



# the investigative investor

REAL-TIME REPORTING FROM BLUE HERON RESEARCH PARTNERS

## On the Hiring Line

AS EMPLOYMENT RECOVERS, WILL HR AND OUTSOURCING FIRMS FOLLOW?

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Slowly (if not so surely) jobs are coming back. The recent employment reports have confirmed that hiring is on the upswing. The latest Bureau of Labor Statistics data showed an estimated 431,000 jobs were added in May, although the vast majority of those were temporary Census Bureau hires. Despite the weak private sector contribution, the direction remains up. And on the surface, the monthly results are consistent with the jobs rebound coming out of past recessions.

### THE RECOVERY: JOBLESS VS. JOB ABUNDANT

Pinpointing the nature of job growth is essential to understanding the recovery, and what we found was a mixed bag of responses. **A few sources said they are seeing an early thaw to the hiring freeze that's largely been in place since 2008.** They originally had expected companies to hold off until fall 2010, but now are responding to hiring demands that have begun in earnest. As

The potential for significant price increases may not be realized. To boost revenues, outsourcing managers said they were pushing to add extra services to existing packages.

### ABOUT BLUE HERON RESEARCH PARTNERS

Blue Heron Research Partners is an independent firm that provides fundamental analysis to institutional investors on an exclusive, real-time basis. Our focus is on issues that drive performance, ranging from the strategic and execution skills of a management team to trends taking shape at the sales and operational levels. Our methodology combines investigative journalism and classic value investing tools.

We checked into the staffing and HR outsourcing industry to gain a better perspective on the jobs picture. After all, there are lots of companies that operate behind the curtain of the job numbers, filling open positions faster than they can be posted on a company's website or show up in government surveys. Conventional wisdom says that HR companies such as ADP, Manpower, and Paychex will realize gains in lockstep with jobs returning. Those companies should also increase their operating leverage as employment picks up.

But the recovery may be different this time around, with consequences for the employment services sector. We did a spot check by talking to 10 industry sources about the potential for growth in staffing and HR outsourcing. Here are highlights of their views and concerns.

a recruiting manager in Houston said, "We have seen things definitely pick up, beginning late January or early February. One thing we've found a little different this year is that the positions are at a higher level." But other sources cautioned that the economy will remain in a hiring lull, with many businesses taking a wait-and-see strategy on filling positions. The general outlook: jobs are going to be added only as needed, with companies hiring more aggressively only if they have an improved forecast.

### INTERNAL VS. OUTSOURCING

Most sources said that hiring is occurring, but in a more focused, job-specific way. Said the president of a regional HR outsourcing

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**ON THE HIRING LINE** (continued from page 1)

company in Washington D.C., “We know that the market is certainly warming up, and we’ve seen more project-based work being turned on, less so full-scale outsourcing.” Businesses are adding jobs strictly by necessity, and multiple sources said that companies are tapping internal resources and promoting organically before outsourcing their needs to a staffing agency. A regional HR consultant in the New York area told us, “[Outsourcing] is kind of a last option—they’re trying to exhaust all of their internal resources before they have to ramp up again.” This theme was echoed by Paychex CEO Jon Judge in his company’s conference call in late March, when he noted that fewer companies were looking to outsource while he reduced his revenue outlook for 2010.

**PRICING POWER**

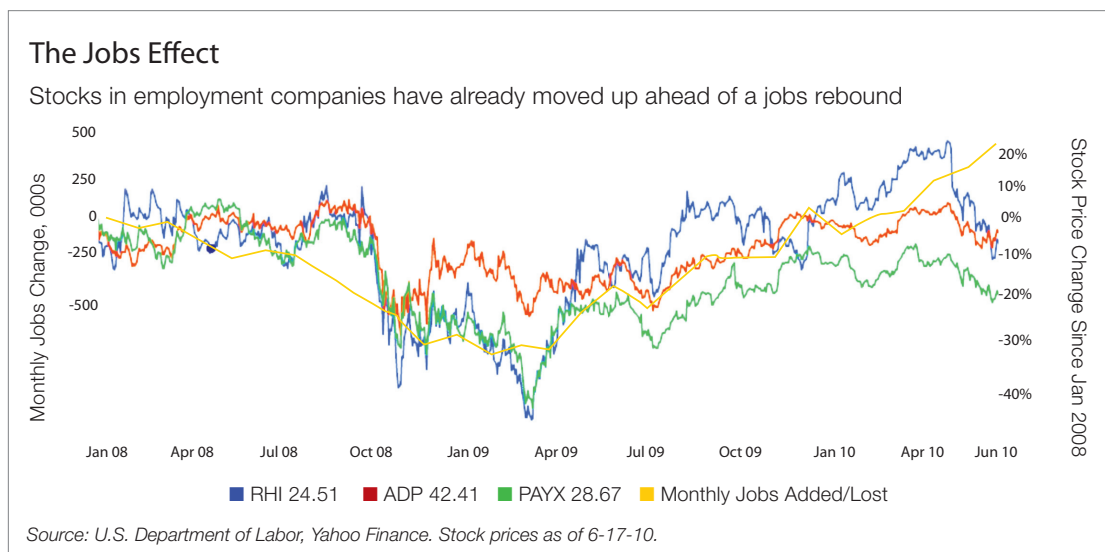
Most sources explained that their fees have remained relatively stable in recent months, with pricing power expected to return as the job market tightens. In fact, some sources said they were turning down some companies that tried to negotiate lower rates. Said one source, “We have had some clients that said, ‘You need to give us a rock-bottom deal because of the market,’ and we’ve actually walked away from some of those.” But the potential for significant increases may not be realized. To boost revenues, outsourcing managers said they were

pushing to add extra services to existing packages, while keeping prices constant in order to attract business. In some cases, firms are scaling back packages so they can maintain the relationship. As one HR executive said, “Because people are watching their money, we created a lower-cost service option that is less expensive than our full-scale outsourcing services.”

**OUR TAKEAWAY**

The return to positive jobs numbers will certainly boost the top line at HR and outsourcing companies. And the larger players will get the bulk of that increase. As a senior HR sales manager in Nashville said, “You have to be a Paychex or ADP to be able to sustain yourself in growth and market. If you don’t have the volume, you just can’t make the dollars.” We would be concerned, however, that **the jobs rebound may not expand the need for HR outsourcing dramatically.** If anything, companies responded to the recession by outsourcing whatever they could, on top of the outright cuts to their payrolls. With the recovery underway, they may just tighten their belts more and handle as much as they can internally.

We’d be happy to dig deeper into this sector for a client that wants to know more. As always on projects, we can find and talk to dozens of qualified sources in the trenches in the industry, and bring back real-time results. Please call or email us for more information on getting started. ■



TRUCKING

# Shifting Gears

HOW A CHANGE IN ENGINE REQUIREMENTS MAY IMPACT TRUCK MAKERS

The road ahead for the trucking industry is getting cleaner—and costlier. In 2010, the U.S. Environmental Protection Agency has tightened its emissions standard to 0.2 grams of nitrogen oxides per horsepower hour. This significant reduction (versus the previous standard of 1.2 grams) has forced diesel engine manufacturers to bring out new models to meet the requirements, which in turn has spurred price increases of about \$10,000 for new trucks.

Truck buyers and lessors have been down this road before. The previous change in EPA emissions rules took place in 2007, when an average \$5,000 price increase led to massive pre-buys. The rush to beat the price hike inflated sales in the quarters prior to the regulation's enforcement period and depressed sales in the following quarters.

This time around, OEMs have witnessed a rather weak pre-buy during 4Q09 and 1Q10. They point to the abysmal difference in the economics of the two milestone years. Only

a few customers with high levels of certainty about their future freight contracts bought ahead of the increase. Everyone else decided to postpone buying as a tradeoff for more certainty. **These holdouts could hold the key to what growth will look like for the major truck makers for the rest of 2010 and into 2011.** Learning why they didn't buy and their alternative strategies could shed some light into the future market dynamics.

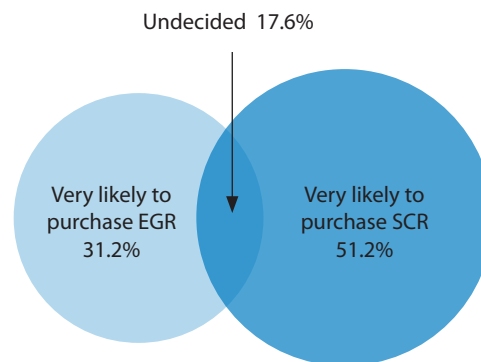
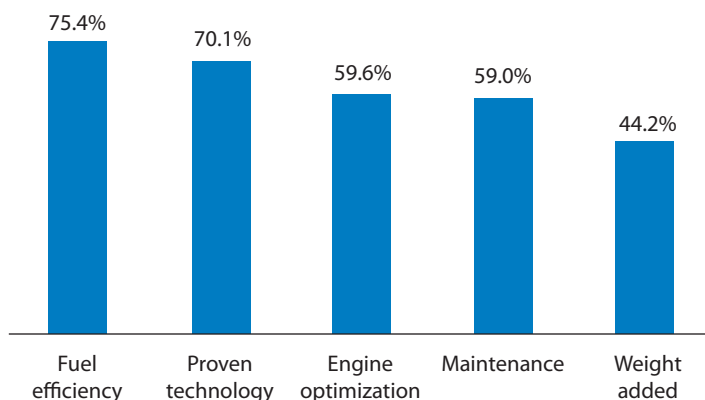
"In past years part of the pre-buy was not only related to pricing but fuel economy," said one truck dealer on the West Coast. Indeed, previous EPA changes hurt fuel economy, costing the fleets more money on an operating basis. As a multi-brand dealer in the Midwest said of the massive 2007 pre-buy, "There was a common understanding that the price of the unit was going to go up, and that the fuel mileage was going to go down." Fleets knew what to expect from the older engines and the decision to pre-buy seemed like a no-brainer.

*Continued on page 4*

## Choosing Sides

Truck buyers must choose between two technologies to meet new emissions standards. Fuel efficiency is better but more expensive with SCR.

Important factors in buying a 2010 compliant engine  
(% saying very important)



Source: Navistar Q2 2010 presentation, survey of potential buyers

## SHIFTING GEARS *(continued from page 3)*

### ENGINE OPTIONS

The 2010 requirement has led to two engine technologies, which take different approaches to meeting the standard. One version, SCR (Selective Catalytic Reduction), is expected to be an upgrade in terms of fuel mileage. “With the new trucks and technology, fleets will enjoy a 3-5% increase in fuel economy, which is a huge savings to a large fleet,” said a dealer.

But SCR requires the use of urea, which is an extra cost for an added tank, and somewhat of a change in maintenance and operating practices. What’s more, the system usually increases overall engine weight, which decreases payload. According to one calculation, it would take roughly 750,000 miles for the fuel savings to compensate for the SCR price increase.

The other technology, EGR (Exhaust Gas Recirculation) is essentially a progression from the EPA 2007 engines, which had a reputation for hurting fuel efficiency. While these engines will not modify maintenance or operational protocols or payloads, they have raised questions about engine durability and oil degradation issues. **Navistar (NAV)** has been an outspoken proponent of EGR, while most of the other OEMs have lined up behind SCR.

### A WEAK PRE-BUY

The result is that fleets have a tough decision to make before jumping in with all 18 wheels on the new trucks and engines. There’s a delicate equation to be solved between fuel economy, maintenance costs, and forward demand. As one dealer noted, **“We are seeing a little bit**

**more bid activity on these trucks, but when they get to the surcharge, a lot of them don’t buy the unit at that point. They just back off.”**

The real test will come once the industry runs out of the older engines and the new emission standard takes effect; both technologies will then compete for buyers. Because the 2010 pre-buy has been weak, some in the industry expect the second half of 2010 to be light on demand as well. But many of our sources said they expect stronger sales for the rest of the year. Some OEMs are starting to reduce their prices, lowering the sticker shock. And U.S. truck tonnage and sales have been rising for several months; through April, net orders were up 72% year-over-year.

Compare this to the muted forecasts coming from the major OEMs. They have been conservative in giving guidance on sales growth for the year in North America. **Daimler AG (DAI)** expects 10%, while **Paccar (PCAR)** forecasts as little as 2% for its low end. On its June 9 conference call, Navistar said it expects sales to stay flat at 4Q09 levels until an increase in late 2010. Part of the reluctance to boost sales guidance is due to softness in construction and vocational truck sales. But the fleet operators, like **JB Hunt (JBHT)**, **Landstar (LSTR)**, and **Werner (WERN)** are all reporting higher earnings and pointing to strong full-year results.

So there’s a fork in the road ahead for the OEMs and related companies. Which direction the industry may take bears watching, as the new engine decisions get made. ■

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## VIEWPOINT

## Building a Better Research Model

## HOW WE'RE INVESTING IN OUR OWN BUSINESS



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Every time we examine a business, we ask about how effectively the company invests its money.

In the spring of 2005, six months before launching Blue Heron, I took a job as the world's oldest unpaid intern. As a financial journalist, I understood how to dig for information, but I needed to learn more about how investors think. So with a blessing from my ever-patient wife, I found a small-cap value hedge fund that was understaffed and convinced the manager that if he could teach me the basics of crunching numbers, I could show his analysts how to perform qualitative research.

The fund had an unusual discipline. We built all the financial models from scratch, piecing together years of 10-Ks and determining on our own what happened to every dollar a company took in or spent. When a CEO announced a new plant, for example, we would call around to price out the actual costs versus what the company intended to spend. The goal was to find undervalued companies that were earning more than their cost of capital. While my first instinct was that most companies earned more than they spent on their investments, I soon realized that many companies blow their capital on stupid acquisitions, poorly timed expansions, or aborted strategies. This might be something that Warren Buffett has known since birth. For me, it was a revelation.

In fact, every time we examine a business, we ask about how effectively the company invests its money. Does the CEO capitalize on opportunities, or run for cover when things get tough? How accountable is management for meeting long-term expectations? Is capital allocation knee-jerk or strategic? What's more, I also apply this understanding to how we operate as a business. If our goal is to be the best specialty research firm available to investors on an exclusive basis, what steps do we need to take with own people and processes?

During 2009, when a lot of investors slashed research budgets in response to their negative returns in 2008, many people were telling us to hunker down and ride out the storm. Instead, we

doubled down. We launched an external newsletter using our proprietary reporting. This enabled us to stay in front of clients and also keep our bench active. Then we allocated funds to build a better database so we can track the 15,000-plus sources we've interviewed. And we spent several months working with outside legal counsel to develop a compliance plan that protects our clients and shows them that we are a long-term partner.

More recently, we've formalized two roles that are integral to how we function. Eric Garland, a veteran journalist and entrepreneur, joined us a year ago to help edit projects. He's now taken on the role of Director of Research. This newsletter is a product of his efforts. On the business side, we brought on John Tesoro, an investment banker and institutional sales manager with senior-level experience at Pacific Crest Securities, Adams Harkness, and Alex. Brown. John's role is to build client relationships within a framework of exclusive, customized, and collaborative investigative research. These roles follow the decision to put my long-time partner Thor Wasbotten in charge of compliance and training. Thor coordinates closely with our law firm and is unquestionably ethical and passionate about protecting our clients.

These investments have established a blueprint so we can continue to improve the quality and breadth of our research. For instance, we now have a researcher based in Europe who has expertise covering some of the most complicated healthcare companies around the world. We're also exploring new hires in Asia and South America.

How will we know if we are investing properly? Like many companies, the answer comes down to the customer. We welcome your feedback. Tell us whether you are getting a service that helps you make better investment decisions. What aren't you learning that you need to know? What sectors do you care about? If there's one other thing I learned about companies that invest successfully, it is that the people in charge must also be good listeners. ■