Sidoti Small Cap Conference Transcript

Hey, good afternoon, everyone. It's now 4:00 PM here in East Coast, and we're ready for our final presentation of the day. My name is Mark Riddick, a senior analyst with Sidoti and Company. And I thank you for joining this Sidoti December small CAP virtual conference. Our presenting company is Barrett Business Services or BBSI. And joining us today is Gary Kramer, President and CEO and Anthony Harris, Chief Financial Officer. Now, before we begin, just a reminder, we will have time for Q&A following prepared remarks. There's no need to wait until the end. Just click on the Q&A button throughout and we'll be leaving time to answer your questions at the end. And with that, we can turn the call over to Gary. Thank you very much for joining us today.

Thanks, Mark, and hello everybody and thank you for taking the time to join the call to learn more about BBSI. With me is Anthony Harris, our CFO. I'm Gary Kramer, the CEO. And as you think of BBSI, first and foremost, we like to display our mission statement and it's to deliver expertise and solutions that enable our clients to prosper and we're going to get into what some of these solutions are. But really, the key differentiator for us in our business is our expertise and the people that provide that expertise, so we're going to talk about our business teams a little bit. In the next slide.

So, as you think of, you know who we are and what we serve. You know right now 3 out of 10 businesses will be around after 10 years, right? So, if you're a business owner, that's a scary proposition to start your own business. Knowing that you're going to have about a 70% failure rate. And we think that as an organization we can help change the trajectory of our clients' success. And the way that we do that is through our business model.

So, if you're a business owner, you start your business because you know you've got a product or you've got an idea. And then in order to start to scale, you have to hire folks to buy yourself time and first thing you do is you hire some friends. You hire some family. And then, you exhausted everything and now you have to go hire strangers and you hit an inflection point. And really at that point, that's when BBSI can partner with the business owner to help them grow their business with the idea of letting them get back into what they love about their business, which is growing their business as opposed to the administration and compliance and all the headaches that come from being a business owner.

Through the next one. The way that we do that is through our business teams. So, you know, this is really our differentiator in the market. Our business teams, our local with our clients. So, you have a business team which is going to be a business strategist, which is the tip of the spear. You're going to have a HR specialist. You're going to have payroll and data. You're going to have somebody that's going to be there for risk and safety and then ultimately for recruiting. If you want to hire, we can do recruiting for you. Really, it's that business team. And if you think of that business team, it's like a fractional ownership for a small business. That small business doesn't need a VP of HR, but what they need is somebody for one hour a week and that's when they can use our fractional model for our business teams. And then, after our business teams, we've got all the different tools that we use to support the business. HR. We have a payroll platform. We offer workers' comp, risk and safety on workers' comp. We have a health insurance offering. We also have a 401K offering, which most small businesses have trouble getting. We can do staffing and recruiting. We have a training and learning development system that they can use and plug into and that's all wrapped within our technology solution, which we call myBBSI.

And then for myBBSI, people are our product, but ultimately you wrap that around good technology. So, we have our own proprietary web portal that all of those tools we just talked about are all wrapped through that. And this is our own web portal and we launched it in 2020 and we continue to make investments every year. The biggest investment we made last year was to roll out our health insurance offering through myBBSI. But you know, as you look at our Balance Sheet and we look at the business going forward, we'll have more investments in technology to support our clients.

So, hello everyone. I'm Anthony Harris, the CFO, as Gary noted. Just drilling in here on a couple of those product categories that are particularly high value-add for small businesses. One of those is the workers' compensation program. It's an area of focus for us historically in our business. And I would say we are truly best in class at this product. So, particularly for a blue or gray-collar company that has workers' compensation expense exposure, it's going to be a huge pain point for them. For one, for a higher risk labor business, it can be one of the greatest expenses, perhaps second only to payroll and those costs can fluctuate pretty significantly based on their accident experience. So, one thing about this is it's required coverage for almost every business in the country. So, they have to have it. So that gives us an immediate touch point with almost every small business to say this an area we can come and help you with and do better at it and we really are better at it. So, if you don't use a service like BBSI, where we're partnering with you as a PEO. So typically, in the traditional workers' comp insurance market, where you're getting quotes from a number of carriers, they're doing kind of deskside underwriting. So, their pricing average portfolio rates. We get to come in and meet with business owner because we have that local service team. We're understanding the risk. We can underwrite that risk more effectively, which in the culture of the business we can actually see the tag out. See the harnesses that are being used and develop safety plans, so we can also mitigate that risk. We can say, here's what's going on here, here's how we can help you get there. We can do safety meetings. Do the trainings. Best in class claims administration dedicated to the service team with the latest technology. Best in class oversight. Actuarial oversight. So truly a holistic view of workers' compensation. We've had consistent, strong performance for many years. That said, we deliver this with low risk to shareholders. So historically, we retained more of that workers' compensation risk. However, since 2020, when Gary Kramer took over as CEO and I took over as CFO, we really went on a journey to de-risk the business overall and earnings volatility, in particular de-risk our workers' compensation program. So, if you were familiar with us before, this would be a big change for us. So as opposed to retaining the claims risk for our workers' compensation program, we actually now have a fully insured program where we take zero dollar claim risk for the vast majority of our clients. But we structured it in a way that is still beneficial to shareholders. So, because we're so good at managing risk, mitigating risk, we've typically seen our claims' cost come at well below industry average. We've structured our fully insured program so that if claims favorably, we get money back. If claims develop adversely, we don't have to pay anything extra. So, it takes all the downside risk out, but we still have all the upside benefit. In addition to being fully insured, that move happened in 2021, we also sold off most of our historical claims that we had held at that time, as well. So big shift in our model here, able to deliver the exact same value to our small business clients, without the underlying volatility risk to the business.

Second big product category to talk about, and this is new for 2023, is the health benefits offering. So, it's another area where the PEO industry has had a lot of value to offer to small businesses. As a small business, it's been difficult to get medical coverage with the ACA. You're getting it through, typically, these best rate exchange in the small group market, very prescribed plans, prescribed age-banded rates a lot of administrative burden that falls on the small business or their local broker. Through this program, we're able to offer them best in class master group policies, similar policies to what you have access to if you were a larger firm, like a Fortune 500 employer. Full suite of benefits, national provider networks and comprehensive service, so all of the administration, the COBRA, the HSA, the FSA, all of that is handled by our service teams. It is integrated into our portal, the myBBSI portal. And it's, again, offering them better large group plans they wouldn't typically have access to as a small corp.

For this one, again, for shareholder risk, completely zero retained claim risk by BBSI. So, other large PEOs do retain some of the medical risk. We do not. That's a differentiator here for us. So, we essentially resell these fully insured policies using our purchasing power, which has incremental accretive margins to us, but more importantly, continues to enhance that value proposition to that client and really expands our addressable market.

So, 2023 is the first year we started selling this nationwide. 1/1/24 will be the first January 1 start date nationwide for us. January 1 is obviously a large start date for medical benefits. So that's a key milestone for us as we launch this nationwide. This will continue to help us expand that value proposition to new companies where maybe they have no workers' comp risk, didn't have as many needs on the payroll or HR side, but this was a pain point for them.

Physical market opportunity. If you're not familiar with our industry, you know 85% of businesses don't currently use a PEO model like we have, that fractional ownership model. But the industry is growing rapidly. Tons of whitespace though both across the country for BBSI, but also, even in the markets where we are most penetrated. We're still talking about, you know, single digit levels of penetration for us in terms of the small businesses that we work with. So, we could grow. We talked about people ask us about our competitors. The reality is we don't truly compete with other PEOs very often. We really are going and educating small businesses on this concept of being able to partner with a PEO like us, having access to a service team, and all the benefits they can pick up with that. So, tons of growth potential ahead of us still.

Looking at our distribution strategy and how we go to market, we are primarily a referral partner aligned sales channel company. So, 95% of our new business comes from referrals. A lot of those referrals are from actually existing clients. So, we do a lot of work with our business owners. We do business on our round tables. We get a lot of referrals through that, but we also partner with other business leaders and advisors in our communities. So, it turns brokers, attorneys, CPAs, banks, partner with them to get referrals and that helps us be much more efficient certainly than average on our sales strategies. Our sales efficiency or yield conversion on those referrals is much higher than the traditional direct selling initiatives. We've had a great success in that and been able to get great leverage in the communities that we operate in.

When you think about kind of the full client journey, how this works, so as we get those referrals in, again this is kind of different from the traditional, let's say insurance market or broker relationship, where we get a referral in, we do what we call a client alignment process, so actually have that service team that we talked about earlier meet with the business owner. Talk about all of the different aspects of the team that they're going to have access to. How we can help that small business and it really is a tailored experience. So, we actually do a business blueprint. Understand what that business owner wants out of their business, where their business is going. They will actually do a full discovery process, understand, and cast kind of a vision of where we're going to go together that we'll continue to update through at least quarterly strategic meetings. So, through this process and alignment upfront, making sure that we have that kind of aligned expectation of where we're going. It really helps contribute to that client retention, which is best in class. Our client retention run 90 plus percent. These are annual contracts, but they're Evergreen contracts, so they auto renew. Clients can choose to leave us, but again, once they embrace the model, small business owners tend to love it.

In terms of where we're at, we have 68 established markets, and when we say established market, which means we have a physical presence for those physical service teams local in our communities. So, we don't have an 800 number. If you have an HR concern or a payroll issue or a risk, an accident that needs an investigation, you call your dedicated team's cell phone numbers right, and they're there in your community and they're working with you. So, that decentralized service structure is a key differentiator for us, in terms of that value and contributes to that high customer retention rate we have.

As we think of future growth, you know, I can say the company for our controllable growth has never operated as strongly as it is now. So, when we talk about our organic growth, it's our controllable growth. Which is clients we add and WSEs they have and clients that run off and WSEs they have. Our client adds and our client pipeline has been the best that it's ever been. Our client retention has been the best that it's ever been. We're up to 90%. So, for what we can control, we're doing very well as an organization. I can say that our service is phenomenal and then our sales tactics preferred.

Looking at, you know, part of our model too, as we grow when our clients grow and part of the way they grow is by wage inflation or by hours worked or by adding worksite employees. This year so far, we've seen wage inflation, which was a tailwind, but we've also seen some of our clients shrink, because of the macroeconomic environment which was a little bit of a headwind.

Then we're going to continue to add additional business teams and then we're going to upsell our new existing products, right. So, we got new products that we're trying to sell into our installed base. So that's our benefits model. So that's the organic side. And as we think of our geographic, Anthony mentioned our asset light model. So right now, we're in about 14 markets on the asset light. What they are is we hire a salesperson, and we give them a good compensation package. We train them and then we service that business virtually and then as they grow that business, we'll let them invest in a brick and mortar or hire folks locally and we're having our first brick and mortar that we're opening in Chicago. But we're doing well in Chicago, Oklahoma, and Texas. We're going to see some branch expansion there. And as I think to '24. You know, we're recruiting now about 50 different markets and we're going to hire, and it all comes down to the people. We're going to hire anywhere from 10 to 15 over the next 12 months to grow those geographic expansions. And as we think of our model, right? So, we like to say that over a market cycle, we can grow our top line by 10% and that equates to 15% on the bottom line and the way that we do that is we leverage with scale. So, we're able to grow our SG&A at a lower rate than we grow our revenue growth and that gives us earnings accretion and also good revenue growth. So, the model is built so that we don't just grow for growth, we grow for profitability.

When we're looking at our positioning, we feel like BBSI in the in the sweet spot of, you know, the difference between our true HRO and our true business consulting. BBSI sits in the middle of the two markets, and we feel like we're in a really good spot and we're pleased with the product, and we're pleased with our location.

Yes, a couple of slides here on our past performance. Again, mentioning that that white space is a strong value proposition of the industry, overall. And again, BBSI's value within that industry as a high touch, high quality service provider. So consistent strong growth, obviously a little bit of a pause there during the pandemic. But even in the pandemic, our clients, proved to be honestly more resilient than expected. And we were able to help them navigate that which really helped demonstrate once again that value coming out of having a partner, like BBSI, is to a small business owner. Strong strategic growth. Again, 2023 is the first year that we started selling the medical benefits offering. So that is a key new product addition for us. It opens up new addressable market going forward.

Here's a look at EPS growth. Coming out of the pandemic, consistent EPS growth. You know, consensus again, trending well for 2023 above the $6.54. And strong continued upward trend from here in line with Gary's note about earnings leverage. So, expecting our market cycle to get about a 1.5X earnings leverage growth on top of our top line rates. If our top line is 10%, earnings grow by 15%. So, with that, Mark, we can turn it over to questions.

Excellent, and so for everyone joining us, again, feel free to just click on the Q&A button at the bottom of your screen to submit questions. We already have quite a few already, so we can get started with those. The first is around your expectations around BBSI's benefits program as we go into the next year and what you feel is the size of that addressable market.

You know, so a couple of questions there. So, the size, right? If I think of the size, it really changes our target market where historically we were blue or gray, now we can sell a product into the white-collar space. So, we look at our total addressable market as being doubled, if not more, and then on the distribution side, you know historically we've had great success with PNC Referral Partners. Property and casualty referral partners. With our new health insurance offering, we're able to tap into employee benefits which we think will potentially double our distribution channels. So, feel very good about quality, the TAM of both distribution and client size. You know we'll continue to make investments on IT, as well to better support the product, but ultimately, to make it so that our IT is more attractive to I'll say larger, more sophisticated clients, and the white-collar clients. To make sure that we round out our tech stack offering so that when we go to sell this in the white-collar space, it's a desirable tech product and we're close to that. We're going to have some investments we're making over the next few years and honestly, we've been making investments in tech for the last five years and I don't think we'll ever be done with your tech stack, as long as you're methodical with your product road map. And then for expectations on the benefits program. So, we mentioned that at the end of Q3 during our earnings call. So, we have, you know, I'll say two pipelines, right? We have a pipeline #1 of existing clients that we want to sell our benefits into. Right. So, if we look at the business we have on the books for benefits, number one, and then the business that's in the pipeline and what we think will close. We said at the end of Q3 that we are very confident that the benefits offering will be accretive to earnings in '24 and we didn't give a number. They asked for a number, we didn't give a number. But looking at it and say, OK, well, we had to make investments in IT. That's going to come through as depreciation. We had to hire a group of folks to sell service and underwrite the business and that's about 30 folks that we had to bring on to make sure that the product was successful. So, as we look at those costs coming into '24, we know that, based upon the commissions we're going to make and what we're able to upsell on the PEO side, that we're going to make money on this product. We haven't given a guide yet for how much money we think we're going to make. So, you know, as we think of the benefits, the benefits as meeting our expectations, we're making money on it. This is not a one-year play. This is a multi-year play and then as we think of the regular, I'll call traditional, PEO business. For Q3, we spent a lot of time on sales and marketing and a lot of time on lead gen. and our prospects that were in the pipeline at the end of Q3 were about 80% higher than Q3 of the prior year. And these are legitimate prospects that have been scrubbed that we've met with that were in the proposal stages. And so, these are not, you know, business cards that somebody got out of fishbowl at Applebee's. These are legitimate prospects, and our pipeline is that much bigger. So, as we as we think to '24, it's like, OK, we feel good that our benefits offering is getting traction, number one, and then number two, our traditional PEO offering, our strategies are bearing fruit as well in Q4 and Q1 looks like we're going to shape up to be a great selling season for us.

Excellent, and then shifting gears to use of cash, one of the questions is around the capital allocation priorities and maybe we can sort of talk a little bit about the free cash flow generation that that you're able to provide, as well.

Yeah, it's a great question, because it really wasn't in the presentation, but we generate a lot of free cash flow. So, all essentially annual recurring revenue for us, it's not a capital-intensive business, right? So that growth and we're adding those markets new markets with market development managers. That's salary that's baked into our SG&A and our earnings leverage models. But the reality is we don't need a lot of capital. We're investing in IT, but we have excess free cash flow and so we've been returning that to shareholders. We have a dividend that we're committed to, but we also believe, continue to believe, there's a lot of intrinsic value in our stock and we have a stock buyback program. So, we returned over $100 million to shareholders in the last, you know, about a year and a half and still about over 60 million left on a current stock buyback program that's approved by the board and we continue to execute on that. Obviously, we're always looking for strategic investments in the business. You know, Gary mentioned product expansion and investment in IT, and we'll continue to do that, but the company generates consistent free cash flow and we've had a lot of success with that buyback program.

OK, great. And then one of the questions that we have is around maybe you could talk a little bit about if your competitive set, as well. But specifically, there's a question regarding differentiation between yourselves from Automatic and Paychecks.

So, you know, we get this. Everybody tries to put you in a box, and we get this question a lot about our competitors. If you look at the true compares, there's two publics that are out there. It's Insperity and TriNet, as far as a true PEO. ADP has a large business segment called total source, which is a PEO as well. I would say, our models are different for three main reasons. Right. One is, you know, we're local with our clients. Right. Our competitors are selling, you know a 1-800 shared service center. So, our model is, we think, better, because we have those local people that are going to be there to support that business, right? So that if that client has an issue with an employee and they don't know how to do a termination, we can go on site helping with the termination and get a settlement release at the last vacation day. Get a check cut and delivered. Right. That's the differentiator for us in that local market as opposed to you know, here's a website. Do it on your own and we'll overnight you a check, right? So, there's just a big difference in the service we provide. So, the service, we think our service is better than the market.

The second thing is, we don't take risks on the workers' comp, we don't take risk on the healthcare. Most of our competitors take that risk. Right with risk, you know comes, you know, they got upside and downside with it. We decided to lay that off to the market so that we can make our business, you know, hopefully easily understandable to investors and to protect shareholder value. And then the third is, you know, we are the probably the one that has a distribution strategy that we can go both direct and through referral partner channels. So, we have an Omni channel distribution strategy that we think gives us a better pipeline and gives us better opportunity and we select on who we want to partner with BBSI.

Okay, and then another question that we have in. This comes in and asks about how long it might take to, when you enter a new market, to achieve normalized margins after absorbing startup costs and I believe that maybe this is a maybe a two-part question in a way that it could be taken as geographic marketplaces, or, as well as new line of business for BBSI.

So, if we take the new market development managers right. I'll take the most successful one we've had so far. The gentleman started late last year, was training in '22. Started to sell 1/1/23 in Chicago. So far, he's 11 months in and has 13 clients on the books. Those 13 clients run to about a $14 million run rate, right? So, if we were to build that on an annualized basis would be 14 million and he will be profitable based on what he has in the book now. But we are continuing to invest behind him. We're doing a brick and mortar. We're looking at real estate now. We're looking at hiring other folks locally to help support that business with the idea that he's going to have clients that are going to get client referrals. He's going to have more referral partners that are going to be giving them more business. His business will more than double in '24, right. So, if he added 13 in '23, we think in '24, he'll add 18 to 24 new clients, and he will be profitable in '24, so you know in a lot of the markets, it's really not a function of the market. It's a function of the person, right? So, the person, right, they have to be a salesperson. They got to have a sale pedigree, a sales profile. They've got to be comfortable in the business services and ultimately, they got to be a hunter. And if they are, they would be successful, and we'll invest behind them and then we've got other success in Oklahoma and Texas and other in other states, where we're going to be adding brick and mortars behind those folks, as well.

Okay. And then it's part of your prepared remarks. One of the things that you touched on was the strong client retention of 90% area there. I was wondering if you could expand on that a little bit. One of the questions here is around the average length of time that clients have been with you. But also, then expands to, you know, what's driving that strong retention level and maybe competitive set perhaps, but more so around the retention level.

When we do our job right and we align with the clients, you know, we really become an extension of their team, right? And it becomes an invaluable extension. And typically, the business that runs off, you know, I want to say that you know five or six points is because they sold or closed the business, right. So, they could sell the business, they could M&A, they could close the door, go out of business, retire. That's the lion share of our runoff. So, after you take that out of the equation and you say how many clients are we losing because of service, it's a small percentage point and then how much of the business are we losing because of price, that's the other piece. And you know, we're going to lose business to price. We're never going to be the cheapest, right? We got to make sure that we get a return for shareholders, and we get a return on our management dollars. But ultimately, when we look at the business, you know from what we can control, we're doing really good things on the service side. And then the duration, you know that one, we don't have kind of refreshed stats on the average duration. But it's been 90% now for several years. Before that it was, you know, high 80%. So yeah, I mean, it was interesting. I was at a client event. Last month in Northern Cal and we had clients that have been with us for 25 years, moving around for a long time, but I would say that's the minority, not the majority. I'd say the average duration is, we'll call it three to five years.

OK, great. And then one of the questions that we had come in and it's very active on the questions today. So, thank you, folks. Wanted to talk about the areas of country that maybe that you see the greatest growth opportunities. Whether that's driven by regional expansion opportunities or just maybe, you know, areas that you think have more upside than some others?

Yes so, good question. We look at our products. I mean, our product can work in any market. We've built big branches in places that you have never heard of, or I've never heard of until I moved to the West Coast like Medford, OR Twin Falls, or Idaho Falls, ID. We've got big, big branches in small places, so the model has proven that it can work in big markets. It can work in small markets. It can work in rural; it can work in urban. So, we've, we've proven that the model works. So first and foremost, you know we mentioned our controllable growth. Right. And everybody's got a sales goal, and everybody's got a retention goal for their branch, and we've consistently hit our controllable growth numbers. From Southern Cal to Northern Cal, to the Northwest, to Mountain, to the East Coast, we’re hitting our controllable numbers everywhere. And one thing we have seen, is some of our clients slow down and that's been I'll say more episodic. We saw clients slowdown in Portland in construction, in the Bay Area in construction, more so than say, Southern Cal. So as far as our controllable, we're seeing good growth everywhere. As far as our clients? It varies by geography and varies by industry.

And that makes a lot of sense. And then I know we're a couple of minutes over. But we only have one question left, so we accommodate this one. Last question is around how the clients behave and employers and the timing of their updates and changing of plans at the end of the year. So, I wanted to get a sense of what your backlog may look like entering next year or some level of visibility that that you feel comfortable sharing? Thank you.

So, we feel, you know, when we think of the 1/1 selling season, it's getting to the close. Even though we're close, we closed 4 accounts this week. We're getting to the close, because if you think about 1/1, you got to have the plan design. You got to set the premiums, the clients got to make the selection and then OK after that's done, then you got to push all of the employees through the enrollment. You got to get the employees time to go in and make an enrollment selection. So, we're getting down to where we don't think we're going to close a lot more 1/1 business, but we still have, you know, 40 plus clients that are going through the enrollment process now. You know, and we based upon the guide we gave, as far as, you know, being comfortable that we're going to be profitable with this business in ’24, there's been nothing that's come in that's changed that. If anything, we think ‘24 is going to have more upside in it than when we originally thought when we talked back in Q3.

Well, that sounds like an excellent way to end the presentation and end the day. Doesn't it? So, I want to thank you both for joining us with a wonderful presentation and thank all of our participants. Have a wonderful remainder of the day. Thank you, everyone. Thank you.

Thank you, everybody.