



Automatic Data Processing (ADP)

Updated August 7th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$163	5 Year CAGR Estimate:	6.3%	Volatility Percentile:	27.3%
Fair Value Price:	\$136	5 Year Growth Estimate:	8.0%	Momentum Percentile:	86.2%
% Fair Value:	121%	5 Year Valuation Multiple Estimate:	-3.6%	Growth Percentile:	77.3%
Dividend Yield:	1.9%	5 Year Price Target	\$199	Valuation Percentile:	21.7%
Dividend Risk Score:	A	Retirement Suitability Score:	B	Total Return Percentile:	26.2%

Overview & Current Events

Automatic Data Processing is one of the largest business services outsourcing companies in the world. The company provides payroll services, human resources technology, and other business operations to more than 700,000 corporate customers. Automatic Data Processing was founded in 1949 and currently trades with a market capitalization of \$73 billion. With 44 years of consecutive dividend increases, it is also a member of the prestigious Dividend Aristocrats Index.

ADP reported Q4 earnings on 7/31/19 and results were strong once again. Revenue was up 6% to \$3.5 billion on a reported basis, and also up 6% on an organic constant currency basis. Strength continues to accrue from the company's PEO Services segment, which saw revenue rise 9% in Q4. Excluding zero-margin pass-through benefits revenue, the top line was up 7% in Q4. Segment margin was also up 70bps in Q4. For the Employer Services segment, revenue was up 4% in Q4 thanks to an 11% increase in new bookings and a stronger client retention rate, which is now 90.8%. Acquisitions pressured margins for the segment, sending them 30bps lower in Q4.

Adjusted net earnings were up 13% to \$498 million, while adjusted EBIT came to 19.1% of revenue, or \$669 million. The company saw 20bps of downward pressure on margins from acquisitions, but that is expected to be temporary. Earnings-per-share were up 15% in Q4 on an adjusted basis to \$1.14.

ADP offered up guidance for fiscal 2020 of a 6% to 7% revenue gain, an adjusted EBIT margin increase of 100bps to 125bps, and adjusted diluted earnings-per-share growth of 12% to 14%. ADP's guidance has typically been conservative and therefore, is raised throughout the year. However, we're taking the cautious approach and taking ADP's guidance at face value, implying \$6.16 in earnings-per-share for this year.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
EPS	\$2.39	\$2.52	\$2.82	\$2.80	\$3.11	\$2.89	\$3.25	\$3.70	\$4.53	\$5.45	\$6.16	\$9.05
DPS	\$1.34	\$1.42	\$1.55	\$1.70	\$1.88	\$1.95	\$2.08	\$2.24	\$2.50	\$3.06	\$3.16	\$4.43
Shares	502	492	491	484	483	466	456	445	439	436	433	410

Automatic Data Processing has compounded its adjusted earnings-per-share at a rate of 6.6% per year over the last decade, which we believe it can exceed moving forward given that its recent earnings growth has accelerated meaningfully. Moreover, it expects at least 12% growth in adjusted earnings-per-share in the current fiscal year, per the new guidance figure, on top of 22% growth in fiscal 2018 and 20% growth in fiscal 2019. Beyond this year, we believe the company is capable of delivering 8% annualized growth in earnings-per-share over full economic cycles.

Much of this growth is likely to be driven by the company's Professional Employer Organization (PEO) Services segment, which continues to deliver very impressive revenue growth. Importantly, this revenue growth has been accompanied by meaningful margin expansion, which means that the segment's growth has had an outsized impact on the firm's bottom line. In addition, the company's buyback has been a low single digit tailwind annually for earnings-per-share growth in the past decade, and we expect that will continue moving forward. We see the company's fundamentals as very strong given recent results, and we think ADP will grow at meaningful rates for a long time to come.

The dividend is just half of earnings, so we see lots of room for growth in the coming years.

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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	16.0	17.2	18.7	18.7	21.8	24.5	29.0	26.0	27.0	27.1	26.5	22.0
Avg. Yld.	3.2%	3.3%	3.0%	2.9%	2.8%	2.5%	2.3%	2.5%	2.3%	2.1%	1.9%	2.2%

Despite recent relative weakness in the stock and higher earnings estimates for this year, Automatic Data Processing is still quite expensive. Shares trade for 26.5 times this year's earnings-per-share estimate, which compares unfavorably to our new, higher fair value estimate at 22 times earnings. That implies a meaningful 3.6% headwind to total returns annually as we see the current valuation as unsustainable. We've boosted our estimate of fair value to account for recent strong growth. Even so, the stock is quite expensive today. The combination of a significantly higher dividend payout and what we believe will be a moderating share price should produce a slightly higher yield. Indeed, we see the yield moving up from today's 1.9% to 2.2% in five years.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	56%	56%	55%	61%	61%	68%	64%	61%	55%	56%	51%	49%

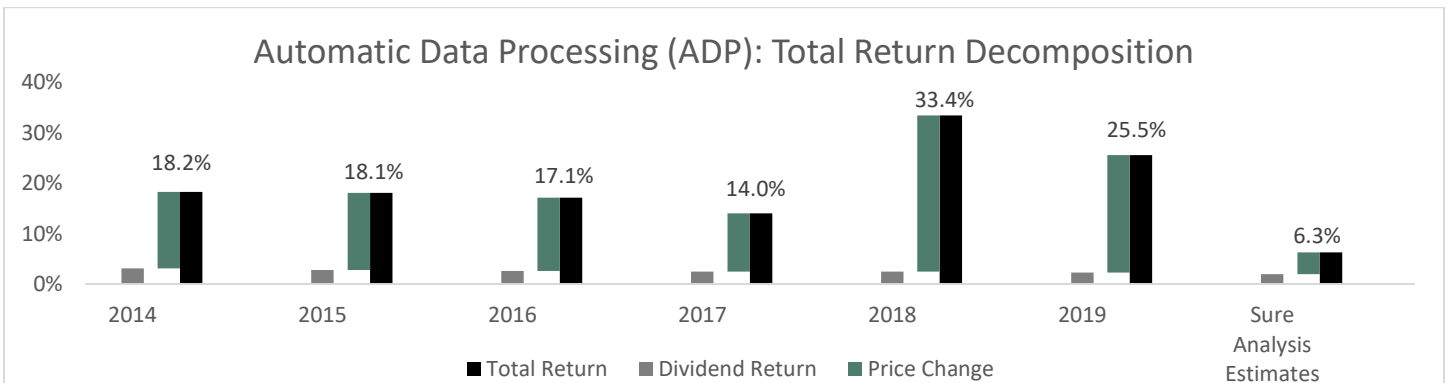
What immediately stands out about ADP's quality metrics is the ostensibly high levels of debt. Fortunately, the vast majority of this debt is in the form of client fund obligations – money that is held by ADP before being paid out to the employees of its corporate customers. These client fund obligations are actually a source of competitive advantage, as they behave like insurance float and allow the company to invest the proceeds into low-risk investments and generate additional investment revenue. Indeed, the company's long-term debt is quite minimal, which leads to very high levels of interest coverage. Its highly scalable business model means that minimal additional assets are required to service the payroll needs of more customers. Accordingly, client fund obligations (expressed as a percentage of total assets) will naturally expand over time.

Recessions will undoubtedly harm earnings potential given that ADP needs people to be employed, but it held up very well during the last recession and should again perform well in future recessions.

Final Thoughts & Recommendation

ADP's shares are pricing in a lot of optimism and growth, and we see it as significantly overvalued. In total, we expect 6.3% total returns annually, consisting of the 1.9% yield, 8% earnings-per-share growth and a 3.6% headwind from the valuation. Given the stock is now closer to fair value than it has been in a long time, we're upgrading ADP to a hold. While the stock is still expensive, ADP has outstanding growth potential.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	8928	9833	10595	9442	10226	10939	11668	12380	13326	14175
Gross Profit	3898	4125	4392	3868	4185	4511	4828	5110	5483	6089
Gross Margin	43.7%	41.9%	41.4%	41.0%	40.9%	41.2%	41.4%	41.3%	41.1%	43.0%
SG&A Exp.	2127	2315	2453	2200	2370	2497	2637	2783	2972	3064
D&A Exp.	309	315	319	251	267	278	289	316	378	409
Operating Profit	1771	1810	1939	1668	1815	2014	2191	2327	2512	3024
Operating Margin	19.8%	18.4%	18.3%	17.7%	17.7%	18.4%	18.8%	18.8%	18.8%	21.3%
Net Profit	1211	1254	1389	1406	1516	1453	1493	1733	1621	2293
Net Margin	13.6%	12.8%	13.1%	14.9%	14.8%	13.3%	12.8%	14.0%	12.2%	16.2%
Free Cash Flow	1455	1428	1661	1342	1518	1639	1511	1655	2044	2122
Income Tax	656	673	727	588	637	694	741	798	550	713

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	26862	34238	30817	32268	32060	33111	43670	37180	37089	41888
Cash & Equivalents	1643	1389	1548	1699	1584	1639	3191	2780	2170	1949
Acc. Receivable	1037	1288	1315	1516	1415	1547	1743	1704	1984	2439
Goodwill & Int.	2926	3789	3750	3682	2375	2297	2216	2361	3130	3395
Total Liabilities	21383	28228	24703	26078	25390	28302	39188	33203	33629	36488
Accounts Payable	150	153	167	157	152	195	152	150	135	126
Long-Term Debt	40	34	17	15	12	9	2008	2002	2002	2002
Total Equity	5479	6010	6114	6190	6670	4809	4482	3977	3460	5400
D/E Ratio	0.01	0.01	0.00	0.00	0.00	0.00	0.45	0.50	0.58	0.37

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	4.6%	4.1%	4.3%	4.5%	4.7%	4.5%	3.9%	4.3%	4.4%	5.8%
Return on Equity	22.4%	21.8%	22.9%	22.9%	23.6%	25.3%	32.1%	41.0%	43.6%	51.8%
ROIC	20.9%	21.7%	22.8%	22.8%	23.5%	25.3%	26.4%	27.8%	28.3%	35.6%
Shares Out.	502	492	491	484	483	466	456	445	439	436
Revenue/Share	17.72	19.73	21.53	19.38	21.17	22.99	25.41	27.49	30.06	32.39
FCF/Share	2.89	2.87	3.37	2.76	3.14	3.44	3.29	3.68	4.61	4.85

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

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