

*An Ephor Group 2013 Review &
2014 Forecast of Human
Resource Outsourcing (HRO) &
HR Transactional Services*

Q1 2014

An HRO Transactional Services Overview

*Annual Review and
Forecast for the HCM &
BPO Payroll Processing
Services Sector*

Ephor Group, LLC

ABOUT THE AUTHOR

The Ephor Group, founded in 2002, is a strategic advisory firm exclusively missioned to provide strategic advisory services, executive management guidance, corporate development, financial resources, and operational performance improvement methodologies to Business Process Outsourcing (BPO) companies, with a specific focus on Human Resource Outsourcing (HRO) including Payroll Services, Workforce Management (WFM) and Human Capital Management (HCM) Services. Since its inception, the firm has deployed its expertise to over 20 HRO organizations creating nearly \$600m of shareholder wealth, while investing nearly \$100m of institutional capital to progressive, change oriented, “out of box thinking”, wealth centric management teams and business models.

Ephor Group’s (“Ephor”) principals and professionals illustrate nearly 60 years of strategic management and investor experience in the sector, having developed, managed or co-invested in such notable business models as Synadyne (PEO), Tandem Payroll (Payroll), Perquest (Payroll/WFM) HRAmerica (ASO), SmartTime (Time & Labor) HRAdvance (Benefit Admin.), and Achilles Group (HCM). Of particular note, most of the aforementioned organizations were “exited” as a result of the strategic buyer community.

Ephors’ Managing Partner, Garry Meier, is a well-known and respected thought leader and speaker on the HRO/WFM outsourcing sectors, having served as Chairman & CEO of Outsource International (OSIX), a publicly traded \$850M revenue provider of HRO/WFM outsourcing services that included Payroll, PEO, Staffing, Recruiting, Fractional HR Services, Worker Compensation Cost Containment, and Training. Mr. Meier’s additional operating assignments included, President & COO of Medaphis Physician Services (MEDA), a publicly traded outsourcing provider of healthcare workforce management services that grew to nearly \$650M in revenue. Currently Mr. Meier is the Chairman of Latin American Card Services (LACS), a high growth oriented, \$280m in revenue, provider of payroll, debit card, and WFM financial services to the Latin American marketplace, with locations in 10 LATAM countries.

At present Mr. Meier’s focuses his time on advising Boards of Directors, CEOs & Executives, and Investors on their strategy, growth and investment initiatives, as well serves on the US Senate Finance Committee for Small Business.

Ephor trusts the enclosed brief review of 2013 and forecast for 2014 and beyond provides meaningful information and insight as to the HRO sector and influences you’re strategic and tactical decision making processes.

Ephor Group

- **Founded in 2002**
- Ephor has a dedicated HRO/HCM Practice
- **8 Successful Co. Exits**
- Sector Leadership & Expertise since 1992
- **Significant M&A Experience**
- International Expertise
- **Deployed >\$100m of Capital**
- Advisor to US Senate Finance Committee on Small Business

2013 OBSERVATIONS & HRO SECTOR SUMMARY

The ole saying “Payroll is Payroll” has finally gone by the wayside and its associated legacy thinking that has inhibited us in the past. The other ole saying that “the definition of insanity is doing the same thing over and over and expecting different results” has never been more applicable then now.

Change in all aspects of our business, especially in the way we think about technology and utilize it, how we are organized, who we partner or ally ourselves with, how we represent our clients future needs and interest, what size we are versus; what size we need to be, and how smart we are, will determine our individual successes and our collective sector success in the near-term.

Below, Ephor has highlighted just a few of the many issues that the HRO sector told us in 2013:

- Demand for outsourced payroll services grew at a <5% rate due to the anemic job market and slow economic growth within the US economy. However the demand for reporting requirements in the areas of compliance, healthcare services, retirement plan management, and other workforce management areas grow >25% in 2013, due to the administration’s “big government” needs to know it all” demeanor. It is clear that this influence and requirement is here to stay for the near-term.
- In general, executives and leadership in the sector *have not changed or facilitated change effectively* in order to take full advantage of the changing HRO and WFM marketplace and client requirements, and the resulting opportunities. This lack of change management leadership *has resulted in an 18% increase in sector bankruptcies, “surrenders” or failures over the past 18 months.*
- The need for investment in technology has never been so prevalent in the sector; the lack of technology and its cost has driven a few of the sectors providers to “sell out” at sub-enterprise market valuations, thus enterprise valuations reflecting the “surrender” attributes have become quite prevalent.

2013 Demand

- **Payroll Services**

<5% Growth in sector demand in 2013 driven by an anemic job market & slow GDP growth

- **WFM**

>25% Growth in sector demand driven by increased reporting, compliance & employment lifecycle requirements

- The sector experienced an increasing requirement and desire for data and bundled services such that more data is consolidated into information that can be “mined” for reporting and workforce management effectiveness.
- Those few progressive providers that have focused on bundled services, data and outcomes-oriented information have gained market share and have increased client retention. Therefore they will be the most attractive providers to “partner” with the best “Beyond Payroll Service Providers.” We are seeing a bifurcation in the market of those that are “getting it” and those that simply will not.
- The need for “alliances” and the types of allies came running to the forefront in 2013. All participants in the “food chain” need core payroll data for use in their area of specialty more quickly and more seamlessly than currently exist. Therefore, selection of vendors, partners, and technology, along with distribution allies are critical to your success as a sector competitor. The question is what is your strategy and plan for the future?
- Size and Scale matters more so than ever! The customer marketplace and the strategic buyer community prefer larger boutique organizations (\$10-\$50M revenue) that are “smart and skilled enough” to focus on a specialized vertical market or illustrate a specific sector focus; therefore they become the “comfort buy”. The successful participants will couple this focus with intimate and personalized customer service, versus “subscale providers” where risk of failure is more prevalent, or as compared to “branded” national providers and their “call/service center” one-size-fits-all business models.
- Information & Data Security forever is a risk to be managed and must become a proactive part of every system, process and the culture. It is much more difficult to enhance security as an after- thought, add-on, or patch. Some vendors will “get it”, more vendors simply will not. Sector participants need to know the difference and demand that security be a key focus in the design of a solution, the resulting operating system, and the subsequent workflow processes and procedures.

There is a bifurcation in the market between “Beyond Payroll Service Providers” who are getting it and those that simply will not.

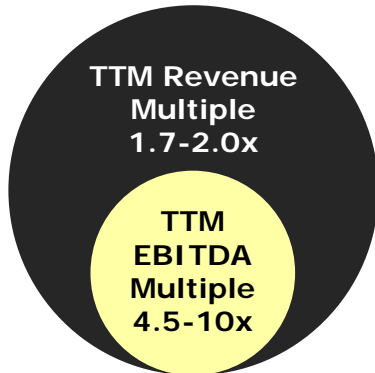




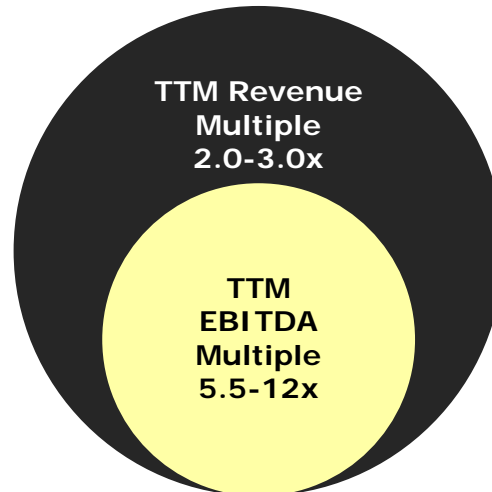
ENTERPRISE VALUATIONS & NOTED M&A TRANSACTIONS

2013 M&A Transaction Valuation Multiple Ranges

Payroll Outsourcing Services "Technology Light"



Payroll & HCM Software & "Bundled" HRO Services



Payroll outsourcing services enterprise values (in \$) were flat or slightly lower than in 2012.

Notable 2013 M&A Transactions			
Acquirer	Acquired Co.	Rev. Multiple	Details
	Private Payroll Provider (\$5-7M Revenue)	1.90	Independent payroll & WFM services provider located in central US.
	PayRoll S.A.	Market Value	Public transaction for HRO payroll and employee benefits services with operations in Argentina, Chile and Peru.
	Private Payroll Provider (\$2-4M Revenue)	Market Value	Independent payroll & HR services provider.
	Payroll Evolution, LLC	1.95	Independent payroll & WFM solutions provider.
	Ovation Payroll	2.20	Acquirer paid 9x EBITDA for this payroll outsourcing firm with ~100 employees.



In 2013 the lower middle market to subscale market experienced flat to somewhat lower valuations as M&A activity volume was likewise suppressed over 2012. Specifically in the HRO/WFM sector where the enterprise valuation metric is a multiple of EBITDA, the market presented itself at >7 times adjusted pro forma trailing twelve month (TTM) EBITDA. In the Payroll services sector where the enterprise valuation metric is a multiple of revenue the subscales commanded 1.7x -2.0x TMM Revenue. These valuations purchase price multiples have been possible due to the significant availability of liquidity to finance leveraged buyout (LBO) transactions. Total Debt / TTM EBITDA for middle-market LBO transactions have steadily increased since hitting a low in 2009, currently achieving 5.3x in 2013.

Valuations

- **HRO/WFM Valuations**
>7x pro forma TTM EBITDA
- **Payroll Services**
1.7 – 2.0x TTM Revenue
- **Significant Financing Options**
Adequate Capital available for the “Best Business” models

2014 & BEYOND: KEYS TO STRATEGIC & MARKET SUCCESS IN THE HRO SECTOR

Payroll Service Providers Can Become Key Players in the WFM Arena

- Payroll service providers have several advantages as the workforce management arena matures and evolves. Payroll is the source of key data that drives many of the services provided to employees. Payroll processing is complex, and is getting more complex and more regulated each day. Taxing issues, tax preparation and the flow of funds from tax, insurance, benefits administration services require controls, and many of core competencies that payroll service entities illustrate. HCM management and Payroll Services require that providers have working relationships and access to the national banking system to move customer funds throughout the financial system. Other HRO and WFM service providers generally do not have the same level of access to the system that payroll providers have, and they need that access. Exploit your “special skills.”
- Technology is being developed, adopted and being utilized at lightning speed, and in many cases the technology is ahead of us, the providers, in terms of subject matter expertise, system of security and controls, and our employees are demanding convenience and immediate multi-platform access to their personal information. Business practices and user practices will need to be revised and in some cases invented. Our core technologies will

need to be capable, compliant, controlled, and customer friendly, and provided in that order!

Payroll Services “Special Skills”

— **Driver of Employee Services**

— **Payroll Process Complexity is Increasing**

— **Taxation Issues, Preparations & Flow of Funds**

— **Access to the National Banking System**

— **Ahead of the Technology Curve**

WFM Solutions are Changing Who the Decision Maker Is & the “Buyer Community”

- Workforce management solutions *are changing who the decision maker is*. In smaller firms with less than 50 employees with simple to moderate needs, the decision maker remains the owner and/or the office manager. In larger companies, historically, the payroll group was a specialized section inside the Human Resources department and they made either the decision or were very strong advocates of the solution. HR, historically, managed the workforce from organization requirements, to job and skill definitions, to candidate search – interview/examine – hire – on-board – handbook, monitor and score performance, educate, retire or fire. Each of these functions had their own area specialists, data bases, and software.
- Times are changing, driven by technology and regulations. Functions are being brought together. Few solutions are being constructed to provide more comprehensive services. A single system of record, primarily the HR core system, is being requested to supply information and services to administrators and employees alike.
- The decision making dynamic is moving from separate specialized sections within the Human Resources department to a single higher level executive or committee of executives. Therefore we must change who we market to and who we sell to. *It is clear that the buyer community will be a “higher level, more perceptive and sophisticated professional” who enjoys a more holistic view of their organization and needs.*



Payroll Service Providers Will Need New Organization Models to Provide a WFM-Centric Product Set

- Employers in the future will be driven by more complexity and regulation/compliance as such will be driven to find knowledgeable holistic solutions to managing their workforce. It is clear that most will want to outsource their requirements to providers with deep domain subject matter expertise and the best technology.
- The truth is most payroll providers lack the specific segment subject matter expertise in other employee lifecycle segments than payroll to provide this holistic single point of “intellectual capital”.

Future Factors

- More Complexity
- More Regulations/Compliance
- **A More Sophisticated Buyer**
- **Deeper Domain Knowledge**
- **Effective Change Management**
- Innovative Organization Structures
- Effective Partnering & Alliances

- Ephor believes that a select few payroll providers are in a position to re-organize themselves to expand beyond payroll, provide funds transfer, settlement services, tax treasury services and compliance reporting, either as a lead or as a participant in an alliance, in bringing together a broader, more “bundled” list of services to satisfy the market’s holistic requirements. Let there be no doubt that those that do accomplish this with the required

domain expertise will have a distinct competitive advantage. These alliances may well end up being exclusive, but they don’t need to be. Issues like “who owns” the customer relationship, the system of record, system level changes, control over data exports, compliance/reporting, security of code and data access and dealing with breach/damage/loss of data, all are part of what is required in building these holistic alliances, technologies and business processes.

- The legacy and failed thinking of the past of “just plug and play”, poor or no business practices, a lack of rules, accountability, and experience is a recipe for failure. It is imperative that as providers we reposition ourselves as a trusted and knowledgeable source and advisor for the new and changing buyer community.

In closing, Ephor suggests that those sector participants that “dare to cross that chasm of change” and position themselves as sector leaders will be handsomely rewarded by enterprise valuations that should reflect a 25% to 40% premium above the valuations presented earlier in this report.





Please contact Ephor Group at 214.702.6427 or ephor@ephorgroup.com for further information and discussion relating to:

- 2013 transaction details
- 2014 market forecast
- Overview of Ephor Group's services: *"Solving the Value Equation"*
- A discussion of your company's strategy, growth and resource requirements





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