Why Do PEO Start-Ups Succeed (or Fail)?

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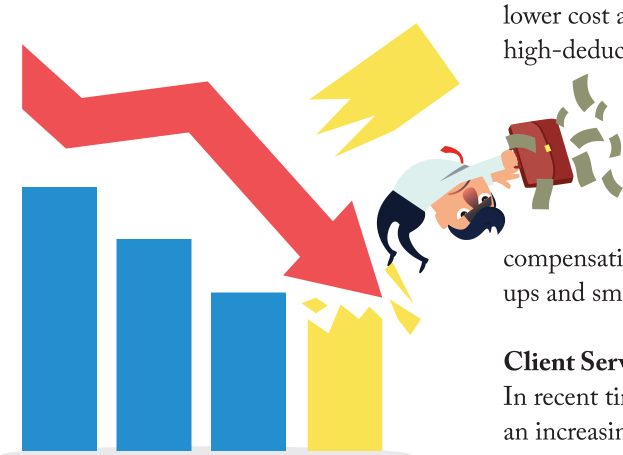
How the demographic of new start-up PEOs has evolved over time is interesting to me. In yesteryear, the typical profile of a start-up PEO operator was a PEO veteran who had learned the trade on the sales, operations, or finance teams of established PEOs.

This was followed by a growing trend of new entrants emerging from other market verticals such as insurance brokers, payrolls, and staffing companies.

Some say that the era for new start-up PEOs has come to an end with the accelerating wave of PEO consolidation, with the distance between the small and the large getting greater, with an increasing advantage to economies of scale. Is this the reason that start-up PEOs sometimes fail?

Can Start-Ups and Small PEOs Compete with Large National PEOs

By my appraisal, based on publicly available information and my educated estimate, the four largest PEOs by worksite employee (WSE) count have an estimated 1.475 million of a 4 million market, about 37 percent.



The question is, is it possible for start-up PEOs to compete with these companies on a smaller scale and be competitive, profitable, and successful?

In today's environment, some of the major competitive advantages once held by larger PEOs have narrowed in several areas.

PEO HRIS Technology and Mobile Apps

In recent years, many of the PEO software providers have moved to cloud-based systems that are priced on a per employee per month (PEPM) basis, which gives the smallest of PEOs access to the same technology as some of the PEO market's largest entities.

Workers' Compensation

Also in recent years, the greater PEO market has been focused more on white- and gray-collar business than the historical blue-collar market. At a much lower average manual rate,[1] the significantly lower cost advantages of the large PEO high-deductible workers' compensation program are largely mitigated to a minor percentage of payroll. This combined with affordable and reasonably available and rated workers' compensation programs have kept start-ups and smaller PEOs competitive.

Client Service

In recent times, the PEO industry has had an increasing focus on automation. As the distance in size becomes greater from the biggest to the smallest, so does the distance from the client.

In a November 26, 2018, article in *Business News Daily*, "20 Small Business Trends and Predictions for 2019" by Adam C. Uzialko,[2] Uzialko made the following observations related to small businesses (which are the focal point of the PEO target market):

- Businesses will further adapt to the modern customer, focusing on delivering faster, more efficient personalized service;
- Technology will not replace the human touch; and
- Genuine relationships trump technology.

These revelations should give solace to those entrepreneurs concerned that they cannot compete in an evolving PEO market.

Outsourced Back-Office Solutions

For those entrepreneurs who do want to add infrastructure, expertise, strategy, and capacity to their new start-ups, an outsourced PEO back office may be an excellent solution to compete

1 The workers' comp manual rate is the starting point for calculating the cost of a workers compensation policy. These manual rates are examined yearly. This yearly review is done to ensure that enough funds are generated to operate the system and that each employer is responsible for their fair share of the total cost requirements. *http://cutcompcosts.com/2010/07/workers-comp-manual-rate.html.*

2 *www.businessnewsdaily.com/7605-business-trend-predictions.html.*

more effectively at this stage of the PEO lifecycle.

So Why Do PEO Start-Ups Fail?

There are a few reasons start-up and smaller PEOs have been more competitive in recent years.

According to a July 11, 2018 *YFS Magazine* article, "Most Start-Up Failure Statistics are Misleading" by Marsha Kelly,[3] the "delusion of start-up failure" is likely from a National Association of Restaurant Association report saying that 80 percent of restaurants fail within two years.

According to the *YFS* article, the Small Business Administration claims that:

- Two-thirds will be in business after two years; one-third will fail.
- Forty percent will still be in business after 10 years.

These statistics sound much better than some of the traditional lore as once reported by a 2002 Bloomberg report.[4] So, start-up PEOs might fail for the same reasons many other small businesses fail.

Lack of Capital

Like all business start-ups, lack of capitalization can be a major factor in a PEO start-up's demise. For nearly 20 years, people have asked me how much it costs to start a PEO. In general, I have answered, at least $500,000, which includes working capital. Of course, this is a generalized answer assuming that the entrepreneurs:

- Are not part of a large entity starting a PEO division and planning on building a large sales force and infrastructure (new PEO divisions of existing companies have a completely different set of financial dynamics);
- Are in a favorable geographic, business, and regulatory market/climate;
- Have strong entrepreneurial and business skills, including business development;
- Are not taking money out of the business prior to positive cash flow;
- Have good advisors; and
- Have friends and family clients or early adopters that will contribute revenue (cash flow) early on.

However, PEOs have achieved positive cash flow with both less and more than my standard response related to capital requirements.

Lack of Business, Management, and/or Industry Experience

To be successful in the PEO business, entrepreneurs must possess or employ others who have expertise in operations, sales, and financial management with experience in the PEO or a related industry. However, this weakness can be partially mitigated by

3 *https://yfsmagazine.com/2018/07/11/most-startup-failure-statistics-are-misleading-heres-the-truth.*
4 *www.bloomberg.com/news/articles/2002-03-03/the-bottom-line-on-startup-failures.*

engaging with strong industry advisors and mentors.[5]

Lack of a Strong, Well-Thought-Out Strategic Plan

We've all heard the adage, "If you fail to plan, you plan to fail." The strategic plan is the cornerstone of a start-up PEO and should be completed with the assistance of industry advisors such as PEO consultants, PEO insurance professionals, PEO legal counsel, and other trusted business advisors. This planning and legwork should be completed in advance of any decision to enter the PEO space. Ensure you have a full 360-degree view of what the risks and rewards are of being successful or failing within the PEO industry, even if you are coming from within the industry.

Lack of Network and/or Client Acquisition Capability

Before entering the PEO industry, have a built-in or ready-made portfolio of potential prospects and potential early adopters to shorten the timeline to generate revenue and its related cash flow. You must have a firm understanding of client acquisition costs (CAC) versus customer lifetime value (CLV). Obviously, CAC must be much lower than CLV. Ultimately, client retention is also a major factor. Sales is the life blood of the business and it is imperative for start-up PEOs to have highly developed and productive business development resources.

Lack of Strong Advisors, Mentors, or Advisory Board

Sometimes, it is better for a PEO start-up to learn by someone else's experience rather than reinventing the wheel or making costly mistakes that could impair the flightpath to scalable profitability. Make sure you consider seeking out reputable, experienced advisors to help ensure the success of your new entity. Experience matters.

Summary

Over the past few years, I have evangelized that I have never been more bullish on the PEO industry. Even with a rapidly consolidating industry and evolving competitive landscape, change will create a myriad of market opportunities for highly focused, capitalized, and well-planned PEO market entrants.

This is one of my favorite business quotes that reflects the evolving market and changing times: "The world is changing very fast. Big will not beat small any more. It will be the fast beating the slow." Rupert Murdoch, executive chairman of the Fox Corporation. ●

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5 See the Find a Service Partner feature on the NAPEO website at *www.napeo.org/peo-resources/tools/find-a-service-provider* and the NAPEO Mentor Program at *www.napeo.org/membership/mentor-program*.