Fourth Background Screening Industry Survey
January 2008

KPMG Corporate Finance LLC
Objectivity. Insight. Experience.

KPMG Corporate Finance LLC

KPMG Corporate Finance provides a full suite of investment banking and advisory services to its domestic and international clients. Our professionals have the experience and depth of knowledge in global M&A to advise clients on mergers and acquisitions, sales and divestitures, buyouts, financings, restructurings, fairness opinions, infrastructure project finance, and other strategic initiatives. In addition, we remain independent of financing sources, helping to ensure that our efforts are objective and aligned with the goals of KPMG's firms' clients. Operating in 51 countries, KPMG's Corporate Finance practice comprises more than 1,800 professionals, who are able to meet the needs of KPMG's firms' clients across the globe. On a global basis, KPMG's Corporate Finance practice regularly outranks almost all other financial advisers by volume of deals completed annually.

January 2008
Fourth Background Screening Industry Survey

KPMG Corporate Finance LLC would like to thank all of the companies that participated in the fourth edition of our Background Screening Industry Survey. We received responses from a wide range of companies: from large, diversified firms with significant technology infrastructure and Fortune 500 customer lists, to small regional service providers with local customer bases and modest technology investments. Ultimately, the success of the survey would not have been possible without the candid feedback that we received from each of you, so please accept our appreciation for making this survey a success.

Overall, we believe the results of the survey provide a broad perspective on the current state of the background screening industry, as well as the future of the industry. We have summarized our findings based on all of the responses that we received and have also segmented responses into large companies (annual revenues greater than $25 million), medium-sized companies (annual revenues between $5 and $25 million) and small companies (annual revenues less than $5 million) in our summary of key findings. While not all respondents provided their revenue classification, we believe that an analysis of responses by company size provides a meaningful perspective on the competitive environment of the industry as a whole, as well as the issues facing different size companies.

If you have any questions or comments on the survey, would like more information on KPMG Corporate Finance or would like to discuss our thoughts on the background screening industry, please contact me. Thank you once again for your participation and we look forward to hearing from you.

Cherie Smith Homa
Managing Director
410-949-8692
csmith@kpmg.com

We welcome the opportunity to meet with you, learn more about your company's objectives, and discuss our people and capabilities.

KPMG Corporate Finance — Objectivity. Insight. Experience.
KPMG Corporate Finance LLC is a leading middle market adviser serving domestic and international clients. We offer a full suite of investment banking and advisory services.
Visit us online at www.kpmgcorporatefinance.com/us.

Contents

1. Key Findings

1.1 Technology remains key in delivering service, however, industry providers are placing a lower importance on technology as a differentiator

Virtually all background screening firms provide a technology-enabled screening service. The industry has evolved over the past few years and a base level of technology is required even to be considered a viable service provider. Said another way, utilizing technology – whether it is proprietary or a third party system – to deliver service is now standard in the screening industry. That said, less than 40% of survey respondents indicated that technology was generally a differentiator in the sales process. Furthermore, respondents did not feel that technology drives customer purchasing decisions. Less than one in four respondents ranked technology in the top three factors driving their customers purchasing decision.

As background screening technology advances and companies become more comfortable conducting business over the internet, technology is utilized to more fully automate the interaction between providers and their customers. Background screening providers are able to save time and money and also reduce data entry errors by enabling their customers to input requests electronically through a hosted online application. Almost 65% (compared to 62% last year) of all background requests are submitted electronically from clients. Roughly 70% of screening requests to large and medium-sized companies are submitted through a hosted application. There has been a steady increase in the companies providing results through hosted online services as almost half of the respondents claim that more than 75% of results were transmitted through hosted online services. Almost 57% (compared to 52% last year) of the background requests to small companies were submitted through a hosted application, showing that even small firms are increasingly moving towards automated interactions.

Electronic tracking of background checks is also becoming increasingly offered. Roughly 90% (compared to 83% last year) of respondents provide electronic tracking of background checks with almost all of the large and medium companies offering electronic tracking. Over half of companies offer instant response for criminal background checks with almost 70% of medium companies offering instant products. For roughly 14% (compared to 12% last year) of companies, the revenues from instant check products were more than 50% of their total revenues.

Technology is critical to delivering screening services to customers. Automation yields a better customer experience by improving information access, accuracy and efficiency. Although technology is being utilized more in the delivery of service and has become critical to competing in the industry, technology is not the same differentiator that it was even two or three years ago.

1.2 While integration of services is expected to increase in all areas, only integration with HRIS has shown substantial growth

The level of integration that has been requested by customers to date varies by provider size. Although there has been a four year trend of increased requests by customers to integrate their offerings – especially with HRIS – integrated services still comprise only a small portion of the market. Not surprisingly, the larger background screening companies have had the most requests to provide integrated solutions and their experience with integration will likely provide a competitive advantage in winning larger accounts.

Integration with HRIS

In prior years, survey respondents have projected that integration with HRIS would increase. Approximately 34% (up from 22% last year) of the respondents have received requests for integration from more than 10% of their customers. Almost half of the large companies have seen requests from more than 10% of their customers likely reflecting the needs from their larger customers. Going forward, one half (up from 41% last year) of providers feel that the integration will "significantly increase" with HRIS. Compared to recruiting systems and assessment testing, the integration with HRIS is expected to be more pronounced.

Integration with Recruiting Systems

The requests from customers for integration of recruitment systems have shown only modest increases. Overall, roughly 22% (compared to 19% last year) of the companies have received requests for integration from more than 10% of their customers. Almost 40% of the large companies and 25% of medium providers have seen requests from more than 10% of their customers. However, in contrast, only 10% of small providers integrate with recruiting systems. Even though the growth has been slow with recruiting systems, almost 40% of providers expect that requests for integration will "significantly increase."

Integration with Assessment services

Integration with assessment testing has not reached the same level as integration with HRIS and recruiting systems and this is unlikely to change. Almost 95% of the respondents indicated that few of their clients have requested integration with assessment testing. The integration is not expected to rise as over half of respondents expect this level to remain the same.

1.3   Customer penetration of ancillary services has increased

As background screening providers seek closer ties to their customers and increase the average revenue per candidate, offering ancillary services such as employment verification, educational verification, applicant tracking and drug testing, has become more prevalent. While the level of respondents offering the various ancillary services has remained consistent with prior years, providers are more successful at selling the ancillary services to their existing customers.

Consistent with the last survey, almost all of the respondents offer employment and educational verification, while over 80% offer drug testing and over 25% offer applicant tracking. The number of customers purchasing these services has increased as follows:

- Almost 70% (up from 56% last year) of the respondents claim that more than 20% of their clients are users of educational verification services.
- Almost 16% (up from 7% last year) of the respondents claim that more than 20% of their clients use the applicant tracking services.
- Almost 48% (up from 40% last year) claim that more than 40% of the clients use the service.

The notable exception to increased customer penetration is drug testing. Companies may have an established relationship with outside drug testing firms already so the movement of this service to screening companies has been slower to materialize. Generally, as human resource departments become more accustomed to outsourcing services, we expect background screening providers to continue to benefit.

1.4 Concentration risk is inversely related to customer size

Customer concentration - Almost half of the larger providers do not have a customer that accounts for more than 5% of revenue and 84% do not have a customer that accounts for more than 10% of revenue. Conversely, 64% of small providers have a single customer representing over 10% of their revenues. Furthermore, 6% of small providers have a customer that comprises over 40% of their screening revenue. Over half the medium-sized providers indicated that their largest customer accounted for 5 to 10% of revenue.

Geographic concentration - Concentration in immediate geographic region is largely seen in small companies with almost 45% having more than half their revenues and 73% of them having more than 20% of their revenues coming from the immediate geographic region. In contrast, larger companies have lesser geographic concentration with over 90% generating less than 20% of the revenues from immediate geographic region.

1.5 Pricing remains a key factor driving customer purchasing decisions

Respondents were asked to rank the top three factors driving customer purchasing decisions. The rankings varied by provider size, however, consistent with the last three surveys, price remains key. Price was once again ranked the number one factor driving customer purchasing decisions by 30% of the respondents and was the top factor cited by small and medium-sized companies followed by customer service. Almost 80% of all respondents ranked price among the top three factors and, regardless of provider size, it was the factor most cited in the top three.

For large providers, customer service was cited as the most important factor driving customer decisions. Price was ranked as the second most important factor along with technology, turn around time and the ability to offer a comprehensive suite of products. While price is not the most important factor driving customer decisions for large companies, it is still an important factor with three out of four respondents ranking price in the top three.

The following charts highlight the factors that were cited most by providers. Table 1 summarizes the factors that were most cited as the number one factor driving customer purchasing decisions (with the percentage of respondents ranking the factor number one in parenthesis).

Table 1: Factors Cited as the Number One Driver of Customer Decisions		
Large providers	**Medium providers**	**Small providers**
Customer service (23%)	Price (38%)	Price (31%)
Price (15%)	Customer service (21%)	Customer service (25%)
Technology (15%)		
Suite of products (15%)		
Turnaround (15%)		

Table 2 highlights the factors driving customer decisions that were most cited in the top three (with the percentage respondents ranking the factor in the top three listed in parenthesis).

Table 2: Factors Cited in the Top three Drivers of Customer Decisions		
Large providers	**Medium providers**	**Small providers**
Price (77%) Turnaround (54%) Customer service (46%)	Price (83%) Turnaround (62%) Customer service (59%)	Price (75%) Turnaround (39%) Customer service (72%)

1.6 Challenges vary based on provider size

Respondents were asked to rank the top three challenges in their business. The rankings varied by provider size. Medium and small companies ranked recruiting professionals as their most significant challenge. Identifying, recruiting and maintain a team of professionals that are knowledgeable about the industry is more challenging for these companies than the larger competitors in the industry.

In contrast, the large companies felt that building internal company infrastructure and investing and maintaining technology were the main challenges. Large companies are providing various solutions to the market and generally target a larger and more demanding customer. Furthermore, some of the large players have made acquisitions historically and establishing one platform and one infrastructure has been difficult.

The following charts highlight the most important challenges being faced by the industry. Table 3 summarizes the challenges cited as the number one challenge (with the percentage of respondents ranking the factor number one in parenthesis).

Table 3: Factors Cited as the Most Important Challenge Facing the Company		
Large providers	**Medium providers**	**Small providers**
Maintaining the technology (23%) Building company infrastructure (23%)	Recruiting (31%) Margin compression (24%) Competition (17%)	Recruiting (22%) Competition (19%)

Table 4 highlights the challenges being faced by the companies that were cited the most in the top three (with the percentage respondents ranking the factor in the top three listed in parenthesis).

Table 4: Factors Cited in the top Three as Challenge Facing the Company		
Large providers	**Medium providers**	**Small providers**
Margin compression (69%) Building company infrastructure (54%) Maintaining the technology (46%) Competition (46%)	Recruiting (66%) Maintaining the technology (48%) Margin compression (45%) Legal and FCRA compliance (45%) Competition (41%)	Recruiting (22%) Competition (19%)

1.7   Large and medium-sized providers are facing margin pressure

We have previously debated whether background screening services are more of a commodity or a customized professional service. While most respondents (43%) characterized the market in the middle of the two, 34% thought it is more commodity-like, whereas 26% indicated it is more customized. Interestingly, the larger the provider, the more they characterized the services as a commodity, with over half of the large and 37% of medium providers, but less than 25% of small providers, describing the industry as a commodity.

The percentage of respondents lowering prices "often" to win or maintain business has increased drastically. Almost 23% (up from 16% last year) of respondents have "often" lowered the prices in order to win or maintain business. Large and medium providers lower prices most frequently with 38% of large companies (up from 20% last year) and 24% of medium companies (up from 13% last year) lowering their prices "often" to win business. Furthermore, margin compression was cited in the top three challenges by over half of all respondents. In fact, almost 70% of large providers cited margin compression as a critical challenge.

The average revenue per search has increased, with 25% (up from 21% last year) of respondents reporting revenues greater than $75 per search. This increasing trend in average revenue per search is more pronounced with small and medium providers, with over 40% of small companies and 17% of medium-sized companies reporting revenues per search greater than $75.

Approximately 64% of all respondents indicated that the profitability of a search has either stayed the same or decreased. This is led by roughly 80% of medium-sized providers and over 60% of large providers. In contrast, half of the small companies indicate increased profitability. The difference between the small providers on one hand and the medium and large providers on the other can be explained by (1) intensified competition among large and medium players who lower price to gain market share and (2) small companies being able to increase prices due to a better customer experience with improvements in technology and processes. While smaller companies may not be facing the same margin pressure as the medium-sized and large companies, almost half of small companies still view margin compression as a key challenge to their business.

1.8   Industry consolidation continues

Historically, the background screening industry has witnessed substantial annual deal volume with over 50 publicized transactions over the past few years. The pace of disclosed transactions in 2007, however, has slowed. The large industry consolidators Choicepoint and First Advantage made only one screening acquisition in 2007.   While overall deal activity has slowed most companies are still considering M&A as an alternative. Over the past year,

- Almost 30% (up from 25% last year) of the respondents considered selling their business
- Almost 57% (down from 64% last year) of respondents were approached by a potential acquirer seeking to buy their business
- Almost half (compared to 56% last year) of the respondents considered buying another business and nearly 14% acquired another company

- Over 70% (up from 64% last year) of the companies established strategic relationships to expand the sales channel

Generally, consolidation is not changing the outlook of providers with only 11% (compared to 5% last year) of the survey respondents indicating that consolidation has hurt their ability to win new business or maintain their customer base. In contrast, about 47% (compared to 52% last year) of the respondents feel that industry consolidation has enhanced their position in the industry.

1.9 Although competition remains strong, providers project strong industry outlook

Large and medium-sized companies continue to grow their customer base by taking business from other third-party suppliers. Over 77% (down from over 80% last year) of large companies, and almost 93% (up from 83% last year) of medium-sized companies were able to take customers from other providers. The number of new implementers (companies implementing background checks for the first time) has decreased from 36% in 2004 to 30% in the last survey to 24% today.   This likely reflects a more saturated market and the level of new implementers will decrease going forward.

The environment to win new accounts is highly competitive with almost 78% of the respondents indicating that they generally compete against one to three competitors and 21% stating that they generally compete against four or more competitors when seeking new business. The large providers typically face more competition (38% indicate that there are generally four or more competitors for new business). The intense competition at the upper end of the market is also reflected with low customer retention rates. Almost 23% of large companies have customer retention rate less than 90% whereas only 7% of the medium companies and almost no small companies have less then 90% customer retention rate.

Almost half of the respondents cite the large national providers (ADP, FADV, Kroll, etc.) as the most significant competitors. Not surprisingly, 85% of large providers and 54% of medium-sized providers indicated that the large national providers are their primary competition.

The competition in this industry remains high with almost 72% of the respondents (consistent with last year) expecting competition to increase over the next 12 months. Roughly half of all respondents cited competition in the top three challenges facing their business (the second most frequent answer behind margin compression).

Consistent with last year's survey, virtually all respondents expect revenues to increase over the next 12 months. That said, the growth is anticipated to be more modest than in previous years. Over 86% of respondents project revenue to increase by more than 10% and 35% of respondents project their revenue to increase by more than 25%. Medium-sized providers continue to be the most optimistic about growth. Roughly 40% anticipate revenue growth above 25%. This is down from 50% in the last survey and down further from 75% the year before. Strong industry dynamics will continue to drive growth, however, the industry remains exposed to changes in the overall economic outlook and hiring trends, both of which are uncertain for 2008.