

## Barrett Business Services, Inc. Second Quarter 2022 Earnings Call

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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 2022. Joining us today are BBSI's President and CEO, Mr Gary Kramer, and the company's CFO, Mr Anthony Harris. Following the 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. The statement provides important questions regarding forward-looking statements. The company's remarks during today's conference call will include forward looking statements. These statements, along with other information provided 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 the score will be available for replay through September 3, 2022 starting at 8:00 PM Eastern time today. 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](http://www.bbsi.com). Now, I would like to turn it over to the president and chief executive officer of BBSI, Mr Gary Kramer. Please proceed, sir.

Thank you, Claudia. Good afternoon, everyone, and thank you for joining the call. We had an excellent Second Quarter both financially and operationally. Our performance momentum continued across all facets of the business and resulted in us once again raising our full year outlook.

We exceeded our internal estimates of controllable worksite employee growth plus our clients continue to grow, which resulted in better than expected financial results. Regarding our client and WFC stack, we continue 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 Q2.

This is the result of our three pronged strategy. First, to mature and deepen relationships with our existing referral partners. Second, to utilize technology in digital campaigns to target nurture new referral partners. And third, to utilize technology in digital campaigns to target potential clients directly.

I'd like to put a finer point on our new referral partner initiative. Through the first six months of 2022, we have strategically targeted about 5,000 new potential referral partners. And we have forged new partnerships with about 20% of them. This is a long term strategy, trust is earned slowly over time. As these new referral partners see BBSI and our product in action, we believe they will become more comfortable in recommending BBSI to their clients.

We've added about 15 new accounts from these efforts so far this year, but expect much more in the back half of the year and into the future. The next trend that we previously discussed is that we've 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 continues to be stronger than pre-pandemic levels. I like to attribute that to the work we do with our clients and the value our teams bring in this ever changing and complex economic environment. The results of all these efforts, or what I refer to as our controllable growth, is that we added approximately 3,200 worksite employees year over year from net new clients.

We build as a percentage of payroll and we grow as our clients grow by adding worksite employees with wage inflation and as hours work increases. Our client base is resilient and we exceeded our internal forecast for worksite employee growth in the quarter. Regarding our financial results. During the quarter, our gross Billings increased 14% over the prior year quarter and exceeded our expectations.

For our PEO business, our average worksite employees were up 9% over the prior year quarter, which is the culmination of controllable growth as well as our clients hiring. We exceeded our internal forecast for our worksite employee stack. Moving to our staffing operations. Our staffing business increased 21% over the prior year quarter, and we continue to experience favorable year over year growth trends.

We are seeing more applicants, we are placing more applicants, and companies are increasing wages to attract employees. It is still a thin recruiting market, and we are unable to fill all orders, but our fill ratio is improving. We could have grown more, but continue to have challenges filling orders with the tightness of the labor market. We've made investments in staffing and recruiting, and we're seeing positive results in recruiting for our PEO clients.

Moving to the field operational updates. We are very pleased with our progress of our asset light model. Our first class is doing well and we've added 10 accounts and have 9 in contracting. Our second class is hired and will be training in Q3. At the end of Q2, we operated in 13 states and 68 markets, which is consistent with the prior quarter.

Some markets will be more profitable than others due to their maturity. But with our evolution, every market is expected to be profitable. Regarding product updates. First, I am pleased to report that we successfully renewed our workers compensation facility and received better pricing and better terms.

Regarding the price. Our underwriting and loss experience continues to exceed expectations and we were rewarded with a lower premium rate. Regarding terms, the expiring program contained a small potential-- a small potential additional premium provision which was removed at the renewal. We now have no downside and only share in the upside of our disciplined operations.

Second, we just announced that we entered into a strategic multiyear partnership with one of the world's leading health insurance companies. This has been in the works for about a year now and the teams have been working hard on this product offering. I'm going to break this up into a couple of different sections to better explain the offering.

Regarding the Why Now. This is the number one product that our clients have asked us to invest in. We have the ability to bring them savings of group buying power which will allow them to attract and retain employees. We were the largest PEO without a health insurance offering, and as a late adopter, we have no legacy system constraints and can partner with best in class providers, underwriting services, and administrators.

Regarding the structure. This is a fully insured program where we take no underwriting risk. We have been de-risking the workers' compensation program over the past couple of years, and it was a key objective of ours to not take underwriting risk. Regarding the product, BBSI clients will now have access to discounted products and plan designs that are not currently available to them in the traditional small group market.

We will be offering health insurance plus ancillary benefits, including but not limited to, dental, vision, life, disability, and critical illness products. Regarding the administration. This offering is made available and will be delivered seamlessly through our My BBSI portal. Clients will find value in the ease of administration, billing, and compliance. Regarding distribution.

We have been and will continue to be a referral partner friendly CEO. We view referral partners as our clients as well, and this is an opportunity to attract new referral partners that specialize in the benefit space. Regarding rollout. We have the people, products, operations, and technology in place to start selling now. And we will be offering this product to our existing clients in every state except California for the one-one '23 enrollment season.

We will perfect our craft and then shift our focus to California and to new prospects. We view this as an opportunity to diversify our clients profile while expanding our total addressable market. Regarding the economics. We anticipate that this will increase margin and accelerate growth, but we are not going to provide any guidance at this time.

We will get through the one-one selling season and expect our 2023 outlook will include the benefit of this new offering. A lot of effort and thought has gone into building this out and I would like to thank everyone at BBSI and our partners for their effort. The company is ready for this, we're excited to go to market, and more importantly, our clients are asking for this.

Next, I'd like to shift and speak to the macro economy. The growth in worksite employees for our install base during the second quarter was strong and our July numbers were equally strong. Wage inflation is still prevalent, but at a slower growth rate than 2021. As the payroll in HR company for over 8,000 clients over various states and industries, there is nothing in our data that would reflect the slowdown in the economy at this time.

We are also not seeing any slowdown in our staffing and recruiting services either. However, we would be remiss if we didn't acknowledge that times are growing more challenging for business owners given tight labor markets, record inflation, supply chain challenges, and a rising interest rate environment.

As we look ahead to the balance of the year, our confidence in raising guidance starts with our higher than expected Q3 starting point for our install base of clients and WFC stack plus optimism of our revamped and disciplined sales and service teams executing on controllable growth. Anthony will provide more color to our full year outlook in his prepared remarks.

As I think in the future, we have consecutive quarters of great momentum and I don't see it slowing. Our client retention is the best it's ever been and we're seeing more business opportunities. Our prospects continue to be larger because of our technology stack coupled with our Nationwide offering. We are executing to our plan and things are going well. Our optimism increases exponentially as we think of the opportunities that our new benefits offering brings to our existing clients, new clients, and new referral partners. Now I'm going to turn the call over to Anthony for his prepared remarks.

Thanks, Gary. Hello, everyone. I am pleased to report that we had strong results for the quarter in all areas of our operations. PEO growth billings increased 14% over the prior year quarter to \$1.8 billion, while staffing revenues increased 21% over the prior year to \$30 million.

As Gary noted, our increase in gross billings was driven by stronger than expected growth from net new clients in the quarter, continued stronger than expected hiring within our client base, and higher average billing per worksite employee. Overall, WFC has increased 9% over Q2 '21, and average billing per WFC increased 5%.

The increase in average billing per WFC was driven primarily by rising wages and our existing employee base, offset partially by a greater portion of lower wage rolls being hired than we have seen in prior quarters. PEO gross billings growth by region versus the prior year second quarter were as follows.

Mountain states grew 34%, East Coast grew 22%, the Pacific Northwest grew 10%, Southern California grew 11%, and Northern California grew by 10%. We continue to see Southern California growth trends consistent with other regions driven by new client additions as well as increased client hiring and wage increases.

Regarding pricing, the workers' compensation market remains competitive, but we are seeing stabilization in pricing and competitor behavior. There have not been significant changes in market pricing in recent periods. Our gross margin rate is again trending ahead of prior year through Q2 with continued cost savings and payroll taxes and more significantly from lower worker's compensation expense in the quarter.

Our workers compensation program continues to perform well with favorable claims frequency trends and favorable development on historical claims reserves. This quarter included an actuarially determined reduction of prior year estimated liabilities of \$6.5 million compared to \$5.5 million in the year ago quarter.

As Gary described, we renewed our fully insured workers compensation program effective July 1 of this year. The prior year program has performed favorably and our renewed program includes several enhancements, including lower premium rates and more cost certainty. For the 12 month policy effective July 1, 2022, if claims develop favorably in future periods, BBSI receives the benefit of those lower claims costs through returned premium from the carriers.

If claims develop unfavorably, there is no additional premium that can be owed. But as BBSI continues to participate and all of the upside of favorable worker's compensation cost trends, it has no exposure to downside risk. This is another step in our strategic effort to de-risk our workers compensation program.

Turning to operating expenses, SG&A in the quarter is on plan. Our top line growth and profitability are ahead of expectations and we have accordingly increased accruals for employee profit sharing and incentive compensation. But our relative SG&A growth remains on target. With regards to the launch of the new health benefits offering, we will incur costs before revenue in the current year as we build out our people, processes, and systems to accommodate the selling season and prepare for the January 1 launch.

These investments will result in incremental SG&A expense of approximately \$2 million in 2022. As a reminder, we expect an average earnings growth rate of approximately 1.5 times our top line growth rate. Even with the incremental expense in preparation for the benefits offering, we continue to expect earnings leverage to be ahead of target for the year.

Moving to our invested assets. Our investment portfolios earned 1.6 million in the first quarter compared to 2 million in the prior year. As we noted last quarter, with the rapid increase in interest rates in the year, our fixed income portfolios have moved to an unrealized loss position. However, we intend to hold these securities and our portfolio continues to be managed conservatively with an average duration of 4.1 years, average quality of investment at AA, and average yield of 1.8%.

Turning to the balance sheet, we had \$111 million of unrestricted cash and investments at June 30 compared to 127 million at March 31. The decrease is primarily due to the timing of payroll taxes and stock repurchases. As a reminder, BBSI is now complete debt free.

As I revisit our strategies for driving shareholder value that I summarized last quarter and includes prior, we continue to generate consistent profitable growth in earnings leverage, we have further reduce the risk of our workers compensation program, we're investing in growth initiatives, now including a new product launch in the form of health benefits for clients, and we continue to return capital to shareholders through our dividend and stock buyback.

Continuing under the board's \$75 million share repurchase program, in the second quarter, BBSI repurchased 270,000 shares at an average price of \$73.88 per share, including 159,000 shares since our last update on May 4th. Year to date, we have now purchased more than 5% of the company's shares outstanding. The company also paid 2.2 million in dividends in the quarter and reaffirmed its dividend for the following quarter. We paid 4.4 million in dividends year to date.

Given the strong results for the quarter and positive trends, we are increasing our full year outlook. We now expect gross billings for the year to increase between 11 and 13% up from 10% to 12% previously. We expect average WFC to increase between 7% and 8%, up from 4% to 6% previously. And we expect gross margin as a % of gross billings to be between 3.05 and 3.15% up from 3.0% to 3.1% previously. And we expect our effective annual tax rate to be between 26% and 28%, up from 25% to 27% previously. I will now turn the call back to Gary for closing remarks.

Thanks, Anthony. We continue to always think of the client first and to advocate for the success of the business owner. I want to thank all of our professionals who work tirelessly to help our clients thrive. The company is in a great position and the new benefits offering is only going to accelerate future growth. Now I'd like to turn the call over to the operator.

Thank you very much, sir. At this time, we will be conducting a question and answer session. If you would like to ask a question, please press star and 1 on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star and two if you would like to remove yourself from the question queue. For participants using speaker equipment, it may be necessary for you to pick up your handset before pressing the star keys.

Just another reminder, if you'd like to ask a question, please press star and then one. We will pause to see if there are any questions. The first question comes from Chris Moore from CJS. Please proceed, Chris.

Hey, good afternoon guys, thanks for taking a couple of questions. Maybe we can start with the health care benefits, so just trying to understand the mechanics a little bit better. So will it be open enrollment throughout the year for the select markets or certain discrete dates when clients can sign up, how does that work?

Yeah, hey Chris. So we're starting outside of California-- Well, let me take a step back. So we were active in the market looking for acquisitions. And one of the requirements was we were trying to find somebody that had a benefits offering. We're not having a lot of luck in the acquisition side, so that's when we turned and said instead of buy it we're going to build it. So we shifted to the build it.

We have our IT in place, we have our people in place, we have our partners in place, and the product is a very good product, very good process, very compelling value prop to the small business. And we're going to do it outside of California to start because we really want to learn and master our craft before we bring it in to California.

So what we're doing now is we will start to sell to our existing clients outside of California with the intent that we sign them up, we go through the open enrollment, and then come one-one '23, they're on our master plan. So it's a pretty-- hopefully, it's going to be a pretty seamless process as far as the value prop and conversion. We've got some assumptions for, but once we get through the one-one selling season and we know what our conversion rates are for the clients, we'll have a better feel for how the numbers and the guide are going to work.

Got it. And it's exclusive to one health insurance company or how does that look?

For this side, we have one health insurance company and then we have another company that we're going to offer the ancillary benefits through.

Got it. And maybe just in terms of the revenue model from your side.

So this will be-- on the revenue side, this will be a 23 event not a 22.

Correct.

And when we give guide-- when we give guide next year, this figure, we'll know what our conversions were for the one-one selling season and we'll have a good handle on what we think the positive effect of revenue and margin will be.

No, but in terms of-- as clients sign up and start to enroll in on the first, just how do you-- what does it look like in terms of how do you get paid as these customers sign up? Is it flat fee? I'm just trying to understand what it looks like.

So the important thing here is we're not-- everybody understand that we're not taking underwriting risk. We got out of the underwriting risk business on the workers' Comp when we de-risk the model. And we are not taking underwriting risk on the health care either. But just in general, we have good underwriting-- we're underwriters on workers' Comp and that's how we get the good terms when we go out and renegotiate our workers' Comp programs at the market. And we're going to be good underwriters on the health care side.

So this isn't going to work for everybody, it's going to work for those that fit well into our model because we've got to preserve the underwriting integrity of it. But the basic math is our revenue is going to go up, we will have a health care expense that will be passed through, and ultimately, we're going to keep a margin on this business that compensates us for all these activities. I mean, if you want to if you want to think of it in simple terms, we are a reseller of health insurance and receive compensation for the resale.

Got it, that definitely helps. I will leave it there and jump back in line, thanks.

Thank you. The next question comes from Vincent Colicchio from Barrington Research. Please proceed, Vincent.

Gary, I wasn't clear on your pipeline for new sales prospects and referral partners and how it compared to the prior quarter, I don't know if you mentioned that.

I didn't mention it, but our lead activity, we're seeing much more in the top of the funnel than we've seen over-- we're way over-- we're way over pre-pandemic levels now. So Q2 was better than Q1 as far as business coming in at the top of the funnel, and that's got to deal with A, the work the folks are doing in the field, and then B, the effort and strategic initiatives we have as far as meeting and bringing on new referral partners and then also trying to go get some business on the direct side.

So if I look at your guidance and your growth expectation for worksite employees, it looks like very little increase in the second half. Is that just conservatism? What are your thoughts there?

Yeah. I'll say we've tempered expectations a little bit on the back half of the year when we look at same customer sales as far as our clients hiring, it is a tight labor market out there. Our clients hiring exceeded our expectations in Q1 and Q2, but we're trying to go back to say a more moderate pace of-- more of a flattish customer sales on our clients hiring on the back half.

And that's the whole point. Everything in our data, everything is looking good. We do not see an economic slowdown here. There feels to be a little bit of a disconnect between Wall Street and Main Street right now as far as employment. But just in general, we're trying to be cautious as we give guide as we look at the back half of the year.

And could you give us some help directionally what Q3 Revs should look like versus Q2?

Yeah. So Q3 billings we think year over year will be strong, similar growth rates honestly. I mean, the trends are very consistent in terms of our progressive sequential growth, Q2 going into Q3. So similar year over year and sequential growth trends Q3 to Q2.

And then keep in mind for Q4, we lose a business day, and that's about up to 50 basis points of--

Yeah, on the year, it's about 50 basis points. In Q4, it'll be about two percentage points off because of the lost business day.

OK. And on the acquisition side, soon, we go into a-- we're debating-- everyone's debating if we're in a recession or not. Adding health care's a big positive for business development here. Will you be opportunistic if we go in a recession and the values drop significantly on the acquisition side or is that going to shut off for now?

We're actively looking. We don't say no to looking at deals, but we do say no if the deal doesn't make sense. But we're actively looking in the market. OK. I'll go back in the queue, thanks.

Thank you. And ladies and gentlemen, just another reminder, if you'd like to ask a question, please press star, then 1. If you'd like to ask a question or a follow up question, please press star then 1. We will pause to see if there are any further questions before we conclude. There are no further questions. 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.

Thank you. Thank you everybody for dialing in, thank you everybody for your interest in BBSI. Things are going really well at the company and we're looking positive ahead. So we are optimistic and looking forward to the future here, so thank you everybody.