in today's conference call to discuss BBSI's financial results for the second quarter ended June 30, 2023. Joining us today are BBSI's President and CEO, Mr. Gary Kramer; and the company's CFO, Mr. Anthony Harris. Following their remarks, we'll open the call for your questions.

Before we go further, please take note of the company's safe harbor statement within the meaning of the Private Securities Litigation Reform Act of 1995. This statement provides important cautions regarding forward-looking statements. The company's remarks during today's conference call will include forward-looking statements. These statements, along with other information presented that does not reflect historical fact, are subject to a number of risks and uncertainties. Actual results may differ materially from those implied by these forward-looking statements. Please refer to the company's recent earnings release and to the company's quarterly and annual reports filed with the Securities and Exchange Commission for more information about the risks and uncertainties that could cause actual results to differ from those expressed or implied by the forward-looking statements.

I would like to remind everyone that this call will be available for replay through September 2, 2023, starting at 8:00 p.m. ET tonight. A webcast replay will also be available via the link provided in today's press release as well as available on the company's website, at www.bbsi.com.

Now I would like to turn the call over to the President and Chief Executive Officer of BBSI, Mr. Gary Kramer. Sir, please go ahead.

Thank you, and good afternoon, everyone, and thank you for joining the call.

We had a strong second quarter, and I am pleased with our results. We continue to execute on our short-term and long-term objectives, and we exceeded all of our internal controllable key performance indicators.

Regarding our client and WSE stack, our controllable growth exceeded our expectations in the quarter as we continued to execute on our various strategies to increase the top of the sales funnel, and I am pleased to say that we once again exceeded our expectations in new clients and in new worksite employees.

As discussed previously, we have been able to sell and support larger clients with our upgraded technology stack and national PEO licenses. This continues to progress favorably, and the average size of the clients that we are adding are larger than the average size of the clients that are running off.

Regarding client runoff, our retention in the quarter was better than the prior year quarter and continues to remain stronger than prepandemic levels. I'd like to attribute that to the work we do with our clients and the value our teams provide.

The result of all these efforts, or what I refer to as controllable growth, is that we added approximately 3,700 worksite employees year-over-year from net new clients. However, our clients' hiring was lower than we forecasted. In particular, we experienced a slowdown in April and May in Northern California and in the Northwest with our clients who work in or around new residential construction. These clients reduced their worksite employees, reduced overtime and reduced hours worked. We had positive client hirings in our other geographies, which was more than offset by the weakness in Northern California and the Northwest, and our net client hiring was negative in the quarter.

To summarize, we grew our worksite employees by 2%, which was on plan for the quarter, as we sold and retained more business, and this was partially offset by weakness in Northern California and Northwest operations.

Moving to our staffing operations, our staffing business declined by 32% over the prior year quarter and was lower than we anticipated. We mentioned previously that we repriced the portfolio and jettisoned clients who were not achieving an adequate return. We also shifted our strategy to recruit for PEO clients and placed 121 applicants in the quarter, which generated equal margin to staffing, but resulted in less top line revenue.

We also experienced macroeconomic factors including, but not limited to, supply or demand, which varies by geography. Overall, business owner sentiment was cautious in the second quarter. And while we are seeing July requisitions increase sequentially, it is below prior year.

Moving to the field operational updates. We are very pleased with our entrance into new markets with our asset-light model. Our market development managers are doing well and largely achieving their goal of adding and servicing new clients and new referral partners. Our first 3 classes have all graduated, and we're selling in their respective markets in the second quarter. Our fourth class has been through training and is selling in their markets in Q3. Our results thus far are better than we expected and are exceeding our internal return hurdle rate.

Regarding product updates, we continue to execute on the sale and service of BBSI Benefits, our new health insurance offering. As a refresher, we rolled out our benefits offering in California in the second quarter and are now selling and servicing BBSI Benefits in every market where we operate.

I am pleased to report that we more than doubled our planned participation in the quarter and now have over 135 clients on our various plans, with more than 3,000 total participants. Our value proposition is resonating well, and we have success with small and large clients in white- and blue-collar industries in every state we operate and with a diverse distribution channel.

We have learned some lessons and have made some modifications to our technology and to our operations along the way. The company is now shifting to the 1/1/24 selling season, and we have gained confidence in our craft and have the product and teams in place to be successful.

Next I'd like to shift to our view for the remainder of the year. We have consecutive quarters of great momentum. Our controllable growth exceeded our expectations in Q2, and this trend continued into July. We are selling and servicing BBSI Benefits in all markets now, and we continue to be optimistic regarding the road ahead. We have de-risked the business and have a track record of achieving strong controllable growth.

The confidence in the strength of our operations results in predictability in cash flows. As such, I am pleased to announce that our board has authorized a new $75 million stock repurchase program.

Now I'm going to turn the call over to Anthony for his prepared remarks.

Thanks, Gary, and hello, everyone. I'm pleased to report we finished Q2 with strong results and strong controllable growth, as we continue to exceed our expectations for worksite employees added in the quarter from new clients.

Our overall gross billings increased 5% in Q2 '23 to $1.9 billion, versus $1.8 billion in Q2 '22.

We achieved diluted earnings per share of $2.47, compared to $2.48 in the prior year quarter.

PEO gross billings increased 5.1% over the prior year quarter to $1.9 billion, while staffing revenues decreased 32% over the prior year to $20 million.

Our worksite employees grew by 2% in the quarter, which is the result of adding more worksite employees than expected from net new PEO clients, offset in part by a reduction in hiring within our existing customer base.

Average billing per WSE increased 3% in the quarter. As expected, client wage rates have remained resilient and increased in the quarter, which will continue to be a source of billings growth, going forward.

Average hours worked per employee remain lower than prior year, but we have seen continued improvement in average hours worked and overtime hours since Q1. Within the quarter, there was positive sequential improvements, with each month showing improved hiring and more hours worked than the previous month.

Looking at PEO gross billings growth in total by region versus the prior year second quarter: East Coast grew 12%; Southern California grew 9%; Mountain States grew 5%; the Pacific Northwest decreased by 1%; and Northern California decreased by 2%.

As Gary discussed, staffing revenues are down, driven by strategic shifts in our model, a focus on profitable clients and the current economic environment. The reduced staffing volume has been accompanied by lower costs to support the model, and with positive trends in orders we expect the year-over-year decline in staffing to improve in the remainder of the year.

Our workers' compensation program continues to perform well and benefit from favorable claim frequency trends and favorable claim development. This strong performance has once again resulted in favorable actuarial adjustments of prior claim liabilities. As a reminder, our current client workers' compensation exposure is now primarily covered by our fully insured program, with no retained liability by BBSI.

As we have de-risked our workers' compensation program in recent years, we have entered into several fully insured policies and agreements that provide for potential returned premium to BBSI if claims develop favorably over time. As we begin to recognize benefits from these returned premiums, we will now update how we refer to the effect of workers' compensation adjustments as "prior year liability and premium adjustments." In Q2 '23, we recognized favorable prior year liability and premium adjustments of $6.3 million. This compares to favorable prior year liability and premium adjustments of $8.5 million in the second quarter of 2022.

We renewed our fully insured workers' compensation policies effective July 1, 2023. The program continues to perform well, and we once again renewed with favorable terms, including cost savings, a multiyear commitment, no downside risk to BBSI for future adverse claim development and the continued ability for BBSI to participate in any favorable claim development via return premium.

In addition, we revised our payment terms for the program to enable us to hold funds longer, which will result in increased investment income in 2023 and 2024.

Our gross margin rate was better than expected in the quarter due to the cost savings from lower workers' compensation expense and our increased focus on pricing discipline. We are tightening our outlook for our gross margin rate for the year to better reflect the favorable results through the first 6 months as well as anticipated trends in Q3 and Q4.

Turning to operating expenses, SG&A for the year continues in line with our plan, which is to grow slower than prior year and slower than our billings growth rate. As a reminder, SG&A includes increases associated with the launch of BBSI Benefits, which have been largely offset by savings driven by cost management efforts.

Moving to our investment income, our investment portfolios earned $2.1 million in the second quarter, up $500,000 from the prior year. Our book yield is 2.3%, up from 1.8% in the prior year quarter. Our portfolio continues to be managed conservatively, with an average duration of 3.9 years and average quality of investment, AA.

Turning to the balance sheet, we had $133 million of unrestricted cash and investments at June 30, compared to $160 million at December 31. The decrease is primarily due to the timing of quarterly payroll tax payments and stock repurchases.

As a reminder, BBSI is completely debt free, and we do not incur any increased expense associated with higher interest rates.

Continuing under the board's share repurchase program, in the second quarter BBSI repurchased $10 million of shares, at an average price of $82.23 per share. The company also paid $2 million of dividends in the quarter and reaffirmed its dividend for the following quarter.

Since the launch of the repurchase program in February 2022, the company has now repurchased over $65 million of stock, representing approximately 11% of shares outstanding, at an average price of $79.70 per share.

Management and the board continue to be highly optimistic about the long-term value of our business and the growth potential ahead of us. That value is made even more compelling by the enhancements we've made over the past several years, which have been reflected in stronger controllable growth from client adds, positive earnings leverage, reduced risk and strong performance from our workers' compensation program and product expansion that increases our addressable market.

With this perspective and with the success of the February 2022 repurchase program, the board has approved a new $75 million 2-year stock repurchase program, effective July 31. The new program replaces the previous program and represents capacity to acquire approximately 12% of the outstanding shares of the company at the current share price. The renewed program will allow management to continue to show our commitment to being thoughtful stewards of capital and generating long-term value for shareholders.

Turning to our outlook for the year, we now expect gross billings to increase between 4% and 6%, a slight decrease from the 5% to 8% in our prior outlook to account for the slower client hiring and hours worked we have observed in our existing customer base.

We continue to expect average WSE to increase between 2% and 4% for the year.

And given the lower workers' compensation expense and our increased focus on pricing discipline, we now expect gross margin as a percentage of gross billings to be between 3.1% and 3.15%.

And we continue to expect our effective annual tax rate to remain between 27% and 28%.

I will now turn the call back to the operator for questions.

The first question is from Chris Moore, of CJS.

From my own edification anyway, I thought it might be helpful, could you compare and contrast the challenges that you're facing now versus at the beginning of the pandemic? They feel quite different, but I wanted to maybe have you go a little bit deeper there and make sure that I understand them.

Chris, I would say we are a much better company now than we were prepandemic. We talk about our controllable, which is clients we add and the WSEs they have and clients ultimately that run off and WSEs they add. And our controllable is the best it's ever been, right? So plain and simple, the things that we can control and the things that we can handle are far superior than they were prepandemic.

I think through June, as far as clients we added and WSEs they had, we're up, like, 35% compared through 6 months of last year. Like, that's how much better we are year after year after year.

So for us, we feel very good and very confident in our day-to-day go-to-market operations.

But the one place where we are, and it's not in every geography and it's primarily for the construction vertical in Northern Cal and in the Northwest, we are seeing a slowness in our clients, our existing clients slowness, in hiring. Many of them are shedding a little bit of workforce that has to deal with residential construction.

So if you kind of just think of it as we're going to keep selling through -- whatever we do, we're going to keep selling through. That's the one thing we can control, is what we sell and what we service. And then, ultimately, our clients are going to turn and start to grow again. We just don't know when that's going to be.

Got it. That's helpful. Maybe just shift gears to the health care side. When will we have the visibility as to whether or not health care could generate meaningful or have a meaningful impact on '24 results? Is that unrealistic? Is that possible? Is it really more of a '25 time frame when you'll start to get meaningful revenue there?

So in our numbers now, we reflect some of the health care we're selling. We're reflecting 100% of the expense to service the business and the technology to service the business. So we've always said that 2023 is going to be expense before revenue. The revenue is really going to generate in '24.

And I would say that we've modified our operations. We've modified our IT some. We've learned some lessons. We're comfortable with our craft. And really right now is when we're getting ready to go and embark on the 1/1/24 selling season. That usually kicks off mid- to end of August, into September. So you typically will make the sale sometime in Q3, and then in Q4 is when you start to do your enrollment and your onboarding for the 1/1.

So I say that because when we get to Q3, which our Q3 earnings is in November, we'll have an idea for how well our sell-through is going to be for '24 and for what our participation is going to be for '24. So we'll be able to foreshadow in our Q3 earnings what we think the effect is going to be for the '24 calendar year.

The next question is from Jeff Martin, of Roth MKM.

Gary and Anthony, I hope you don't mind a little background noise [indiscernible]. But Gary, I just wanted to dive into a little bit more you referenced some technology and operational adjustments that you're making. Wondering what specifically those are, and is that specifically related to the Jan. 1, '24, selling season that you just referenced?

Good question, Jeff. I'll say we're comfortable with our client-facing IT, and we're not going to have a lot of changes there. Really, the changes we're making are kind of lessons learned for how we handle sales efficiency and the sales process, right? So the technology investments that we're making now is to make our folks in the field much more efficient so that they can spend more time selling as opposed to handling some high-burden leverage activities.

Okay. Great. And then on the workers' comp renewal, the program renewal, you mentioned the opportunity to hold cash longer and generate some additional investment income. What other benefits do you see coming through from that renewal, if any? And then, how should we think about the workers' compensation expense ratio for the balance of this year and also for 2024?

Thanks, Jeff. The ratios, the performance of the portfolio has continued to be strong and, frankly, very consistent, and we're proud of that. For the renewal, it really reflected the cost savings. So we renewed at lower rates. Now even at that rate, we will continue to get premium back if those claims continue to develop favorably over time.

The key -- one of the key changes was that changing the payment terms so we can hold the premium from our clients for longer before we remit that on to the carriers. And we think that change alone should add about $1 million of investment income to the current year and closer to $3 million in next year. So that's a big change for us in the economics of that model.

Overall, though, the terms, the program continues to operate very favorably. At least, we're finding that at this point.

Okay. Great. And then one more if I could. In terms of the health care offering, you referred last quarter to the July 1 selling season being the second largest of the year. Do you have any comments around how things performed in July there? I know it's still very early, but anything anecdotal would be helpful.

I mean, if you -- in my prepared remarks, we said we more than doubled the participants on the plan in the quarter, right? So if you just think of how well we did for 7/1, we did equally, if not better, than what we did for our 1/1 selling season. So we're pleased with that result.

And really, what that -- if you think of it, that was -- I'm looking at -- I'll give you a stat here real quick. For California, in the quarter, it was about a little less than 30 deals that we sold for 7/1, and that was really their first quarter that they started to sell benefits. So we look at that and say, okay, well, we've got the reps, we know what we're doing, we're comfortable with how to do it, we've got to make some modifications so that we can do it a little bit better. But really, we have the confidence that we can go out and now sell this business for the 1/1 selling season, which was part of the plan, right? The plan was to do the reps, get ready so that we can capitalize for 1/1.

Okay. And then one more, if I could. In terms of the uptake, are you seeing that from launching new clients, launching existing clients [indiscernible] the new clients? Are you seeing that in more of the white-collar area? The blue-collar area? Is it just really [kind of dependent]?

The sell-through right now is about, to our existing clients, it's been about 70% of the clients we brought on for benefits have been to existing clients. So then if you look at the other, call it, 30%, we're having really good success in the central part of the state with our new market development managers. And that's a mix of -- I would say there it's predominantly white-collar versus blue-collar. But it's really, -- you look at it across the board, we're doing well with existing clients, with new clients, white- and blue-collar, and then we're starting to get more referral partners that want to do business with BBSI because we have this offering.

The next question is from Vincent Colicchio, of Barrington Research.

Gary, I'm curious, how is wage inflation trending in your client base versus your prior expectation?

Vince, I'll take that one. We're continuing to see very resilient wages. So I mentioned last quarter that our client wages are up between 5% and 6%, which is consistent with or a little above national average. And we're still seeing that. Even sequentially, wages are up again. So the resiliency of those wages is in line with expectations. And as I said, that will continue to be a source of billings growth in the future.

Okay. And then how about pricing on new and renewing clients? Is that in alignment with plan?

So we've had a lot of initiatives internally. As I mentioned, our focus on pricing discipline, especially on that PEO product. And we are continuing to meet or exceed those expectations, which we're seeing in our margin results.

I would say part of -- if you look at our guide, our reguide, we brought up our gross margin target. And part of the reason we brought up our gross margin was because of our ability to charge more for our product now.

And maybe it's early to assess this, but I know you were energized, for lack of a better word, about the idea of all the health care brokers you could bring in the fold for referrals. Are you seeing them become a source of referrals? Or is it too early to gauge that?

Good question. We are excited about it. We love to partner with folks that understand our value prop and feel comfortable recommending us.

We are getting better at talking to health brokers. Part of that is we had to learn our craft and our trade, and we're getting more comfortable in our own skin now. And we're gaining that comfort, and we're able to go talk to them regarding this product offering.

It's still early days. I can't say that we see anything that's going to tilt the pendulum yet, but it's something that we have focus and attention and discipline on to make sure that we're still -- you can think of it as just double the potential referral partner size of the company, and we're making sure we're trying to knock on all those doors.

And then one last one for me. Any help you can give in terms of the cadence to revenue and earnings in the back 2 quarters?

So we're seeing consistent trends on that controllable growth. So we're forecasting that to be pretty consistent in Q3 and Q4. Obviously, client hiring has been slower. So we are factoring that into our forecast. Our typical pattern of Q3 being our most profitable quarter should continue, though.

At this time, this concludes our question-and-answer session. I would now like to turn the call back over to Mr. Kramer for closing remarks. Please go ahead.

Thank you. I just want to thank all of the BBSI professionals for all their hard work they do in supporting our clients. And thank you, everybody, for dialing in, and this concludes our call. Thank you.

Ladies and gentlemen, that concludes today's conference. Thank you for joining us. You may now disconnect your lines.