NAVIGATING THE ECONOMIC LANDSCAPE IN A TIME OF UNCERTAINTY

THE STAFFING INDUSTRY PLANS FOR THE FUTURE

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An Overview of the Economy

We can't stand idly by and not plan because the future is unknown. We are operating in a down economy now, and we have a long way to go before returning to "normal" times. The country was on the precipice of a depression a little over a year ago due to the housing crisis and the repeal of the Glass Steagall Act, which led to the near bankruptcy of our financial institutions, risky derivatives, credit default swaps et al. While things were not handled as well as they could have been due to the urgency of the situation and special interests, consumer confidence almost dropped off the radar screen, and "real" unemployment rose to some 17%. The stock market fell over 50%. The Fed rescued giants like AIG and GM, and over a trillion dollars was spent on financial bailouts and stimulus packages. This was followed by the Madoff scandal, excessive executive compensation and squeezing of credit to consumers and small businesses with over 100 FDIC seizures of failed banks. Small companies, who have been responsible for most of the hiring during the last few decades, are now skittish about adding staff, while large companies continue to trim staff to drive up earnings 150% vs. 2008. The shock wave is forcing down prices in a deflationary spiral – from dollar menus at McDonalds to the discounting of luxury goods.

And all of this was preceded by the decade from hell – starting with the dot com bust, household incomes not keeping up with inflation, housing prices off by 25% in the last four years, healthcare costs rising at twice the inflation rate, two unfunded wars driving up the deficit, and the Enron scandal. It is now clear that we are not keeping up with India and China, and our once-vaunted economic advantage is waning. We are in danger of becoming a second-class country down the road. This is one of the reasons why larger staffing firms have hedged their bets by investing heavily overseas during the last decade. In the words of the legendary singer/composer Leonard Cohen: "Everybody knows the dice are loaded. … Everybody knows that the fight was fixed." So, is it any wonder why staffing firms remain uncertain about the future?

The Political Environment

We now have a political situation in gridlock where almost nothing gets done. We have moved from a period of initial optimism under a new president with a supermajority in the Congress to disillusion with government, dismal approval ratings and few real accomplishments except for a healthcare plan that will still take four years to fully realize, with a questionable impact for our industry. And while the government says the recession is over the average person thinks they are living in an alternate reality with high unemployment, stagnant wages and escalating health costs. Stirring the pot is everyone from extremist media and the tea party movement to secessionists, linked up via social networks and a political process operating under a zero sum game philosophy where victory is only achieved when the opposition losses and moderates seeking compromise are pilloried for lack of principles. This situation locks in a climate of uncertainty.

The Supreme Court ruling that freedom of speech applies to corporations and individuals alike, now allows no limitations on campaign spending to promote causes. On first blush this would appear to be good news for staffing companies, which of course are corporations themselves. However, this might not be the case after further reflection. The largest corporations with the most money and influence are those corporations that are the users of staffing resources and may have very different agendas from us. Even the largest staffing companies are inconsequential compared to the 800-pound gorillas that we serve. Although there are many areas we have in common, they will seek to maximize their profits, which often will be at variance with our interests. This includes outsourcing their needs to countries with cheaper foreign labor, taxes and a more favorable business climate; minimizing the hiring of employees; commoditizing temps/contractors by minimizing mark-ups via VMS systems; supporting government mandated healthcare, which takes the burden off of them but has been one of the intrinsic economic benefits provided by temp services; and influencing other legislation in ways that we might not favor, but can't fight. All of these factors, again, add to uncertainties.

Staffing Overview

The executive job outlook for this year looks encouraging, although overall direct hiring is expected to drop, based on SIA projections. The highest demand is expected in healthcare, clean energy, pharmaceutical and high-tech sectors at the AVP level and higher. Non-executive direct hiring activity is forecast to be up by others, however. One survey noted that about half of the corporations expect to lift their hiring freezes by the second quarter. While only 14% of these firms added staff last year, 20% were anticipating doing so this year – specifically, high tech, followed by manufacturing, financial services, and sales and various professional areas. However, hiring by small companies, which has been the greatest source of new jobs over the last couple of decades, can be expected to remain sluggish.

We have lost well over seven million jobs from our high in December 2007. Many of those jobs will never return. The old concept of an interim layoff with the expectation of being hired when business improves is over, as many sectors have learned to do without. Those jobs that have seen the greatest impact here are those related to automation, computerization, off-shoring, construction, office services, retail and low skill assembly line workers. Some 40% of those unemployed have been so for over six months and will have to be retrained for other work. Overall, employment is off 10% from its high in mid-2007 though the temp job sector is rising from the depths; however, it is still off 37% from its high in late 2006. We hit bottom during the first quarter of 2009 and have now fully recovered from that point, rising 15%. We are still off 26% from our high. Some of the sectors expected to see growth are IT, biotech, healthcare (but later on in the recovery), food services and education.

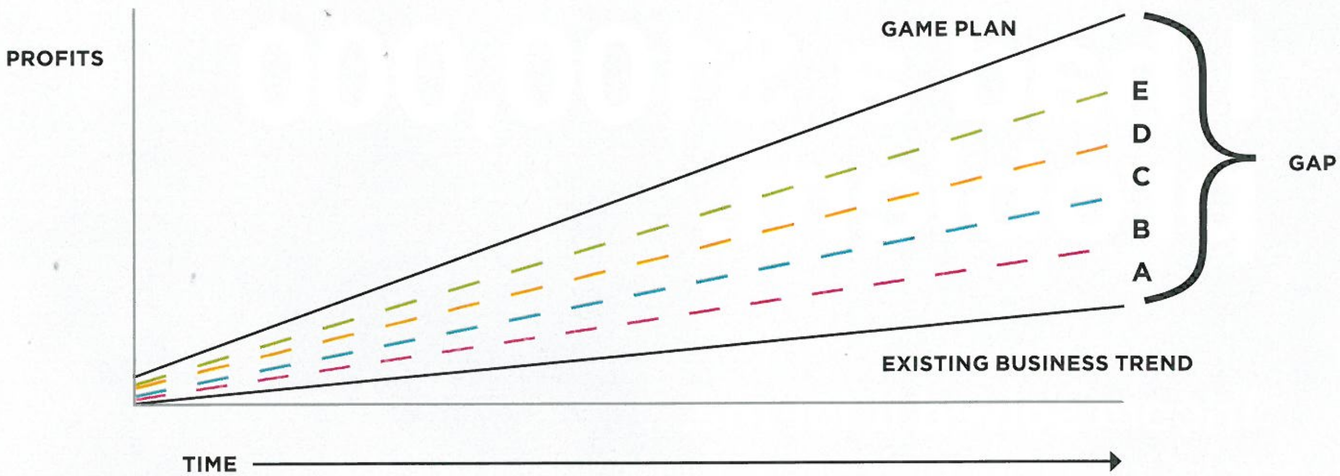
Planning During Uncertainty

Even though there are things we don't know or can't control, we have to develop plans that factor in uncertainty.

Alternative Scenarios. Companies have traditionally used temps after a recession before adding on staff. However, it does not appear that this is a transitory thing this time around. After more than a year and a half of lower employment, temps/contracting continues to recover. Even as manufacturing comes back, companies are increasing output by extending the workweek and adding temps, not bringing back laid-off employees. Their concern is the sustainability of the recovery, the higher cost of adding staff, the uncertainty of healthcare and other legislation, plus changes regarding taxes. It is quite possible temps will make up a greater portion of the workforce over time and we will follow the European model with twice our temp penetration rate which started increasing eight months ago and keeps rising. Planning, by its very nature, is based on uncertainty. Yet some people feel that planning is just a waste of time as there are just too many unknowns. This could not be further from the truth and is like the proverbial ostrich sticking its head in the sand. Planning deals more with devising alternative scenarios and, hence, uncertainty. One of the leading general consulting firms has even created a "center for managing uncertainty." We will deal with this concept from a staffing perspective here.

Identifying Unknowns. The mere activity of entering into a planning process identifies the key internal and external variables so one can intelligently deal with them. Although we can't shape the future to our liking or eliminate risk, strategic planning deals with the direction

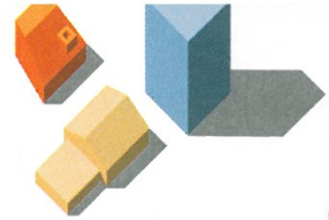
FIGURE 1: GAP ANALYSIS



the company is heading in and where it wants to be. Tactical planning deals with the specifics of getting there. Planning is a process, not an event. It takes continuous updating and is not something to do once and check a year later to see if you guessed right. New facts and conditions are routinely introduced, and the plan is revised. It is a living document.

Sensitivity. Analysis tests alternative scenarios with modest changes in the key parameters effecting potential outcomes (the government did this with their stress test of the banks to see if they were solvent enough to emerge from the bailout, but many think that the game was fixed and the test was too weak and aimed at achieving a predetermined outcome, which defeated the purpose of the exercise). You should model your company on the variables that may be faced to make an intelligent decision if those events unfold. This would include such things as sales, profits, rate of return, company valuation, cash flow, borrowing requirements, financial ratios, market share, technology requirements, investments, hiring decisions, degree of risk, comp plans, organizational changes, etc. The results are proactively dealt with before the events unfold and it's too late to do anything about them. For example, if it appears that certain state legislation may be enacted that would be unfavorable to your business then you need to figure out what to do before this comes about. Some options might be:

1. Work with state staffing associations to head off changes if possible,
2. Consider moving your business out of state,
3. Prepare your clients for the reality that the cost of doing business will be rising for all



competitors so that price increases might be inevitable,

4. Determine how to best reduce your costs if the price increases you desire will not stick,

5. Be able to balance lower profits in one area with higher profits elsewhere,

6. Exit the areas being impacted if it is severe enough and selling before the bloom is off the rose, and

7. Create value-added services to save your clients money, justify raising your prices, and be more competitive.

Small changes in some areas may bring disproportionate results, for better or worse. Some options will be better than others but you may not be able to select which ones you may have to operate under. Others could lead to unintended opportunities or consequences that may not have surfaced unless sensitivity analysis was explored. You can't predict all events but you can run enough reasonable scenarios so that if a situation with enough similar factors were to occur, you can fast track a response. As you gain familiarity with this approach it becomes easier to deal with uncertainty. Not that risk can be eliminated but it becomes easier and quicker to deal with, with improved outcomes. Companies that plan well do better than those that do not. This is how Fortune 500 corporations became successful, but you don't have to be one to operate like a large company.

Implementation. When the plan is selected and you are comfortable with the assumptions, it should be implemented. You need to continue to monitor the key variables regularly, modifying the strategy and tactic as needed and defining clear responsibilities, deadlines and measurable deliverables. This is called an action plan. The smaller the business unit the faster changes can be made, as there are fewer levels of management to deal with. The first step is to set realistic objectives. For example, a light industrial staffing firm dealing with IT clients recognized the potential in IT contracting but to capitalize on this market it should hire personnel that understands the technical jargon, the business process and the corporate culture inherent in IT contracting. LI typically generates business with a heavy emphasis on outside sales reps making cold calls, while IT sales are generated from telemarketing activities and VMS contracts.

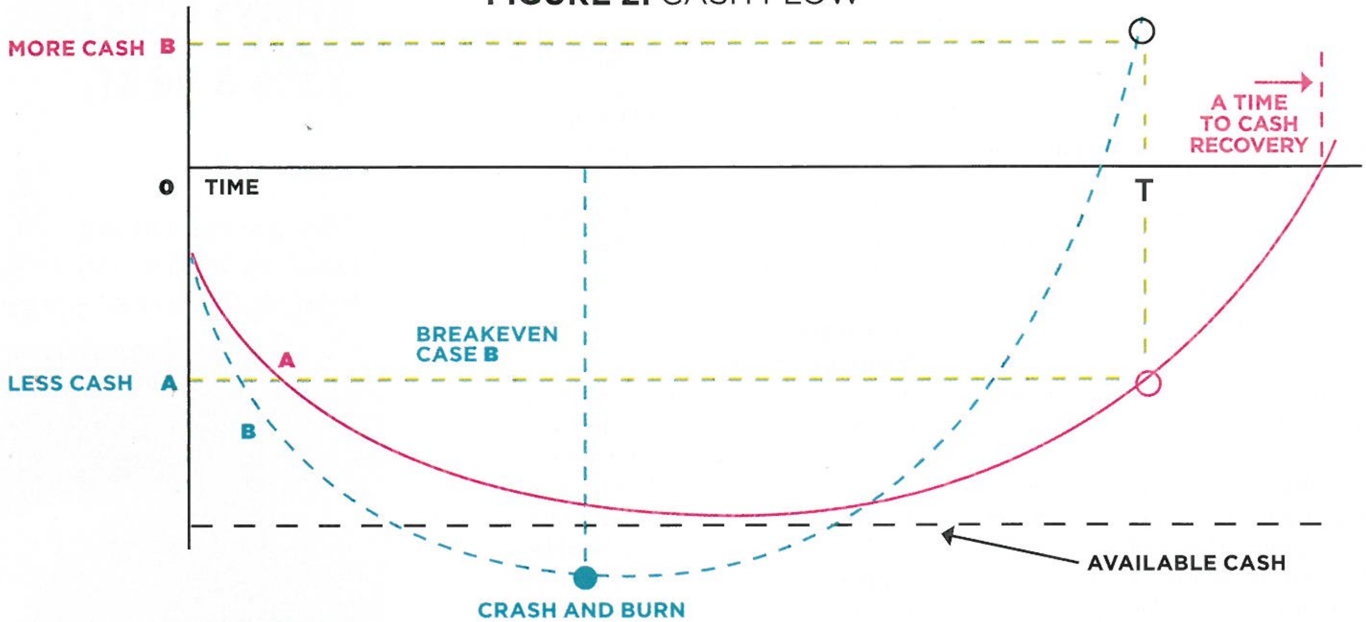
Recognizing Your Limitations

You must be realistic about the prospect of getting money in today's financially conservative market to fund growth. Thus, if you have limited retained earnings and are maxed out on your line of credit (LOC), you may not be able to support a rapid growth. For example, if you were to win a large contract with very thin margins and long payment terms you may have to pass on it if the cost of factoring the receivables destroys whatever gross margins you have generated. You have to consider the risks you may face if you take on more than you can handle plus the costs of liquidated damages for not delivering the goods. Then, we have to evaluate the risk reward ratio. That is taking on something beyond your ability and defending yourself from a potential lawsuit. These are just some of the factors you need to consider in managing growth – either filling in your deficiencies or passing on a great opportunity, but for someone else.
PLEASE SEE FIGURE 1.

Gap analysis is determining how you will build your business from where it currently is heading to where you want to it to be. The difference between the two outcomes is called the void or gap. When properly done, this is converted into a road map of how you can expect to get to your desired end point, with a discrete series of well-thought-out and detailed steps to fill in the gap (A through E). Each step becomes its own business plan that must be regularly monitored and tracked.

Value Added Services. Earlier we touched upon value added services, which are a means of separating you from

FIGURE 2: CASH FLOW



your competition and are critical in today's price-sensitive world. If you do not create and provide these services you will be brought down to a commodity pricing level where much of our industry already is. We have worked with our clients to brand and trademark their value added services. The first step is to assess the client's needs to discover which needs are not being adequately met, and then custom design a program. A sampling, or laundry list, of these services might include volume discounts, alternative billing methods, full-service staffing, training workshops, salary surveys, customized consulting, evaluating existing client employees, manpower planning and assessment, cost savings programs, etc.

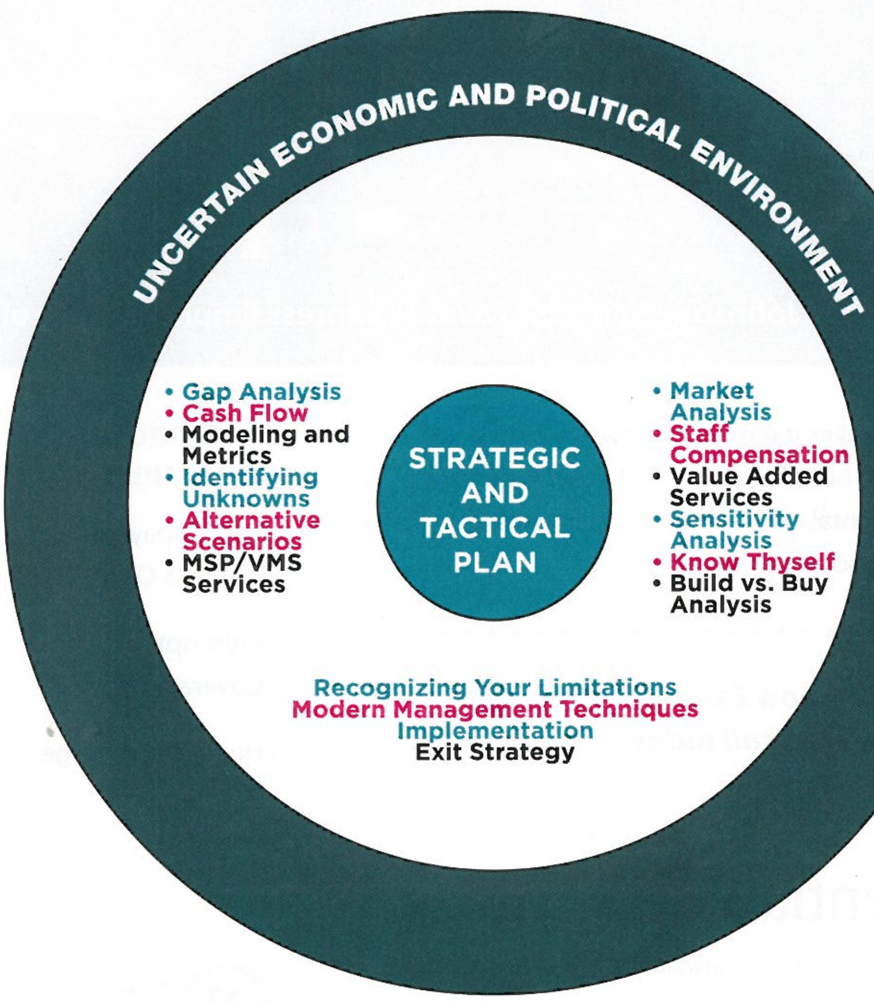
We recommend that a threshold be set to provide these programs free of charge so as not to spread resources too thin and also provide these where they can have the greatest impact. For example, a company might have an account doing $4 million of staffing business in your specialty of which you have a quarter of their business, or $1 million. Your value proposition might be you will provide them with a package of customized services that is hypothetically worth $400,000 (a 10% savings). To the extent that this does not cost you money, such as by lowering your prices, but rather provides your client with the intellectual property that you have created, so much the better. The more items on your laundry list to choose from the better you can customize your service.

MSP/VMS. Unless you were doing your staffing on Mars during the last few years you know there has been a revolution in our industry that was kicked up a few notches due to the recession where every penny is being squeezed out of the procurement process and half of all contingent staffing goes through a filtering process that has commoditized contingent staffing. And this can only be expected to grow. Margins are generally beaten down, as you become just another vendor with no ability to get credit for your value added services. One way to capitalize on this, however, is to take over the MSP/VMS process, which is now possible for mid-sized staffing firms. Using the above example where one has 25% of the business in their core staffing competency, and there is another $4 million in other staffing services, here are the rough economics. You acquire a modestly priced VMS system to manage the fulfillment process. You move from your $1 million level in your specialty generating a 23% margin or $250K/year to $3 million at an 18% margin for $540K. You manage the other $5 million, which might be provided by five staffing firms at 25%, where each subcontractor was generating $250K at a 23% margin. The new arrangement might have three staffing sub-vendors left standing at an 18% gross margin of $300K each. A 3% VMS fee would be charged leaving them with the same $250K in net margin. Assuming a 2% cost to support the VMS system, this would add another $50K to your profits for a total of $590K, or $390K more than you initially generated. And the client saves 5% on $8 million, or $400,000. Often a .5% fee could be charged to them, which they now clearly could afford, further improving your profits. And, even more importantly, you are now in the driver's seat.

Market Analysis. It is surprising how many staffing companies don't know the size of the market they serve. With this information you can determine your market share, which is critical in setting a strategy. For example, if you have grown from 10% to 30% in your market you may find that you have to sacrifice price to increase market share, as your competitors will now be fighting for survival. Your clients may also not want you to monopolize the market. Your strategy may be to enter another market with similar size and growth rates, and you can move from 0% market share to 10% as you did in your home market. But clearly this is easier said than done, and you will need a well-thought-out marketing plan.

Staff Compensation. Any good plan must adequately address staffing compensation. Motivation and retention of key sales reps and recruiters are at the heart of any business. But cash is always king. We normally recommend creating two comp plans: (1) an annual "win-win" comp plan, so that as your profits change so does your staff comp, and in the same direction, and (2) long-term retention plans to keep your best people with you over the long haul. Both plans can only be properly executed by modeling your comp plan as an integral part of your profit plan. After this is done it must be sold

FIGURE 3: INTEGRATING THE ELEMENTS FOR PLANNING UNDER UNCERTAINTY



to the staff so they understand its rationale and that you are both in this together.

Cash Flow. The key difference between an accrual P&L and a cash flow statement is that the former tells you how your business is performing while cash flow tells you if you have enough money to actually to run your business. This is critical if you are operating close to the edge and may go bankrupt before you collect, or plan to grow. Simply stated, the faster you go, the "behinder" you can get. PLEASE SEE FIGURE 2 FOR DETAILS. The example which illustrates this point at a given amount of cash available. In Case B rapid growth leads to bankruptcy (the crash-and-burn point) if operating conditions are not altered. In Case A we are able to avoid this problem although this led to a longer period of time until we can recover the cash we have invested in the business and generate less cash down the road (at time T). However, at least you survive. Case B would be better, but only if you don't run out of money first.

Modeling and Metrics. All well run companies both model their operations and track their metrics. Metrics are an intrinsic part of the planning process and move from the realm of "nice to know" factoids and ratios such as margin rate or fill ratio to an integrated mathematical model or a profitability algorithm allowing you to do "what if" analysis and planning. At a recent owners seminar we demonstrated this and one of the attendees said, "Wow, I never knew there was a practical use for the algebra I learned in school."

For example, if you decrease your margin rate by 5% but you are able to increase your fill ratio by 15% (all other things being equal) you will generate 10% more profit, which is certainly more important than getting higher margin rates. Or, if you measure productivity and efficiency you can determine where the problem is. Thus, if you make more marketing calls and that gets proportionately more job orders (efficiency ratio of JO/marketing calls), you should focus your efforts on productivity (make more calls) not efficiency (converting calls to JOs). This is called management by exception, where you concentrate your efforts on where the problem is as opposed to spreading management resources equally in all areas. The next step is to implement this approach; i.e., which clients you want to reduce margin rates to fill more orders vs. where is your fill ratio maxed out and lowering your prices would accomplish nothing? These are some of the principles that all well-managed companies use today.

Build vs. Buy. Another part of the planning process is determining how much of your growth should come from organic (internal building) growth vs. acquisitions (buying). You can usually grow your business faster via acquisitions than on your own, particularly when entering a new specialty or geographic market, but the risk of buying someone else's headache is a very real one. So acquisitions are not for amateurs, and going it alone is very risky.

Modern Management. You reach a point where you have outgrown your ability to integrate acquisitions, multiple offices, and lines of business or run a larger and more sophisticated organization without adopting modern tools, systems and management expertise. This is called moving from the entrepreneurial to a professionally managed company. Not all owners can make this transition successfully, but with the right staff; an open mind; and willingness to learn, change and accept outside help it can be done.

Know Thyself. Some organizations are very risk averse and unwilling to change, even if this means not growing. If one recognizes they are leaving money on the table that is fine. It is their company and no one has the right to tell them what to do. Nevertheless, if that is their decision they still need a plan based on compliance issues vs. pursuing a growth and profit maximization program. Either approach requires a proactive vs. reactive process so they have enough time to implement whatever their plan is and not be surprised by events that are thrust upon them. They need sufficient time to react because they should have their antennas out for warning signals. These events should trigger you into action with enough time to at least get off the road before you get hit by the proverbial truck.

Exit Strategy. Yet, everything eventually must come to an end. This is called exit planning. The acquisition market is unfortunately not a very good option today, although buyers should be able to get some very good deals. We are, in fact, down some 85% from our highs in late 1998. A good alternative is a management employee buyout (MBOs) option where the team buys the company out of its future cash flow, or even better the ownership transition option (OTOs) where the owner remains an active investor in his company (i.e., chairman of the board), but gives the day-to-day management decision making to his management team, while retaining equity and actual control. This can be done via a pseudo equity arrangement with the management team, which still provides a win-win situation for both parties. It's like selling your company while retaining it, too.

Summary

As you put together strategic and tactical plans, you are surrounded by the external uncertainties of the economy and political events. PLEASE REFER TO FIGURE 3. You have to factor into your thinking all of the controllable elements discussed above, and then develop alternatives, constantly reevaluating your assumptions and making changes to a dynamic process that should increase your odds of being successful. SI

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