



Automatic Data Processing (ADP)

Updated January 29th, 2021 by Josh Arnold

Key Metrics

Current Price:	\$166	5 Year CAGR Estimate:	6.9%	Market Cap:	\$71 B
Fair Value Price:	\$142	5 Year Growth Estimate:	8.0%	Ex-Dividend Date:	03/12/21
% Fair Value:	117%	5 Year Valuation Multiple Estimate:	-3.1%	Dividend Payment Date:	04/01/21
Dividend Yield:	2.2%	5 Year Price Target	\$208	Years Of Dividend Growth:	46
Dividend Risk Score:	B	Retirement Suitability Score:	B	Last Dividend Increase:	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 \$71 billion, producing nearly \$15 billion in annual revenue. With 46 years of consecutive dividend increases, it is also a member of the prestigious Dividend Aristocrats Index.

ADP reported second quarter earnings on January 27th, 2021 with results coming in better than expected on both the top and bottom lines. The top line posted just a 1% increase year-over-year, which is uncharacteristically low for ADP, as revenue expanded to \$3.7 billion. Employer Services sales totaled \$759 million, easily beating consensus of \$663 million. However, new business bookings declined -7%, which is also uncharacteristic for ADP. PEO Services beat estimates as well, rising to \$187 million for the quarter. While growth wasn't very strong for ADP, the company did beat estimates widely by simply not contracting at the expected rate.

Adjusted EBIT fell fractionally to \$648 million, and EBIT margin followed suit, declining 30bps to 22.9%. Earnings came to \$1.52 per share, well ahead of estimates. The company raised its guidance as well as it sees rapidly improving employment trends among its customers. Revenue is now expected to be +1% to +3%, which is up from the prior range of -1% to +1%. In addition, earnings-per-share is now expected to be -2% to +2%, which is up strongly from the prior range of -7% to -3%. Given this, we've boosted our estimate of earnings-per-share for this year from the prior \$5.60 to the new value of \$5.90.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
EPS	\$2.52	\$2.82	\$2.80	\$3.11	\$2.89	\$3.25	\$3.70	\$4.53	\$5.45	\$5.92	\$5.90	\$8.67
DPS	\$1.42	\$1.55	\$1.70	\$1.88	\$1.95	\$2.08	\$2.24	\$2.50	\$3.06	\$3.52	\$3.72	\$5.47
Shares¹	492	491	484	483	466	456	445	439	436	429	424	410

Automatic Data Processing has compounded its adjusted earnings-per-share at a rate of nearly 9% per year over the last decade, which we believe it can come close to matching moving forward given that its recent earnings growth had been accelerating meaningfully prior to COVID-19. Beyond 2021, 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

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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to come. We see Q2 results and raised guidance as supporting the revenue recovery and margin expansion thesis and see meaningful progress towards getting back on its prior growth track.

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	28.1	24.0
Avg. Yld.	3.3%	3.0%	2.9%	2.8%	2.5%	2.3%	2.5%	2.3%	2.1%	2.2%	2.2%	2.6%

The stock has pulled back since our last update and shares are now much closer to our estimate of fair value. Shares trade for 28.1 times this year's earnings-per-share estimate, which still compares unfavorably to our rather high fair value estimate at 24 times earnings. That implies a headwind to total returns in the coming years, even after we've boosted our estimate of fair value from the prior value of 22. If the valuation multiple does decline, this will send the yield higher over time. We see the yield moving up from today's 2.2% to 2.6% 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%	63%	63%

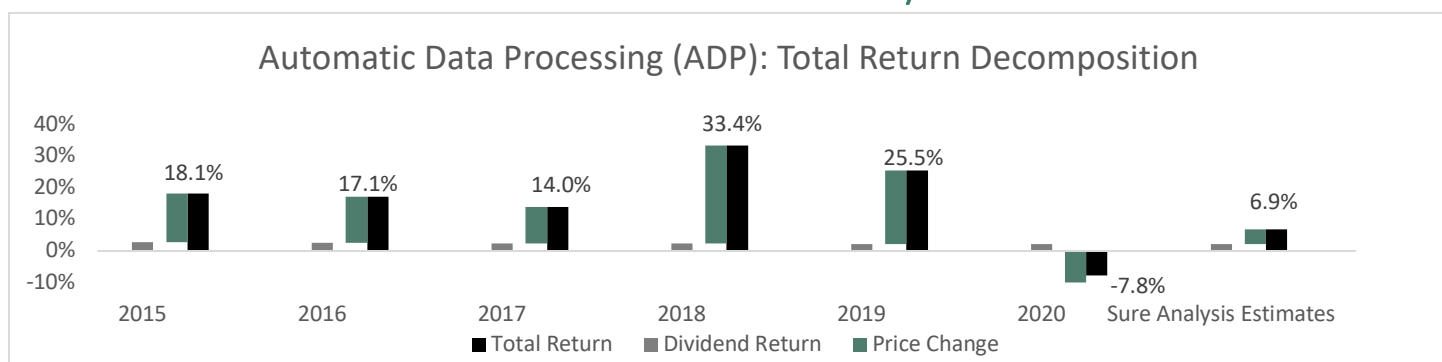
What immediately stands out about ADP's quality metrics is the high levels of debt. Fortunately, the vast majority of this debt is in the form of client fund obligations – money that is held by ADP before being paid out to the employees of its corporate customers. These client fund obligations are actually 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 is performing better than expected during this downturn. 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 come down while estimated earnings have risen, so we see the value proposition of ADP as much better than it was. The stock is still overvalued in our view, the company is rebounding quicker than expected into 202. We continue to rate the stock a hold based upon its 6.9% projected annual total returns and exceptional dividend streak.

Total Return Breakdown by Year



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Income Statement Metrics

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

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	34,238	30,817	32,268	32,060	33,111	43,670	37,180	38,849	41,888	39,166
Cash & Equivalents	1,389	1,548	1,699	1,584	1,639	3,191	2,780	2,170	1,949	1,909
Acc. Receivable	1,288	1,315	1,516	1,415	1,547	1,743	1,704	1,984	2,439	2,441
Goodwill & Int.	3,789	3,750	3,682	2,375	2,297	2,216	2,361	3,130	3,395	3,525
Total Liabilities	28,228	24,703	26,078	25,390	28,302	39,188	33,203	34,113	36,488	33,413
Accounts Payable	153	167	157	152	195	152	150	135	126	102
Long-Term Debt	34	17	15	2,185	9	2,008	2,002	2,002	2,002	2,005
Total Equity	6,010	6,114	6,190	6,670	4,809	4,482	3,977	4,736	5,400	5,752
D/E Ratio	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
Return on Assets	4.1%	4.3%	4.5%	4.7%	4.5%	3.9%	4.4%	5.0%	5.7%	6.1%
Return on Equity	21.8%	22.9%	22.9%	23.6%	25.3%	32.1%	42.3%	43.3%	45.2%	44.2%
ROIC	21.7%	22.8%	22.8%	20.1%	21.2%	26.4%	28.7%	29.6%	32.4%	32.5%
Shares Out.	492	491	484	483	466	456	445	439	436	429
Revenue/Share	19.73	21.53	19.38	21.17	22.99	25.41	27.48	30.06	32.39	33.72
FCF/Share	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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