



# Automatic Data Processing (ADP)

Updated November 26<sup>th</sup>, 2020 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$174	<b>5 Year CAGR Estimate:</b>	3.3%	<b>Market Cap:</b>	\$75 B
<b>Fair Value Price:</b>	\$123	<b>5 Year Growth Estimate:</b>	8.0%	<b>Ex-Dividend Date:</b>	12/10/20
<b>% Fair Value:</b>	141%	<b>5 Year Valuation Multiple Estimate:</b>	-6.7%	<b>Dividend Payment Date:</b>	01/01/21
<b>Dividend Yield:</b>	2.1%	<b>5 Year Price Target</b>	\$181	<b>Years Of Dividend Growth:</b>	45
<b>Dividend Risk Score:</b>	B	<b>Retirement Suitability Score:</b>	C	<b>Last Dividend Increase:</b>	2.2%

## 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 \$75 billion, producing \$14+ billion in annual revenue. With 45 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 28<sup>th</sup>, 2020 and results for both the top and bottom lines came in better than expected. Revenue was down -1% year-over-year to \$3.5 billion on a reported basis, and also declined on a constant currency organic basis. Net earnings were up 3% to \$602 million, while adjusted net earnings were up 4% to \$605 million.

Adjusted EBIT increased 5% to \$781 million, with adjusted EBIT margin rising 120bps to 22.5%. The company managed to continue to improve its margins through transformation initiatives and expense management, which was partially offset by lower client fund interest revenue, as well as higher zero-margin pass-through revenue.

Diluted earnings-per-share rose 5% to \$1.41 on an adjusted basis, and the company raised guidance after Q1 results. We now expect \$5.60 in earnings-per-share this year, up from \$5.00 after Q4 results.

The company also raised its dividend by ~2%, increasing its dividend growth streak to 45 years.

## Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
<b>EPS</b>	\$2.52	\$2.82	\$2.80	\$3.11	\$2.89	\$3.25	\$3.70	\$4.53	\$5.45	\$5.92	<b>\$5.60</b>	<b>\$8.23</b>
<b>DPS</b>	\$1.42	\$1.55	\$1.70	\$1.88	\$1.95	\$2.08	\$2.24	\$2.50	\$3.06	\$3.52	<b>\$3.72</b>	<b>\$5.47</b>
<b>Shares<sup>1</sup></b>	492	491	484	483	466	456	445	439	436	429	<b>424</b>	<b>410</b>

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. Beyond this year, we believe the company is capable of delivering 8% annualized growth in earnings-per-share over full economic cycles, after weakness from COVID-19 has passed.

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, excluding COVID-19-related weakness, and we think it will grow at meaningful rates for a long time to come. We see Q1 results as supporting the revenue recovery and margin expansion thesis and see meaningful progress towards getting back on its prior growth track.

<sup>1</sup> 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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/E	17.2	18.7	18.7	21.8	24.5	29.0	26.0	27.0	27.1	26.8	31.1	22.0
Avg. Yld.	3.3%	3.0%	2.9%	2.8%	2.5%	2.3%	2.5%	2.3%	2.1%	2.2%	2.1%	3.0%

The stock has rallied enormously since our last update and shares now appear to be quite expensive. Indeed, shares trade for 31.1 times this year's earnings-per-share estimate, which compares quite unfavorably to our rather high fair value estimate at 22 times earnings. That implies a sizable headwind to total returns in the coming years, even after we've boosted our estimate of fair value to account for recent strong growth. If the valuation multiple does decline, this will send the yield higher over time. We see the yield moving up from today's 2.1% to 3.0% in five years, in part thanks to strong forecasted dividend growth.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	56%	55%	61%	61%	68%	64%	61%	55%	56%	59%	66%	66%

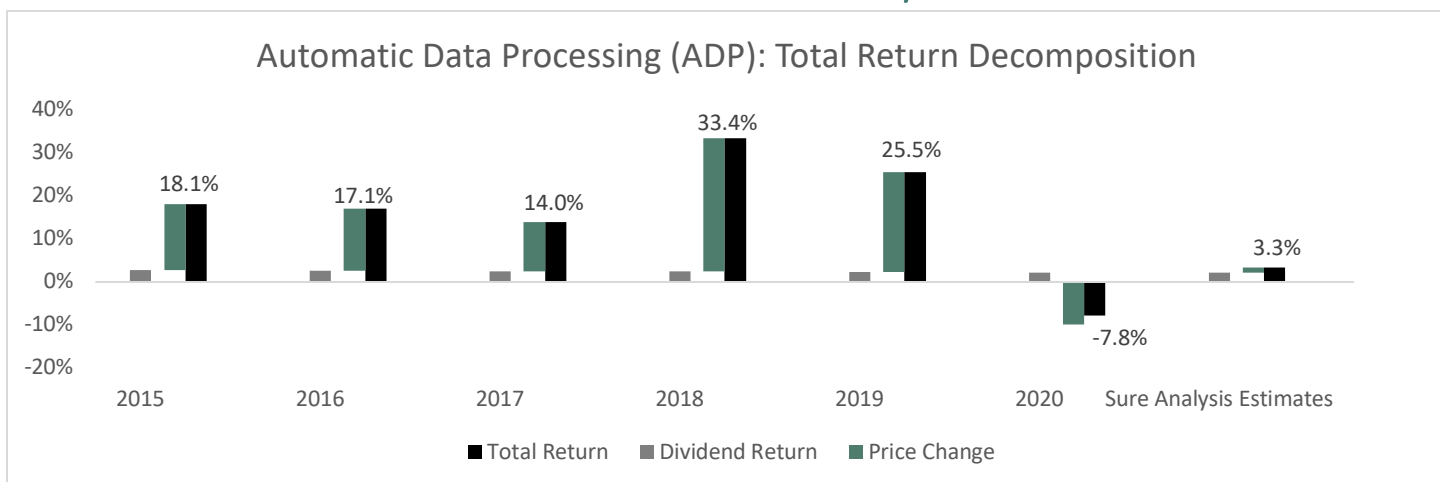
What immediately stands out about ADP's quality metrics is the high levels of debt. Fortunately, the vast majority of this debt is in the form of client fund obligations – money that is held by ADP before being paid out to the employees of its corporate customers. These client fund obligations are actually 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. Fiscal 2021 may prove difficult for ADP given high unemployment numbers, but we expect it will rebound into fiscal 2022 as conditions normalize.

## Final Thoughts & Recommendation

Shares have rallied strongly since our last update, creating a situation where the stock is overvalued in our view. The post-COVID rebound is well underway and we like the stock's fundamentals, but the overvaluation has total projected returns at just 3.3% annually. Shares earn a hold rating.

## Total Return Breakdown by Year



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## Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>Revenue</b>	9,833	10,595	9,442	10,226	10,939	11,668	12,372	13,328	14,175	14,590
<b>Gross Profit</b>	4,125	4,392	3,868	4,185	4,511	4,828	5,128	5,517	6,089	6,145
<b>Gross Margin</b>	41.9%	41.4%	41.0%	40.9%	41.2%	41.4%	41.4%	41.4%	43.0%	42.1%
<b>SG&amp;A Exp.</b>	2,315	2,453	2,200	2,370	2,497	2,637	2,774	2,959	3,064	3,003
<b>D&amp;A Exp.</b>	315	319	251	267	278	289	316	378	409	480
<b>Operating Profit</b>	1,810	1,939	1,668	1,815	2,014	2,191	2,354	2,557	3,024	3,142
<b>Operating Margin</b>	18.4%	18.3%	17.7%	17.7%	18.4%	18.8%	19.0%	19.2%	21.3%	21.5%
<b>Net Profit</b>	1,254	1,389	1,406	1,516	1,453	1,493	1,788	1,885	2,293	2,467
<b>Net Margin</b>	12.8%	13.1%	14.9%	14.8%	13.3%	12.8%	14.5%	14.1%	16.2%	16.9%
<b>Free Cash Flow</b>	1,428	1,661	1,342	1,518	1,639	1,511	1,655	2,044	2,122	2,410
<b>Income Tax</b>	673	727	588	637	694	741	829	398	713	716

## Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>Total Assets</b>	34,238	30,817	32,268	32,060	33,111	43,670	37,180	38,849	41,888	39,166
<b>Cash &amp; Equivalents</b>	1,389	1,548	1,699	1,584	1,639	3,191	2,780	2,170	1,949	1,909
<b>Acc. Receivable</b>	1,288	1,315	1,516	1,415	1,547	1,743	1,704	1,984	2,439	2,441
<b>Goodwill &amp; Int.</b>	3,789	3,750	3,682	2,375	2,297	2,216	2,361	3,130	3,395	3,525
<b>Total Liabilities</b>	28,228	24,703	26,078	25,390	28,302	39,188	33,203	34,113	36,488	33,413
<b>Accounts Payable</b>	153	167	157	152	195	152	150	135	126	102
<b>Long-Term Debt</b>	34	17	15	2,185	9	2,008	2,002	2,002	2,002	2,005
<b>Total Equity</b>	6,010	6,114	6,190	6,670	4,809	4,482	3,977	4,736	5,400	5,752
<b>D/E Ratio</b>	0.01	0.00	0.00	0.33	0.00	0.45	0.50	0.42	0.37	0.35

## Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
<b>Return on Assets</b>	4.1%	4.3%	4.5%	4.7%	4.5%	3.9%	4.4%	5.0%	5.7%	6.1%
<b>Return on Equity</b>	21.8%	22.9%	22.9%	23.6%	25.3%	32.1%	42.3%	43.3%	45.2%	44.2%
<b>ROIC</b>	21.7%	22.8%	22.8%	20.1%	21.2%	26.4%	28.7%	29.6%	32.4%	32.5%
<b>Shares Out.</b>	492	491	484	483	466	456	445	439	436	429
<b>Revenue/Share</b>	19.73	21.53	19.38	21.17	22.99	25.41	27.48	30.06	32.39	33.72
<b>FCF/Share</b>	2.87	3.37	2.76	3.14	3.44	3.29	3.68	4.61	4.85	5.57

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

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