

Current Environment for Background Screening Companies

This information is based on a presentation made at the Pre-employment Screeners Conference in November 2010 by Cherie Smith Homa, Managing Director, KPMG Corporate Finance LLC. For a copy of the full presentation, please contact Cherie at csmith@kpmg.com.

The fourth quarter of 2008 marked a change not only for background screening providers but for every company, employee and consumer in the US. However, two years after the collapse of the financial system, the background screening industry is in a much more stable environment. This article discusses the overall environment for background screening companies including an overall market update, an overview of the industry landscape and an outlook for 2011 and beyond.

Overall market update

The health of the background screening industry is closely linked to the health of the overall economy and an understanding of broad economic indicators influences the outlook for the industry. The challenge today is that there is conflicting economic data; there is good news followed by bad news and vice versa. Take two key indicators as an example – growth and unemployment.

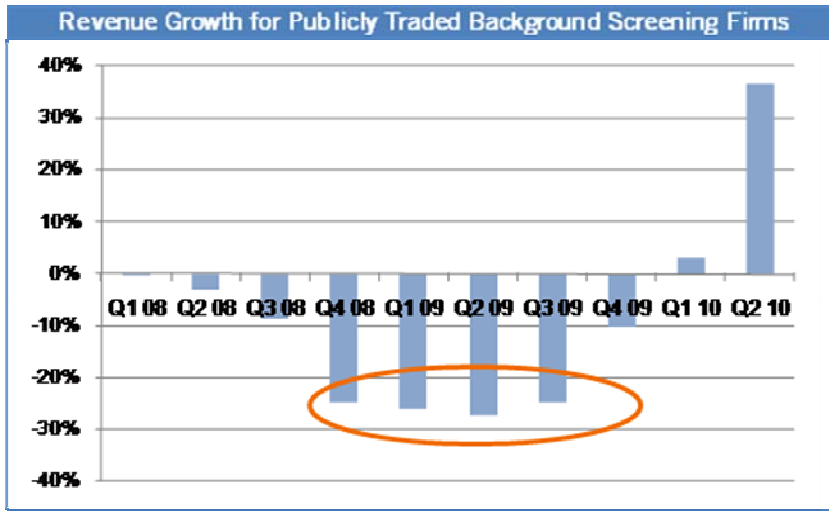
- **GOOD NEWS:** The economy is growing. According to the Department of Commerce real gross domestic product (GDP), the output of goods and services produced by labor and property located in the United States, increased at an annual rate of 2.5 percent in the third quarter of 2010. This represents the fifth consecutive quarter of growth which continues to be driven by a deceleration in imports, rebuilding of inventory, and an increase in personal consumption. According to the latest Wall Street Journal Economic Forecasting Survey, economists expect GDP to increase 2.8 percent for the full year 2010 and 3 percent in 2011.
- **BAD NEWS:** Unemployment remains persistently high. According to the Bureau of Labor Statistics, the number of unemployed persons was 15.1 million in November and the unemployment rate increased to 9.8 percent, up from 9.6 percent in the previous three months. While the unemployment rate remains historically high, it has edged down from the recession's October 2009 peak of 10.2 percent and, since December 2009, employment in the private sector has increased by 1.1 million. That said, at the current rate of job creation, the U.S. would need nine more years to recapture the jobs lost during the recession, not taking into account the 5 to 6 million jobs required for the expanding population.

To date, the recovery has largely been a jobless recovery. Companies are reluctant to invest or hire and are building up cash reserves as a precaution against another downturn. Even so, overall sentiment is for an improvement in the economic environment in 2011, although it is expected to be a long, slow recovery.

Industry Landscape

The background screening industry is highly fragmented and can be characterized by a barbell shape. There are a handful of larger participants, a limited number of mid-sized players and hundreds of small, privately-held providers. In 2010, there are four providers with screening revenue greater than \$100 million, five to 10 providers with revenue between \$20 and \$100 million, 40 to 50 providers with revenues between \$5 and \$20 million and hundreds with revenue less than \$5 million. The total market, which is estimated to be between \$1.6 and \$2.2 billion, has decreased 15 to 25 percent since its peak in 2007/2008.

The chart below highlights the year-over-year quarterly revenue growth for the companies that publicly report background screening revenues. Hiring and screening revenue declined substantially beginning in the fourth quarter of 2008 when the revenue of service providers declined over 25 percent on a year-over-year basis. This challenging environment persisted for four consecutive quarters. While the trend has been improving since the fourth quarter of 2009 and annual quarterly growth returned in 2010, the growth is tempered by the fact that revenues were so depressed in 2009.



During the third quarter of 2010, KPMG Corporate Finance spoke with over 20 background screening providers in an effort to gauge the industry outlook. Every background screening provider is experiencing 2010 revenue growth and expects revenue to exceed 2009 by 10 to 50 percent, with the growth largely fueled by increased hiring among their existing customer base. Not surprisingly, the service providers that experienced the largest 2009 declines are experiencing the highest 2010 growth. That said, very few companies expect their 2010 revenue to exceed their 2008 revenue. They are still off their peak but the outlook for 2011 remains positive. Approximately half of the screening providers interviewed expect to achieve their highest revenue ever in 2011.

With the downturn in top line revenues, providers made substantial changes to their businesses. Providers have been able to maintain margins as they re-negotiated rates with vendors and have focused on process improvements. Although technology is no longer a differentiator in the market, it does continue to drive efficiencies. In addition to technology enhancements, providers reduced headcount on average 30 to 50 percent. Although some providers are hiring again, the hiring represents only a fraction of what was let go. Companies may achieve their peak revenues in 2011 but they will do so with 20 to 30 percent less staff. The silver lining in the downturn is that screening providers believe that they operate much more efficiently today. That should position the providers better for the future.

Outlook for 2011 and Beyond

The background screening industry has matured over the past several years. Providers are more efficient today and are now looking to drive top line revenue growth. What will drive that growth?

- Increased implementation of screening – Although this was a historical growth driver for the industry, we see no meaningful growth in the US from further penetration of the market.
- Taking business from competitors – This will continue to drive specific company growth but will not grow the overall industry. To take business away from competitors, providers have been lowering their prices. While this may be a good short term strategy, it has set a new, lower price level in the industry.
- Enhanced offerings to existing customers – Providers continue to try to adjust their offerings to differentiate themselves and have expanded their offerings, including integrating more with their customers, to maintain and expand their customer relationships.
- Increased hiring – As the economy recovers and corporate spending rebounds, hiring levels will increase. There is embedded growth within the existing customer base. That said, growth in hiring will be more modest as companies are doing more with less people.

Those companies that survived the economic downturn are now better positioned to grow profitably going forward. It is not likely that the industry will return to double digit growth rates but there is a real opportunity for screening providers to continue to become more relevant to their customers and be viewed as a key solution in the recruiting and hiring process.