Paychex, Inc. PAYX

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Analyst Note 10-08-2008

Given the current economic environment, we are changing our fair value uncertainty ratings for the payroll-outsourcing services firms. This is not a reflection upon the underlying fundamental quality of Paychex PAYX or Automatic Data Processing ADP, but it is a reflection of the uncertainty that has risen amid the current challenges in the credit markets. The difficulties facing businesses along the entire U.S. economic spectrum has heightened the risk profile of the aggregate investment market. Accordingly, government-related securities and other high-quality instruments have experienced a dramatic "flight to quality," which ultimately drags interest rates for these investments down. We have been impressed by the management of the investment portfolios for both firms and strongly expect this to continue. The conservative makeup of each portfolio is not a concern; interest rates, however, for the high-quality holdings of these portfolios may move even lower and have an impact upon float income. We continue to believe that Paychex and ADP are very strong businesses that produce great free cash flows and returns on invested capital.

Thesis 09-04-2008

Paychex was formed through the consolidation of 17 payroll processing companies in 1979 and has been one of the most successful human resources outsourcing firms in the United States. The minimal amount of capital required for operations and the firm’s significant competitive advantages have allowed it to produced returns on invested capital that have averaged 70% over the last 10 years. High customer switching costs, inherit scalability, and a respected brand image are the main drivers of the firm’s wide economic moat, which we believe form a potent combination that will last for some time to come.

Switching from one payroll processing vendor to another is a very difficult task, and customers’ unwillingness to do so has allowed Paychex to build a relatively sticky client base. This inelasticity has enabled the firm to raise prices annually and expand profits. Strong scalability has also allowed the firm to be price competitive without feeling margin pressure. Paychex is the second-largest player in the payroll outsourcing market (based on revenues), and it can leverage its 572,000 clients to spread costs associated with its servicing infrastructure. The firm’s strong brand also plays a significant role, since clients are hesitant to entrust their critical HR functions and payroll cash to an unproven competitor. The combination of these factors has produced margins that have been well above 30% during the last five years.

Contributing to these returns is the firm’s focus on servicing small and medium-size businesses. More than 99% of its clients fall into this category, and it has left the servicing of

Morningstar Rating

Stock Price
As of 10-08-2008
$28.14

Fair Value Estimate
$51.00

Consider Buying
$38.30

Consider Selling
$66.30

Fair Value Uncertainty
Low

Economic Moat
Wide

Stewardship Grade
A

Bulls Say

- High customer switching costs has allowed Paychex to annually raise prices at a rate above that of inflation.
- The firm’s focus on small to medium-size businesses gives it great pricing power.
- Paychex and its main rival, ADP, make up approximately 40% of the payroll outsourcing industry, and this allows for significant profit opportunities.
- The firm services one in 10 401(k) record-keeping plans in the United States.

Bears Say

- Interest income from client temporary funds could fluctuate greatly, given the current interest rate environment.
- The firm’s co-employment service line has exposed it to a greater amount of employee compliance and regulatory risk.

larger firms to the other major player in the payroll outsourcing industry, Automatic Data Processing ADP. The focus on smaller client servicing does give more fluidity to the firm's client base when compared to ADPADP, but we believe it also gives Paychex more pricing power and a greater ability to expand operating margin. Both firms have also left each other alone, for the most part, in order to exploit different parts of the payroll outsourcing market. This has been good in our opinion because excessive profit draining competition was avoided and both firms were able to reap the rewards.

The recent push into other noncore HR services could distract management and waste resources.

Providing other HR-related services to its customers is currently a main focus of the company, and we believe this strategy can add significantly to profitability. Paychex is one of the leading providers of 401(k) record-keeping services, and it also provides material services in the workers compensation insurance and total HR outsourcing markets. Revenues for these noncore services have grown to be approximately a quarter of total revenue. With very small incremental costs associated with these ancillary services, most of this additional revenue flows to the bottom line.

Valuation

We are raising our fair value estimate to $51 from $46. Our confidence in the ability of Paychex to manage revenue accretion and scalability through an economic slowdown has been strengthened. We are forecasting revenue growth to average 10% over the next three years, up from 8%. Customer retention and additions are expected to be higher because the natural business closures during an economic trough have been less numerous over the last year then originally forecasted. We also anticipate margins will increase a bit more as the firm is able to raise prices with greater ease and leverage the limited capital that is required for operations. Paychex also finds itself with a large amount of investable cash, which contributed approximately 6% to fiscal 2008 revenues. This investable portfolio of cash, also known as float, is a product of the lag between when Paychex receives and pays payroll-related funds on behalf of its clients to employees or other entities. During this lag, the firm is able to invest and earn interest on these funds. This component of the business has steadily continued to contribute less to overall revenue however, and we forecast this trend to continue. The average interest rate earned on float is expected to average approximately 3.5% during our 10-year explicit forecast, since Paychex has been very conservative with its investment decisions and we expected this to yield a return close to midterm U.S. government rates. Given our assumptions, we forecast revenue to slow in the near term but recover to a compounded annual growth rate of 10% over our 10-year explicit forecast period. We expect operating margins to stay positive and range from a low of 39% to a high of 44%, averaging 42%. To reach our Consider Buying price of $43, the compounded annual growth rate of revenue would have to be 9% and operating margins would have to average 40%.

Risk

The firm faces a near-term but mild recessionary head wind. Revenue growth and margins did retrench during the last economic slowdown but the effects were mild. The management of funds provided to Paychex from its clients to pay their employees and taxing authorities could create potential problems if handled improperly. If interest rates take an unexpected turn down or if the firm invests in assets that significantly underperform, revenue could be hurt along with its brand image. Unfavorable regulatory requirements could also pressure margins and revenue if adverse changes are made to government regulations relating to tax and/or employee benefits.

Close Competitors		TTM Sales $Mil	Market Cap $Mil
	Paychex, Inc.	**2,093**	**10,431**
*	Automatic Data Processing	8,777	19,149
*	CEN:USA	1,585	5,188
*	Administaff, Inc.	1,662	527
*	Gevity HR, Inc.	565	121

* Morningstar Analyst Report Available

Data as of 06-30-08

Strategy

Paychex is trying to branch out into other HR service offerings outside of the core payroll business. Combined revenue from the retirement, comprehensive HR outsourcing, and workers compensation lines have grown to approximately 25% of total revenue. These services are heavily marketed to current customers to try and boost profit per client. Paychex has recently entered the health and benefits services market, believes this segment is severely underpenetrated, and offers significant room for revenue and profitability growth. These ancillary services not only contribute to greater profitability, but also boost retention.

Management & Stewardship

Stewardship at Paychex has been fairly amenable to shareholders. We like the fact that the CEO and chairman roles are separate, with founder and former long-time CEO, B. Thomas Golisano, serving as chairman. His 10% equity stake is beneficial to shareholders in our opinion, because a great amount of his wealth is tied to the firm’s equity value. CEO Jonathan Judge has been with the firm since 2004 and his leadership seems to be on the right track. Board independence and annual elections for all board members, along with mandatory equity ownership requirements for the executive management team, also add to our favorable assessment of overall shareholder friendliness. We're impressed with the management of Paychex's portfolio of temporary client funds. While many firms that found themselves with large amounts of investable cash chased the supposedly high quality and returns of mortgage-backed securities, Paychex stayed conservative, with government bonds and sacrificed return for preservation of capital.

Profile

Paychex competes in the payroll outsourcing industry. It is the second-largest player in terms of revenues and focuses on providing this service to small and medium-size business. Paychex was created from the consolidation of 17 payroll processors in 1979 and services approximately 572,000 clients. The firm has 12,200 employees and is headquartered in Rochester, N.Y.

Growth

Revenue growth has been robust averaging 16% over the last 10 years. Revenue growth did slow slightly at the back end of the last recession, but it quickly recovered.

Profitability

Margins have averaged approximately 36% over the last 10 years and have been fairly stable, increasing to 40% in 2008. Margins actually increased slightly during the last recessionary period, which demonstrates the firm’s ability to perform well even in a weak environment.

Financial Health

Paychex is in excellent financial health with no debt on its balance sheet. Its ability to generate strong cash flow should keep the company unlevered.

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