Barrett Business Services, Inc. Third 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 third quarter ended September 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 will 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 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 1, 2023, starting at 8:00 p.m. Eastern 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'd 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 another strong quarter, and I am pleased with our results. We continue to execute on our short-term and long-term objectives and we surpassed 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, national PEO licenses, along with BBSI Benefits. 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 pre-pandemic 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 our controllable growth, is that we added approximately 4,300 worksite employees year-over-year from net new clients. This was partially offset by slower client hiring in the quarter. Our clients increased their workforce sequentially over the second quarter, but by less than we were forecasting. Anthony will provide more color for the portfolio by geography and industry.

To summarize, we grew our worksite employees by 1%, which was slightly lower than forecast for the quarter as we sold and retained more business, but this was partially offset by slower-than-anticipated client hiring.

Moving to our staffing operations. Our staffing business declined by 25% over the prior year quarter and was slightly better than we anticipated. We mentioned previously that we repriced the portfolio and jettisoned clients where we were not achieving an adequate return. We also shifted our strategy to recruit for our PEO clients and placed 83 applicants in the quarter, which generated equal margin to our traditional staffing model, but resulted in less top line revenue. We also experienced microeconomic factors, including supply and demand imbalances, which vary by geography.

Moving to the field operational updates. We are very pleased with our entrance into new markets with our asset-light model. We have 14 total new market development managers that are in various stages of their development. They are doing well and largely achieving their goals of adding and servicing new clients and new referral partners and have a robust pipeline. Our results thus far are better than we expected and are exceeding our internal return hurdle rate, and we are actively recruiting for the next class.

Regarding our product updates, we continue to execute on the sales 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 through October, we have 160 clients on our various plans with more than 3,500 total participants. Our value proposition is resonating well, and we are having success with small and large clients in white- and blue-collar industries, in every state we operate and with a diverse distribution channel.

We are in the thick of the 1/1 selling season, and our business teams are offering BBSI Benefits to our existing clients as well as potential new clients. It is still too early to provide any definitive guidance but we are pleased with our current pipeline. If we close the current opportunities that are in our pipeline at our historical benefits closing rate, then we are confident that this product will be accretive to earnings in 2024.

Next, I'd like to shift to our view of the remainder of the year and the 2024. Our various sales strategies continue to increase the top of the sales funnel, our controllable growth exceeded our expectations every quarter this year, and that trend continued into October. Our qualified prospects at the end of the quarter were approximately 75% greater than the prior year quarter. If we close this business near our historical close rate plus close on our benefits opportunities, and we are setting ourselves up for a strong start to 2024. If there's no dislocation in the economy, and we close out the year in the manner I just described that we expect to see improved gross billings growth in 2024 over 2023.

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

Thanks, Gary. Hello, everyone. I'm pleased to report we finished Q3 with strong results as we continue to exceed our expectations for profitability and worksite employees added in the quarter for net new clients. Our overall gross billings increased 3% in Q3 '23 to $1.96 billion versus $1.91 billion in Q3 '22. We have achieved diluted earnings per share of $2.68 compared to $2.45 in the prior year quarter. PEO gross billings increased 3.3% over the prior year quarter to $1.94 billion, while staffing revenues decreased 25% over the prior year to $22 million. Our worksite employees grew by 1.1% in the quarter, which was the result of adding more WSEs than expected from net new PEO clients, offset in part by slower hiring within our existing customer base.

Looking at client hiring more closely. We have seen overall hiring trends stabilized in the quarter and increased modestly on a sequential basis, but the pace of hiring remains slower than historical trends and slower than expected. We continue to see this slowness primarily in the construction sector and most concentrated in our Northern California region.

Average hours worked and overtime hours per employee have continued to stabilize in the quarter as well. Average billing per WSE increased 3.5% in the quarter, driven by higher average client wage rates, which remain resilient and which will continue to be a source of billings growth going forward.

Looking at overall PEO gross billings growth by region versus the prior year third quarter, East Coast grew 12%, Mountain States grew 8%, Southern California grew 5%, the Pacific Northwest decreased by 3%, and Northern California decreased by 3%.

As Gary discussed, staffing revenues are down year-over-year, driven by strategic shifts in our model and the current economic environment. That said, our staffing revenues increased sequentially and we expect this stability to continue through year-end.

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 adjustments for prior year claims. In Q3 '23, we recognized favorable prior year liability and premium adjustments of $2.2 million. This compares to favorable prior year liability of premium adjustments of $1.4 million in the third quarter of 2022. As a reminder, our client workers' compensation exposure is now primarily covered by our fully insured program with no retained liability by BBSI.

Our gross margin rate improved in the quarter due to the cost savings from lower workers' compensation expense and our ongoing focus on pricing discipline. In addition, our profitability continues to benefit from cost management efforts that have largely offset the impact of our ongoing investments in the launch of BBSI Benefits and our expanding team of market development managers. As a result, SG&A for the year continues to grow slower than prior year and slower than our billings growth rate.

Moving to investment income. Our investment portfolios earned $2.3 million in the third quarter, up $700,000 from the prior year due to higher yields and more favorable cash flow timing associated with our current fully insured program. Our investment portfolio continues to be managed conservatively with an average duration of 3.5 years and average quality of investment at AA. Our balance sheet remains strong with $129 million of unrestricted cash investments at September 30 and no debt.

Continuing under the Board's July 2023 repurchase program announced last quarter, BBSI repurchased $11 million of shares in the third quarter, to $64 million remaining available under the program. The company also paid $2 million in dividends in the quarter and reaffirmed its dividend for the following quarter.

Turning to our outlook for the year. We are updating our outlook to reflect our year-to-date results, and we now expect gross billings to increase between 4% and 5%, a slight decrease from the 4% to 6% in our prior outlook. And we expect average WSEs to increase between 2% and 3% for the year, a slight decrease from the 2% to 4% in our prior outlook. We continue to 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.

Our first question comes from the line of Jeff Martin with ROTH Capital Partners.

Wanted to dive into a little bit more on the sales funnel. What are some of the things you're doing differently this year versus years past, maybe that's leading you to hit your internal controllable targets?

Jeff, I would say that we've had laser focus on the top of the funnel. We've tried and refined over the past couple of years to make sure that we're getting as many looks as we can, targeting clients directly, targeting referral partners, targeting benefits brokers. So it's really not just one easy button. It's a lot of different strategies that we have been executing on over the past, I'll say, 2-plus years. And then we're really just seeing good results for that now. We've -- I said in my prepared remarks that our prospects, right? So these are qualified prospects that we're in the process with -- we're about 75% higher at the end of September than we were against September of '22. So we've got that many more possible potential clients that can join into Q4 into Q1. So we're just -- we've got a lot of energy going there, and hopefully, we're going to see the reward of it going into Q4 and Q1.

And then remind us on the BBSI Benefits side, what's the investment this year and next year that you've got to essentially cover to become earnings accretive there? And then second part to that question is, can you give us an update on some of the new referral partners that you've brought on board some specifically for BBSI Benefits, would be helpful.

This is Anthony. Jeff, I'll take the investment question, and then Gary can speak to the referral partners. But we spent about $3 million of total expense investment to operate this program. So that's essentially the run rate we're at right now. Obviously, as it scales over time, that could change a little bit, but that's where we're at.

And then on the referral partner side, we -- I have the stat, I just don't have it with me for how many new referral partners we brought in, in the quarter, but we have a constant discipline to attract new referral partners. We've got army of folks in the field, that's what they do on a day-to-day basis, and they're doing it very well as far as making -- we call it making new friends. But we're -- part of that strategy is as we talk about our total addressable market is, we're now able to go to employee benefits brokers where -- before they could refer to us, but we didn't really have a product that they could sell into their clients because it wasn't -- didn't have the health insurance. But now that we have the health insurance, we're able to tap into almost twice as many employee brokerages out there.

And then last one for me. In terms of growth drivers for next year, obviously, a rebound in hiring from clients would be a big one. But is potential for workers' compensation rates in California, in particular, is that -- are you viewing that as a potential growth driver next year?

We're not seeing any -- I think I said in the prior calls that we're seeing -- we're seeing some carriers be less aggressive than they were. There's still competition in the marketplace, but they're less aggressive than they were. We are not seeing anything that is driving accounts to market as far as rate increases on the workers' comp side. We're seeing some of that on the health insurance side. We're seeing clients go to market because in some markets they're getting 20-plus percent rate increases on their medicals. So that's driving some accounts to market. But on the workers' comp, it's still trading in that plus or minus 2%, plus or minus 5%. It's not really a pain point that's driving business to market yet, and we're not forecasting that.

Our next question comes from the line of Chris Moore with CJS Securities.

Maybe just a quick follow-up. The $3 million incremental expense on health care. Some of that is in '23 and some in '24. Or where does that get placed?

Annual expense is in 2023, and we ramped a little bit, but we were fully -- mostly fully staffed for the year. So that's the approximate run rate for '24 as well.

And maybe just one more on the health care side. So do you expect the ultimate penetration here to match the penetration of existing business, for example, 75% of the health care to be in California. Is it a [geography] bias? Is there some other bias by type of employment? Just trying to kind of get your thoughts there.

As we are mastering our craft for benefits, we've had better success selling it into our installed base. So I think we said 160 clients that have enrolled through October of those 160, 20% of those are new business. So that's new to BBSI. We wouldn't have brought those clients on to call that 30%, we would not have brought those clients on if we didn't have benefits. So that's allowing us to pick up additional business that we wouldn't have received.

But as we're learning our craft, it's a little bit easier to sell it to your friends, right, in our clients. They know us well. They know the products we deliver. They trust us. It's a little bit of an easier sell to sell it into your installed base than to sell it to a new. But what we want to get to in the future is, after we sell through the -- our installed base continue to sell into new clients. But you can kind of see how this will ramp over time, right? We doubled the book on 7/1. We'll probably double it again on 1/1 as far as our portfolio of clients that buy the benefits, and then we'll see where it goes from there.

And just kind of big picture. Just trying to get a sense as to how much visibility you have in fiscal '24 as of November 1. Do you know much today that you didn't know 3 to 4 months ago. Just trying to get a better sense as to how you're seeing early '24.

We feel -- looking at our pipeline that we have, we've got 2 pipelines to think. We've got a pipeline of benefits opportunities. And we feel good with that loan if we close that at our historical benefits closing rate that we're going to have an accretive year for benefits in '24. So it's going to be -- we're going to make more than the $3 million we're going to spend, right? We're not going to give a number until we get into '24, but we're going to make more than the $3 million we're going to spend on it.

And then if you look at the pipeline for our traditional non-benefits prospects, that's the largest pipeline we've ever had at the end of Q3. So if we do what we do, and we're good at doing that, right? Over the last 2 years, we've really been executing on our controllable, right, of adding clients and adding WSEs. If we keep doing what we're doing with the pipeline we have, we feel very optimistic about '24. So if you say, all right, we've got all these good things going on the controllable side and then even if, say, our client hiring is flat, it's going to be easy for us to have a better gross billings year in '24 over '23.

Our next question comes from the line of Vincent Colicchio with Barrington Research.

Gary, [site] construction is a weak sector. If I remember correctly, that's been weak for some time. I'm curious, are you seeing that deteriorate?

No, we're -- I mean, we actually saw it come back some in Q3. So sequentially, our clients hired in Q3 over Q2. Now it was a slight positive. It wasn't a big positive, but it was still positive. And I will take a positive over a negative any time. But if you think of when we started to see the slowdown in our clients, it was November, December of '22. And then we saw it come back into Q1 of '23, Q2 of '23, and we've seen it slowly come back, reverse out in Q3. So it's still early, but we're thinking, especially in the Bay Area where we're seeing it come back. We're hoping that, that trend is reversed.

And one clarification. Did you say the profits gained from staffing clients within PEO offset losses from clients that you shared in the staffing line?

So this is a challenging one to try to explain. We do recruiting for our clients now. And when we booked the recruiting phase, say $10,000, right? We hire -- we recruit for our clients and they hire somebody and we get paid a $10,000 recruiting fee. So that recruiting fee is profit for us. The sale we recognize on that is $10,000. The profit we recognize to keep it simple is $10,000.

Now where that's different is if that was traditional staffing business and say that person was making $75,000 in wages, we would book the wages plus taxes plus other things into the revenue line. So that revenue would have been, call it, $100,000, but we would have made our $10,000 in profit. So it's a little bit of a shift in the accounting for recruiting for staffing. And all we're trying to say is, we're making adequate margins on staffing. We're just not realizing -- we're making an adequate profit on staffing. We're just not realizing as much revenue as we used to, nor are we realizing the cost of it.

And then you mentioned staffing. I believe you mentioned should grow sequentially. What's driving that -- is in particular?

Yes. We had sequential growth in this quarter and we're projecting modest sequential growth next quarter. Again, we're talking small positives here, not large percentage sequential increases. But the key takeaway is the large declines really, we think, are behind us. And so the -- for example, the 25% decrease in revenue now is really representing just that year-over-year compare where if you look at the trend line now, it's flat to positive. So we're really holding that. We've seen, as Gary said, the activity in staffing that we're excited about is not necessitating to large increases in revenue, but it's still showing up as some revenue and certainly margin.

As you go after bigger clients and the competitive, I think the competition is a little different. Are you seeing competitive pressures increased in the current environment?

No more than normal. I mean, there's competition everywhere. But with our product and our people in the field, it's really our differentiator, right? We can talk about all these different tools that we have as far as workers' comp or health insurance and yada, yada, yada, but the people in the field doing the work being there with the business owner, that is the core product, and that's what we're able to sell in the market. That's what keeps the business on the books. That's the one that the clients truly find the value is in those -- this unit.

Our next question comes from the line of Marc Riddick with Sidoti & Company.

I wanted to just touch a little bit on the follow-up on the construction commentary. And if I want to -- I just want to sort of go back because if I remember correctly from a timing perspective, first, last year, there was -- there were impacts some beyond the controllables, if you will. If I remember correctly, you had weather impacts, I think in -- if I remember correctly, book at the fourth quarter and into the first quarter, I was wondering if you can talk a little bit about the timing of maybe what you saw then and how that might sort of play out if -- I don't know if easing comparison is a fair way to put it, but I was wondering if you could talk a little bit about maybe what you saw there in -- how we might see it flow through this time around?

We saw our clients start to shrink Q4 and it accelerated into Q1. It happened at the same time you had interest rates going up really high. You had a shift in the macro economy and then we also had terrible weather in California, specifically Northern California as well. So you had a confluence of all of these happening at the same time. It left us in that position of we think -- it's a piece of -- it's a little bit of each. It was hard to discern from where we were sitting, what was going to happen. We thought it was going to come back in Q2 of '23, but ultimately, it didn't come back. But our confidence now is in those clients that reduce staff that we just referenced, we saw them hire more folks in Q3, and we saw sequentially our clients grow in Q3. So that's what gives us the optimism of -- they dipped for 3 quarters and then they pulled back and get started to add people back into Q3 this year.

Actually that's where I was going with that. And then I was sort of curious as to -- on a different track, but there's a little similarity there. So [indiscernible] bring us up to speed maybe what you're seeing with the banking and finance customers. I mean, as we showed to anniversary those challenges that again or outside of the controllables, maybe you could sort of bring us up to speed -- maybe on what you're seeing there?

I mean we really weren't that affected by the banking crisis a year ago. We don't have a lot of direct clients in that space. Obviously, all of our clients use banking services. So we were watching very closely to see if there are impacts of our clients. It wasn't a prevailing pain point beyond a few anecdotal stories. So we then recover very quickly from that. I mean for our clients in the blue- and gray-collar space, the biggest headwind has been construction and really driven by the cyclical nature of that with interest rates.

And then the last one for me. I was wondering if you could circle back to benefits for a moment. Are there any particular client verticals or any particular customer groups that are -- who have responded more positively than others? Or are there any differentiation that you're seeing as to those who are being part of that add. And then also maybe you talk a little bit about the sales cycle and maybe how that's played out compared to what your expectations were.

If you just think of who we're selling to, we're primarily trying to sell into our installed base. So that's really no new vertical for us, but we're having good success selling it into our installed base and really in every state, right? There's not a state that we're not able to sell into. So we feel comfortable that we have the product that works in every state and that our clients are eager and willing to pay for. So we feel good there.

The one thing I would just say that we're seeing success on is in our new markets, right? So our market development managers, about 80% of the business they're bringing on for new business, they're selling benefits as well. So we feel pretty optimistic that in these greenfield, they have many different products to sell, and they try to figure out what's the best way to crack the market, and they're doing a great job cracking the market. I'm proud of all of them.

So just in general, in those new markets, we are seeing more white-collar than blue-collar just because of their comfort and maybe their [Technical Difficulty] and the folks that they know because we're typically hiring folks that come from in and around the business, I'll say, from our industry or adjacent industry. So feel good with the growth there.

And then as the sales cycle, right, this is -- we know that this is not a quick sales cycle, right? It's typically going to take you 3 months to 4 months, right, from the time you sell it. From the time you do the underwriting and you sell to -- then you have to get the employees through the enrollment process. It just takes a little more lead time to get -- to make sure it's done properly, make sure it's done accurately. But like we wish we could give you a better number right now, but we're right in the middle of the sick for the 1/1 season. Most of the folks are going to make their decisions. Most of the clients are going to make their buying decisions in mid-November, mid-to-end-November with the idea of start your enrollments around Thanksgiving or in the first week of December, so the kind of everything wrapped up by mid-December. But until we get through those enrollments, we're not going to have a real good definitive estimate on what we think our sell-through was for the 1/1 season.

There are no further questions in the queue. I'd like to hand the call back to management for closing remarks.

Thank you. Just again, I want to thank all the BBSI professionals for another great quarter on controllable growth. Everybody is doing a great job, and we appreciate everything you do for the organization. Thank you, everybody.

Ladies and gentlemen, this does conclude today's teleconference. Thank you for your participation. You may disconnect your lines at this time, and have a wonderful day.