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<b>New Rec: Administaff</b>	<b>(ASF-\$29.85)</b>	<b>December 19, 2001</b>
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**Position: Sell      Target: \$15      Timing: 2 (1=aggressive; 5=cautious)**

\$MM	Q4 01e	Q1 02e	Q2 02e	Q3 02e	F2001e	F2002e	F2003e
<b>Revs \$</b>	<b>1,205.9</b>	<b>1,137.6</b>	<b>1,211.1</b>	<b>1,293.0</b>	<b>4,380.0</b>	<b>5,048.0</b>	<b>5,850.1</b>
<b>EPS \$</b>	<b>0.39</b>	<b>(0.19)</b>	<b>0.15</b>	<b>0.35</b>	<b>0.67</b>	<b>0.78</b>	<b>0.89</b>
<b>Y/Y Gro</b>					<b>15%</b>	<b>16%</b>	<b>13%</b>
<b>PE</b>					<b>44</b>	<b>38</b>	<b>34</b>
<b>PSR</b>					<b>0.20</b>	<b>0.17</b>	<b>0.15</b>
<b>Consnsu</b>	<b>0.39</b>	<b>(0.19)</b>	<b>0.15</b>	<b>0.36</b>	<b>0.67</b>	<b>0.85</b>	<b>1.13</b>

**Shares Out: 28.9M**

**Market Cap: \$863M**

**FYE: Dec**

Summary: Administaff (ASF) is a professional employer organization (PEO) providing outsourced human resources to small and medium size white-collar businesses. A PEO is an organization that manages the administration of human

resources and employer risks for its clients. Basically, it provides benefits administration for things like health insurance and pensions, and it processes payroll and tax returns, and sometimes manages the hiring/firing process.

The company was founded in Houston, Texas in 1986 and went public in January 1997. ASF was a first mover in the Texas PEO market and as a result has had great success in that state. At the time of the IPO, Texas represented 81% of ASF's revenue. The company has a total of 9 sales offices in Houston, Dallas, Austin, and San Antonio, which represent its original markets. Since then, ASF has tried to duplicate the success it had in Texas with an expansion into most metropolitan markets within the United States. As of Q301, 56% of ASF's revenue was generated from 26 Non-Texas sales offices, with the remaining 44% from the 9 sales offices in Texas.

The critical revenue drivers in the PEO business model are worksite employees (WSE) and fees per worksite employee. In 1998, 1999 and 2000, ASF posted annual OWS estimated actual WSE growth of 26%, 29%, and 38% respectively. However, in 2001, year over year quarterly growth rates increasingly declined, to 14%(Q1), 9%(Q2), and 7%(Q3).

Competition in the PEO industry is intense and barriers to entry are low. The two biggest competitive advantages in the industry have been "first to market" recognition and pricing. ASF was the "first to market" in Texas, which was an advantage. It currently receives a premium price for its services, which is not at all an advantage, as we will discuss.

ASF is considered a high growth company by the "street" and has been awarded a high stock price. Currently, the stock is trading at \$29.85, which represents 35 times estimated 2002 EPS of \$0.85, which is just a 27% expected EPS increase over 2000. The "street" is then aggressively forecasting a 33% EPS growth rate in 2003, to \$1.13, and a 27% increase in 2004, to \$1.44. The "bull" story is that ASF can duplicate the market dominance it established in Houston, Dallas, San Antonio, and Austin in other major metropolitan cities across the country.

In its Q301 conference call, management provided guidance for 2002 and forecasted an EPS growth rate of 25%-30%, to \$0.86-\$0.90 per share. It stated that in order to achieve this EPS growth target the company needs to grow average WSEs by "only" 18,000 or about 25% Y/Y. Management believes this is achievable and cites its Q301 45% increase in its sales force over the year ago period as the reason. Management also stated that its 25%-30% EPS growth factored in no improvement in the economy and no increase in pricing. Bullish analysts applauded ASF's 2002 projections and believe there is significant potential upside to these numbers. First, they say ASF has historically faced no

problems in raising prices and second, a weak economy could be even better for ASF, as small businesses are more likely to enter into money saving arrangements.

We doubt that ASF can meet these aggressive expectations. First, Texas has become a problem for ASF. We estimate that growth has slowed substantially in Texas. Indeed, we estimate that ASF actually lost ground in Texas recently and that average WSEs actually declined year over year in Q3 01. This is not what bullish analysts expect to happen in Texas. The problem in Texas appears to be caused by two developments. First, ASF has raised its prices in Texas, as it has elsewhere, to the point where it is not generally competitive. ASF raised prices 14% and 19% in Q201 and Q301 respectively, twice the rate of its historical increases. We think these price increases are largely driven by higher costs, which we discuss below, and by a desire to meet "street" expectations. However, we think these increases are also clearly harming the business. Second, it appears that many of ASF's best sales people in Texas have left the company and have joined competitors. We have spoken with some of these former reps and they tell us that they are able to quote lower prices with their new employers and that they are winning business from ASF. We discuss this problem in more detail later.

Texas alone could not provide enough of a market for ASF to meet "street" expectations for growth. As a result, ASF has expanded outside of Texas. In our view, the campaign to grow outside of Texas is not going well. First of all, it appears to be one of the main drivers behind ASF's rapidly rising cost structure. Second, rates of growth outside of Texas are already slowing. High prices and lack of a first mover advantage appear to be hindering ASF outside of Texas.

Here in New England, for example, ASF is quoting prices for small business accounts that are substantially above the prices that competitors are charging. This is mostly due to higher administrative fees that ASF charges compared to the competition. We know that the cost of health benefits and worker's comp insurance are basically the same at all the competitive PEOs. We estimate that the fees that are being charged by ASF in New England can run as much as 171% higher than the competition in year one, and 134% higher in the second year and beyond. We think, under these circumstances, ASF will not make the kind of headway outside of Texas that the "street" is hoping for.

"Street" analysts seem to believe that all ASF has to do is put more feet on the street (Main Street) in order to gain lots of business. This does not appear to be the case, and the evidence is to the contrary. ASF is trying to impress investors with talk of new offices, which implies growth. Here in Boston, for example, ASF announced the opening of a second office. However, much to our

surprise, it turns out that the second Boston office is actually in the same location as the first Boston office. Was the announcement just meant to impress investors?

We think that ASF is between a rock and a hard place. It must raise prices in order to keep up with its rising costs so that financial results are not disastrous while it tries to expand to meet WSE growth expectations. However, these high prices are making ASF uncompetitive in the market place. Former ASF sales people confirm this notion.

ASF is expected to grow average WSEs by about 18,000 in 2002 in order to meet earnings expectations. In addition, gross margins are supposed to improve without price increases. We estimate that neither of these exceptions will be met. As we detail below, we expect ASF to gain about 12,000 average WSEs in 2002, and for operating margins to slightly increase by 75 basis points to 16.5% as rising operating expenses are offset by a 250 basis point increase in pricing. Without a pricing increase, operating margins should decline, in our opinion, and ASF's results would be worse than we forecast. The result is that we estimate that ASF will earn \$0.78 in 2002, and \$0.89 in 2003. The "street" expects EPS of \$0.85 in 2002, and \$1.13 in 2003.

We think that ASF shares are worth approximately 16 times our 2002 estimate of \$0.78, which represents EPS growth of 16% over 2001. This yields a share price of \$12.50. 15 times our 2003 EPS estimate of \$0.89 would give a \$13.35 stock price. We are setting our initial target at \$15.

#### Background:

ASF records revenue according to the standards established under EITF 99-19, *Recording Revenue Gross as a Principal rather than Net as an Agent*. Basically, ASF records the payrolls of its small business customers as revenue, whereas its real economic revenue is only the markup fee (gross profit) it receives, almost all of which is a discretionary administration fee. As a result of grossing up its revenue, ASF was able to record revenue of \$3.7B in 2000, rather than its "gross profit", or fees, of \$139M. When we refer to operating expenses as a % of revenue, we use gross profit as the denominator, as we think fees comprise the true revenue of the company and are more relevant than gross revenues.

#### Discussion:

1. Losing ground at home. Texas growth has slowed

a. ASF began operations in Houston, Texas in 1986. The company

established a strong customer base in Houston, and in 1989 widened operations to San Antonio and Austin. After duplicating its Houston success in these two additional markets, the company opened a Dallas office in 1993. Currently, ASF has nine sales offices in the state of Texas. ASF had a first mover advantage in Texas. As a result, the company was able to gain a dominant market share in the major Texas markets while maintaining aggressive pricing. This dominance paid off in 2000 when the company grew its average Texas WSE base by 11%, 20%, 19% and 28% on a Y/Y basis in Q1 through Q4 respectively. However, in 2001, these growth trends reversed, as shown in the table below:

Estimated Texas Avg. WSEs

	Q499A	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Texas	25,396	28,565	31,076	32,204	32,613	30,897	31,495	31,097
Y/Y% chg.	-6%	11%	20%	19%	28%	8%	1%	-3%

In its public filings, ASF discloses the percentage revenue from the Texas markets as well as total monthly average WSEs in aggregate. Therefore, it is possible to calculate a reasonable estimate for average Texas WSEs. For the calculation above, we assumed each WSE represents the same portion of revenue. In reality, the Texas WSE totals are probably slightly larger due to non-Texas markets having larger salaries, but for the sake of simplicity, the method we use is adequate to demonstrate that average Texas WSE growth slowed in 2001. In fact, we think the above table is evidence that ASF actually lost ground in Texas in the third quarter.

b. Competition within the PEO industry is increasing, especially in Texas, according to our sources. This notion is supported not only by ASF's slowing growth in Texas, but also by our discussions with industry sources. Due to the size of Texas, it is considered by most PEOs as one of the most significant opportunities for growth. However, competition is not coming from an increase in the number of new PEOs, but from existing companies that have become more formidable competitors, such as Team America (TMOS), E3, and Advantech. According to multiple sources, these companies have become increasingly competitive and are taking market share from ASF in its Texas markets, especially in the Dallas market.

Several of our sources are former top ranking ASF sales representatives. These people tell us ASF lost many of its top performing Texas reps over the past 24 months due to a change in the commission structure. These reps went to competitors.

The original ASF Texas market reps had large "books" of business. After several years of high growth, ASF begin to cut commission rates on existing clients. Many of the original reps were unhappy with this and went to work for

competitors. Our understanding of the sales rep attrition is as follows: Dallas lost four of its top reps in Q200, Houston lost four of its best reps beginning in Q499, and San Antonio lost four of the original five who started the office beginning in mid-1999. We think, as do our sources, that the loss of experienced reps in these markets has caused a loss of WSEs for ASF in Texas. The former ASF reps are taking back their old customers. Sources in Dallas and San Antonio confirmed this, claiming to have taken former clients to their new employers. They told us it has been easy because it is simply a value proposition to small business owners, and their fees may be just 50% of ASF's. We will discuss the problems with ASF's value proposition below.

According to our calculations, ASF's average Texas WSE base peaked in Q400 at 32.6K and has since declined to 31.1K as of Q301. This is alarming, as Y/Y quarterly Texas average WSE growth ranged from 11%-28% in 2000 and turned negative in Q301. This data supports the comments we are hearing from industry insiders about the increasing competition in Texas and ASF's recent loss of clients to its competitors.

Given its problems in Texas, ASF needs to expand outside of Texas. However, expansion outside Texas will be less profitable and will be difficult, in our opinion.

## 2. Markets outside Texas have been harder to penetrate.

a. Even before ASF went public in 1997, it was clear that Texas alone could not provide the level of growth needed to maintain an increasing stock price. Therefore, it was necessary to have a market presence outside of Texas. In 1989, ASF initiated its national expansion plan by opening an office in Orlando. The next non-Texas office was opened in Atlanta in 1994. Since then, offices have been opened in Phoenix, Chicago, Boston, New York, New Jersey, San Francisco, Los Angeles, St. Louis, Baltimore, Washington D.C., Denver, and Charlotte. As of Q301, ASF had 26 non-Texas sales offices in 18 markets.

The new markets into which ASF expanded have not been as receptive to ASF as were the Texas cities. We attribute this to the lack of "first mover" advantage and to ASF's high prices. While ASF was busy opening new offices in Texas from the mid-80's to the early 90's, other PEOs were doing the same in non-Texas markets. As a result, expansion into new markets has been increasingly difficult and costly. Below we illustrate that ASF has not been able to duplicate its Texas success.

OWS Estimated avg. WSEs per Region

	Q100	Q200	Q300	Q101	Q201	Q301
NE	4,011	5,657	6,583	7,958	7,399	8,146

SE	6,185	6,701	6,805	6,468	6,584	7,154
Central	6,291	7,232	8,210	8,759	9,231	9,846
Texas	28,764	31,059	32,072	31,005	31,495	31,097
West	8,636	10,286	12,052	13,271	13,168	14,592
Total	53,897	60,934	65,722	67,460	67,878	70,835

Y/Y chg. in OWS Estimated avg. WSEs per Region

	Q100	Q200	Q300	Q101	Q201	Q301
NE				99%	31%	24%
SE				5%	-2%	5%
Central				39%	28%	20%
Texas				8%	1%	-3%
West				54%	28%	21%
Total				25%	11%	8%

We calculated the above tables from information in ASF's public filings. We are able to provide figures for Q1 00 through Q301 because ASF began reporting regional revenues as a percentage of total revenues and Y/Y regional revenue growth in Q201. Using the Y/Y comparative disclosures from Q201 and Q301, we were able to back into the Q1 00/01 balances.

The regional comparison of average WSEs above is evidence ASF has not been successful duplicating its Texas dominance in non-Texas markets. Bullish analysts counter by saying it takes time for sales offices to develop. While there is certainly some truth to this assertion, it is also important to understand that it is taking ASF substantially more sales offices to generate the same quantity of average WSEs as it did in its original markets. In other words, the business model is deteriorating as ASF goes outside Texas.

For instance, in 1996, after ten years of being in Houston, ASF had about 12,000 WSEs from two sales offices in this city. After twelve years in Orlando (1 office), five years in Charlotte (1 office), and eight years in Atlanta (3 offices), we estimate ASF has only 8,100 WSEs in these five Southeast sales offices. Also, we estimate ASF has only 14,600 WSEs in its nine Western region sales offices, 5 cities. We think the low number of WSEs per sales office is indicative of the difficulty ASF is experiencing with its expansion plan.

b. ASF has historically increased the pricing of its service offerings per average WSE by about 7%-9% annually, but in Q201 and Q301, ASF increased Y/Y prices per average WSE 19% and 14% respectively. These were the first Y/Y double digit price increases since Q499. The "street" applauded ASF for "successfully" instituting such large increases. However, we think the large price increases are more indicative of the increasing costs and problems associated with generating new business outside of Texas. While ASF increased pricing 19% and 14% per average WSE in Q201 and Q301, its operating

expenses per average WSE increased 18% and 13% respectively. This was the first time operating expenses per average WSE increased at a double digit rate since Q499. In the end, the large price increases instituted by management and applauded by the “street” resulted in only nominal gross margin percentage improvement.

We inquired of other regional and national PEOs and found that they, too, raised prices, but not at double digit rates. Our sources tell us ASF has been extremely aggressive at increasing pricing and as a result, has had high attrition of its existing client base in 2001. Competitors think ASF is at the top of its pricing potential, as it has been raising the price of the already most expensive offering in the industry. We also think ASF will have difficulty raising pricing in the future. We have examined ASF's pricing in New England compared with three New England competitors. The first year fees for the same package that were proposed by ASF were 171% higher than the second highest quote. We will detail these quotes later.

c. The market for PEO services is very competitive and the purchasing decision of a small business owner is most often based on price. While small businesses are price sensitive, ASF management has stated it is not interested in customers who purchase based primarily on price. It claims to be looking for businesses with a “definitive getting better agenda.” We are not sure exactly what that means, but we think it translates to ASF is looking for businesses that are less price sensitive. ASF’s recent results suggest such businesses are becoming harder to find, as we estimate ASF has signed up 6.7K new WSEs for the first nine months of 2001 versus 20.5K for the same period in 2000. We think the sudden drop in new WSEs is the result of the price increases instituted by ASF. As we have noted, in 2001, it appears that the Texas base of WSEs shrunk and growth rates from Non-Texas markets declined significantly.

3. The problem can be seen in the numbers. Operating expenses per average WSE rose very rapidly in the first nine months of 2001. This was offset by price increases. However, ASF's ability to raise prices is limited. Moreover, price increases have slowed WSE growth. This poses a difficult dilemma for ASF.

a. Operating expenses per average WSE increased significantly in 2001. For the first nine months of 2001, Y/Y operating expense per average WSE increased 15% versus 1% for the same prior year period.

### Quarterly operating expenses

	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Operating Expense	25,404	27,862	29,494	33,540	36,332	36,760	36,030
Opex per WSE	471	457	449	493	539	542	509
Y/Y Chg. per WSE	3%	2%	-1%	6%	14%	18%	13%

After Q400, it appears that ASF lost its ability to control costs. Operating costs increased substantially as ASF continued to expand outside Texas. ASF opened five new sales offices in the first nine months of 2001, the same as in the prior year nine months. However in 2001, it appears that the profitability of these offices was not adequate to keep the operating expenses associated with the new offices in line with previous quarters. Operating expense per WSE increased at double digit rates for each 2001 quarter. Though volume of WSEs rose, it did not rise fast enough.

b. ASF has been offsetting rising operating expense per WSE with higher price increases. In the first nine months of 2000, ASF increased Y/Y pricing 4%, but in 2001, as operating expenses escalated, it increased Y/Y pricing 14% for the same period. This is illustrated below:

### Quarterly Price Increases

	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Gross Profit	20,705	31,342	40,067	46,420	27,829	41,539	49,321
Gross Profit/ WSE	384	514	610	683	413	612	696
Y/Y chg per WSE	9%	4%	2%	8%	7%	19%	14%

ASF's gross profit is based on three things: the spread between the cost of health benefits and what ASF can charge, the spread between worker's comp and what ASF can charge, and an administration fee. The rising gross profit spread is mainly the result of increasing administration fees. It has become very difficult to make money on increasing the spreads on health insurance and worker's comp.

Y/Y pricing per average WSE increased faster than Y/Y operating expenses per average WSE in six of the last seven quarters. This is a key selling point of "bull" analysts as it allowed ASF to maintain increasing operating margins per average WSE. However, the more ASF expands, the more difficult this has become. Evidence of this difficulty is shown in Q201 and Q301, when ASF had to make substantial increases to its pricing to match higher operating expenses. This allowed the company to mask the rapidly rising operating expenses.

As previously noted, ASF has historically increased pricing 7%-9% annually. In the past, price increases in this range have been sufficient to increase operating margin dollars per average WSE. In Q201 and Q301, the very high additional operating expenses associated with expansion outside of Texas put Y/Y increasing operating margins per average WSE in jeopardy. As a result, the company significantly raised pricing above the historical average to maintain the trend. Below we illustrate what would have happened to the Y/Y change in operating margins per average WSE had ASF raised pricing at the high end of historical increases, 9%, and not at 14%-19%..

Actual operating margins vs. 9% historical pricing increase (per avg. WSE)

	Q200	Q300	Q201	Q301
Actual Gross Profit	514	610	612	696
Y/Y chg.	4%	2%	19%	14%
OWS Gross Profit			560	665
Y/Y chg.	4%	2%	9%	9%
Operating expense	457	449	542	508
Actual Op. Margin	57	161	70	188
Y/Y chg.	28%	10%	23%	17%
OWS Op. Margin			18	156
Y/Y chg.			-68%	-3%

Had ASF raised pricing at the high end of historical rates, operating margins per average WSE would have decreased Y/Y by -68% and by -3% in Q201 and Q301 respectively.

Industry sources tell us that ASF already has very high prices relative to the competition. They tell us that they have been gaining market share as a result of ASF's high pricing structure. We discuss the issue of ASF's ability to continue to raise prices in more detail below when we compare ASF's prices to its competitors.

c. We expect operating expenses to continue to increase per average WSE in 2002. ASF has undertaken three high cost initiatives for 2002. Those initiatives are: 1) The opening of six new sales offices, 2) The completion of a new 40K square foot addition to the corporate headquarters in Houston, and 3) The opening of a new 170K square foot service center in Los Angeles.

We think these initiatives will continue to increase operating expenses. With these additional costs, we estimate that ASF can only meet its 2002 EPS targets by either growing its WSE base by about 20%, or by raising prices. However, we doubt that ASF can succeed with either of these strategies.

d. It will be difficult to raise prices any more. ASF already has the

highest prices in the PEO industry. The recurring theme we heard in the course of our research was ASF is too expensive. To verify this fact, we compared price quotes from four New England PEOs including ASF. The criteria used was the same for all quotes. Those criteria were 1) 12 employees, 2) Annual payroll of \$1.5MM, 3) 100% employer paid HMO, and 4) Workers' compensation code of 8810 (clerical) for all employees. The results were as follows:

	A=B+C+D+E	B	C	D	E=A-B-C-D		
Company	Total	Taxes	Health	WC	Admin Fee	Enrollment fee	Year One Cost
ASF	180,750	83,949	54,924	2,700	39,177	7,500	46,677
Company 1	147,417	83,949	52,128	2,700	8,640	300	8,940
Company 2	150,153	83,949	46,800	2,700	16,704	545	17,249
Company 3	156,573	83,949	54,924	2,700	15,000	600	15,600

All the PEOs that provided quotes for the proposed job used a full disclosure model, except ASF. By full disclosure, they show the client how much it is paying for each component. There are three components to each of the PEO quotes. Those components are 1) Health benefits, 2) Workers' compensation, and 3) Administration fee. The administration fee is where PEOs generate the great majority of its gross profit. It is the markup, or discretionary part of the fee. Benefit costs are typically passed on to the client.

Because ASF quotes the job as a flat percentage of payroll, it is difficult for the client to know exactly what it would be paying for each component. However, given the higher degree of specificity in the other three quotes, it is possible to make a reasonable estimate. To calculate the administration fee embedded in ASF's quote, we calculated all the employer taxes based on the criteria submitted. We used the same workers' compensation factor quoted by the three other PEOs (it was the same for all three) and we took the highest health insurance quote offered by the three PEOs. We used the highest health quote because that is more conservative in computing the administration fee. If we used the lowest health quote, the administration fee would have been higher. The result was that ASF's fee is 134% higher than the next highest competitor. To ensure this figure was reasonable, we verified it with former ASF sales reps. Based on the job criteria in the quote, they said it was consistent with ASF's pricing for WSEs and payrolls of this size.

ASF's enrollment fee was also very high. The three competitors quoted the job between \$25 and \$116 per WSE. However, ASF quoted a flat rate bargain of \$7,500. This comes out to \$625 per WSE. This is in excess of ten times more than any of the other PEOs who quoted the job.

In the aggregate, for the first year cost, ASF is 171% higher than the next closest competitor who quoted the job. We had heard how expensive ASF was, but we did not realize the extent to which its pricing is not competitive. This explains why our sources in Dallas and in San Antonio told us it was easy to take old clients with them when they went to a competitor. We also understand why ASF management is looking for price insensitive businesses.

e. ASF's high prices have made it difficult to add WSEs. The consequence of the significant Q201 and Q301 price increases was attrition in ASF's dominant market, Texas, and decelerating growth in its non-Texas markets. Evidence of this is provided in the table below:

Estimated Avg. WSEs Texas/Non-Texas

	Q499A	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Texas	25,396	28,565	31,076	32,204	32,613	30,897	31,495	31,097
Non-TX	21,872	25,332	29,858	33,518	35,394	36,563	36,383	39,738
Total	47,268	53,897	60,934	65,722	68,007	67,460	67,878	70,835

Y/Y Avg. Texas/Non-TX WSE Growth

	Q499A	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Texas	-6%	11%	20%	19%	28%	8%	1%	-3%
Non-TX	102%	100%	105%	99%	62%	44%	22%	19%
Total	25%	40%	51%	50%	44%	25%	11%	8%

The premium prices charged by ASF appear to have resulted in a 5% loss in average Texas WSEs in 2001. It also appears to have caused a rapid deceleration in the rate of average non-Texas WSE growth. Non-Texas average WSE growth has decreased each quarter since Q200. If ASF is able to meet its stated 2002 average WSE growth of 18K, it will have to stop the Texas attrition as well as double its current Y/Y non-Texas growth rate. This seems highly unlikely.

As we previously noted, our sources say ASF is easy to compete with in Texas because of its high prices. They also claim because of the high price increases in 2001, they won over several former ASF clients. One competitor told us that in the last 2.5 months it has gained 1,200 new WSEs in Dallas alone. We were surprised by this, as this competitor's sales force is less than 10% of the size of ASF's. To put the magnitude of this gain in Dallas by an ASF competitor in perspective, we estimate through Q301, ASF has signed up only 6,700 WSEs from all of its offices in 18 cities in the United States.

f. Even if ASF just maintains its prices at their current levels, with no increases, we estimate that ASF will not be able to meet its stated average WSE growth goals of about 18,000 in 2002. As the table below indicates, we estimate that ASF was able to add only 4,820 new WSEs over the last year. We estimate that It added 6,688 in the last nine months, but that it actually lost 1,868 WSEs in Q4 00.

OWS Estimated Actual WSEs at end of quarter.

	Q499A	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Texas	26,020	31,463	31,877	33,781	32,165	31,074	31,510	32,381
Non-TX	22,409	27,902	30,626	35,160	34,908	36,773	36,399	41,380
Total	48,429	59,365	62,503	68,941	67,073	67,847	67,909	73,761

Y/Y change in OWS Estimated Actual WSEs

	Q499A	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Texas	-3%	20%	20%	19%	24%	-1%	-1%	-4%

Non-TX	108%	116%	104%	98%	56%	32%	19%	18%
Total	29%	51%	50%	50%	38%	14%	9%	7%

Management has stated that in order to meet 2002 EPS growth of 25%-30%, it will need to grow average WSEs by 18K. According to our calculations, this represents actual total WSE growth of about 23K, or 31%, assuming WSEs are signed up evenly throughout the year. In 2001, we estimate actual WSEs grew by only 10%, or 6,700K, in the first nine months. That, coupled with three consecutive Y/Y quarters of negative Texas growth, leads us to think ASF's goal is unrealistic.

g. If ASF tries to raise prices more, the problem of adding sufficient WSEs will get worse. As we have shown, ASF has the highest prices in the industry. Therefore, it is difficult for it to raise prices. However, old habits die hard, and ASF may resort to further price increases in the event of slower than forecasted WSE growth, which we anticipate. We think further increases in pricing would in turn further impede ASF's WSE growth.

To illustrate this problem this, we show a quarterly comparison of the Y/Y change in percentage price increase versus the Y/Y change in OWS estimated actual WSEs.

Est. Texas/Non-Texas Organic Growth (Rev. growth less Gross Profit/pricing increase)

	Q100A	Q200A	Q300A	Q400A	Q101A	Q201A	Q301A
Pricing	9%	4%	2%	8%	7%	19%	14%
Act. WSE							
Texas	20%	20%	19%	24%	-1%	-1%	-4%
Non-TX	116%	104%	98%	56%	32%	19%	18%
Total	51%	50%	50%	38%	14%	9%	7%

The table shows that increasing prices corresponds with slower growth rates in actual WSEs. This, of course, makes sense. Texas, ASF dominant market, is very price sensitive. Each price increase in 2001 led to attrition on a Y/Y basis. Given this situation, it does not appear that ASF can raise prices in Texas without losing WSEs. In the non-Texas markets, price increases led to a deceleration in the growth rates. From the table above, each Y/Y price increase has led to a simultaneous reduction in the growth rate, as actual WSE growth has decelerated each quarter since Q100. Given the above price sensitivity of Texas and given that unfavorable relationship between price increases and non-Texas growth, we think any further price increases will have unfavorable consequences for ASF.

4. As a result, expectations for WSE growth and EPS growth are too high.

ASF management provided guidance for 2002 during the Q301 conference

call. The expectations put forth in the call were for 1) An increase in average WSEs of 18K, 2) A 1%-3% decline in operating expenses per WSE, 3) A growth in revenues of 20%, 4) No growth in gross profit percent, implying the lack of reliance on price increases, 5) EPS growth of 25%-30%, and 6) the opening of six new sales offices. Given this, we think the 2002 revenue model as proposed by ASF, which is consistent with the “street” forecast, would look like this:

	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E	2002E
Revenues	1,154,209	1,236,263	1,330,526	1,490,395	5,211,393
Worksite Salaries	955,904	1,021,080	1,103,296	1,250,301	4,330,581
Benefits/Payroll Tax	166,609	164,019	167,820	173,955	672,403
Gross profit	31,696	51,164	59,410	66,139	208,410
Salaries	18,504	19,176	19,803	20,385	77,869
G&A	13,107	13,056	13,044	12,684	51,891
Commissions	4,010	3,924	3,450	3,349	14,732
Advertising	1,633	2,178	1,445	1,509	6,766
Dep./Amort.	4,180	4,840	4,994	4,983	18,997
Total Operating Exp.	41,435	43,174	42,736	42,911	170,256
Operating Margin	(9,739)	7,990	16,674	23,228	38,154
Interest Inc (expense)	900	1,000	1,100	1,200	4,200
Other, net	0	0	0	0	0
Earnings before tax	(8,839)	8,990	17,774	24,428	42,354
Income Taxes	3,491	(3,551)	(7,021)	(9,649)	(16,730)
Net Income	(5,347)	5,439	10,753	14,779	25,624
Shares	27,750	29,500	29,700	29,900	29,500
EPS	(0.19)	0.18	0.36	0.49	0.87
Average WSEs	77,102	81,602	86,102	90,602	83,852

Y/Y change	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E	2002E
Revenues	11%	18%	23%	28%	20%
Worksite Salaries	10%	17%	22%	22%	18%
Benefits/Payroll Tax	16%	23%	26%	37%	25%
Gross profit	14%	23%	20%	21%	20%
Salaries	14%	14%	16%	17%	16%
G&A	11%	18%	19%	16%	16%
Commissions	28%	35%	36%	40%	34%
Advertising	12%	18%	19%	22%	18%
Dep./Amort.	12%	18%	16%	16%	16%
Total Operating Exp.	14%	17%	19%	19%	17%
Operating Margin	15%	67%	25%	27%	37%
Interest Inc (expense)	-35%	4%	19%	33%	0%
Other, net	-100%	-100%	-100%	0%	-100%
Earnings before tax	24%	45%	24%	27%	30%
Income Taxes	26%	47%	24%	27%	30%
Net Income	23%	44%	24%	27%	30%
Average WSEs	14%	20%	22%	25%	20%

% of Revenue	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E	2002E
Revenues	100%	100%	100%	100%	100%
Worksite Salaries	83%	83%	83%	84%	83%
Benefits/Payroll Tax	14%	13%	13%	12%	13%
Gross profit	3%	4%	4%	4%	4%

% of Gross Profit	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E	2002E
Gross profit	100%	100%	100%	100%	100%
Salaries	58%	37%	33%	31%	37%
G&A	41%	26%	22%	19%	25%
Commissions	13%	8%	6%	5%	7%
Advertising	5%	4%	2%	2%	3%
Dep./Amort.	13%	9%	8%	8%	9%
Total Operating Exp.	131%	84%	72%	65%	82%
Operating Margin	-31%	16%	28%	35%	18%
Interest Inc (expense)	3%	2%	2%	2%	2%
Other, net	0%	0%	0%	0%	0%
Earnings before tax	-28%	18%	30%	37%	20%
Income Taxes	11%	-7%	-12%	-15%	-8%
Net Income	-17%	11%	18%	22%	12%

We do not think this model is realistic. First of all, this model hinges on average WSEs growth of about 1500 per month, or 18,000 for the year. Anything under this amount would mean that operating expenses per average WSE as forecast by the model would not decrease 1%-3%, but that they would increase.

## 5. OWS Projections

We have assumed ASF will increase average WSEs by 12,000 in 2002 and by 8,400 in 2003, or 16% and 10% year over year growth respectively. The "street" is forecasting average WSE growth of 18,000 (25%) and about 21,000 (25%) in 2002 and 2003 respectively. Our operating expense estimates are in line with the "street" on a dollar basis, but our operating expenses per average WSE are higher due to fewer overall average WSEs to absorb the costs. The "street" is forecasting an increase in annual operating margin dollars of 17% per average WSE. However, we are forecasting an improvement of only 7%, which we think is conservative based on 2001 trends. This improvement is the result of a 250 basis point increase in pricing. We think this adds to the conservatism of our estimates, since the company has not been signaling that it will attempt to further increase prices. The end result is a 75 basis point improvement in 2002 operating margins in our projection.

	2000A	2001E	2002E	2003E
Revenues	3,708,531	4,379,995	5,047,976	5,850,116
Worksite Salaries	3,110,240	3,669,373	4,192,853	4,895,318
Benefits/Payroll Tax	459,757	537,213	650,450	760,998
Gross profit	138,534	173,409	204,674	237,041
Salaries	54,477	67,454	78,496	89,600
G&A	35,426	44,810	52,784	62,956
Commissions	9,278	11,135	12,539	13,286
Advertising	5,117	5,760	6,260	7,687
Depreciation/Amortization	12,002	16,807	20,668	24,692
Total Operating Exp.	116,300	145,967	170,747	198,222
Operating Margin	22,234	27,442	33,927	38,820
Interest Income (expense)	4,430	4,187	4,200	5,400
Other, net	(50)	0	0	0
Earnings before tax	26,614	31,629	38,127	44,220
Income Taxes	(9,714)	(12,701)	(15,060)	(17,467)
Net Income	16,900	19,455	23,067	26,753
Shares	28,700	28,850	29,500	30,180
EPS	0.59	0.67	0.78	0.89
Y/Y chg.	2000A	2001E	2002E	2003E
Revenues	64%	18%	15%	16%
Worksite Salaries	65%	18%	14%	17%
Benefits/Payroll Tax	62%	17%	21%	17%
Gross profit	55%	25%	18%	16%
Salaries	48%	24%	16%	14%
G&A	53%	26%	18%	19%
Commissions	44%	20%	13%	6%
Advertising	25%	13%	9%	23%
Depreciation/Amortization	69%	40%	23%	19%
Total Operating Exp.	50%	26%	17%	16%
Operating Margin	85%	23%	24%	14%
Interest Income (expense)	73%	-5%	0%	29%
Other, net	-105%	-100%	0%	0%
Earnings before tax	70%	19%	21%	16%
Income Taxes	100%	31%	19%	16%
Net Income	57%	15%	19%	16%
% of Revenue	2000A	2001E	2002E	2003E
Revenues	100%	100%	100%	100%
Worksite Salaries	84%	84%	83%	84%
Benefits/Payroll Tax	12%	12%	13%	13%
Gross Profit	4%	4%	4%	4%

% of Gross Profit	2000A	2001E	2002E	2003E
Gross profit	100%	100%	100%	100%
Salaries	39%	39%	38%	38%
G&A	26%	26%	26%	27%
Commissions	7%	6%	6%	6%
Advertising	4%	3%	3%	3%
Depreciation/Amortization	9%	10%	10%	10%
Total Operating Exp.	84%	84%	83%	84%
Operating Margin	16%	16%	17%	16%
Interest Income (expense)	3%	2%	2%	2%
Other, net	0%	0%	0%	0%
Earnings before tax	19%	18%	19%	19%
Income Taxes	-7%	-7%	-7%	-7%
Net Income	12%	11%	11%	11%

	Q1 00A	Q2 00A	Q3 00A	Q4 00A	Q1 01A	Q2 01A
Revenues	755,545	864,450	962,039	1,126,497	1,043,419	1,044,776
Worksite Salaries	629,937	721,984	804,525	953,794	872,280	869,821
Benefits/Payroll Tax	104,903	111,124	117,447	126,283	143,310	133,416
Gross profit	20,705	31,342	40,067	46,420	27,829	41,539
Salaries	12,068	12,283	13,905	16,221	16,164	16,818
G&A	7,562	9,028	9,022	9,814	11,845	11,071
Commissions	2,212	2,165	2,331	2,570	3,133	2,914
Advertising	930	1,502	1,249	1,436	1,458	1,849
Depreciation/Amortization	2,632	2,884	2,987	3,499	3,732	4,108
Total Operating Exp.	25,404	27,862	29,494	33,540	36,332	36,760
Operating Margin	(4,699)	3,480	10,573	12,880	(8,503)	4,779
Interest Income (expense)	799	931	1,107	1,593	1,394	965
Other, net	9	(2)	(3)	(54)	3	439
Earnings before tax	(3,891)	4,409	11,677	14,419	(7,106)	6,183
Income Taxes	1,420	(1,609)	(4,262)	(5,263)	2,769	(2,409)
Net Income	(2,471)	2,800	7,415	9,156	(4,337)	3,774
Shares	26,900	28,600	29,800	29,500	27,500	28,500
EPS	(0.09)	0.10	0.25	0.31	(0.16)	0.13

Y/Y chg.	Q1 00A	Q2 00A	Q3 00A	Q4 00A	Q1 01A	Q2 01A
Revenues	59%	71%	71%	57%	38%	21%
Worksite Salaries	59%	72%	72%	57%	38%	20%
Benefits/Payroll Tax	56%	68%	67%	57%	37%	20%
Gross profit	53%	57%	53%	55%	34%	33%
Salaries	37%	39%	51%	65%	34%	37%
G&A	49%	73%	47%	45%	57%	23%
Commissions	51%	44%	39%	45%	42%	35%
Advertising	1%	49%	34%	17%	57%	23%
Depreciation/Amortization	93%	88%	64%	47%	42%	42%
Total Operating Exp.	44%	54%	49%	52%	43%	32%
Operating Margin	16%	93%	65%	64%	81%	37%
Interest Income (expense)	9%	59%	95%	135%	74%	4%
Other, net	-86%	-111%	-143%	-105%	-67%	21850%

Earnings before tax	19%	83%	68%	51%	83%	40%
Income Taxes	18%	81%	65%	103%	95%	50%
Net Income	20%	85%	69%	32%	76%	35%

% of Revenue	Q1 00A	Q2 00A	Q3 00A	Q4 00A	Q1 01A	Q2 01A
Revenues	100%	100%	100%	100%	100%	100%
Worksite Salaries	83%	84%	84%	85%	84%	83%
Benefits/Payroll Tax	14%	13%	12%	11%	14%	13%
Gross Profit	3%	4%	4%	4%	3%	4%

% of Gross Profit	Q1 00A	Q2 00A	Q3 00A	Q4 00A	Q1 01A	Q2 01A
Gross profit	100%	100%	100%	100%	100%	100%
Salaries	58%	39%	35%	35%	58%	40%
G&A	37%	29%	23%	21%	43%	27%
Commissions	11%	7%	6%	6%	11%	7%
Advertising	4%	5%	3%	3%	5%	4%
Depreciation/Amortization	13%	9%	7%	8%	13%	10%
Total Operating Exp.	123%	89%	74%	72%	131%	88%
Operating Margin	-23%	11%	26%	28%	-31%	12%
Interest Income (expense)	4%	3%	3%	3%	5%	2%
Other, net	0%	0%	0%	0%	0%	1%
Earnings before tax	-19%	14%	29%	31%	-26%	15%
Income Taxes	7%	-5%	-11%	-11%	10%	-6%
Net Income	-12%	9%	19%	20%	-16%	9%

	Q3 01A	Q4 01E	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E
Revenues	1,085,944	1,205,856	1,137,560	1,211,068	1,293,010	1,406,338
Worksite Salaries	903,136	1,024,136	944,964	1,003,696	1,072,436	1,171,757
Benefits/Payroll Tax	133,487	127,000	162,863	158,771	161,164	167,652
Gross profit	49,321	54,720	29,734	48,601	59,410	66,928
Salaries	17,035	17,437	18,096	19,073	19,679	21,647
G&A	10,950	10,944	12,389	13,162	13,395	13,837
Commissions	2,534	2,554	3,379	3,231	2,958	2,971
Advertising	1,213	1,240	1,427	1,734	1,571	1,528
Depreciation/Amortization	4,298	4,669	4,154	5,202	5,540	5,773
Total Operating Exp.	36,030	36,845	39,445	42,402	43,144	45,757
Operating Margin	13,291	17,875	(9,710)	6,199	16,267	21,172
Interest Income (expense)	928	900	900	1,000	1,100	1,200
Other, net	85	0	0	0	0	0
Earnings before tax	14,304	18,775	(8,810)	7,199	17,367	22,372
Income Taxes	(5,645)	(7,416)	3,480	(2,843)	(6,860)	(8,837)
Net Income	8,659	11,359	(5,330)	4,355	10,507	13,535
Shares	28,900	29,200	27,750	29,500	29,700	29,900
EPS	0.30	0.39	(0.19)	0.15	0.35	0.45

Y/Y chg.	Q3 01A	Q4 01E	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E
Revenues	13%	7%	9%	16%	19%	17%
Worksite Salaries	12%	7%	8%	15%	19%	14%
Benefits/Payroll Tax	14%	1%	14%	19%	21%	32%
Gross profit	23%	18%	7%	17%	20%	22%
Salaries	23%	7%	12%	13%	16%	24%
G&A	21%	12%	5%	19%	22%	26%
Commissions	9%	-1%	8%	11%	17%	16%
Advertising	-3%	-14%	-2%	-6%	30%	23%
Depreciation/Amortization	44%	33%	11%	27%	29%	24%
Total Operating Exp.	22%	10%	9%	15%	20%	24%
Operating Margin	26%	39%	14%	30%	22%	18%
Interest Income (expense)	-16%	-44%	-35%	4%	19%	33%
Other, net	2733%	-100%	-100%	-100%	-100%	0%
Earnings before tax	22%	30%	24%	16%	21%	19%
Income Taxes	32%	41%	26%	18%	22%	19%
Net Income	17%	24%	23%	15%	21%	19%

% of Revenue	Q3 01A	Q4 01E	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E
Revenues	100%	100%	100%	100%	100%	100%
Worksite Salaries	83%	85%	83%	83%	83%	83%
Benefits/Payroll Tax	12%	11%	14%	13%	12%	12%
Gross Profit	5%	5%	3%	4%	5%	5%

% of Gross Profit	Q3 01A	Q4 01E	Q1 02 E	Q2 02 E	Q3 02 E	Q4 02 E
Gross profit	100%	100%	100%	100%	100%	100%
Salaries	35%	32%	61%	39%	33%	32%
G&A	22%	20%	42%	27%	23%	21%
Commissions	5%	5%	11%	7%	5%	4%
Advertising	2%	2%	5%	4%	3%	2%
Depreciation/Amortization	9%	9%	14%	11%	9%	9%
Total Operating Exp.	73%	67%	133%	87%	73%	68%
Operating Margin	27%	33%	-33%	13%	27%	32%
Interest Income (expense)	2%	2%	3%	2%	2%	2%
Other, net	0%	0%	0%	0%	0%	0%
Earnings before tax	29%	34%	-30%	15%	29%	33%
Income Taxes	-11%	-14%	12%	-6%	-12%	-13%
Net Income	18%	21%	-18%	9%	18%	20%

	Q1 03E	Q2 03 E	Q3 03 E	Q4 03 E
Revenues	1,400,220	1,388,894	1,468,421	1,592,581
Worksite Salaries	1,164,562	1,162,249	1,241,572	1,326,934
Benefits/Payroll Tax	200,710	183,852	186,582	189,855
Gross profit	34,948	57,360	67,470	77,264
Salaries	21,420	21,587	22,792	23,800
G&A	14,566	15,269	16,228	16,893
Commissions	3,684	3,422	3,100	3,080
Advertising	1,799	2,106	1,915	1,867
Depreciation/Amortization	5,998	6,055	6,199	6,440
Total Operating Exp.	47,467	48,440	50,234	52,080
Operating Margin	(12,520)	8,920	17,236	25,183
Interest Income (expense)	1,200	1,300	1,400	1,500
Other, net	0	0	0	0
Earnings before tax	(11,320)	10,220	18,636	26,683
Income Taxes	4,471	(4,037)	(7,361)	(10,540)
Net Income	(6,848)	6,183	11,275	16,143
Shares	28,500	30,500	30,500	31,500
EPS	(0.24)	0.20	0.37	0.51

Y/Y chg.	Q1 03E	Q2 03 E	Q3 03 E	Q4 03 E
Revenues	23%	15%	14%	13%
Worksite Salaries	23%	16%	16%	13%
Benefits/Payroll Tax	23%	16%	16%	13%
Gross profit	18%	18%	14%	15%
Salaries	18%	13%	16%	10%
G&A	18%	16%	21%	22%
Commissions	9%	6%	5%	4%
Advertising	26%	21%	22%	22%
Depreciation/Amortization	44%	16%	12%	12%
Total Operating Exp.	20%	14%	16%	14%
Operating Margin	29%	44%	6%	19%
Interest Income (expense)	33%	30%	27%	25%
Other, net	0%	0%	0%	0%
Earnings before tax	28%	42%	7%	19%
Income Taxes	28%	42%	7%	19%
Net Income	28%	42%	7%	19%

% of Revenue	Q1 03E	Q2 03 E	Q3 03 E	Q4 03 E
Revenues	100%	100%	100%	100%
Worksite Salaries	83%	84%	85%	83%
Benefits/Payroll Tax	14%	13%	13%	12%
Gross Profit	2%	4%	5%	5%

% of Gross Profit	Q1 03E	Q2 03 E	Q3 03 E	Q4 03 E
Gross profit	100%	100%	100%	100%
Salaries	61%	38%	34%	31%
G&A	42%	27%	24%	22%
Commissions	11%	6%	5%	4%
Advertising	5%	4%	3%	2%
Depreciation/Amortization	17%	11%	9%	8%
Total Operating Exp.	136%	84%	74%	67%
Operating Margin	-36%	16%	26%	33%
Interest Income (expense)	3%	2%	2%	2%
Other, net	0%	0%	0%	0%
Earnings before tax	-32%	18%	28%	35%
Income Taxes	13%	-7%	-11%	-14%
Net Income	-20%	11%	17%	21%