

Payments, Processors & IT Services

ADP/PAYX – reiterating the bear case; maintain Underperform ratings

Industry Overview

Macro tailwinds have peaked and valuations are rich

Following our ADP/PAYX downgrade on 4/3/23 ([ADP/PAYX - running out of steam; downgrade to Underperform from Neutral](#)), we reiterate our Underperform rating on both stocks. We don't see structural issues with these businesses, but believe the dual macro/cyclical tailwinds of employment and rates have peaked, implying limited headroom in estimates as revenue growth decelerates this fiscal year. Unemployment is expected to gradually move higher, while rates are forecast to plateau after one more small hike and then gradually decline. ADP/PAYX P/E multiples are also rich.

ADP/PAYX typically lag as unemployment starts to rise

ADP and PAYX have historically lagged the S&P500 during the initial phase of a rising unemployment cycle (Exhibits 1, 2). The US unemployment rate in August rose to 3.8% from 3.5% in July, representing the highest level since Feb. 2022. BofA Economists' current forecast is for unemployment to gradually increase to a 4.3% peak in 1Q25 (Exhibit 3). Since the pandemic recovery, ADP/PAYX shares have benefited from historically low unemployment. We think this tailwind is likely over and expect rising unemployment will weigh on shares over the coming quarters.

Float income benefit peaking

In addition to the tailwind of historically low unemployment, ADP/PAYX estimates and share price have benefited from rising interest rates, which help drive higher float income (which is ~100% margin). BofA Economists are currently forecasting just one additional 25bps rate increase before rate cuts begin in 2Q24 (Exhibit 4).

F24 guidance has limited upside

ADP and PAYX both issued guidance for F24 (which ends 6/30/24 for ADP and 5/31/24 for PAYX) as part of their F4Q23 earnings. ADP guided F24 revenue growth of 6%-7% (Street was 5.9%) and Adj EPS growth of 10-12% (Street was ~9%). PAYX guided for 6%-7% revenue growth (Street was 6.3%) and Adj EPS growth of 9%-10% (Street was ~7%). While this guidance doesn't seem unachievable (especially given strong bookings trends exiting F23), given less help from macro and with customer retention already at record levels, we see limited upside to numbers.

Valuation unattractive vs. V/MA

ADP and PAYX currently trade at 26x / 25x C24 P/E, respectively, vs. large-cap comps V and MA, which trade at 25x / 28x, respectively. In our view, Buy-rated V and MA are higher-quality business models with more of a competitive moat and secular tailwind than ADP and PAYX, and therefore warrant a higher relative valuation multiple, especially at this point in the cycle for employment and rates. We leave our ADP/PAYX POs unchanged at \$225/\$103, which reflect 10%/15% potential downside from current levels.

11 September 2023

Equity
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Exhibit 1: Companies mentioned

ADP/PAYX valuation unattractive vs. V/MA

Ticker	Company	Rating
ADP	Automatic Data	Underperform
MA	Mastercard Inc	Buy
PAYX	Paychex	Underperform
V	Visa	Buy

Source: BofA Global Research

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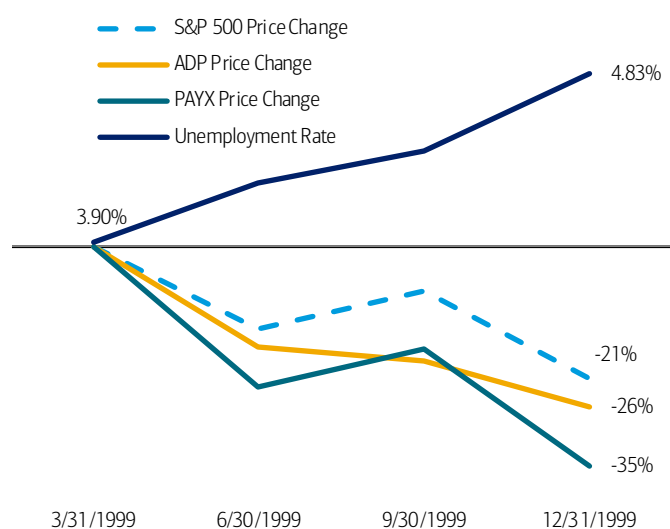
Reiterate Underperform on ADP and PAYX

Shares of ADP and PAYX have meaningfully outperformed the S&P500 since the end of June, we believe mostly due to higher rates (10-year yield now 4.26% vs. 3.84% at end of June), and some rotation to lower-beta tech names. While ADP and PAYX have lagged the S&P500 YTD, we reiterate our Underperform ratings on both, as we see receding tailwinds from macro trends in both employment and interest rates.

We have seen in prior cycles that ADP and PAYX tend to underperform at the early stages of rising unemployment (Exhibits 1, 2). We are currently seeing signs of an upward unemployment trend, as the August unemployment rate of 3.8% increased 30bps m/m, to the highest level seen since February 2022. August unemployment was also 30bps above the 3.5% consensus expectation. BofA economists are now forecasting unemployment to gradually increase until peaking at 4.3% in 1Q25 (Exhibit 3).

Exhibit 1: Unemployment rate vs ADP/PAYX/S&P500 - 1999

ADP/PAYX underperformed as unemployment began to rise in 1999

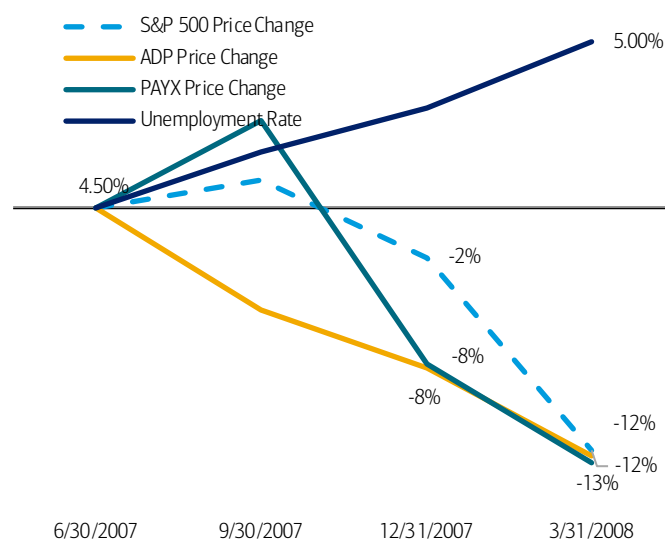


Source: Bloomberg, BofA Global Research

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Exhibit 2: Unemployment rate vs ADP/PAYX/S&P500 - 2Q07-1Q08

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

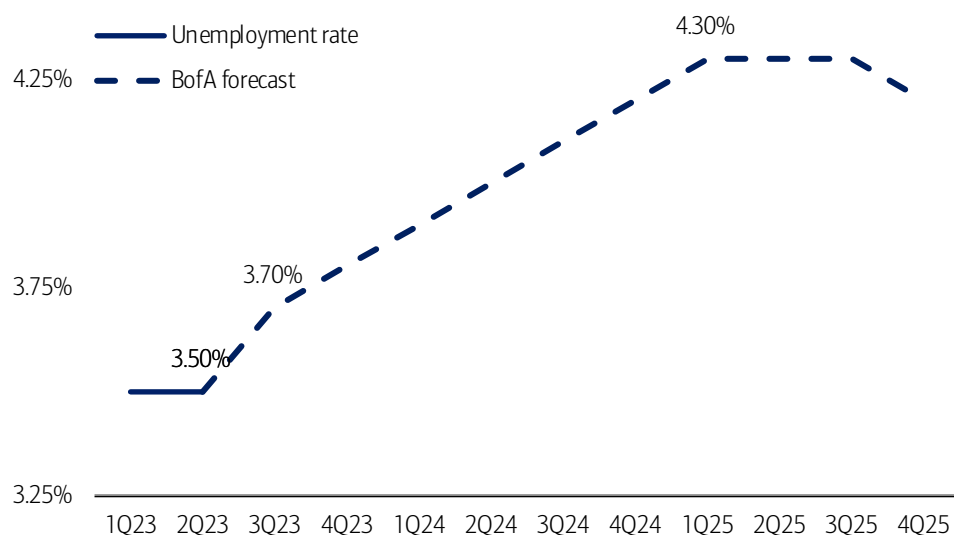


Source: Bloomberg, BofA Global Research

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Exhibit 3: BofA expects unemployment to peak at 4.3% in 1Q25

BofA forecasted unemployment rate



Source: BofA Global Research

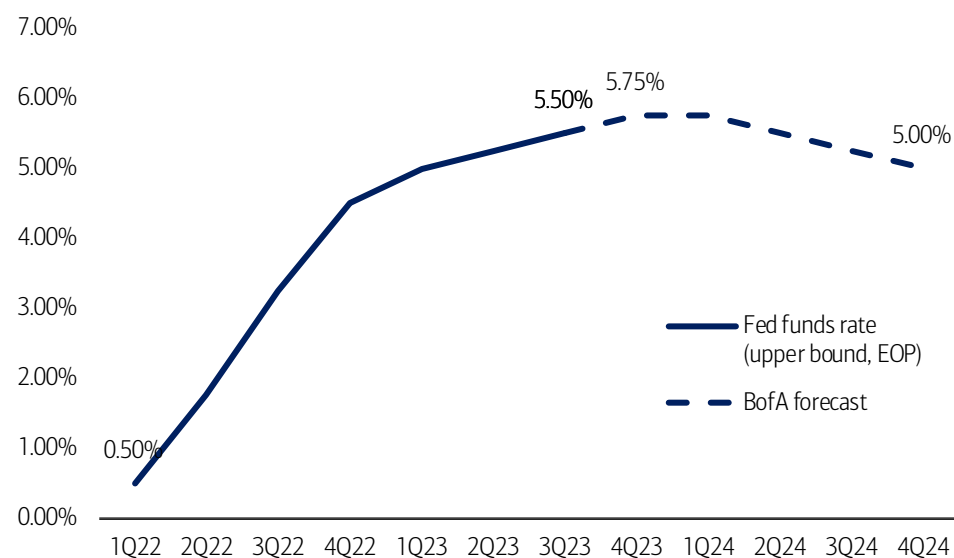
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Higher interest rates have also served as a tailwind for ADP and PAYX since the hiking cycle began in March 2022. This is because the companies earn interest income on float balances of payroll and tax funds that they temporarily hold for clients. This float income is essentially 100% margin, so it has a disproportionate effect on earnings.

As seen in Exhibit 4, BofA economists are now forecasting reaching a terminal rate of 5.75% in 4Q23 following a final 25bps rate hike in November, with rate cuts forecast to begin in 2Q24. While we believe this pattern is generally assumed in ADP and PAYX's guidance, given where the Fed is in the rate hike cycle, float income seems less likely to surprise to the upside in F24.

Exhibit 4: BofA expects to reach terminal rate of 5.5%-5.75% in 4Q23

BofA forecasted Federal Funds rate



Source: BofA Global Research

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Exhibit 2: 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\$ 249.37	B-3-7
MA	MA US	Mastercard Inc	US\$ 414.84	B-1-7
PAYX	PAYX US	Paychex	US\$ 120.54	B-3-7
V	V US	Visa	US\$ 247.29	B-1-7

Source: BofA Global Research

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Price objective basis & risk**ADP (ADP)**

Our \$225 PO is based on a 50/50 combination of a 23x PE multiple to CY24 EPS and our DCF model. A 23x PE multiple represents an approximate 25% premium to the S&P 500, a slight discount to the 10 year average of about 40%. 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 an approximate 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.

Mastercard Inc (MA)

We utilize a 50/50 blend of 31x '24E GAAP EPS and our DCF model to calculate our 12-month price objective of \$442. Our multiple is a premium vs. the S&P500 given MA's above average earnings growth in a normalized environment, increased diversification, 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 10% 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 \$103 PO is based on a 50/50 combination of a 23x PE multiple to our CY24E EPS and our discounted cash flow (DCF) model. A 23x PE multiple is an approximately 20% premium to the S&P 500, which is 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 28x C'24E EPS (GAAP) and our discounted cash flow (DCF) model to calculate our 12-month price objective of \$275. Our multiple is a slight premium to V's historical average, which we view the multiple as justified given Visa's growth profile, increased diversification, 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.

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	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
	Blue Owl Capital Corporation	OBDC	OBDC US	Derek Hewett
	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
	EngageSmart	ESMT	ESMT US	Jason Kupferberg
	Essent Group	ESNT	ESNT US	Mihir Bhatia
	Fidelity National Information Services	FIS	FIS US	Jason Kupferberg
	Fiserv Inc	FI	FI 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
	OneMain Holdings, Inc.	OMF	OMF US	Mihir Bhatia
	PayPal Holdings Inc	PYPL	PYPL US	Jason Kupferberg
	Safehold, Inc	SAFE	SAFE US	Derek Hewett
	Shift4 Payments, Inc	FOUR	FOUR US	Jason Kupferberg
	Sixth Street Specialty Lending, Inc	TSIX	TSIX US	Derek Hewett
	Starwood Property Trust	STWD	STWD US	Derek Hewett
	Telus International	TIXT	TIXT US	Cassie Chan
	Telus International	YTIXT	TIXT CN	Cassie Chan
	Toast	TOST	TOST US	Jason Kupferberg
	Visa Inc.	V	V US	Jason Kupferberg
	WEX Inc.	WEX	WEX US	Mihir Bhatia
NEUTRAL				
	Affirm Holdings	AFRM	AFRM US	Jason Kupferberg
	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
	DLocal	DLO	DLO US	Jason Kupferberg
	Ellington Financial	EFC	EFC US	Derek Hewett
	Enact Holdings	ACT	ACT US	Mihir Bhatia
	Goldman Sachs BDC, Inc.	GSBD	GSBD US	Derek Hewett
	Golub Capital BDC, Inc.	GBDC	GBDC US	Derek Hewett
	Jack Henry & Associates	JKHY	JKHY US	Jason Kupferberg
	Ladder Capital Corp	LADR	LADR US	Derek Hewett
	Marqeta	MQ	MQ US	Jason Kupferberg
	PennyMac Mortgage Investment Trust	PMT	PMT US	Derek Hewett
	SoFi Technologies Inc	SOFI	SOFI US	Mihir Bhatia
	Synchrony Financial	SYF	SYF US	Mihir Bhatia
	Thoughtworks	TWKS	TWKS US	Jason Kupferberg
	TPG RE Finance Trust, Inc.	TRTX	TRTX US	Derek Hewett
	TTEC Holdings	TTEC	TTEC US	Cassie Chan
UNDERPERFORM				
	ADP	ADP	ADP US	Jason Kupferberg



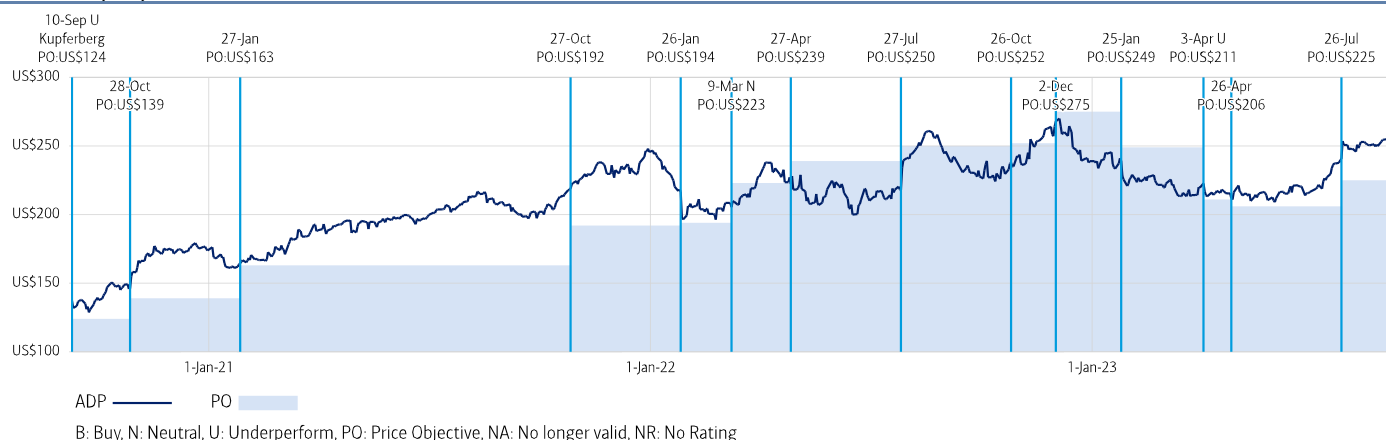
US - Payments, Processors, Specialty Finance and IT services Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Angel Oak Mortgage Inc.	AOMR	AOMR US	Derek Hewett
	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
	EPAM Systems	EPAM	EPAM US	Jason Kupferberg
	Guild Holdings Company	GHLD	GHLD US	Derek Hewett
	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
	Radian Group Inc	RDN	RDN US	Mihir Bhatia
	Rocket Companies, Inc.	RKT	RKT US	Mihir Bhatia
	TaskUs	TASK	TASK US	Cassie Chan
	Western Union	WU	WU US	Jason Kupferberg

Disclosures

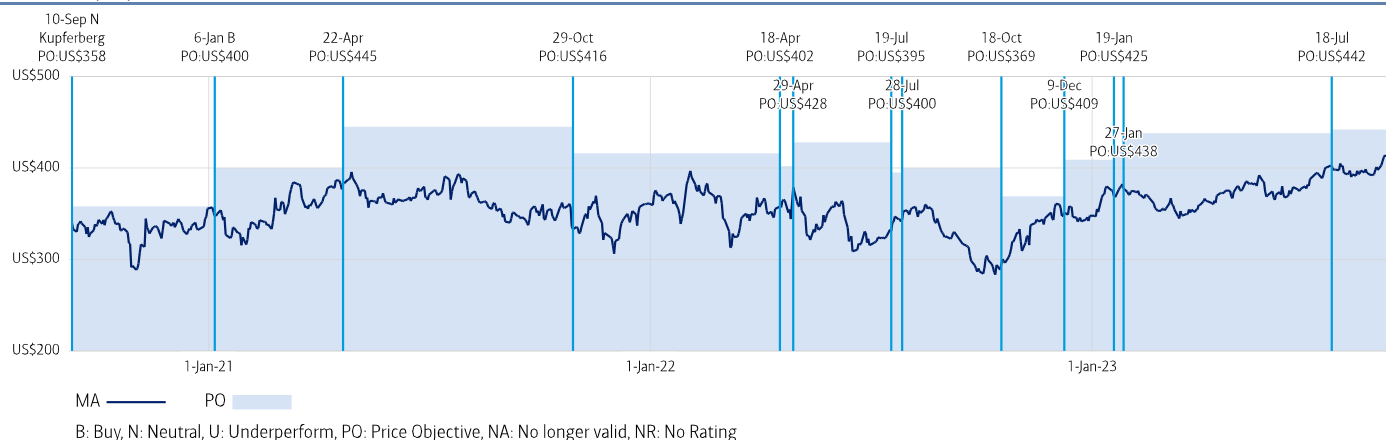
Important Disclosures

Automatic Data (ADP) Price Chart



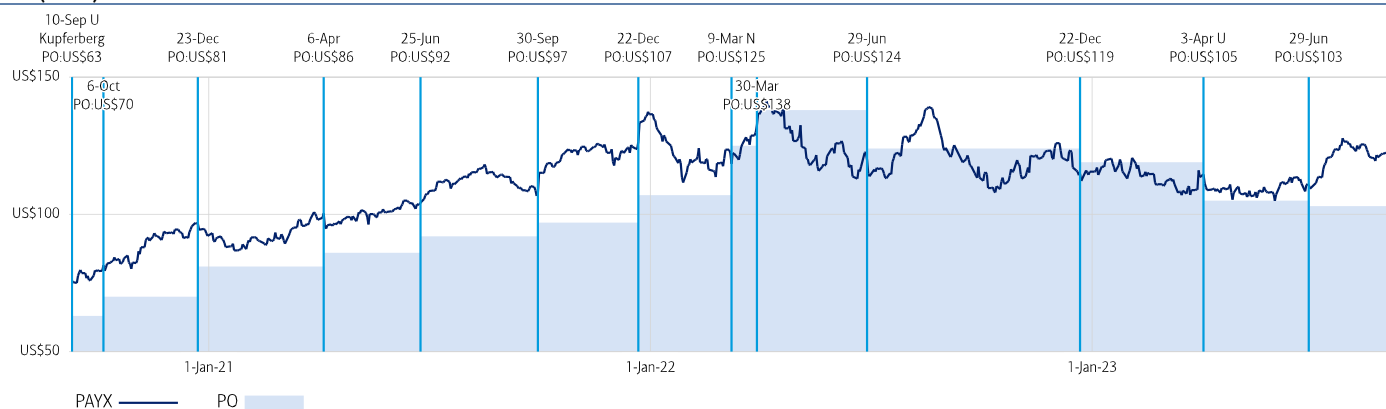
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Mastercard Inc (MA) Price Chart



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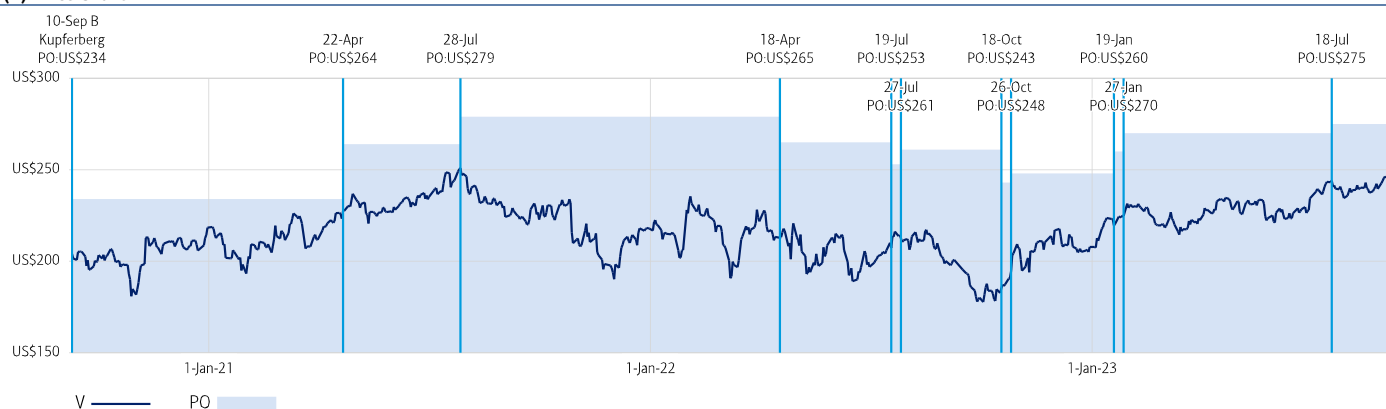
Paychex (PAYX) Price Chart



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 30 Jun 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	212	53.13%	Buy	103	48.58%
Hold	89	22.31%	Hold	45	50.56%
Sell	98	24.56%	Sell	30	30.61%

Equity Investment Rating Distribution: Global Group (as of 30 Jun 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1877	53.28%	Buy	1040	55.41%
Hold	815	23.13%	Hold	464	56.93%
Sell	831	23.59%	Sell	385	46.33%

^{R1} 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 ^{R2}
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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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