



Professional Employer Organizations: Fueling Small Business Growth

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Exploring the Impact of PEOs

In recent years, a series of broad economic changes, especially those related to technology and globalization, has dramatically shifted the competitive landscape for all companies in the economy. Most of these changes are, at their foundation, directly related to an organization's people. This means professional employer organizations (PEOs) – with their extensive array of HR services and employee benefits – are now uniquely positioned and have significant potential to help businesses better meet their challenges in the face of today's demanding economic conditions. This study explores the evidence to determine how PEO clients are faring relative to other companies in the economy.

Most notably, a company's ability to survive and profit increasingly hinges on the degree to which it can manage its employees more effectively than its competitors can manage theirs. As traditional sources of competitive advantage have eroded in the face of globalization and technology change, the importance of a company's people has steadily increased. People – including their skills, knowledge, and creativity – represent a critical asset on which a company must depend for success in today's competitive marketplace.

Most employers know this in their gut, and a growing body of research confirms that so-called "human capital management" has been elevated to an essential organizational core competence that generates significant and sustainable competitive advantage. The best evidence that exists on the effects of better people management is based on the experiences of larger companies, but the lesson applies to companies of all sizes, who are all subject to the same economic forces and compete in the same marketplace. For example, the strongest predictor of a company's probability of surviving for at least 5 years after its initial public offering is its level of investment in human resources.¹ And the stock prices of "people companies" – those organizations that made Fortune's "100 Best Companies to Work For" list in at least 3 of the past 10 years – outperformed the S&P 500 by 99 percentage points over that period (109 percent versus 10 percent gain).²

Achieving sustainable competitive advantage through better management of employees is a huge challenge for even the largest and most sophisticated companies. But that challenge is even greater for small and mid-size organizations. And PEOs point to precisely that value proposition: they help their clients manage the "people side" of their businesses more effectively, avoiding compliance pitfalls and creating key benefits for the business and its employees, while simultaneously freeing up time for owners and executives to concentrate on growing their business by focusing on operations, strategy, and innovation. The existing evidence, summarized in this study, confirms this dynamic.

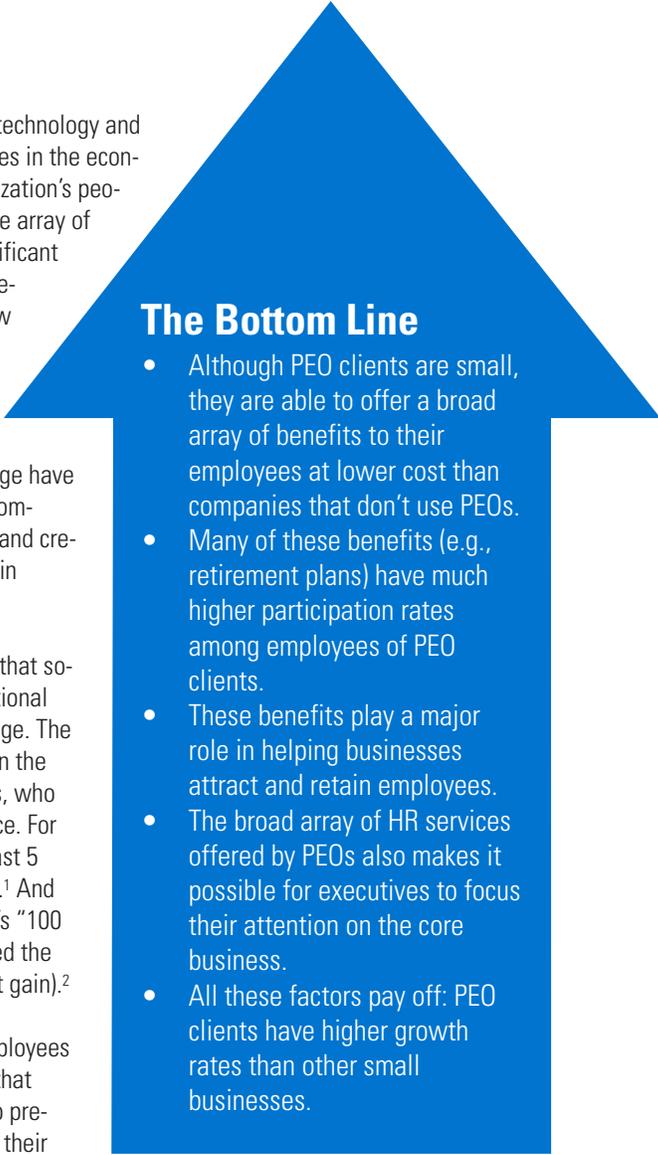
PEO Services and Benefits

Evidence (described in additional detail in the sections below) indicates that PEO clients offer better benefits to their employees, offer a wider array of employee-related services, and are able to do this while saving money (money that can be redirected to grow the business).

Most PEO clients are small to mid-size companies. The average number of employees among PEO clients is less than 10.³ Organizations of this size usually have only a "bare bones" HR functionality, which typically focuses on the most basic HR needs: hiring employees, getting them paid on time, and navigating the complex world of taxation (including FICA and FUTA) and other compliance requirements in an accurate and timely manner.

Even these basics can be time-consuming, distracting, and fraught with potential for error. (The potential for errors – and associated penalties – is a significant area of risk for any employer.) PEOs typically take over these key HR responsibilities for their clients, administering employee payroll and benefits, personnel management, workers' compensation services, and monitoring and managing risk in these areas.

At the same time, PEOs make available to their clients a broad array of additional employee-related services. Each of these other services generates advantages for the business and/or its employees. In the next subsection, we explore one such service, focusing specifically on the extent to which retirement plans are disproportionately available to, and used by, employees of PEO clients. This generates a variety of benefits that accrue to both the company and its employees.



The Bottom Line

- Although PEO clients are small, they are able to offer a broad array of benefits to their employees at lower cost than companies that don't use PEOs.
- Many of these benefits (e.g., retirement plans) have much higher participation rates among employees of PEO clients.
- These benefits play a major role in helping businesses attract and retain employees.
- The broad array of HR services offered by PEOs also makes it possible for executives to focus their attention on the core business.
- All these factors pay off: PEO clients have higher growth rates than other small businesses.

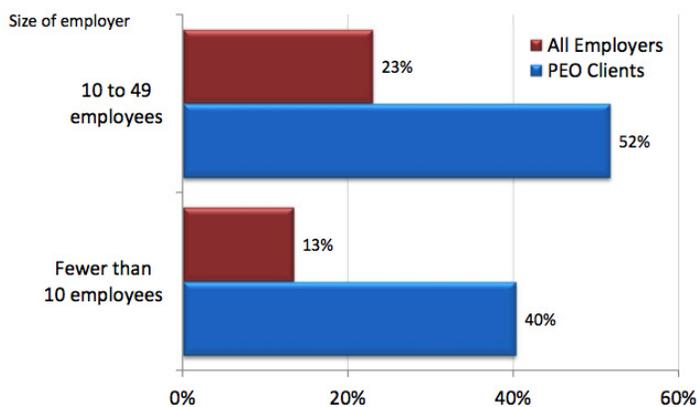
Retirement Benefits

Among the most valuable PEO services are employer-sponsored retirement benefits, such as 401(k) (or similar) plans. Retirement benefits play a major role in companies' abilities to attract and retain employees. A 2011 Towers Watson survey found that 47 percent of employees cited retirement benefits as an "important" reason to stay with their current employer, and 35 percent of employees viewed retirement benefits as an important reason they decided to work for their current employer in the first place.⁴

Nevertheless, retirement benefits are rare among most small businesses. The availability of retirement plans represents a major difference between PEO clients and other small businesses. Nearly all PEOs (98 percent) offer some type of retirement plan to their clients (although not all clients choose to take advantage of these services).⁵ In contrast, in 2011, only 16 percent of all employees of the smallest companies (those employing fewer than 10 workers), and 30 percent of those at companies with 10 to 49 employees, work for a company that sponsors some type of retirement plan, according to the Employee Benefit Research Institute (EBRI).⁶ A survey of small businesses without retirement plans found those businesses encountered a variety of obstacles to offering such a plan: "it costs too much to set up and administer" was the second most frequently-cited obstacle to offering a retirement plan, while others pointed to burdensome administration. ("Revenue uncertainty" was the most frequently-cited obstacle.)⁷

The differences in retirement plan availability are reflected in similarly large differences in employee retirement plan participation between those working for PEO clients and others. Among the smallest businesses (employing fewer than 10 workers), the percentage of employees participating in employer-provided retirement plans is over 3 times greater among employees of PEO clients than it is among employees of all other similarly-sized businesses (40 percent versus 13 percent; see Figure 1).⁸ For employees working for somewhat larger businesses (with between 10 and 49 employees), there is also a major difference: 52 percent of employees versus 23 percent.

Figure 1. Percentage of workers participating in retirement plan



In addition to providing key benefits to businesses in terms of employee attraction and retention, the greater participation in retirement plans naturally provides major benefits to employees as well. A large body of research shows that having accessible retirement savings options at work has a significant impact on people's ability to save for their future. For example, a 2013 survey found employees with access to workplace retirement benefits are significantly more confident about their retirement prospects, more likely to also be saving for retirement outside of work, and more likely to have concrete retirement savings strategies and plans.⁹

By making it much easier for the underserved small and mid-size employer population to provide retirement plans to their employees, PEOs provide a service that creates value for employees and for our broader society. And in so doing, PEO clients reap key benefits in turn – being able to attract and retain higher quality employees enables them to grow faster (as described in additional detail below).

Broad Array of Services

From the array of PEO-provided services, in the section above, we focused in detail on retirement plans for two reasons. First, high-quality data exists measuring the availability of retirement plans both within the PEO environment and for smaller businesses overall, making it possible to accurately compare across the two populations of companies. Second, as described above, retirement plans create key benefits across a range of stakeholders that include both the employer and employee. While the data do not allow for similar quantitative comparisons between PEO clients and others for numerous other available services, it is reasonable to expect that similar patterns prevail for many of those services as well: greater availability for PEO clients, with significant benefits that accrue to employers, employees, or both. The chief administrative officer at a hotel management firm reports, "We appreciate being able to give employees access to our PEO's broad selection of benefits, which enables them to effectively meet their individual needs."¹⁰

These additional services fall into a wide variety of categories. For example, of the PEOs responding to NAPEO's 2013 Financial Ratio & Operating Statistics Survey, 100 percent reported that they provide clients with compliance assistance on HR-specific regulations such as EEOC and FMLA. Nearly two-thirds of all PEOs responding to the survey offer online training services for clients' employees – a valuable, but typically quite challenging, investment for small firms to make. A large majority of PEOs also offer services in performance reviews and developing job descriptions. Both of these fall into the category of HR-related tasks that are time-consuming and involve significant potential risk if not executed correctly.

Another key service offered by PEOs is the administration of workers' compensation programs. Virtually all states (except Texas and Oklahoma) mandate workers' compensation coverage for worksite employees. In many cases the PEO secures that coverage for its clients, while in others PEOs assure that coverage is in place. Workers' compensation can be a highly complex program and, as such, is one that can demand significant time and expertise to administer. A large amount of detailed research has been conducted in recent years on whether there are any differences in workers' compensation administration and compliance between PEO clients and other small businesses.¹¹ Overall, the research concludes that PEO clients perform comparably, if not slightly better, relative to other employers on a range of key workers' compensation measures. This positive finding is particularly notable, given the small size of PEO clients and the disproportionate compliance burden faced by smaller businesses.

Table 1 provides a detailed summary of the extent to which a wide range of services are provided by PEOs to their clients. Like retirement plans, many of these services are likely available to a much higher percentage of PEO clients than to other businesses, especially among the smallest employers.

More Services at a Lower Price

Despite this broad array of offerings, PEOs are able to provide these services at a lower cost than their clients would have to pay for more basic HR administrative services. For example, in 2011, PEOs' gross profit margin was \$1,187 per worksite employee; this figure represents the revenue remaining after all direct employee-related costs (salaries and wages, health or medical, FICA, etc.) have been paid. Out of its gross operating margin, a PEO must pay all of its own operating expenses. So, in essence, the figure of \$1,187 represents the amount PEO clients are paying for HR administration and all other services offered by their PEO.

Table 1. HR service offerings by PEOs, % offering¹²

HR service offering	% of PEOs offering service
Compliance assistance on HR-specific regulations such as EEOC, FMLA	100.0
Retirement plans for employees	98.4
Assistance with job descriptions	98.4
Paid time off (PTO) tracking and reporting	98.4
Customized employee handbooks	95.1
Background screening	95.1
Telephone consultation re: HR and personnel matters	95.1
Employee exit interview assistance	93.4
Pre-employment drug testing	91.8
Wage and salary compensation planning assistance	86.9
Performance review assistance/tracking	86.9
Recruitment/job placement	72.1
Employee surveys	70.5
Online training services for supervisors and employees	65.6
Personality testing	59.0
Turnover analysis and reporting	59.0
Professional licensing and certification tracking	45.9

There are no strictly comparable numbers available for non-PEO clients; the best available comparison for such companies comes from Bersin & Associates and puts HR spending at \$1,500 per employee within companies with fewer than 1,000 employees.¹³ (No breakdown for smaller-size employers is available.) Given considerable economies of scale for larger companies in this group (since they can take advantage of their larger size to spread fixed costs over their entire employee population), this figure of \$1,500 almost certainly underestimates the cost for very small businesses which, as noted above, represent the primary clients of PEOs.

Putting these numbers together (see Figure 2) tells us that a conservative estimate is that PEO clients enjoy a 21 percent savings on HR administration. This is true even as they enjoy a significantly higher level of services. For the typical PEO client – a small to mid-size employer – this savings is likely to be many times greater than this conservative, lower-bound estimate.

Figure 2. HR administration costs, per employee



Considering both the broader services available and the cost savings realized from small businesses outsourcing their HR responsibilities, Peter Cappelli of the Wharton School at the University of Pennsylvania was quoted recently on this topic: "This is one of those rare instances that is both cheaper and better. It's a big burden on a local HR manager to know everything."¹⁴ A similar point is made by Martin VanMeter of VanMeter Realty, a small realty company based in Durant, Oklahoma: "Working with a PEO has provided us an economical way of hiring people without the stress of paperwork and payroll. Our PEO is always available to answer questions or provide support to the employees."¹⁵

PEO Clients Grow Faster

Overall, the evidence described in the section above indicates that PEO clients spend less for more services and for greater expertise in HR service administration. These services provide key benefits for the businesses, such as greater capacity to attract and retain key employees. Beyond the lower costs and benefits discussed above, however, it's likely that the most fundamental reason the majority of small business owners hire PEOs is to relieve themselves of the major administrative burden associated with HR, thereby freeing themselves to do what they do best: focus on their business. The operations manager at a financial planning firm sums it up succinctly: "Our relationship with a PEO gives us the freedom to focus our attention on our clients."¹⁶ Investment website SeekingAlpha.com echoed this point recently in a discussion of the services offered by ADP's PEO (TotalSource): "The value-add for PEO services is huge, especially since it allows busy owners to focus on business-centered operations rather than the often tedious day-to-day back office tasks."¹⁷

If PEOs are successful in enabling small businesses to focus more directly on what it takes to succeed in a competitive marketplace, it follows that PEO clients should grow faster than other comparable organizations. And, indeed, this is what the evidence shows.

The number of workers employed by PEO clients has grown more quickly than a variety of key comparisons. A leading firm in the PEO industry, Slavic 401(k), worked with Dr. Dragan Radulovic of Florida Atlantic University to develop a "PEO Employment Index" that has tracked changes in employment levels across thousands of PEO clients since December 2004. The index, which reflects the overall industry mix in the United States and is weighted by geography to also reflect the geographic distribution of U.S. companies, is based on employment at the company's PEO clients that offer 401(k) plans. As discussed earlier, virtually all PEOs (98 percent) offer some form of retirement plan, so this PEO Employment Index can be seen as representative of the broader population of all PEO clients.¹⁸

To best determine the impact of PEOs, we'd ideally compare PEOs' clients' employment growth with a similar measure for U.S. small businesses as a whole. The best source of information in this area¹⁹ is the Intuit Small Business Employment Index, which was launched in 2007. It measures employment for businesses with fewer than 20 employees,²⁰ using an aggregated sample of small business clients that use Intuit's payroll services, supplemented with other information on payroll and self-employment from the U.S. Bureau of Labor Statistics.²¹ Since the inception of the Intuit index, employment at PEO clients is more than 7 percent higher than at small businesses overall (see Figure 3).

Because the Intuit index launched two years after the PEO Employment Index was created in December 2004, it is not possible to make a small business comparison back to the inception of the PEO index. It is possible, however, to compare the PEO index to a broader measure: (non-farm) employment growth in the United States as a whole (see Figure 4).²² For this comparison measure as well, the results show faster growth for PEO clients, this time compared to the economy overall.

In addition, it should be noted that in the more than 3 years since employment among PEO clients "bottomed out" in early 2010 following the end of the recession, employment growth among PEO clients has been higher than for both of the two comparison groups: 9 percent higher than small businesses (based on the Intuit Small Business Employment Index), and 4 percent higher than employment growth in the U.S. economy overall.

Figure 3. Employment growth, PEO clients versus small businesses overall, January 2007 (date of Intuit index inception) = 1000

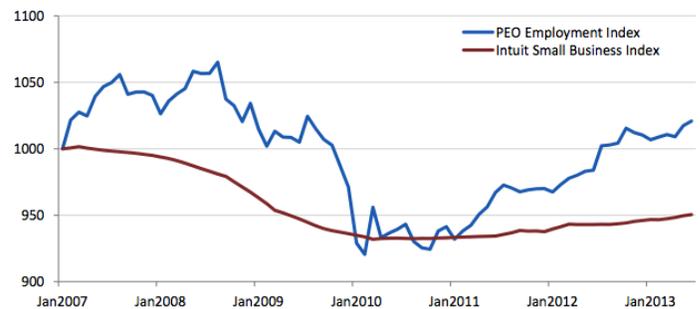


Figure 4. Employment growth, PEO clients versus U.S. employment overall, December 2004 (date of PEO index inception) = 1000



Conclusion

Overall, therefore, the evidence on employment growth suggests that PEOs are making it possible for their clients to grow more quickly than their peers – both other small businesses as well as all companies throughout the economy. This can be attributed to a variety of PEO-related factors discussed in this study. PEO clients have access to a broader array of HR-related benefits and services. Yet they spend less on HR administration than similarly-sized peers, freeing up money that can be reinvested in the business. Some of the benefits PEO clients are disproportionately able to offer – such as employer-sponsored retirement plans – play a major role in helping businesses attract and retain their employees. This too can have a tangible impact on business success: it is easier to keep key high-value employees, while turnover-related costs are reduced. Finally, freed from many HR administrative burdens, executives and managers of PEO clients can focus more of their time on strategy and growth. These factors all combine to yield faster growth for PEO clients relative to other businesses.

Many of these points are illustrated through the experience of a single PEO client. “I am very happy with what our PEO has done for our company,” says Phillip Grove, president and CEO of Seattle-based Conflux, a software professional services company. “By using a PEO, we have been able to grow, in a little over a year, from just the two founders to eight people across six states working from their homes. We expect to double this size within the next year. Our PEO allows us to mine a large talent pool for high quality software developers in a very competitive market, and it allows us to offer competitive benefits. Last but not least, thanks to the PEO, we don’t have to learn all the day-to-day HR, workers’ comp, tax, payroll, and compliance issues for a bunch of different states. This has relieved us from a big burden and allowed us to focus on our business.”²³

Endnotes

- 1 Theresa Welbourne, "Want to Make Money on IPOs? Learn About Companies' HR Management Strategies," *Workforce Management* (September 2010).
- 2 Boston Consulting Group/WFPMA, *From Capability to Profitability: Realizing the Value of People Management* (July 2012). This is not simply a case of "reverse causality." Rather, being a "people company" actually predicts future financial performance, even after controlling for the firm's past performance. In other words, this superior performance is not attributable to a firm's superior past performance.
- 3 This compares to an average of almost 20 for other companies. These figures are based on NCCI's analysis of its data on companies with workers' compensation policies (2007 Workers' Compensation Statistical plan data and Workers' Compensation Policy data, as reported to NCCI). Described in Harry Shuford, NCCI, "Don't Just Speculate, Investigate! The Story Behind the PEO Study," https://www.ncci.com/Documents/Story_Behind_%20PEO_Study-NCCI_AIS_2013.pdf (May 16, 2013), p. 17.
- 4 Steve Nyce, "Attraction and Retention: What Employees Value Most," *Towers Watson Insider* (March 2012), p. 2. <http://www.towerswatson.com/DownloadMedia.aspx?media={267F1391-E57E-48B0-9C5E-070B242032C6}>.
- 5 NAPEO, *2013 Financial Ratio & Operating Statistics Survey*.
- 6 Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2011," *EBRI Issue Brief* (November 2012, no. 378), p. 36. http://www.ebri.org/pdf/briefspdf/EBRI_IB_11-2012_No378_RetParticip.pdf.
- 7 Jack VanDerhei, "Findings from the 2003 Small Employer Retirement Survey (SERS)," *EBRI Notes*, September 2003, p. 1. This is the most recent version of the Small Employer Retirement Survey; EBRI confirmed it has not been conducted since 2003.
- 8 Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2011," *EBRI Issue Brief* (November 2012, no. 378), p. 36 (http://www.ebri.org/pdf/briefspdf/EBRI_IB_11-2012_No378_RetParticip.pdf), combined with calculations of data provided by NAPEO from its *2012 Financial Ratio & Operating Statistics Survey*. The NAPEO results were gathered from PEOs using ranges (e.g., a PEO would report "26 to 50%" of its total worksite employees are covered by a retirement plan). For calculating overall percentages, we used the midpoint of each range.
- 9 Transamerica Center for Retirement Studies, "14th Annual Transamerica Retirement Survey of American Workers" (July 2013), www.transamerica-center.org/resources/TCRS%2014th%20Annual%20Survey%20-%20Worker%20Full%20Report.pdf.
- 10 Quoted by NAPEO, www.napeo.org.
- 11 See, for example, Harry Shuford, NCCI, "Don't Just Speculate, Investigate! The Story Behind the PEO Study," https://www.ncci.com/Documents/Story_Behind_%20PEO_Study-NCCI_AIS_2013.pdf and Mona Carter and Harry Shuford, NCCI, "NCCI's Update on PEO Performance," August 20, 2013, presentation.
- 12 NAPEO, *2013 Financial Ratio & Operating Statistics Survey*.
- 13 Karen O'Leonard and Stacey Harris, "Maximizing Your HR Spend," *Human Resource Executive Online* (June 2, 2011), <http://www.hreonline.com/HRE/view/story.jhtml?id=533338466>.
- 14 Adam Skolnick, "HR: Big Savings for Small Business," *The Fiscal Times* (July 23, 2013), <http://www.thefiscaltimes.com/Articles/2013/07/23/HR-Big-Savings-for-Small-Business.aspx>.
- 15 Quote provided to authors by NAPEO, September 3, 2013.
- 16 Quoted by NAPEO, www.napeo.org.
- 17 SeekingAlpha.com, "Automatic Data Processing Continues to Grow Faster Than Smaller Peers" (August 19, 2013), <http://seekingalpha.com/article/1645022-automatic-data-processing-continues-to-grow-faster-than-smaller-peers>.
- 18 Slavic 401(k) is a third-party administrator of retirement savings plans that specializes in offering plans for the PEO environment. Its index includes approximately 1,500 companies, each of which has between 2 and 99 employees, with an average size of approximately 20 employees. Additional information on the PEO Index is available at <http://www.slavic401k.com/peoindex/publication/index.html>.
- 19 The U.S. Bureau of Labor Statistics (BLS) also reports gross employment gains and losses by firm size through its Business Employment Dynamics data. The BLS data, however, are reported only quarterly and are reported with a 7-month delay. The Intuit index was designed in part to provide a more timely source of information on employment changes among small employers.
- 20 A technical note: given the different sizes of companies in their employer population, the PEO Employment Index (2 to 99 employees) and the Intuit Small Business Employment Index (fewer than 20 employees) are not strictly comparable, as the PEO index includes larger companies. However, there is not a more comparable index available, and the average firm size in the PEO index (20 employees per company) indicates that it tends to be weighted toward smaller companies as well.
- 21 A more detailed description of the Intuit Small Business Employment Index is available at <http://index.intuit.com>.
- 22 The overall U.S. growth rate of employment is derived from BLS data on total nonfarm employment (not seasonally adjusted). See <ftp://ftp.bls.gov/pub/suppl/empst.compaeu.txt>.
- 23 Quote provided to authors by NAPEO, September 3, 2013.

About NAPEO

The National Association of Professional Employer Organizations (NAPEO) is The Voice of the PEO Industry™ and represents about 85 percent of the industry's estimated \$92 billion in gross revenues. NAPEO has some 300 PEO members, ranging from start-ups to large publicly held companies with years of success in the industry, as well as some 200 service provider members. PEOs provide payroll, benefits, and other HR services to small and mid-sized businesses. Approximately 250,000 businesses and more than 2.5 million people are part of PEO arrangements. For more information about NAPEO, please visit www.napeo.org. You can also find us on Facebook at www.facebook.com/napeo and follow us on Twitter @NAPEO.

About McBassi & Company

McBassi is an independent analytics and research firm that helps clients create consistently profitable and enlightened workplaces. McBassi uses the language and tools of business – metrics and analysis – to build successful organizations by optimizing the power of their people. McBassi's principals (Dr. Laurie Bassi and Dan McMurrer) are co-authors of *Good Company: Business Success in the Worthiness Era* (winner of the 2012 Nautilus Gold Award for Business/Leadership) and the *HR Analytics Handbook*.

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