Paychex, Inc (PAYX)

Updated December 19th, 2018 by Nathan Parsh

Key Metrics

Current Price:	$65	**5 Year CAGR Estimate:**	4.6%	**Volatility Percentile:**	31.2%
Fair Value Price:	$57	**5 Year Growth Estimate:**	3.7%	**Momentum Percentile:**	61.9%
% Fair Value:	114%	**5 Year Valuation Multiple Estimate:**	-2.6%	**Growth Percentile:**	20.3%
Dividend Yield:	3.5%	**5 Year Price Target**	$68	**Valuation Percentile:**	20.3%
Dividend Risk Score:	D	**Retirement Suitability Score:**	D	**Total Return Percentile:**	14.0%

Overview & Current Events

Paychex, Inc provides computerized payroll accounting, benefits and human resource services to businesses that employ between 10 and 200 employees. Paychex provides services to more than 600,000 small and medium-sized businesses, primarily in the U.S. The company was incorporated in 1979. Paychex has a market cap of $23 billion and generated $3.4 billion in sales in fiscal 2018.

Paychex reported financial results for the second quarter of fiscal 2019 on December 19th. Earnings-per-share (EPS) was $0.65, $0.02 above analysts' estimates and a 10.2% increase from the second quarter of fiscal 2018. Revenue increased 7% to $858.9 million. This was $0.66 million above the market's expectations.

Management Solutions revenues increased 5% to $685.4 million. This increase was due to a larger client base. Revenue from retirement services was up due to higher asset values. Paychex's acquisition of Lessor Group added 1% to growth in this segment. PEO and Insurance Services revenues grew 15% to $155.2 million. Again, a larger client base was the main driver of growth. Insurance revenue was up on a larger number of health and benefit applicants. Interest on funds held for clients was higher by 31% and was due primarily to higher average interest rates. Paychex continues to benefit from low unemployment rates as this means more workers require payroll and other related services. Expenses were up 10% during the quarter as compensation costs increased. The company's effective tax rate declined to 23.8% from 34.8% a year ago. Paychex expects EPS to grow between 11%-12% this year. We maintain our fiscal 2019 EPS target of $2.85, which would represent growth of 16.3% from fiscal 2018.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	$1.48	$1.32	$1.42	$1.51	$1.56	$1.71	$1.85	$2.09	$2.25	$2.45	***$2.85***	***$3.42***
DPS	$1.24	$1.24	$1.24	$1.27	$1.31	$1.40	$1.52	$1.68	$1.84	$2.18	***$2.24***	***$2.69***
Shares	361	361	361	362	365	363	361	360	359	359	***359***	***359***

Paychex saw a slight decline in earnings during the last recession. Considering that the company's revenue largely depends on the number of people on payrolls, Paychex did an admirable job suffering just a slight decline in EPS as unemployment reached high levels. As long as unemployment remains very low, Paychex should see earnings continue to grow. If unemployment does increase, it is possible that the company could experience just a slight reduction in earnings based on how well the company navigated the last recession. Paychex grew earnings at a rate of 3.7% per year over the past decade. We expect that the company can continue to see this growth rate through 2024.

One area of growth that should be of interest to shareholders is Paychex's recent purchase of Lessor Group, a payroll and human resources provider based in Denmark. While Paychex does have operations in Germany, this acquisition should allow the company to spread throughout Northern Europe.

Paychex has increased its dividend for the past 8 years, with an average raise of 8.3% annually over the past 5 years. On April 27th, the company gave shareholders a 12% dividend increase. With a high dividend payout, we feel that Paychex will be able to grow its dividend in line with earnings.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.

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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Avg. P/E	19.2	22.2	20.7	19.6	21.4	24.1	24.8	24	26.2	25.1	***22.8***	***20***
Avg. Yld.	4.4%	4.2%	4.2%	4.3%	3.9%	3.4%	3.3%	3.4%	3.1%	3.3%	***3.5%***	***4.0%***

Shares of Paychex have decreased $10, or 13.3%, since our October 25th update. Based on expected earnings per share for the year, the stock has a P/E ratio of 22.8, down from 26.3 previously. This is very much in line with the stock's 10-year average P/E of 22.7. We have a target P/E of 20 due to the company's low growth rate. If shares were to revert to this target, the stock would experience multiple reversion of -2.6% per year through 2024.

Safety, Quality, Competitive Advantage, & Recession Resiliency

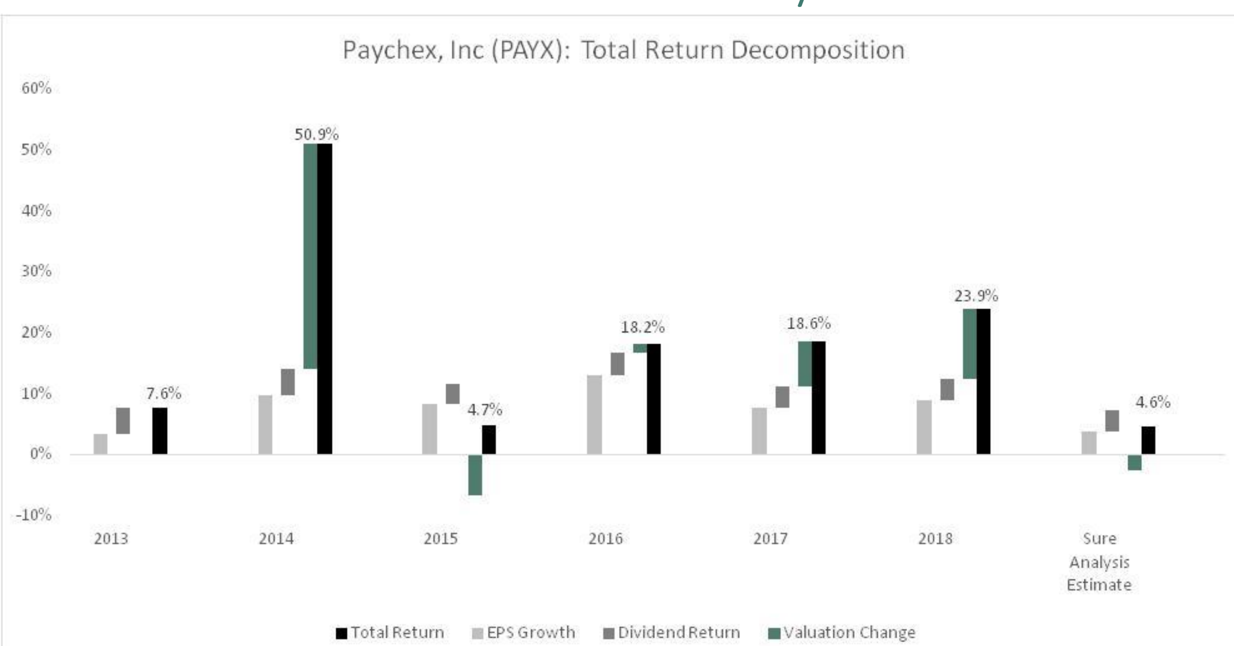
Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	83.8%	93.9%	87.3%	84.1%	84%	81.9%	82.2%	80.4%	81.8%	81.8%	***76.5%***	***78.9%***

Shares of Paychex weren't immune to lower earnings numbers during the last recession. With that said, the company held up pretty well given the circumstances. Paychex has no long term debt, so the company could always tap debt markets to fund an acquisition if need be. One area of concern is Paychex's dividend payout ratio. The average payout ratio over the last decade has been around 84%, though this ratio is now in the mid 70% range due to higher EPS forecasts. This still doesn't leave much room for dividend increases if earnings were to suffer a decline.

Final Thoughts & Recommendation

After accounting for second quarter financial results and the recent share price decline, we now estimate that Paychex can offer a total annual return of 4.6% through 2024. This return is based on earnings growth (3.7%), dividends (3.5%) and multiple compression (-2.6%). The stock still trades with a P/E multiple above that of the S&P 500 and the dividend payout ratio is very high. We have lowered our 2024 target price $10 to $68 due to a lower expected valuation. The company is a hold at current prices, and potential sell based on its mediocre total return profile.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	2007	2001	2084	2230	2326	2519	2740	2952	3151	3381
Gross Profit	1327	1347	1433	1560	1655	1786	1932	2095	2232	2363
Gross Margin	66.1%	67.3%	68.7%	69.9%	71.1%	70.9%	70.5%	71.0%	70.8%	69.9%
SG&A Exp.	597	622	646	706	750	804	878	948	992	1076
D&A Exp.	86	87	89	98	98	105	107	115	127	138
Operating Profit	730	725	786	854	905	983	1054	1147	1240	1288
Operating Margin	36.4%	36.2%	37.7%	38.3%	38.9%	39.0%	38.5%	38.8%	39.3%	38.1%
Net Profit	534	477	515	548	569	628	675	757	817	934
Net Margin	26.6%	23.8%	24.7%	24.6%	24.5%	24.9%	24.6%	25.6%	25.9%	27.6%
Free Cash Flow	608	550	615	617	577	797	792	921	866	1122
Income Tax	279	252	277	312	342	361	385	394	428	362

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	5127	5226	5394	6480	6164	6370	6468	6441	6834	7464
Cash & Equivalents	473	284	119	109	107	153	170	132	185	358
Accounts Receivable	178	187	161	142	133	149	177	409	508	531
Goodwill & Int. Ass.	510	483	591	573	579	581	594	727	715	955
Total Liabilities	3786	3824	3898	4875	4390	4593	4682	4529	4878	5439
Accounts Payable	37	37	45	70	43	49	52	57	57	75
Long-Term Debt	0	0	0	0	0	0	0	0	0	0
Shareholder's Equity	1341	1402	1496	1605	1774	1777	1786	1912	1955	2025
D/E Ratio	0	0	0	0	0	0	0	0	0	0

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	10.2%	9.2%	9.7%	9.2%	9.0%	10.0%	10.5%	11.7%	12.3%	13.1%
Return on Equity	42.0%	34.8%	35.6%	35.3%	33.7%	35.3%	37.9%	40.9%	42.3%	46.9%
ROIC	42.0%	34.8%	35.6%	35.3%	33.7%	35.3%	37.9%	40.9%	42.3%	46.9%
Shares Out.	361	361	361	362	365	363	361	360	359	359
Revenue/Share	5.56	5.53	5.75	6.14	6.38	6.88	7.51	8.14	8.69	9.35
FCF/Share	1.68	1.52	1.70	1.70	1.58	2.18	2.17	2.54	2.39	3.10

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.