PEO STATE OF THE UNION

SEPTEMBER 9TH,2020

INDUSTRY OVERVIEW PER NAPEO

- 900 plus PEOs
- $185 billion in revenue (payroll plus fees)
- 15% market share for firms 10-99 employees
- 175,000 clients with 3.7M employees for an average of 21 lives each
- 35 years -young industry
- Growing at 8.3 % annually since 2007
- Market potential is enormous with 80M+ individuals employed by firms with less than 500 employees earning on average $25,000 in annual salary
- Consolidation by private equity buyers and public PEOs will continue providing greater creditability for industry and more capital for technology and human resources value add
- The balance of the large PEOs will continue to grow as demand rises due greater regulatory/compliance requirements
- Small Business Efficiency Act (SBEA) further legitimizing co-employment and increased market pain in critical areas such as Workers' Comp (WC), Employee Benefits Administration, Human Resources compliance and improved technology
- Covid-19 has created much good will for PEOs due to their HR guidance, best practices, and regulatory updates on workplace issues pertaining to the pandemic

WORKERS COMP -NEW CHALLENGES (LESSER CAPACITY AND COVID-19)

- AmTrust has decided to stop writing PEOs on a Master program in 2019, except for several profitable ones. They will continue to offer WC insurance to PEOs through client policies or multiple coordinated policies. Their performance on Master PEO policies are 10 points higher than remainder of WC book (Amtrust is the 5th largest provider of WC in the US).
- HIIG pulled out of providing WC insurance for PEOs earlier this year due to a variety of reasons.
- It will take another 12-18 months to have a better feel for additional cost of pandemic related WC claims due to presumptive law and growing in many states.

CARRIER & MGU OVERVIEW

<u>There are three main carriers for PEOs desiring large deductibles:</u>

AIG, Chubb and Zurich. These offer large deductibles ranging from $750,000 to $1,000,000.
The top 25 PEOs can be found with these carriers and make up approximately half the industry worksite lives.

Other Major Carriers/Programs:

Clear Spring Property and Casualty**.** The PEO book is believed to be $50,000,000. This is a newer market and very competitive. They can write in 49 states and DC. CCMSI provides their underwriting, claims management, data warehousing and reporting services. They offer an online portal through Fast Comp software.

SUNZ insurance company is believed to be $150,000,000 in premiums excluding their staffing book. Write in all states, mostly deductible programs and are trying to offer guaranteed cost program, but this does not seem to be a fit or working for them. Fronted by Accident Fund, which is now their second market. Good management team, but financially there are concerns for their longevity.

AmWins offers MGU program on State National paper with reinsurance from Chubb*.* The following relates only to PEO/staffing book. Believed to be $ 200,000,000 in premiums, writing in all states. Guaranteed cost, small and large deductible options with low aggregates. The program is growing and there are concerns regarding longevity, since Markel now owns State National and after review fronting and reinsurance pricing should see changes in the future. Good amount of the book had been poor performers within the AmTrust book and were nonrenewed over the past couple years.

Risk Transfer Insurance Agency (RTIA) offers MGU program for SAIC. Risk financing options include GC and small deductible. RTIA has other WC insurance markets for placement of client policies, staffing clients and MCPs. Agency currently using Applied and CSR-24 for servicing their clients.

Key Risk (a Berkely Company) is a new entry into the WC sector for PEOs and we are keeping a close eye on their risk & jurisdictional appetite.

WHAT IS NEEDED TO IMPROVE WC SOLUTIONS FOR PEOs?

- Greater capacity from existing carriers and new markets considering partnering with PEOs
- More use of rating plan alternatives, such as retro plans with low maximums, small deductibles or larger deductibles with low aggregate as it is difficult to underwrite many PEOs with large retentions due to credit risk
- These options will provide opportunities plus a win/win outcome for PEOs & carriers

IMPROVED SELECTION / UNDERWRITING / PRICING

- Many PEOs price WC too thin not fully understanding loss development
- Buying guaranteed cost (GC) makes it easier to be shortsighted
- Formulate plan to keep PEOs within their appetite or their niche
- Writing business outside their area of expertise seems to lead to unprofitable client companies
- Incentivize PEO producers to go after profitable business and adjust the pricing strategy based upon the client’s results
- Understanding the PEOs strategy for Health & WC is key when underwriting and reviewing PEO partners

PEO DISTRIBUTION

- Key is understanding the PEOs distribution channel, pick partners wisely both for internal sales force or if using external agents/brokers and other centers of influence
- Knowledge needed by carrier in who the PEO uses to sell their services
- Finding partners or sales team that are specialists not only cuts expenses, but will allow the PEO to achieve higher growth & increases the PEOs enterprise value

THE STAFFING INDUSTRY - A POTENTIAL BLACK EYE

- Many insurers link both industries erroneously
- Issues include fast growth, PEOs allowing staffing in their book (piggy backing), credit risk, misclassification of codes, lack of safety training or proper onboarding, tough to manage employees and poor risk selection
- Best in class should be pursued but not be written in PEO books as it is sole employment not co-employment.

PEO RISK MANAGEMENT BASIC RESOURCES REQUIRED TO SUCCEED

- Safety training and loss control
- Claims consulting
- Analytics and loss forecasting to dictate service allocation by client and status (good, rehab or bad - carve out or terminate)
- NAPEO risk management certification

FACTORS EFFECTING WC

- WC combined ratio still in low 90s and profitable; however, seems to have bottomed out as it began to increase again in 2019 and due to the unknowns regarding Covid-19 losses in 2020 with lower exposure due to economy shut downs due to pandemic and individual state presumptive coverage responses will add further to loss outcomes.
- Insurance industry wants to underwrite to mid-90s combined ratio due to a lack of investment income
- Claims frequency is down and over last 20 years down more than 50%
- Claims severity is increasing
- Legislation of medical marijuana in many states has caused a stir, yet employers reserve the right to test & terminate for use which will be battled as it stays in the body for a long period (this will continue to change state by state until addressed at a federal level)
- Prescription drugs nearly 18% of every WC dollar spent and the fastest growing expense line item (has grown over 10% in the last few years)
- ACA may be increasing WC fraud as there is adverse selection in healthcare plan purchasing. Purchasers tend to be older, need specialty drugs or have chronic conditions. Due to increased co-pays, deductibles and lesser coverage in key areas such as mental illness including addiction/recovery, WC may be triggered versus using health coverage by individuals not hurt in workplace
- On demand/shared economy will continue growing and be a disruptive force as it drives payroll away from WC. Exposure still exist as many former employers become independent contractors
- Individuals continue to move away from the traditional American model of long-term employment
- WC will ultimately be required, and the cost will be passed on to customer (ex: UBER)

KEY STATES AND CHALLENGES / OPPORTUNITIES AHEAD

- Florida - pricing for clients and PEOs may decrease again which will make it more difficult for PEOs to continue delivering savings and expose them to losing WC to agents or new insuretech WC disrupters
- Texas and New York - the state funds are the most competitive markets and TX always seems to be the best state for WC and business performance
- California – must limit writings, conditions worsening (due to overall claims environment- greater frequency and severity, resulting in development of over 300% at 12 months) and likely to continue deteriorating
- Other than Texas & Florida, larger PEO states including California and New York, will see rate increases as there is a growing disparity in rate adequacy due to increased costs versus current filings. It takes two plus years to change rates in most states. Thus, we are nearing the bottom of the market.

PEOs HEALTH PLANS – HOW TO CONTROL AND PROVIDE LONG TERM VALUE

- PEO industry is partly at fault by allowing for adverse selection through low pricing, participation and contribution levels. The major players including Aetna, CIGNA, United, BCBS, Humana, and Kaiser, have experienced growing pains with PEOs. Some have dropped out of this industry like what we have seen in the WC industry
- Expect state insurance exchanges to grow despite some carriers exiting
- The master versus non master health plan approach amongst PEOs should match their growth strategy by region and class of business
- Health plans should protect WC masters to mitigate fraud. This is a big challenge. More importantly, master group health plans should be aligned to deliver the business PEO strategically desires.
- Covid-19 will have a potentially negative effect on ALL group health plans.

NEW TRENDS

The existing commercial distribution and underwriting cost base is unsustainable long term and the insurance & PEO industries are at risk of DISRUPTION FROM OUTSIDE PLAYERS.

Per Dowling & Partners, 45% of US Gen Ys in 2017 would consider buying their insurance, such as WC, with an online service provider (i.e. Amazon, Google, Apple, Facebook). Technology will continue to evolve especially with capital sources for disruptive distribution and attack high admin & selling expenses.

We are investing in the future of InsureTech for PEOs and other aggregators on a direct B2B basis. This will change the way SMB firms purchase payroll, PAYGO, HR and co employment; similiar to how purchasing personal auto has has been transformative and grown via online insurance providers (such as Progressive , GEICO & others) and its already happening with WC-via carriers like Berkshire Hathaway (BiBerk) whom have no intermediaries, no human underwriting & no reinsurance.

The old school “Boots on the Ground” leaders such as ADP & Paychex are being replaced by new school firms such as Gusto, Square , Intuit, & Zero, whom are integrating pay as you go WC w/ payroll and benefits software via “ Browser Based” solutions.

SUMMARY

The PEO industry will continue to face new challenges but due to increasing demand from small and mid-size firms who seek to outsource their non-core areas, this industry is positioned to grow over the next decade. To meet ensuing greater demand, PEO consolidation will create opportunities for new players that may offer better technology and develop niche areas in a growing marketplace.

We are bullish on the PEO industry for all the items mentioned in our industry overview. With the current disruption this is a prime time for insurance carrier to enter this vertical. Key to profitability is choosing healthy PEO partners and understanding all aspects of the PEOs distribution, services and strategy. Disruption is good and the best PEOs will retain more risk while improving their self-control. These market dynamics do not happen in a vacuum. In the short-term, market movement will create opportunity and with underwriting knowledge and proper discipline a perfect time to enter this industry.

MICHAEL A. ORTOLL, ARM
JV PARTNER | BALDWIN KRYSTYN SHERMAN PARTNERS
CEO & FOUNDER | iPEO SOLUTIONS
Office: 813.452.3667 | Mobile: 813.220.3132

mortoll@bks-partners.com | www.bks-partners.com
mike@ipeosolutions.com | www.ipeosolutions.com
4010 W. Boy Scout Blvd. Suite 200 | Tampa, FL 33607

www.linkedin/in/michaelortoll

iPEO Solutions