

Barrett Business Services, Inc. Fourth Quarter 2022 Earnings Call

Good afternoon, everyone, and thank you for participating in today's conference call to discuss BBSI's financial results for the fourth quarter and full year ended December 31, 2022.

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 results, 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 April 1, 2023, starting at 8:00 p.m. ET tonight. A webcast replay will also be available via the link provided in today's press release as well as available on the company's website at www.bbsi.com.

Now I'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. Good afternoon, everyone, and thank you for joining the call. We had a successful quarter, both financially and operationally, which capped off a record year. We consistently exceeded our internal estimates for client retention, net client adds and work-side employee growth, all of which led to better-than-expected financial results.

Before I speak to the financial performance, I would like to recap some of the key operational and strategic accomplishments for the year. We continue to build out our corporate sales effort and increase the top of the funnel by focusing on lead generation via an omnichannel digital campaign, which brought on new clients and new referral partners. We continue to invest in new geographies, and we are now operational in 14 asset-light markets. We have refined our expansion model, where we attract and hire great people, train them well, apply the lessons we learned in a COVID environment for how to operate remotely and package with our digital initiatives to help grow their market penetration.

We launched 3 new products. The first is BBSI Benefits. We now offer health insurance plus ancillary benefits. This is a fully insured program where we take no underwriting risk. This offering is made available and delivered seamlessly through our myBBSI portal. The second is BBSI U, a learning management portal that our clients can purchase, which contains various catalogs consisting of HR and compliance, risk and safety, leadership and professional skills. This offering is also delivered through our myBBSI portal. The third is BBSI recruiting. We've built out recruiting hubs in every region that support

our branch network and now provide recruiting services for our PEO clients.

We also successfully renewed our workers' compensation facility and received better pricing and better terms and now have no downside and only share in the upside of our disciplined underwriting operations. And we also made further advancements on our Employer of Choice Initiative and earned The Great Place to Work designation for the second year in a row. All of these efforts strategically put us in position for promising top line and bottom line growth in 2023 and beyond.

Moving to our financial results. During the quarter, our gross billings increased 8% over the prior year quarter. To note, this quarter had one less business day than the prior year quarter. Regarding our client and WSE 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 Q4. 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'd like to attribute that to the work we do with our clients and the value our teams provide. The result of all these efforts or what I refer to as controllable growth is that we added approximately 4,100 worksite employees year-over-year from net new clients. Our client hiring was softer than we forecasted in the quarter, and the net result was a 6% increase in our average worksite employees over the prior year quarter. In 2022, we averaged the most worksite employees in BBSI's history. Our growth in worksite employees is a combination of our controllable growth plus our clients' hiring.

Moving to our staffing operations. Our staffing business declined by 13% over the prior year quarter and was lower than anticipated. This decrease is a combination of many factors, including, but not limited to, demand, supply, weather, and it varies by geography. Anthony will give some regional color for what we're seeing in our markets. I mentioned previously that we made investments in our recruiting operations, and we are seeing positive results with BBSI recruiting where we provide recruiting services for our PEO clients. When we place a candidate, we receive a recruiting fee, and then as the candidate joins the client's payroll, we realize PEO revenue. On a year-to-date basis, we've placed 375 candidates with 189 PEO clients and generated over \$3 million of recruiting fees. We expect this to increase as we introduce this product to more clients.

Moving to the field operational updates. We are very pleased with the progress of entering new markets with our asset-light model. Our market development managers are doing well and achieving their goals of adding and servicing new clients and new referral partners. Our first 3 classes have all graduated and are attacking their 14 new markets. Our results thus far are better than we expected and are exceeding our internal return hurdle rate, and we anticipate opening additional new markets in 2023.

Regarding our product update, we successfully executed on the sales and service of BBSI Benefits, our new health insurance offering. As a refresher, we rolled this out to a limited number of existing clients in select markets for the 1/1/23 enrollment season. Our intent was to perfect our craft and then shift our focus to California and to add 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 that this will provide material contribution as we look to the future of BBSI.

I am pleased to say that we had a very successful soft launch in these markets. Our sales, underwriting,

operations and IT all worked in unison as intended. We have successfully sold our medical and ancillary products to approximately 70 clients and have about 1,200 members on our various plans. More importantly, we have gained the confidence through our repetitions and are now bringing this product into all markets for existing clients as well as new prospects. BBSI Benefits is now open for business in every market. In addition to our benefits offering, we also launched BBSI U late in the fourth quarter. This is a learning management portal that our clients can purchase and contains various training catalogs. This does not replace our experts in the field, but will be a valuable tool that complements our offering. It is still early days as this just launched, but we've added over a dozen clients already. We view this as an additional product that will help us retain and add new business.

To emphasize this point, last month, we had an existing client in the Northwest, who began to shop us as they were looking for a learning tool and quickly stayed with BBSI and purchased 87 licenses.

Next, I'd like to shift and speak to the 2023 plan. We know that we have consecutive quarters of great momentum. We know that our client retention is strong and that our sales efforts are resulting in more business opportunities. We know that our prospects continue to be larger. We know that we have [Technical Difficulty] products to offer. We know that we have been executing to our product road map, while achieving our controllable growth goals. I have never been more optimistic about what we can control.

However, times are growing more challenging for business owners, given tight labor market, record inflation, expiring government subsidies, supply chain challenges and a rising interest rate environment. Due to these conditions, we believe that our client hiring will slow in 2023 and have reflected accordingly in our [gross billings] outlook. This is an unknown, and we may be wrong, but we always are on the side of caution when we set our targets. Based upon our optimism of things we can control, slightly offset with slower economic conditions, we are confident that we can continue to grow our business and our profitability at our long-term targets.

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

Thanks, Gary, and hello, everyone. I am pleased to report that we finished the year with strong results as gross billings increased 13% in 2022 to \$7.4 billion versus \$6.6 billion in 2021. This strong growth is from a combination of better-than-expected growth from net new clients as well as stronger-than-expected hiring and wage increases within our existing customer base. In addition, we achieved strong earnings leverage for the year with diluted earnings per share increasing 31% to \$6.54 compared to \$5 in the prior year.

Looking more closely at our Q4 results, net income was \$11.5 million compared to \$10.6 million in Q4 '21. Our Q4 PEO gross billings increased 8% over the prior year quarter to \$1.9 billion, while staffing revenues decreased 13% over the prior year to \$29 million. As Gary noted, our increase in PEO gross billings in Q4 was once again driven by stronger-than-expected growth from net new clients in the quarter as well as higher average billings per WSE. Our average billing per WSE increased 3.3% in the quarter, driven primarily by rising wages in our existing employee base. Our client wages have been resilient, and will continue to drive billing growth going into 2023.

We mentioned last quarter that we continue to watch for slower growth from client hiring in our PEO client base, and we have seen the pace of hiring slow in Q4 relative to prior quarters. Clients associated with residential construction and manufacturing have been most affected, driven primarily by economic

conditions. However, adverse weather across the West Coast in December and continuing into 2023 also served as a headwind to our construction accounts. Other sectors, like hospitality, logistics and services have not seen a slowdown in hiring in Q4.

Looking at PEO gross billings growth by region versus the prior year fourth quarter, the East Coast grew 15%, Southern California grew 13%, Mountain States grew 13%. Northern California grew by 1% and the Pacific Northwest was flat. The weather impacts, I mentioned earlier, were most significant in Northern California and Pacific Northwest regions. The net result of higher starting wages, but slower client hiring is that we continue to expect growth from existing customers in 2023, but at a slower rate than we saw in 2022. As a reminder, we are not anticipating significant incremental revenue from our health benefits offering until after the January 1, 2024 enrollment season.

Looking more closely at the decline in staffing revenues. We noted in the previous quarter that the drivers of our slowing revenue varied by region, and that has continued to be the case through year-end. Our primary challenge in the Mountain States continues to be the availability of labor to fill client orders, as unemployment rates remain at all-time lows. And then in the Pacific Northwest, our staffing billings are more weighted toward agricultural services, and weather and core harvests have resulted in lower billings. Our California regions are more weighted toward light industrial staffing services, and we have seen decreases in demand there due to softening economic conditions.

As Gary noted, we're in the process of leveraging our staffing infrastructure to roll out expanded recruiting and talent acquisition services for our PEO clients. We have seen positive early results in this space. And as these services grow, we'll begin to generate higher average margin rates in staffing as we earn placement fees. Overall, our expectation is that staffing revenues will decline in 2023 due to these ongoing challenges in the labor market and economy.

Moving to our overall gross margin results. Our gross margin rate is again trending ahead of prior year through Q4 with continued cost savings from [lower] workers' compensation expense in the quarter, while our pricing has remained in line with plan. Workers' compensation expense continues to benefit from favorable claim frequency trends and the fourth quarter included a favorable actuarially determined reduction of prior year estimated liabilities of \$600,000. As a reminder, our workers' compensation exposure is now primarily covered by our fully insured program with no downside risk to BBSI for future adverse claim development. However, BBSI can still participate in any favorable development on claim costs in future periods.

With regards to pricing, we continue to see stability in the workers' compensation market. And while the market remains competitive, any pricing adjustments we are making are in line with cost savings. For 2023, we expect this trend to continue. Any pricing adjustments would be well matched to ongoing cost savings, resulting in overall gross margin rates in line with 2022.

Turning to operating expenses. SG&A for the quarter was in line with our plan and included increases associated with the launch of our health benefits offering, as well as higher commissions and employee profit sharing as a result of achieving strong results. Looking ahead to 2023, we are anticipating slower SG&A growth than in 2022. 2023 will include additional investments in our benefits offering of approximately \$1.5 million as we increase capacity for our nationwide rollout. But even with these investments, we still expect favorable earnings leverage in 2023, in line with our long-term targets.

Moving to our invested assets. Our investment portfolios earned \$1.6 million in the fourth quarter,

unchanged from the prior year. As we noted in prior quarters, with the rapid increase in interest rates in the year, our fixed income portfolios are in an unrealized loss position. However, we intend to hold these securities and our portfolio continue to be managed conservatively with an average duration of 3.8 years, average quality of investment at AA, an average book yield of 2.3%.

Turning to the balance sheet, we had \$160 million of unrestricted cash and investments at December 31 compared to \$132 million at September 30. The increase is primarily due to cash generated through operations and the timing of payroll tax payments. As a reminder, BBSI is completely debt free, and we do not incur increased expenses associated with higher interest rates. As we look at our accomplishments in 2022, we generated strong profitable growth with gross billings increasing 13% and earnings per share increasing 31%, well ahead of target. We expanded our growth potential with the successful launch of our new health benefits offering and other products and accelerated geographic expansion to our asset-light model, and we returned significant capital to shareholders through our dividend and stock buyback.

Continuing under the Board's \$75 million share repurchase program, in the fourth quarter, BBSI repurchased 92,000 shares at an average price of \$87.92. In 2022, we have now repurchased nearly 8% of the company's shares outstanding through total purchases in the year of more than \$47 million. The company also paid \$2 million in dividends in the quarter and reaffirmed its dividend for the following quarter. We have now paid \$8.5 million in dividends year-to-date, bringing total capital return to shareholders in the year to \$56 million.

Turning to our outlook for 2023. We expect gross billings to increase between 5% and 8%. We expect average worksite employees to increase between 2% and 4%. We expect gross margin as a percent of gross billings to be between 3.0% and 3.15% and. We expect our effective annual tax rate to remain between 27% and 28%.

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

We take our first question from the line of Chris Moore with CJS Securities.

It's Pete Lukas, for Chris. Just starting with the health care benefits rollout. You mentioned no significant revenue until January '24 enrollment. Just wondering what the main focus for you is in the short run there. Does it change how you price at a client? And are there any additional short-term risks from introducing health care?

Well, that was like 4 questions. I'll try to answer all of them, but feel free to see you back up if I missed it. We had to make sure we perfected our craft before we took this to the masses, which is why we went with the laser approach of only doing for existing clients that already had benefits outside of California, right? And that was to make sure that the product, the people, the IT, the operations, that everything worked and then we had the confidence that we can scale it, right? So that's why we went with a soft launch, and we are very pleased with our soft launch.

Because we're pleased with the soft launch, now we're saying it's -- BBSI Benefits is open for business, and that's when we're going to start to sell in every geography now, right? So in California, we're selling -- in California, we're selling to new or selling to existing, and now we're selling to everybody throughout the country. So we're ready for it. Benefits, in general, the majority of your benefit programs peg around a 1/1 effective date, which is why we know that the work we're doing now to bring on clients. We're going to

bring some on throughout the year. But we know a lot of the work that we're doing in '23 is when we're going to recognize those clients as revenue in '24 when they roll into the new program. So that's why we have a little bit of a bridge to get to 24%.

I don't know if that answered all your questions, Peter?

Yes. Very helpful. And just one more for me. In terms of the gross billing growth guidance of 5% to 8%. Just how do you think about that in terms of what would have to happen to be outside of that range, either above or below? Just what's kind of the main factors driving that are in your mind?

Yes. I feel like I feel like below would have to be some extreme event, think of like a pandemic again. I feel pretty comfortable with the low that it's not going to be below the low. If I think of the upside, there's more upside in our guide than I would say downside, and that's based upon where is our clients' growth going to go as far as WSE adds as far as wage inflation, how are we going to do with our controllable growth, which is clients we add and WSEs that they have and clients that run off and WSEs they have, and that's our net controllable. And we've had a good track record of that over the past 2 years, and we feel real good with our controllable growth. So just in general, if I was going to point to away, I would feel it has a bias to be more up and down, but we're cautious just because it's early in the year, and really, we don't have that crystal ball to see where the economy is going to be in Q3, Q4.

We take our next question from the line of Jeff Martin with ROTH MKM.

Kramer, I wondered if you could elaborate the accounting side, maybe more of a question for Anthony, but I know, Kramer, you have a CFO background. But the placement and recruiting side of the business, that's relatively new. Maybe remind us when you kick that off, \$3 million is pretty substantial amount of fees associated with that. How does the accounting work on that? Is that reported on a gross or net basis? And what kind of margin contribution does that have relative to, say, a temporary staffing position?

Well, Kramer's quickly forgotten all of his accounting knowledge. This is Anthony, Jeff. Yes. So that's a great point. So this product has been rolled out in Q3 and Q4, primarily of this current year, but it's really just getting started. We said positive early results. We're really going to start to see that more in 2023. So our staffing product historically has been much more traditionally aligned to the temp labor market, light industrial temp labor specifically. And we have always done some permanent placement and early conversion in that model.

Really, the change here is that we're taking those skill sets and those capabilities for recruiting, applicant tracking, screening and going and saying, we'll do recruiting and placement for all of our PEO clients, which is obviously a much larger group of companies, much broader range of roles. And with that will also receive on average higher placement fees with those companies than we were in the existing staffing clients. So as we do that, the important thing is for our current staffing presentation in the income statement, we bill for all the wages of our employees and then a markup on top of that. And so that is kind of grossed up on the income statement.

These new fees obviously would just be a placement fee with very little, if any, direct cost of sales component. So they're very high margin, but won't have as big of an impact on the top line on the staffing revenue there. So as we see that, we'll begin to see margins increase. It's obviously a much higher margin rate on those revenues. We'll see how that builds. We don't have a guide to what that number

would be in '23 yet, but you will start to see margin rates improve in staffing even with less of a significant impact on the top line.

Yes. And I'll give you the non-accounting answer. With this new product, because the payroll is not included in the revenue, we think in '23, we can be in a position with our staffing revenue decreases. Our profitability in the Staffing segment could increase.

That sounds great. I wondered if you could characterize the renewal period. You renewed probably the bulk of your clients in January and February. Curious how that year-end transition and into the renewal season has progressed, how that retention compares with the past couple of years?

Yes, good question. We really do forensics on the 1/1 cycle. So we look at all clients that are from 12/15 to 1/15 that we add or run off and look at the WSEs and kind of compare that year-over-year. 2023 we added more clients and more WSEs. We had a little more runoff and a little more runoff of WSEs. But our net WSEs that we added for the 1/1 selling season, it was almost the -- it was slightly at or a little better than where we were for the 1/1/22 selling season. So we feel like we're starting in a good spot for the '23 season. And we feel better because we've got the benefits offering coming and things like that.

But the one thing I would say, which is still a little bit of an unknown for us in Q1 was -- you know this being in Southern Cal, Jeff, the weather we've had in California and even the weather we're still having up in California has definitely slowed our January payrolls for some of our construction clients and January and into February a little bit, but we feel good that it's going to rebound and it's really temporary just based upon the weather.

Yes, it makes sense. And then I was just curious, not so much quantitatively, but qualitatively, we've been in a low workers' comp rate environment for years now. How much do you think that hampered your growth? And do you see any signs of that of easing?

Yes. I mean if you think of inflation, inflation is rampant everywhere and in workers' comp, you're going to see it in the medical side. And that's really what everybody in the market is talking and thinking about is how is the inflationary effect going to affect the medical and then possibly the indemnity. Just in general, you've got all things pointing that workers' comp premium rates have to go up. And we've seen that over the last, I'll say, 15, 18 months, not as quickly as I would like, that's why we're still being thoughtful on our underwriting.

We're very careful with our price to risk selection. But in general, it's bottomed and it's coming up. It's just not going to be -- whenever you have a rate action, a rate action is always slower than a loss action. So it's coming up, but it's coming up a little slower than we would like.

Okay. And then just last one, if I could. You mentioned an incremental \$1.5 million investment in the BBSI Benefits offering. How much is that on top of the annualized incremental SG&A from, say, 2022?

On a percentage basis, it's approximately 1%.

1% of net revenue?

'22 -- sorry, '22 SG&A.

But I guess I got to rephrase this question. What was the investment in the benefits strategy during 2022. I know we got an incremental \$1.5 million this year. Just trying to get a sense of what the cumulative number is.

Yes. No, it's a good question, sorry. It was about \$2 million in 2022.

And a lot of that was weighted towards the back half of the year. And then the other thing you have to keep in mind, it's -- in '23, we are going to have some income that is coming in that's going to offset those expenses for the health care specifically from the commissions and things we're going to make on being the seller of the health insurance.

We will take the next question from the line of Vincent Colicchio with Barrington Research.

Yes. Gary, curious, you had mentioned that you're starting to see hiring slow in the client base. What is the trend you're seeing in wage inflation? Is that also coming in?

Wage inflation slowed down a little bit, but it's still there. And we're still going to have -- as we think of '23, we're still going to have a tailwind to growth for wage inflation just for -- think of folks that got raises sometime in the midpoint of the year of '22. We're going to be realizing that in '23 over a softer comp. So we feel like we got a little bit of a tailwind for wage inflation, and we feel like our WSE growth from our client hiring is going to slow in '23 compared to '22 just because of the macroeconomic conditions.

I forget when you started targeting larger clients, but have you seen the average size of new clients? You already mentioned the average size of new clients is the ones you're losing are small, the ones you're gaining. I'm just curious if that average size of new clients is growing over time?

I would say, our average size is holding pretty consistent now over the last 4 quarters. But it is quite a spread of -- if you went back and looked at '18 and prior for clients we were adding, it's like a -- compared to pre-pandemic, I'd say it took us 2 clients to add pre-pandemic to equal one of the clients we add now.

Okay. And are you finding it easier to -- I know you had struggled to attract leaders for the asset-light groups. Is that getting easier? And how does that affect your calculus and how many groups you launched in '23?

So we launched Class 1 in the beginning of '22, and that class did very well. They added about -- in the year they added, I think it was about 22 clients and 250-ish WSEs. Since then, we launched Class 2 and Class 3, that was really at the back end of '22, where they were selling in December or January into '23. We had a challenging time finding folks, I would say, until after the summer of '22. But I can tell you we've got a really good class of folks that are in there now. We are going to start to look to hire again in Q2 with the idea of hiring Q2, train in Q3, so they can sell in Q4.

Okay. And last one for me. What is your thinking about M&A? Will you become proactive if, in fact, valuations come in '23. And are they coming in? I'll say the market has slowed some with the rising of rates -- interest rates. We're starting to see more action in '23 than we did in the back half of '22, as far as

[SIMS] come across the desk, our company is getting ready to get come out. I can tell you that the valuations we're seeing are getting to more realistic levels than where they were in, say, '21 when things were a little frothy. But we are still -- we still are active in of the market. And if we see something that fits well, good people, good product, good company, we would pull the trigger.

We'll take a next question from the line of Marc Riddick with Sidoti.

I wanted to touch a little bit on the guide content. Actually, I wanted because a lot of my questions already answered, but I was curious about the tax rate that was mentioned. It maybe was a little too kinder than maybe I was expecting. Is that a function of a geographic revenue mix? Or is there something else taking place there with the tax rate?

Our tax rate is always varied for a couple of reasons, including geography and some of our underlying mix with our subsidiaries. That said, the rate for '23 is expected to be very much in line with '22. And really, I would say that's kind of our baseline for a normal rate going forward.

Okay. And then as far as the hiring commentary that you made as far as going into ramping up in the second quarter, I was wondering if there was a general ballpark magnitude that you had in mind as far as what you were looking to add and the idea that having them to be productive, but I guess, by the fourth quarter, I think is what the commentary was. But what type of magnitude we'd be thinking about for the hiring pickup there?

Yes. I mean if we think of where we've added so far, we did a fair amount in Texas. We've done Oklahoma. We've done Detroit. We've done Chicago. We've done some in the Northeast, which gets you to those 14. The way we think about this, in general, is not as much about the market, but about the talent. So when we start to recruit for this in '23, we'll post in [20] markets. And really, it comes down to how many good folks do we think -- because really we're looking for somebody who's going to be an entrepreneur and a grower and a builder. So they're not an easy skill set to find. But we'll post it in 20 markets. And then depending upon how the interviews are going, we'll take 6 or 10 of the best folks. It will be based upon where -- it will be based upon the person and not based upon the geography.

Got it. And then the last thing for me, and you actually touched on this, and I just wanted to follow up on a little bit the commentary on weather and kind of how it's kind of played into the beginning of this year, which, of course, has been historic in many ways. I was wondering, as you had that in mind for the guide is the thought process that maybe some of those construction projects will really just sort of be pushed out into next year? Or do you get the sense that there's a chance to sort of for there to be catch up through the year?

It's an unknown, unfortunately. The weather had a couple of bad weeks in December, but January was really where we saw the bad weather. So our January cash revenue number was a little lower than we expected, but we saw it pull back some in February, but then weather came again in California, and we haven't seen those payroll cycles yet that are going to run. So we don't know if it's -- I hate to say the word transitory, I feel like that's a dirty word now, but we don't know if it's transitory or if it's going to come back.

Thank you. Again, ladies and gentlemen, we have reached the end of the question-and-answer session. I'd now like to turn the call back over to Mr. Kramer for closing remarks. Over to you, sir.

Thank you. I would just like to take the time to thank all the BBSI professionals. Everybody in the company worked hard. We had a great year, and I'm looking forward to '23 to be a better year than we had in '22. I've never been more optimistic about the company. Thank you, everybody, for your support, and we'll talk again in the quarter.

Thank you. Ladies and gentlemen, this concludes today's teleconference. You may disconnect your lines at this time. Thank you for your participation.