

## Payments, Processors &amp; IT Services

**ADP/PAYX – running out of steam;  
downgrade to Underperform from Neutral**

Rating Change

**Deceleration could drive multiple compression**

We were surprised to see how much PAYX rallied on the F3Q print on 3/29/23, given that the company highlighted that headroom for improvement in both employment and interest rates has become much more limited. PAYX also highlighted that for F24 (starts 6/1/23), benefits from pricing and the Employee Retention Tax Credit (ERTC) will wane. While we do not expect ADP to provide an initial view on F24 during its F3Q call on 4/26, we expect some growth deceleration versus F23. We are not suggesting that there is significant downside risk to ADP/PAYX current stock prices, but with the backdrop of slower top-line growth and waning estimate upside potential, there could be risk to ADP/PAYX's C23 P/E multiples of ~26x, and we downgrade both to Underperform from Neutral.

**ADP/PAYX tend to lag when unemployment starts rising**

As seen in Exhibits 3 and 4, our analysis suggests that both ADP and PAYX tend to underperform the S&P 500 during the initial phase of a rising unemployment cycle. BofA Global Research's Economics team forecasts unemployment starting to rise in 3Q23 and peaking in 2Q24 and also forecasts just one more 25bps rate hike before cuts start in 1Q24. As the macro tailwinds of employment and rates abate (and, in some cases, turn into headwinds), we think that these stocks will become less appealing to investors. This is a cyclical call – we believe that ADP's and PAYX's business models remain structurally sound, and if extreme market volatility re-surfaces, these stocks could be viewed as relative "safe havens," especially as key metrics, such as retention, remain robust (but likely have limited room for improvement). On the heels of PAYX's print, the bar for ADP during its F3Q print is likely a little higher, as a similarly modest beat/raise has now become discounted.

**Prefer MA/SQ/V in large-cap Payments**

As we downgrade ADP and PAYX, we maintain our Buy ratings on our favorite large-cap Payments stocks (in alpha order), which are MA, SQ, and V. For example, we do not think that it makes sense that V and ADP trade at the same C23 P/E multiple. We continue to see the networks as particularly durable businesses in the payments landscape, with EPS protection in almost any macro scenario. Direct effects of recent bank failures are minimal, and even if they lead to a hard landing, we think that V's and MA's financial profiles will be the sturdiest in the sector. We believe that SQ has oversold on the recent short report and [found the company's response on 3/30/23](#) (see our report) to be robust and re-assuring as relates to operating metrics and compliance processes within the Cash App business.

**ADP/PAYX POs to \$211/\$105 from \$249/\$119**

We reduce our POs for ADP/PAYX to \$211/\$105 from \$249/\$119, reflecting 5%/8% downside. Our new POs are based on a 50/50 blend of 2023 P/E multiples and our DCFs. We lower our target multiples to 25x (from 29x) for ADP and to 24x (from 26x prior) for PAYX (our multiple for PAYX remains lower than that for ADP given SMB concentration, as SMBs are facing a greater risk from the recent bank failures). These new target multiples reflect a ~35%/~30% premium for ADP/PAYX versus the S&P 500, a slight discount to their respective 3-year historical averages of 43% and 48%, respectively.

03 April 2023

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DCF: discounted cash flow

MA: Mastercard

PAYX: Paychex

PO: price objective

SMB: small and medium-sized business

SQ: Block

V: Visa

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Refer to important disclosures on page 10 to 14. Analyst Certification on page 7. Price Objective Basis/Risk on page 5.

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Timestamp: 03 April 2023 12:01AM EDT

## Downgrading ADP and PAYX to Underperform

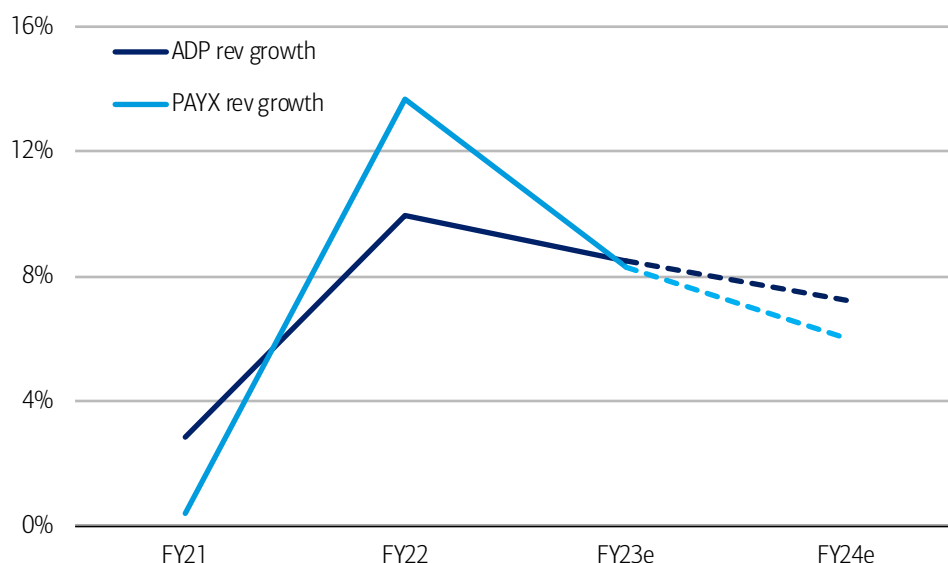
We see a potentially difficult setup for ADP and PAYX shares over the next few quarters, due to cyclical rather than structural factors. While we think that the business models remain solid, the macro backdrop of rising unemployment and declining rates could drive multiple compression and inhibit upside to estimates. And at their current ~26x P/E, we do not think that ADP/PAYX are adequately discounting these issues looming on the horizon.

After the initial shock of the pandemic temporarily caused US unemployment to skyrocket to 13% in 2Q20, ADP/PAYX saw significant benefits from sharp improvements in the labor market over the subsequent 2+ years, as evidenced in Exhibit 1. However, we now believe that the phase of outperforming against consensus estimates/guidance is coming to an end, as headroom for improvement in both employment and interest rates has become much more limited.

F22 revenue growth for ADP/PAYX was 9.9%/13.7%, respectively, and for F23 (which ends in May for PAYX, June for ADP), estimates are for 8.5%/8.3% growth, respectively. F24 revenue growth estimates for both companies are currently in the 6%-7% growth range, in line with PAYX's preliminary F24 guide provided last week.

### Exhibit 1: ADP/PAYX saw revenue growth accelerate during COVID recovery; top-line now slowing

ADP/PAYX F21-F24e revenue growth



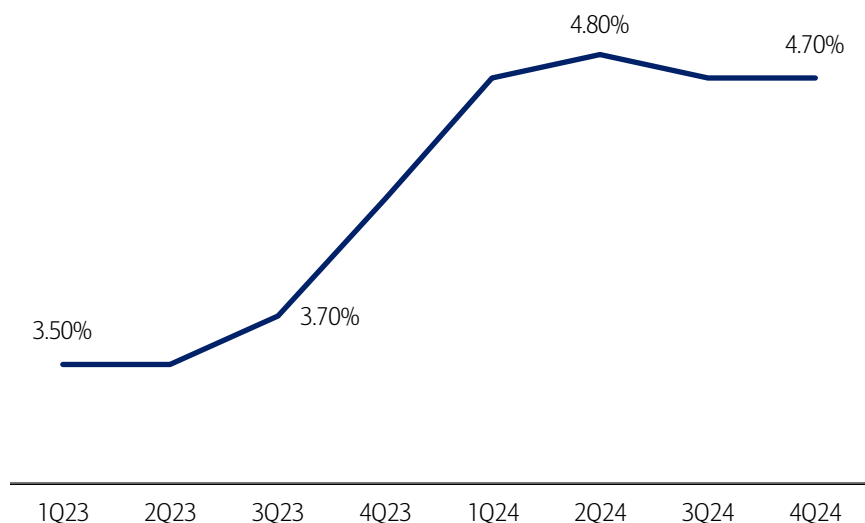
Source: Company reports, BofA Global Research estimates

BofA GLOBAL RESEARCH

The latest BofA Global Research Economics team forecasts call for unemployment to increase starting in 3Q23 and peak at 4.8% in 2Q24, as shown in Exhibit 2.

**Exhibit 2: Unemployment is expected to rise starting in 3Q23, peaking at 4.8% in 2Q24**

BofA Global Research forecasted unemployment rate



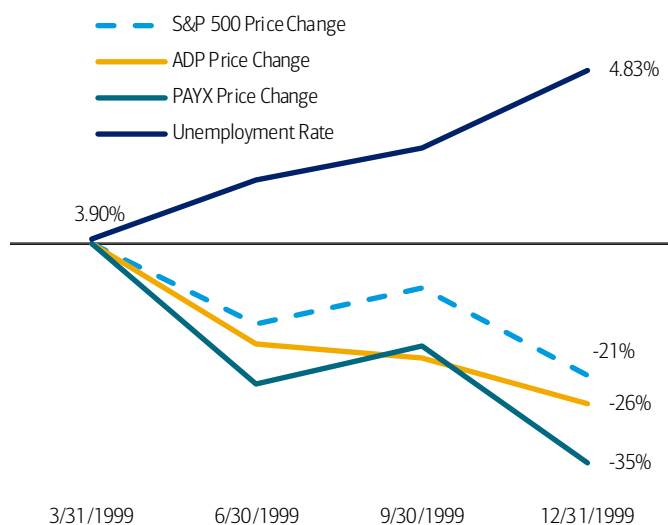
Source: BofA Global Research

BofA GLOBAL RESEARCH

Notably, ADP and PAYX underperformed in the first 2-3 quarters of a rising unemployment cycle during both the tech bubble of 2000-2002 and the Global Financial Crisis of 2007-2009:

**Exhibit 3: Unemployment rate versus ADP/PAYX/S&P 500 – 1999**

ADP/PAYX underperformed as unemployment began to rise in 1999

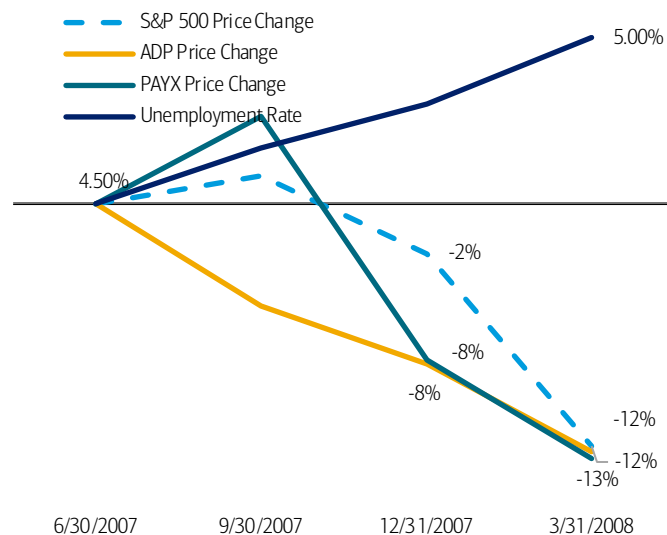


Source: Bloomberg, BofA Global Research

BofA GLOBAL RESEARCH

**Exhibit 4: Unemployment rate versus ADP/PAYX/S&P 500 – 2Q07-1Q08**

ADP/PAYX underperformed as unemployment began to rise in 2H07



Source: Bloomberg, BofA Global Research

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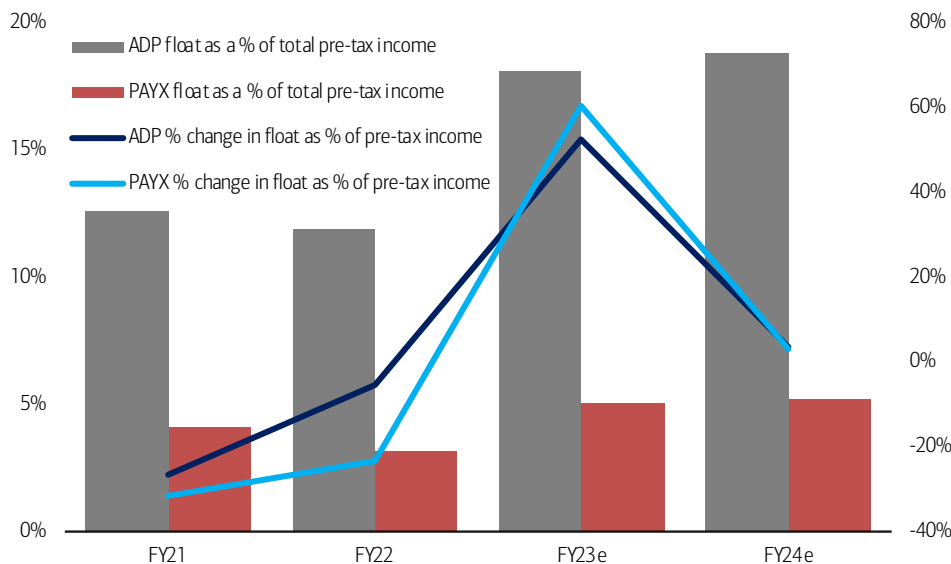
Additionally, as seen in Exhibit 5, over the past year, higher interest rates have been a material contributor to top-line growth and more so to margin expansion/pre-tax income (float income is ~100% margin). Now that the Fed is likely poised to pivot lower (based on forecasts of the BofA Global Research Economics team), a key tailwind is likely to



abate and ultimately become a headwind, assuming that rate cuts materialize as forecasted. That said, ADP's and PAYX's float portfolios are laddered, using fixed-income securities of various maturities (i.e., PAYX disclosed on last week's earnings call that its current duration is ~3.5 years). This laddering blunts some of the effects of changes in short-term interest rates (i.e., Fed funds).

#### Exhibit 5: Tailwind from float income expected to subside in F24

ADP/PAYX float income as % of total pre-tax income (LHS) and % change in float as % of pre-tax income (RHS)



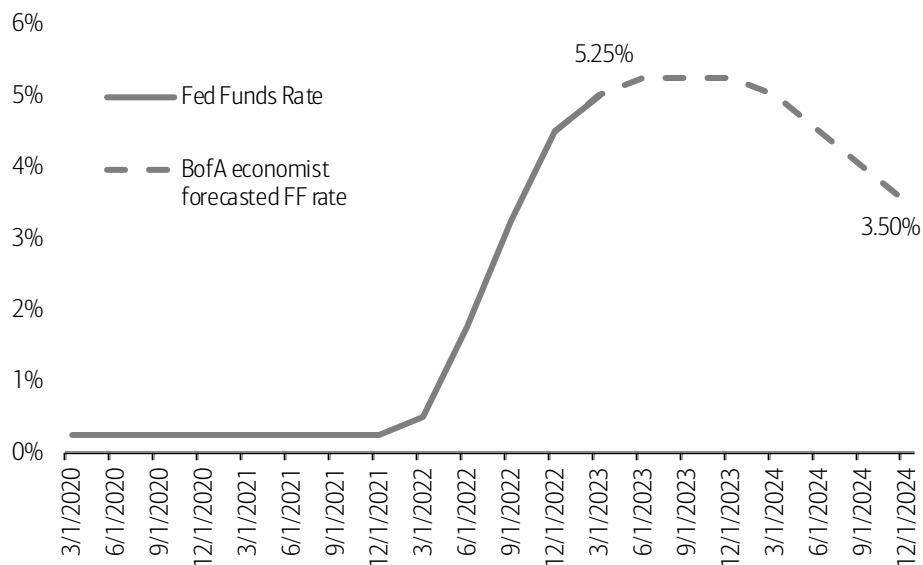
Source: Company reports, BofA Global Research

BofA GLOBAL RESEARCH

As seen in Exhibit 6, the BofA Global Research Economics team's current expectations are for one more Fed funds rate hike (of 25bps, to 5.25%) in May 2023 before a series of cuts, starting in 1Q24.

#### Exhibit 6: Rates are expected to be near peak levels + to decline in coming quarters

BofA Global Research Economics team's Fed funds forecast



Source: Bloomberg, BofA Global Research estimates

BofA GLOBAL RESEARCH

Despite these cyclical challenges, ADP and PAYX currently trade at 41% and 38% premiums to the S&P 500, respectively, not too far from their respective 3-year historical averages of 43% and 48%. Given where employment and rate trends are potentially headed, we think that this premium should be lower.

## PEO/insurance business has become a wild card

The PEO/insurance business for ADP and PAYX (representing 34% and 23% of total revenues, respectively) has struggled over the last few quarters due to weaker healthcare attachment and enrollment rates. While both management teams have suggested that conditions in this segment have likely bottomed and can recover, there is limited visibility on when PEO/insurance can get back to their historical double-digit growth rates. At ADP's November 2021 investor day, management provided medium-term PEO growth guidance of 10%-12%. Since 2019, growth has been closer to 9%; the only year above 10% was F22, and in F23/F24, we are modeling 8.5%/9.5%.

## Increasingly cautious on SMBs

While the SMB market has been resilient to date (with PAYX noting continued strength in March on its recent earnings call), we are becoming more cautious on the potential impact of macro developments on this market. Small businesses are likely to be more impacted by tighter lending standards, which are expected to occur due to the recent bank failures, as SMBs rely heavily on regional bank lending (see the report, [The Flow Show: The Perfect Low 16 March 2023](#)).

### Exhibit 7: Stocks mentioned

Prices and ratings for stocks mentioned in this report

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
ADP	ADP US	Automatic Data	US\$ 219.49	B-3-7
PAYX	PAYX US	Paychex	US\$ 113.54	B-3-7
MA	MA US	Mastercard Inc	US\$ 359.26	B-1-7
SQ	SQ US	Block Inc	US\$ 68.49	C-1-9
V	V US	Visa	US\$ 222.36	B-1-7

Source: BofA Global Research

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## Investment Rationale

### ADP

We rate ADP at Underperform. We view ADP's profitability and solid balance sheet / cash-flow profile favorably, however, we think the risks of rising unemployment and the expectation of lower rates are not properly discounted in the valuation.

### Paychex

We rate PAYX Underperform. We view PAYX's robust profitability and solid balance sheet / cash-flow profile favorably, however, we think the risk of rising unemployment, higher rates, and weakness for SMBs are not properly reflected in current valuation.

## Price objective basis & risk

### ADP (ADP)



Our \$211 PO is based on a combination of a 25x PE multiple to CY23 EPS and our DCF model. A 25x PE multiple represents an approximate 35% premium to the S&P 500, a slight discount to the 10 year average of about 45%. We think this reflects both the momentum ADP is experiencing in sales and retention, as well as the elevated risks of rising unemployment and lower rates. Our DCF uses a 3% terminal rate and a 9% WACC.

Upside risks to our price objective are: 1) stronger than forecast economic / employment backdrop - ADP's business model is tied to cyclical swings in US private sector employment. 2) better than expected margin / new bookings performance and 3) ADP is perceived as a high-quality company than can comfortably endure the unprecedented pressures from the pandemic.

Downside risks to our price objective are: 1) while ADP has a defensive business model, its shares have been tied to cyclical swings in US private sector employment, 2) potential for new competitive entrants or disintermediation through technical innovation, and 3) potential regulatory changes.

### **Block Inc (SQ)**

Our price objective of \$96 is based on a blend of 8x C23E EV/adjusted gross profit (which we use as a proxy for adjusted net revenue) and our DCF (15% WACC, 4% terminal growth). Our target multiple is in-line with the comp group.

Upside risks to our price objective are 1) better-than-expected overall macro conditions for small / medium sized businesses, 2) better-than-expected accretion from pending Afterpay acquisition, 3) re-acceleration of Cash App gross profit growth, 4) market perception of SQ as a terminal value stock.

Downside risks to our price objective are 1) increased competition from a wider group of companies as SQ moves upmarket and international, and intensifying competition in Cash App, 2) overall macro conditions for small/medium-sized businesses, and 3) lack of diversification for Cash App revenue/gross profit streams.

### **Mastercard Inc (MA)**

We utilize a 50/50 blend of 34x '23E GAAP EPS and our DCF model to calculate our 12-month price objective of \$438. Our multiple is a premium vs. the S&P500 given MA's above average earnings growth in a normalized environment, competitive positioning, secular tailwinds, and recession resilience. Our multiple is also slightly higher than its closest peer given MA grows faster, albeit off of a smaller base. Our discounted cash flow (DCF) analysis assumes a weighted average cost of capital of around 9% and a terminal growth rate of 4%.

Downside risks to our price objective are 1) weak consumer spending in the event of a macroeconomic downturn, 2) increased customer concentration and consolidation, 3) legislative and regulatory changes, 4) potential litigation settlements, which could include monetary damages, and/or result in changes in business practices, 5) loss of customer contracts due to increased competition or new entrants, including local/global payment networks, new start-ups and existing large and small technology companies, and 6) large fluctuations in the value of currencies/foreign exchange rates.

### **Paychex (PAYX)**

Our \$105 PO is based on a 50/50 combination of a 24x PE multiple to our CY23E EPS and our discounted cash flow (DCF) model. A 24x PE multiple is an approximate 30% premium to the S&P 500, which is slightly below PAYX's 10-yr average premium of about 50%. We think this correctly reflects PAYX's operating momentum, coupled with elevated risks of rising unemployment, higher rates, and weakness in the SMB market. Our DCF uses a 3% terminal rate and a 9% WACC.

Downside risks to our price objective are 1) slower new business formation, 2) declines in US employment, and 3) greater competition from payroll software firms, which puts pressure on pricing.

Upside risks to our price objective are 1) faster new business formation and 2) strong US employment growth.

### **Visa Inc. (V)**

We use a 50/50 blend of 31x C'23E EPS (GAAP) and our discounted cash flow (DCF) model to calculate our 12-month price objective of \$270. Our multiple is a slight premium to V's historical average, which we view the multiple as justified given Visa's growth profile, execution track record, and large addressable market opportunity. The key assumptions in our DCF model include a terminal growth rate of 3.5% and a weighted average cost of capital (WACC) of around 10%.

Downside risks to our price objective are 1) weak consumer spending in the event of a macroeconomic downturn, 2) increased customer concentration and consolidation, 3) legislative and regulatory changes, 4) potential litigation settlements, which could include monetary damages, and/or result in changes in business practices, 5) loss of customer contracts due to increased competition or new entrants, including local/global payment networks, new start-ups and existing large and small technology companies, and 6) large fluctuations in the value of currencies/foreign exchange rates.

## **Analyst Certification**

I, Jason Kupferberg, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

## **Special Disclosures**

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## US - Payments, Processors, Specialty Finance and IT services Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
<b>BUY</b>				
	Accenture Plc	ACN	ACN US	Jason Kupferberg
	American Express Company	AXP	AXP US	Mihir Bhatia
	Ares Capital Corporation	ARCC	ARCC US	Derek Hewett
	Ares Commercial Real Estate Corporation	ACRE	ACRE US	Derek Hewett
	Barings BDC Inc	BBDC	BBDC US	Derek Hewett
	Blackrock TCP Capital Corp	TCPC	TCPC US	Derek Hewett
	Blackstone Mortgage Trust Inc	BXMT	BXMT US	Derek Hewett
	Block Inc	SQ	SQ US	Jason Kupferberg
	Bread Financial Holdings Inc	BFH	BFH US	Mihir Bhatia
	Carlyle Secured Lending Inc	CGBD	CGBD US	Derek Hewett
	CI&T	CINT	CINT US	Jason Kupferberg
	Compass Diversified Holdings	CODI	CODI US	Derek Hewett
	Crescent Capital BDC	CCAP	CCAP US	Derek Hewett
	DLocal	DLO	DLO US	Jason Kupferberg
	EngageSmart	ESMT	ESMT US	Jason Kupferberg
	EPAM Systems	EPAM	EPAM US	Jason Kupferberg
	Essent Group	ESNT	ESNT US	Mihir Bhatia
	Fidelity National Information Services	FIS	FIS US	Jason Kupferberg
	Fiserv Inc	FISV	FISV US	Jason Kupferberg
	FleetCor Technologies Inc.	FLT	FLT US	Mihir Bhatia
	Flywire	FLYW	FLYW US	Jason Kupferberg
	Global Payments Inc	GPN	GPN US	Jason Kupferberg
	Mastercard Inc	MA	MA US	Jason Kupferberg
	MGIC Investment Corp.	MTG	MTG US	Mihir Bhatia
	New Mountain Finance Corporation	NMFC	NMFC US	Derek Hewett
	Nuvei	NVEI	NVEI US	Jason Kupferberg
	Nuvei	YNVEI	NVEI CN	Jason Kupferberg
	Owl Rock Capital Corporation	ORCC	ORCC US	Derek Hewett
	PayPal Holdings Inc	PYPL	PYPL US	Jason Kupferberg
	Radian Group Inc	RDN	RDN US	Mihir Bhatia
	Safehold, Inc	SAFE	SAFE US	Derek Hewett
	Shift4 Payments, Inc	FOUR	FOUR US	Jason Kupferberg
	Sixth Street Specialty Lending, Inc	TSLX	TSLX US	Derek Hewett
	SoFi Technologies Inc	SOFI	SOFI US	Mihir Bhatia
	Starwood Property Trust	STWD	STWD US	Derek Hewett
	TaskUs	TASK	TASK US	Cassie Chan
	Telus International	TIXT	TIXT US	Cassie Chan
	Telus International	YTIXT	TIXT CN	Cassie Chan
	Visa Inc.	V	V US	Jason Kupferberg
	WEX Inc.	WEX	WEX US	Mihir Bhatia
<b>NEUTRAL</b>				
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	AGNC Investment Corp	AGNC	AGNC US	Derek Hewett
	Annaly Capital Management	NLY	NLY US	Derek Hewett
	Apollo Commercial Real Estate Finance	ARI	ARI US	Derek Hewett
	Bain Capital Specialty Finance, Inc.	BCSF	BCSF US	Derek Hewett
	Blackstone Secured Lending Fund	BXSL	BXSL US	Derek Hewett
	BrightSpire Capital Inc.	BRSP	BRSP US	Derek Hewett
	Capital One Financial	COF	COF US	Mihir Bhatia
	Discover Financial	DFS	DFS US	Mihir Bhatia
	Ellington Financial	EFC	EFC US	Derek Hewett
	Goldman Sachs BDC, Inc.	GSBD	GSBD US	Derek Hewett
	Golub Capital BDC, Inc.	GBDC	GBDC US	Derek Hewett
	Ladder Capital Corp	LADR	LADR US	Derek Hewett
	Paymentus	PAY	PAY US	Jason Kupferberg
	PennyMac Mortgage Investment Trust	PMT	PMT US	Derek Hewett
	Synchrony Financial	SYF	SYF US	Mihir Bhatia
	Thoughtworks	TWKS	TWKS US	Jason Kupferberg
	TPG Real Estate Finance Trust	TRTX	TRTX US	Derek Hewett
	TTEC Holdings	TTEC	TTEC US	Cassie Chan
<b>UNDERPERFORM</b>				
	ADP	ADP	ADP US	Jason Kupferberg
	Angel Oak Mortgage Inc.	AOMR	AOMR US	Derek Hewett



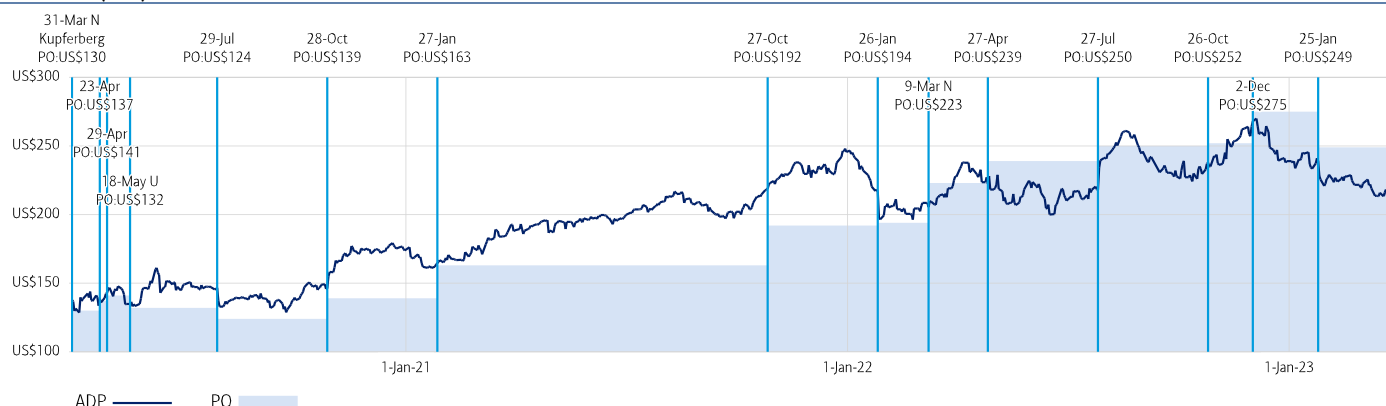
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	CGI Inc.	GIB	GIB US	Jason Kupferberg
	CGI Inc.	YGIBA	GIB/A CN	Jason Kupferberg
	Cognizant Technology Solutions	CTSH	CTSH US	Jason Kupferberg
	Coinbase	COIN	COIN US	Jason Kupferberg
	DXC Technology	DXC	DXC US	Jason Kupferberg
	Enact Holdings	ACT	ACT US	Mihir Bhatia
	Guild Holdings Company	GHLA	GHLA US	Derek Hewett
	Home Point Capital	HMPT	HMPT US	Mihir Bhatia
	Invesco Mortgage Capital, Inc.	IVR	IVR US	Derek Hewett
	loanDepot Inc	LDI	LDI US	Derek Hewett
	MidCap Financial Investment Co	MFIC	MFIC US	Derek Hewett
	New York Mortgage Trust	NYMT	NYMT US	Derek Hewett
	Paychex	PAYX	PAYX US	Jason Kupferberg
	Rocket Companies, Inc.	RKT	RKT US	Mihir Bhatia
	Western Union	WU	WU US	Jason Kupferberg

## Disclosures

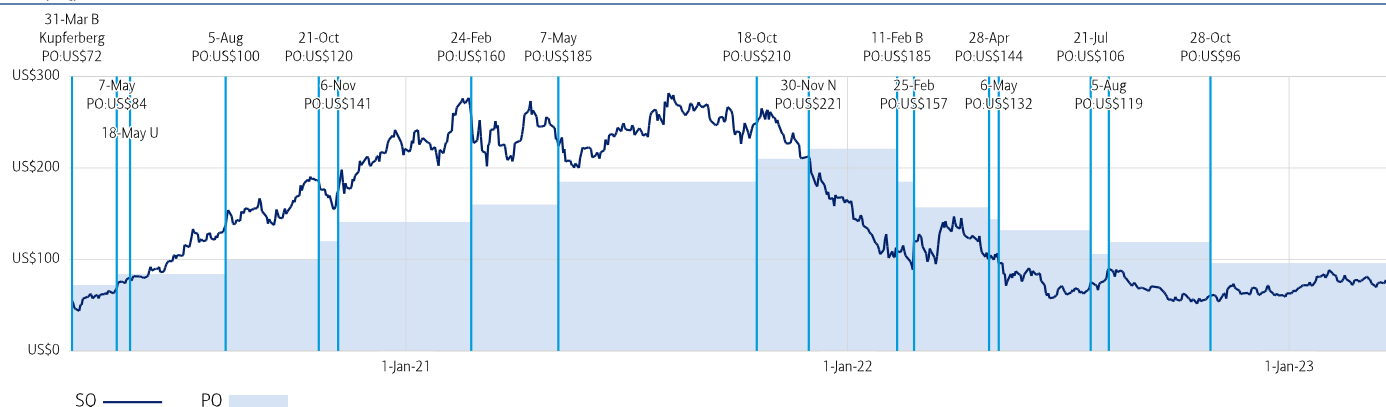
## Important Disclosures

## Automatic Data (ADP) Price Chart

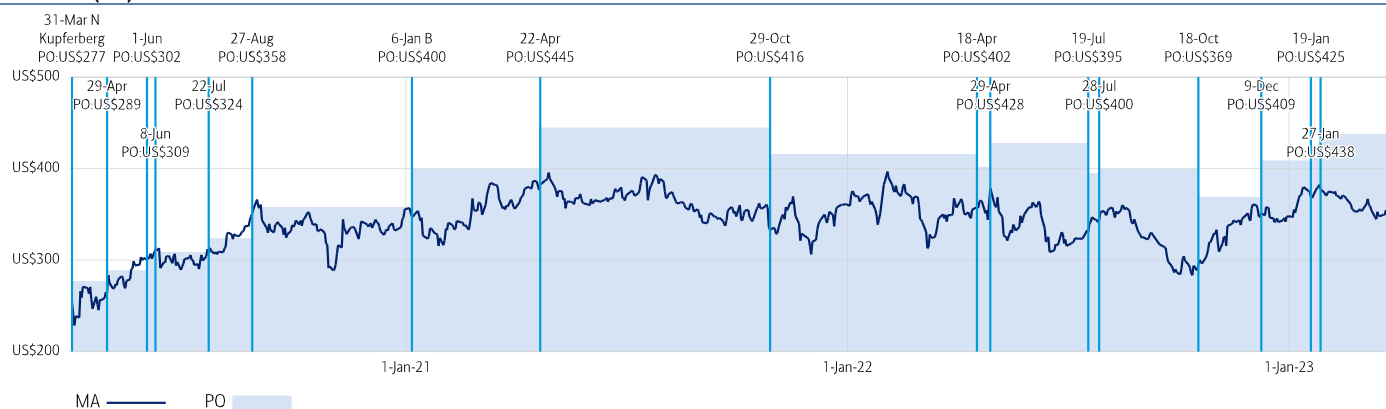


The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

## Block Inc (SQ) Price Chart

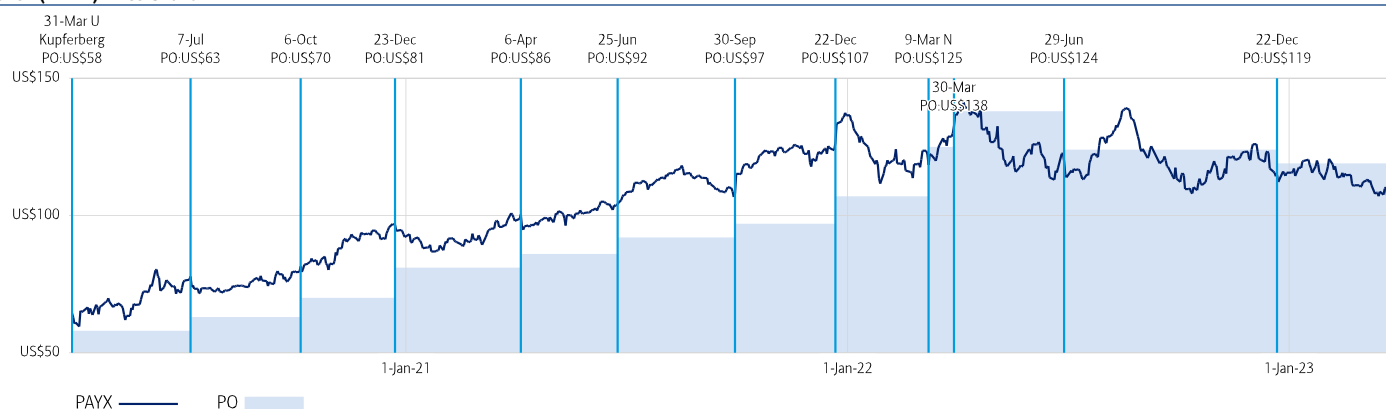


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**Mastercard Inc (MA) Price Chart**

B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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**Paychex (PAYX) Price Chart**

B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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**Visa (V) Price Chart**

B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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**Equity Investment Rating Distribution: Technology Group (as of 31 Dec 2022)**

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	216	50.35%	Buy	113	52.31%
Hold	119	27.74%	Hold	58	48.74%
Sell	94	21.91%	Sell	31	32.98%

**Equity Investment Rating Distribution: Global Group (as of 31 Dec 2022)**

Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	Count	Percent
Buy	1853	52.58%	Buy	1040	56.13%
Hold	840	23.84%	Hold	493	58.69%
Sell	831	23.58%	Sell	404	48.62%

<sup>R1</sup> Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster <sup>R2</sup>
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

<sup>R2</sup> Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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