Automatic Data Processing (ADP)

Updated November 8th, 2019 by Josh Arnold

Key Metrics

Current Price:	$162	**5 Year CAGR Estimate:**	6.2%	**Volatility Percentile:**	28.1%
Fair Value Price:	$136	**5 Year Growth Estimate:**	8.0%	**Momentum Percentile:**	66.3%
% Fair Value:	120%	**5 Year Valuation Multiple Estimate:**	-3.5%	**Growth Percentile:**	80.1%
Dividend Yield:	1.9%	**5 Year Price Target**	$199	**Valuation Percentile:**	29.4%
Dividend Risk Score:	B	**Retirement Suitability Score:**	C	**Total Return Percentile:**	35.8%

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 $71 billion. With 44 years of consecutive dividend increases, it is also a member of the prestigious Dividend Aristocrats Index.

Automatic Data Processing reported first quarter earnings on October 30th, and results and guidance were both in line with prior expectations. Total revenue was up 6% to $3.5 billion, and was also up 6% in constant currency. Adjusted earnings before interest and taxes rose 8% to $745 million as adjusted EBIT margin was up 60bps to 21.3% of revenue.

Employer Services, which offers a range of global human capital management and human resources outsourcing solutions, saw revenue up 4% on a reported basis and 5% on an organic, constant currency basis. In addition, new business bookings were up 6%, while operating margin rose 50bps.

The company's second segment, PEO services, which provides employment administration outsourcing solutions, saw revenue increase 8%. The top line gain was 7% when removing zero-margin benefits pass-through revenue. Operating margin declined 70bps in this segment, primarily attributable to workers' compensation reserves in the company's indemnity business, which contributed 60bps of the total decline of 70bps.

Earnings-per-share came in at $1.34 on an adjusted basis, up 12% year-over-year, and in line with the company's guidance. As a result, we're maintaining our estimate of $6.16 in earnings-per-share in fiscal 2020.

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*	*$4.64*
Shares[1]	502	492	491	484	483	466	456	445	439	436	*434*	*420*

Automatic Data Processing has compounded its adjusted earnings-per-share at a rate of nearly 10% per year over the last decade, which we believe it can come close to matching 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 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, Q1 notwithstanding, 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 it will grow at meaningful rates for a long time to come.

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[1] Share count in millions

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	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	*26.3*	*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%*	*2.3%*

Despite recent relative weakness in the stock and higher earnings estimates for this year, Automatic Data Processing is still quite expensive. Shares trade for 26.3 times this year's earnings-per-share estimate, which compares unfavorably to our rather high fair value estimate at 22 times earnings. That implies a meaningful 3.5% 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. If the valuation multiple does decline, this will send the yield higher over time. Indeed, we see the yield moving up from today's 1.9% to 2.3% in five years.

Safety, Quality, Competitive Advantage, & Recession Resiliency

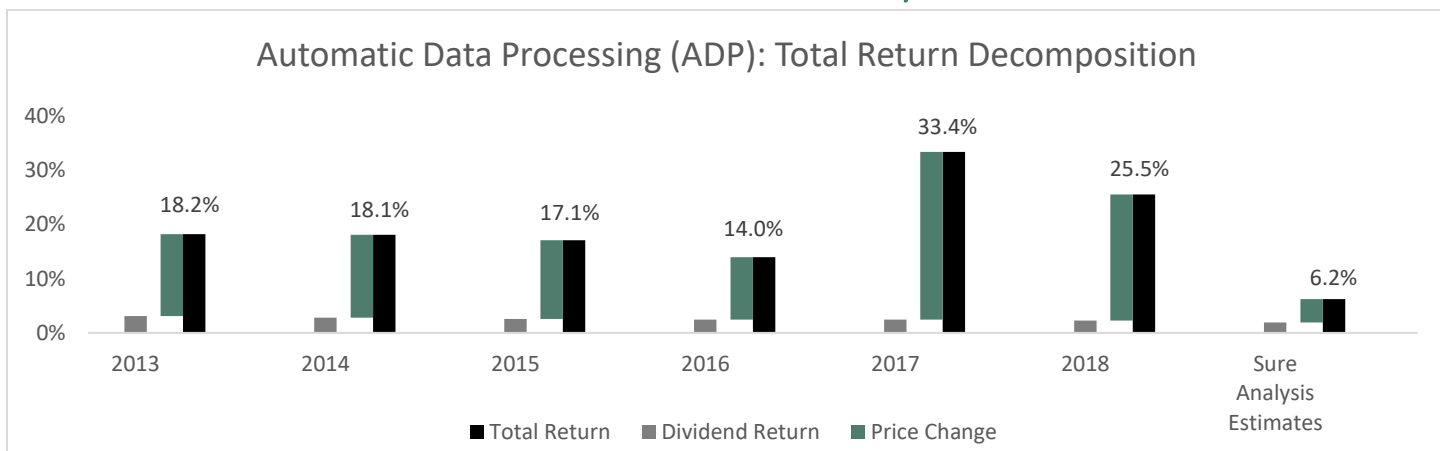| Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	56%	56%	55%	61%	61%	68%	64%	61%	55%	56%	*51%*	*51%*

What immediately stands out about ADP's quality metrics is the 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 scalable business model means that minimal additional assets are required to service the payroll needs of more customers. Accordingly, client fund obligations 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 continue to see it as significantly overvalued. In total, we expect 6.2% total returns annually, consisting of the 1.9% yield, 8% earnings-per-share growth and a moderate headwind from the valuation. While the stock is still expensive, ADP has outstanding growth potential, so we're reiterating our hold recommendation.

Total Return Breakdown by Year

Automatic Data Processing (ADP): Total Return Decomposition

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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.

Disclaimer