

Barrett Business Services, Inc. Third Quarter 2022 Earnings Call

Good afternoon, everyone, and thank you for participating in today's conference call to discuss BBSI financial results for the third quarter. And it's September 30th, 2022. Joining us today BBSI's President and CEO, Mr. Gary Kramer and the company's CFO, Mr. Anthony Harris. Following their remarks, we will open the call for 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 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 December 2nd, 2022 starting at 8:00 PM 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. Gregory Kramer. Sir, please go ahead.

Thank you, Ryan. Good afternoon, everyone, and thank you for joining the call. We had an excellent third quarter, both financially and operationally. Our performance and momentum continued across all facets of the business and resulted in us once again raising our full-year outlook. We are executing on our objectives, and our strategies are delivering superior results. Our growth in worksite employees resulted in better than expected financial results.

Regarding our client and WSE stack, we continue to execute on various strategies to increase the top of the sales funnel. And I am pleased to say that we once again exceeded our expectations in Q3. This is the result of our three-pronged strategy, to mature and deepen relationships with our existing referral partners, to utilize technology and digital campaigns to target and nurture new referral partners, and to utilize technology and digital campaigns to target potential clients directly.

I'd like to put a finer point on our new referral partner initiative. Through the third quarter of 2022, we have strategically targeted about 6,000 new potential referral partners, and we have forged new partnerships with about 18% 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 recommending BBSI to their clients.

On a year-to-date basis, we added 41 new accounts from these efforts, up from 15 last quarter, and expect this to continue to accelerate into the future. We will continue this strategy in 2023, along with targeting new referral partners that specialize in the benefit space. 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 POE 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 prepandemic levels. I like to attribute that to the work we do with our clients and the value our teams provide. The results of all these efforts, or what I refer to as our controllable growth, is that we added approximately 4,300 worksite employees year over year from net new clients.

We build a percentage of payroll, and we grow as our clients grow by adding worksite employees with wage inflation and as hours worked increases. Our client base is resilient, and we exceeded our internal forecast for worksite employee growth in the quarter. Our average worksite employees were up 8% 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 1% over the prior-year quarter and with less than we anticipated. There is still strong demand for labor, and we are receiving more orders, 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. Anthony will give some regional color for what we're seeing in the markets.

I mentioned previously that we made investments in our recruiting operations and we are seeing positive results. One of our objectives was to provide recruiting services for our PEO clients. This is a valuable service to our PEO clients in a tight labor market, which also rewards BBSI. When we place a candidate, we receive a recruiting fee. And as the candidate joins the client's payroll, we realize PEO revenue. We have built out recruiting hubs in every region that support our branch network. On a year-to-date basis, we have placed 287 candidates with 147 PEO clients and generated \$1.7 million in recruiting fees. We expect this to increase as we introduce to more clients.

Moving to the field operational updates, we are very pleased with our progress of entering new markets with our asset-light model. Our first class of four is doing well, and we added 25 new accounts with about 250 worksite employees. In 2022, we started small with our first class as we were learning and refining the various aspects of our new market development program. We are at a point now that we are confident that we can scale this program and have hired and are training the next class of 11 folks.

This class is primarily located in the central states plus a few East Coast markets and will begin selling in Q1 of next year. At the end of Q3, we operated in 13 states and 68 markets, which is consistent with the prior-year quarter and does not include our asset-light markets. 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, we successfully launched our new health benefits offering in the quarter and began selling for the 1/1/23 enrollment season. As a refresher, we entered into a strategic multiyear partnership with one of the world's leading health insurance companies. This is a fully insured program where we take no underwriting risk. We have been derisking the workers' compensation program over the past couple of years, and it was a key objective of ours not to take underwriting risk.

We have invested in IT to allow this offering to be delivered seamlessly through our myBBSI portal, and clients will find value from the ease of administration, billing, and compliance. 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.

In the quarter, we roll this out to a limited number of existing clients in select markets for the 1123 enrollment season. Our intent is to perfect our craft and then shift our focus to California and to new prospects. This will not move the needle for revenue or profit in 2023 as we targeted a very small cohort of clients, but we anticipate this will provide material contribution as we look to the future of BBSI.

We view this as an opportunity to diversify our clients profile while expanding our total addressable market. We have the people, products, operations, and technology in place and are executing to our sales plan. I am pleased with where we are with this new offering and of our sell-through this far. In addition to our benefits offering, we have also been investing in electronic training and development. You've heard me say over the past two years that we've invested in technology that was designed to train and develop our new market development managers. We are taking this technology and are now making it available to our clients through myBBSI.

We are excited to be launching BBSIU in the fourth quarter. This is a learning management portal that our clients can purchase and contains various catalogs consisting of HR and compliance, risk and safety, leadership, and professional skills. This does not replace our experts in the field but will be a valuable tool that complements our offering.

Next I'd like to shift and speak about the macro economy. The growth in worksite employees for our install base during the third quarter was strong. And our October 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.

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. We know that labor is in high demand, that the unemployment rate is still at all-time lows, that the labor force participation is lower than prepandemic levels, that job openings rose last month, that immigration is low, these are all unusual facts that do not fit any previous historical inflationary recession scenario.

Also layoffs should be delayed due to business owners recent memories of how challenging it was to attract new employees postpandemic. Based upon all these factors, plus our higher than expected Q4 starting point for our install base of clients and WSE stack, and our optimism of our revamped and disciplined sales and service teams executing on controllable growth, we believe BBSI is poised for growth in 2023 even if a recessionary environment arises.

As I think to 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 tech 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. With that, I'm going to turn it over to Anthony for his prepared remarks.

Thanks, Gary and hello, everyone. I am pleased to report that we again had strong results for the quarter. POE gross billings increased 13% over the prior-year quarter to \$1.9 billion while staffing revenues increased 1% over prior year to \$29 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, worksite employees increased 8.2% over Q3, '21 and average billing per WSE increased 4.2%. The increase in average billing per WSE was driven primarily by rising wages in our existing employee base offset partially by continued hiring of more lower wage roles relative to the prior year. POE gross billings growth by region versus the prior-year third quarter were as follows. Mountain states grew 21%. East Coast grew 20%. Southern California grew 14%. Northern California grew by 10% and the Pacific Northwest grew 7%.

Staffing revenues increased 1% over prior year, which is a slower growth rate than we have seen recently. We monitor our staffing revenues closely for broader trends, but the slowing growth this quarter was primarily driven by client and region-specific circumstances. In the Northwest, we have agricultural clients where work has shifted from Q3 to Q4 in response to a late harvest season. And in the Mountain States we experienced a slowdown in certain light-manufacturing clients due to supply chain challenges. Both of these examples are transitory. The one market where we have seen demand contraction is in Northern California where we support more technology clients. However, we are not seeing broader negative trends.

We continue to see stability in our workers compensation market and our overall pricing has remained consistent and in line with our plan. Our gross margin rate continues to trend ahead of prior year through Q3, but cost savings and payroll taxes and more significantly, from lower worker's compensation expense in the current year. 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 \$1.4 million compared to \$0.8 million the year-ago quarter. As a reminder, 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 even 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 return premium from carriers. If claims develop unfavorably, there is no additional premium that can be owed, that is BBSI continues to participate in all of the upside of favorable worker's compensation constarins but has no exposure to downside risk.

Turning to operating expenses, SG&A in the quarter is on plan. Our new health benefits program has launched successfully, on schedule, and with costs in line with our forecast. Our top-line growth and profitability are ahead of expectations, and we accordingly, have increased employee compensation expense for profit sharing and incentives. But those increases have been offset by other savings in the quarter.

As a reminder, we expect our earnings growth rate of approximately 1.5 times our top-line growth rate. Even with the incremental expense in preparation for our health benefits offering, we continue to expect earnings leverage to be ahead of target for the year. Moving to our invested assets, our investment portfolios are \$1.6 million in the third quarter compared to \$1.8 million in the prior year. With the rapid increase in interest rates, our fixed-income portfolios remain in an unrealized loss position.

However, we intend to hold those securities, and our portfolio continues to be managed conservatively with an average duration of four years, average quality of investment, AA, and average book yield of 2.1%. Looking at the balance sheet, we had \$132 million of unrestricted cash investments as at September 30 compared to \$111 million at June 30. The increase is primarily due to the results of operations and the timing of payroll tax payments.

As a reminder, BBSI is now completely debt free. We continue to see intrinsic value in our share price relative to our profitability and growth potential. And we've continued to repurchase shares under the board's \$75 million share repurchase program. In the third quarter, BBSI repurchased 130,000 shares at an average price of \$81.74 per share. Year-to-date we have now purchased more than 7% of the company's shares outstanding and still have \$36 million remaining on the program.

The company also paid \$2.1 million in dividends in the quarter and reaffirmed its dividend for the following quarter. We have paid \$6.6 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 12 and 13% up from 11% to 13% previously. We expect average WSEs to increase 8% to 9% up from 7% to 8% previously. And we expect gross margin as a percent of gross Billings to be between 3.1% and 3.2% up from 3.05% to 3.15% previously. And we expect our effective annual tax rate to be between 26% and 28%, is consistent with our previous guide.

As we finish this year and look ahead to the next, we believe BBSI is poised for continued growth even in an uncertain economic environment. We will continue to invest in growth and products, including our new health benefit offering and new market expansion. And even with those investments, we'll continue to benefit from leverage in our operating model. In short we are optimistic about the future and are looking forward to the year ahead. Now I will turn the call back to the operator to open the line for questions.

Thank you. Ladies and gentlemen, at this time, we will be conducting a question and answer session. If you would like to ask a question, please press star 1 on a telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star 2 if you would like to remove your question from the queue. For participant using speaker equipment, it may be necessary to pick up your handset before pressing the star keys.

Ladies and gentlemen, we will wait for a moment while we poll for questions. Our first question comes from the line of Chris Moore from CGS Securities. Please go ahead.

Hey. Good afternoon, guys. Congrats on another great quarter. Maybe we just start on the property and casualty market side. So Hurricane Ian had a significant impact on the property and casualty market-- generated large losses. Is that causing more tightening of risk and rate tolerance by carriers?

Hey, Chris. Good question. It's still early. A lot of that catastrophe was filled off-sea. About 60% of that loss is with Lloyd's out of London. So 40% on the US market, which is where you would have commonality with the workers' comp lines of business. Still early days-- we're seeing the rates trade in a flat band of the plus 2, minus 2. We haven't seen any broad stroking rate increases yet from everybody.

We've continued to see the workers' Comp market get more rational. And we expect that it will stay in that flat to up range for now. We're not seeing the deep discounts anymore like we used to see a year or two ago. It's more trading at where the rate should be.

Got it very helpful. And maybe just the staffing. I mean, although, I don't know how many quarters you can-- and talking about staffing shortages, that obviously continued into Q3. After Q2, you had this thesis out there. So talking about hiring the skilled workers, was it a matter of businesses not being able to find enough skilled labor or they can't afford these workers? Just maybe any follow-up thoughts you had on that from Q3?

Yeah. So we measure our orders, which is really people that want us to hire. So we measure our orders. Our orders are not down. So we're not seeing the orders go down, which the question is, is that the canary and the coal mine and we're not seeing it? Companies are still asking us to go higher for them on the staffing side.

We've had a couple of seasonality things that Anthony mentioned as far as in the Northwest and in the Mountain States. But companies are asking us to hire. That hasn't slowed down. Really these are our fill ratios are dripping down again just because of the availability of the workforce. So we were able to fill less orders on a ratio basis in Q3 than we were in Q2. It's still a tight labor market out there.

Got it. Maybe just the last one for me on M&A. You know my sense is that M&A could happen at some point, but this is not really an area you're spending a lot of energy on currently. Is that a fair statement?

We Look at anything that comes across our desk. We go out and talk to folks as well on the offensive side. We are active in the market. But ultimately, we're going to do what we think is the best for the company for the long term. And we've shifted. We honestly were trying to find a company that had benefits. We couldn't find a company that had benefits that we wanted to buy, and then we started our own benefits department.

And then we're not going to sit idly by and wait for an acquisition. That's why we're going with our asset-light model to enter new markets. So we're excited that we have 11 new BBSI folks that are in the training program that are going to be selling in new markets come Q1. So that's how we're going to fill out the map is with the asset-light model. So if we can find somebody inorganically that fits, we will do that. If not, we will grow it on our own.

That sounds great. I will leave it there. I really appreciate it.

Thank you. Our next question comes from the line of Jeff Martin from Roth Capital Partners. Please go ahead.

Thanks. Good afternoon. Kramer, I was hoping you could give us a sense of what the initial client reaction has been to the new benefits offering? And what kind of uptake rate are you seeing or is it too early to really tell that?

Good question. I'll say that the clients have been asking for this. And Anthony and I were playing back and forth about whether we put a quote in our earnings script because we had a couple of nice quotes, but we ultimately left them out where they were very complimentary of A, BBSI doing this and then B, of the product that they have. We only did this in select markets, and we only did it to current customers that have benefits. So we didn't try to go real wide with this to start. So we went with a very select group.

I can say that we're positive. We're optimistic on the sell-through that we've seen. We don't have good numbers yet. We actually just started to push the enrollment out this week. So we don't know how many participants are going to enroll. We don't know of the total census what it's going to look like. But so far, I think it's been a good launch for us, a good learning exercise.

We learned some valuable things along the way so that when we try to take this thing to scale next year and offer it in California and then offer it to new clients, we're going to have a much better conversion rate because we've learned some things this year.

OK. And then tied to that, what are you seeing in terms of attractiveness to referral partners that specifically traffic within the healthcare market?

That's going to be of focus and attention for us next year. Because 90% of our business comes from referral partners. And of that 90%, a large portion is PNC brokers. We don't have a lot of life and health referral partners now because we don't sell a life and health product. So we look at this and say, we have a mapping of our referral partners that do both sides of the house as far as the life and health and the PNC, and we're working with them. And then we're going to have a strategy similar to what we did this year as far as-- I call it making new friends-- going out and advertising and attracting new referral partners, specifically in the benefits base and explaining the BBSI product.

I mean, we're the broker-friendly PEO. We make sure that if they put the business with us, they're compensated in a similar way as if they put it with the standard market. So really if they put it with us, their life becomes easier because we've got better retention and our platform makes their life easier. There's less administration for the broker when they put it with us. So we think we have a lot of good selling points when we go to the market to try to bring all new referral partners.

OK. Great. And then I was curious on the placements initiative kind of first time you've talked about this. Has this been something you've been doing all year, and it's just starting to reach a material part of the business that you're starting to talk about it? And how much of a focus is this going forward?

We internally we've promoted somebody to run our staffing vertical, and this was one of the objectives was to bring recruiting to our POE clients. So we started in Southern Cal with the recruiting branch to be a hub for Southern Cal. Good results there. Took it to Northern Cal. And then we took it to Portland. Then we took it to the Mountain States. And now we have a recruiting hub on the East Coast as well that supports all of our POE clients.

So we tried it, it worked. And then we took it to all the other markets, and it's working in all the other markets, and now we're at a point where we say we can do this nationally. And it's a good value add. We do recruiting for our POE clients. When we do the recruiting, we get paid a fee. And then they go on POE payroll, and we make POE revenue. So it's a win-win.

Yeah. Sounds very interesting. And then last question, in terms of your workers' compensation outlook as a percentage of gross billings, next year are you thinking it has the opportunity to come down from the 3% to 3.1% range this year? Does it have further room next year to decline?

Yeah. Thanks, Jeff. The answer is we always think we can continue to improve and we will. So at this point, we see positive trends as I noted in my remarks. Nothing worrisome coming through Q3 into Q4. That rate that we're paying now and the fully insured program will continue obviously into the first half of next year. And then we would reset that next July 1. But we'll continue to monitor that and frankly we're optimistic so far in these first two years of our fully-insured program that we're more on the return premium side of that equation. We'll get money back. So it's still early to tell, but the trends are positive.

OK. And then last one for me is, in the absence of a significant fall off in the economy, what do you think that the opportunity to start to grow worksite employees at a double digit rate is and over what time frame?

Yeah, that's we're trying to stay away from '23. We feel-- we said it. My remarks and Anthony said it in his that even if this is a weird recessionary environment because of how tight the labor market is, we feel even if there is a pullback, we can put up growth next year. We feel like we can put up respectable growth. I don't want to really give a range because we're going to wait until we get through Q4, but we feel like we've got the controllable piece going.

The sales machine and the retention machine are going in a positive direction. We've said that quarter over quarter. This quarter we did over 4,000 more WSEs, which is good controllable growth. And then we think we can grow on that. And then it's really the question becomes, what are our clients going to grow like in this environment? But we feel comfortable that all scenarios point to good growth for us in '23.

Great. Thanks for taking my questions.

Thank you. Ladies and gentlemen, if you wish to ask a question, please press star 1. Our next question comes from the line of Vincent Collichio from Barrington Research. Please go ahead.

Yes. Gary, nice quarter. I came on the call a bit late so sorry if this was already said. I'm curious how the PEO sales pipeline changed sequentially, and how your traditional sales engine is working relative to your digital campaign?

Yeah. I mean, we think of these as-- really we've got call it 3 channels that we monitor. Our direct channel, our referral partner channel, and our client referrals. Our client referrals are our big piece of our prospecting. All three are up and to the right. That's the trend we continue to see. We've got more leads that come in every quarter, over quarter. And then it's the scrubbing of those leads to get them through the prospecting and the discovery.

The one thing I would just say is our clients now on average are larger than the clients we've had historically. So we're adding larger clients, and the clients that run off are a little on the smaller side. So we're being able to attract bigger business and retain all of our larger clients, which is a good positive trend, which is a tailwind that's helping support our earnings and WSE growth.

And on the staffing side, you've got some transitory issues you'd mentioned. Will those burn off next quarter in Q4? And so will we see a nice sequential improvement?

Yeah, I think for the Northwest specifically we'll see that pick up because of the late harvest. The supply chain ones-- there's a couple on-sites we have where we do light manufacturing and light assembly. They're the ones that may persist a little bit depending upon the supply chain challenges. I do think the recruiting that we did in Northern Cal is going to continue to slow down specific to the IT sector. As you know, IT is probably the one industry that's under pressure right now.

And the sales and trading capability you're adding to your service, was there a minimal investment in that? Is it let's see how this goes and maybe we'll invest more heavily in this over time? What is your thinking there?

Yeah, it's a small investment for the company. And really we made this investment when we develop the product to train our internal employees. So we built it to train our internal employees to shorten the learning curve. And it's worked well for us. And now we've made some modifications and spun it up so that we can sell to our clients and put some different content in there for them to review. This is not going to be a needle mover as far as revenue or earnings. This is something that the clients have been asking for. And ultimately, we think it will help with retention. So we're going to charge for it. We'll cover our costs, make a little spread, but ultimately, it's a tool that we think will help retain our clients.

OK. And then, as you've said before, clients were asking for health care, which you're fixing now and also a bookkeeping service. Is that the bookkeeping side sort of a back burner? Or is this something you'll consider doing in the next year or so?

We have a parking lot full of products that we would look to add. Bookkeeping is one of them, but we have many of them. And as we think of our product roadmap, we're not going to really-- we're not going to advertise our playbook to the competitors right now.

All right, Gary. Nice job.

Thanks.

Thank you. Ladies and gentlemen, 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.

Sure. Thank you. I'd like to just thank the whole BBSI team for working tirelessly to help our clients thrive. It's been a very good quarter of a very good year for BBSI. And we're proud of where we are, and we're really proud of where we're going. So with that, I will call it quits, and thank you, everybody.

Thank you. The Conference of Business Services Inc. has now concluded. Thank you for your participation. You may now disconnect your lines.