Paycom Software Inc
PAYC: XNYS (USA)

View Stock Summary

Morningstar Rating for Stocks	Fair Value	Economic Moat	Capital Allocation
★★★★	$370.00	Narrow	Exemplary

Paycom Benefits From Sticky Customers That Underpin Our Narrow Moat Rating

Emma Williams • Aug 23, 2023

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Business Strategy and Outlook

Paycom's unified platform appeals to midsize and enterprise clients that prefer an all-in-one payroll and human capital management, or HCM, solution. The company's platform is supported by a single database, which provides a single source of truth and allows efficient software development and maintenance. Unlike competitors, Paycom discourages data integrations to third-party providers but instead incentivizes clients to contain their HCM solutions within its unified platform by offering add-on modules, including time and attendance and benefits administration. In practice, new clients may consolidate their payroll and HCM solutions from multiple providers to an all-in-one solution by Paycom. The company is squarely focused on driving greater automation and employee self-service, supported by complementary analytics tools for clients and the rollout of its self-service payroll module Better Employee Transaction Interface, or Beti.

We expect Paycom will continue to take market share of the growing payroll and HCM industry through industry consolidation and capitalizing on the shortfalls of competitors. The company has reported impressive growth to date, reflecting an ability to win clients and demonstrating how the cost and efficiency benefits of streamlining payroll and HCM solutions to a single platform can overcome inherent client switching costs.

We anticipate Paycom's average revenue per client, or ARPC, will increase at a CAGR of 7% due to a gradual shift upmarket and from taking greater share of wallet through upselling existing and new modules. Paycom's target market has shifted upward over several years, with the company formally lifting the upper bound to over 10,000 employees in fiscal 2023, from 2,000 in fiscal 2013. While we expect Paycom's average client size to increase, we expect its offering to be less appealing to mega enterprises that typically prefer to integrate best-of-breed solutions, in our view limiting the upmarket upside for Paycom.

Bulls Say, Bears Say

Bulls

We expect increasing employee usage and employee self service will entrench Paycom's platform further into a client's business, increasing client stickiness.

Increasing regulatory complexity under a U.S. Democratic Administration should create tailwinds for the payroll and HCM industry.

Paycom's employee self-service payroll Beti is innovating amid an industry shift toward greater employee usage and the consumerisation of payroll and HR software.

Bears

We expect fierce competitive pressures to limit pricing growth and force Paycom to maintain high investment in software development and innovation.

We view Paycom's offerings as largely commoditized, exposing the company to higher risk of pricing pressure.

While Paycom has achieved success moving upmarket, we expect mega enterprises will continue to prefer to integrate best-of-breed solutions.

Financial Strength

Paycom is in a strong financial position. At the end of second-quarter 2023, Paycom had a net cash position of about $500 million and reported about $29 million of long-term debt, which is primarily associated with construction activity at its corporate headquarters. As of August 2023, the company has access to a $1 billion revolving line of credit and a term loan of up to $750 million. Under these agreements, Paycom is subject to certain operating and financial covenants including restrictions on incurring further debt and issuing distributions. We expect Paycom to maintain a net cash position, to comfortably cover interest on outstanding debt, and to remain compliant with these covenants over our forecast period. Paycom pays a regular quarterly dividend in addition to returning capital to shareholders through an ongoing share repurchase program. We expect future share repurchases will be partly offset by the regular issuance of shares under Paycom's employee stock compensation and purchase plan.

Economic Moat

Paycom has garnered a narrow economic moat underpinned by high customer switching costs. Paycom also benefits from intangible brand assets, in our view, based on a growing track record of performance. While dominant provider ADP has invested heavily over the past decade to remain competitive on functionality, nascent providers like Paycom have been able to capitalize on that company's shortfalls and capture market share through the appeal of its nimble, unified, and user-friendly platform. As a result, Paycom's client base grew at a CAGR of 12% to about 19,000 clients over the 10 years to fiscal 2022, outpacing ADP’s growth of about midsingle digits over the same period. To remain competitive and capture further share, we expect Paycom will need to continue to invest in internal software development to expand its portfolio of modules to meet changing client needs, as well a maintained investment in marketing. In addition, we expect the company will face pricing pressure from an increasingly competitive operating environment. Despite this, we are comfortable that Paycom will be able to earn maintainable economic profits for at least the next 10 years.

Paycom holds a minority but fast-growing share of the U.S. payroll and HCM market. The company reports an estimated 5% market share across its 50-10,000 employee client target market. On a more granular basis, we estimate 75% of its client base are in the 50-999 employees midsize market, representing an estimated market share of 6%. This compares with ADP and Paychex's midsize market share of about 30% and 14%, respectively. We estimate a further 5% of Paycom's client base is in the 1,000-plus employee enterprise market, representing an estimated market share of 9%, compared with about 23% for ADP. We assume the remaining share of clients is in the highly fragmented one to 49 employees small-business market, representing an estimated market share of less than 1%. This compares with Paychex and ADP's estimated small-business market share of about 11% and 12%, respectively. Approximately 65% of the small-business market is serviced by regional providers or do-it-yourself solutions using software such as Intuit's QuickBooks or Microsoft Excel, creating meaningful scope for greater penetration. While Paycom has ramped up its efforts to target the small-business market, we expect most future client growth to come from taking share in the enterprise market, leading to high-single-digit growth in revenue per client. We expect Paycom's value proposition to resonate more with larger companies looking to automate and reduce duplication of large volumes of processes and tasks.

Paycom offers a range of payroll and HCM solutions via its unified, cloud-based platform supported by a single database. This platform infrastructure is scalable, can be efficiently maintained and modified, and supports a streamlined user experience without the need for integration to separate platforms or databases. Paycom has developed ancillary HCM modules, including time and attendance, talent management, and benefits administration software within the platform to complement its core payroll solutions adopted by all clients. In recent years, Paycom has deployed features that accelerate its efforts to drive automation and employee self-service, and to reduce redundant processes within a client's business. In practice, this means an employee can have direct access to the HCM database and can fulfill data entry tasks previously undertaken by a payroll or HR department. Such features include employee self-service payroll, Beti, and Direct Data Exchange which measures employee usage and reports on current and potential cost savings and efficiency gains. While self-service functionality and automation is growing across payroll and HCM peers, we believe Paycom is pushing the envelope with employee self-service payroll. However, the industry is highly competitive, and we expect such innovations will be replicated by competitors over time and is therefore not a maintainable source of competitive advantage.

As with payroll and HCM peers, Paycom benefits from high customer switching costs. Payroll and HCM software is typically deeply embedded in a business' operations, making it a costly and time intensive process to switch providers. Alongside monetary costs, a business could face operational disruptions and inefficiencies including having to train employees on the new system, integrate the new solution with other software and risk losing data. Despite operating in a highly competitive environment, Paycom had revenue retention of 93% in fiscal 2022, in line with a 93% four-year average from fiscal 2019. Assuming minimal annual price increases, this implies an average client life span of about 15 years. We expect Paycom's strategic focus on employee self-service and employee usage has increased the stickiness of its clients, supporting an improvement in revenue retention. By shifting responsibility for data entry from a HR department to the client's employees and encouraging employee engagement with the software, we expect Paycom's product offering has become more entrenched in the client's business. Over the long run, we expect Paycom will continue to invest in software development and delivering high grade user experience to maintain high retention rates. Maintaining high customer retention rates allows Paycom to earn a steady stream of recurring revenue at a low marginal cost.

We expect Paycom's reputation for delivering reliable and compliant solutions over the past two decades is supporting their ability to win market share. Payroll is a highly sensitive, complex and mission critical operation for all businesses that place high value on reliability, accuracy, compliance and data security. The potential ramifications for a business from failing to make payroll on time or accurately, being non-compliant with the applicable laws or breaching data security can be severe. While we view product innovation as key to remaining competitive, a payroll and HCM provider's ability to deliver reliable and compliant solutions is paramount. We view the brand equity of legacy providers as stronger relative to new entrants, owing to their to their longer operating histories and larger scale. Nonetheless, Paycom is at an advantage to newer entrants lacking a track record of performance, in our view.

Fair Value and Profit Drivers

Our fair value estimate for Paycom is $370 per share. This implies a fiscal 2023 price/earnings ratio of 50 and a fiscal 2023 enterprise value/EBITDA of 29. Our discounted cash flow model uses a 7.5% weighted average cost of capital.

We estimate revenue grows at a compound annual growth rate of 21% over the five years to fiscal 2027, driven by mid-single-digit industry growth, market share gains, and high-single-digit revenue per client growth due to an increasing skew to larger clients and greater module uptake. We expect fierce competitive pressures to limit like-for-annual-like pricing growth to low-single digits on average. We anticipate Paycom to take share from competitors and from regional providers as the industry consolidates, creating a catalyst for switching behavior through forced client platform migrations.

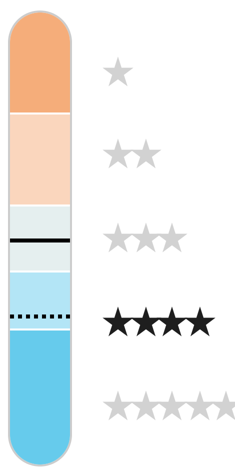
Over the same period, we expect operating margins to decrease to about 27% from 28% in 2022. We anticipate ongoing investment in product innovation and sales and marketing spend to support future growth will weigh on profitability, partly offset by improving operating leverage from increased scale and greater automation and employee self-service.

We expect Paycom will spend about 9% of revenue on capital expenditures each year to support software development and product innovation, broadly in line with the long-run average. Paycom operates in a highly competitive market, and we expect it will need to maintain high levels of investment to ensure that the functionality of its product suite is comparable with peers and meets client needs.

Price vs Fair Value

— Fair Value
$370.00
Aug 2, 2023
Uncertainty
High

····· Price
$244.98
Oct 31, 2023



1-Star Price	$573.50
5-Star Price	$222.00
Economic Moat	Narrow
Capital Allocation	Exemplary

Risk and Uncertainty

We assign a High Morningstar Uncertainty Rating to Paycom. While the company has diversified its revenue across payroll and HCM solutions, it remains nonetheless exposed to swings in economic conditions and labor markets. Our rating is also influenced by upside uncertainty, as we expect Paycom to benefit from industry tailwinds during an economic boom including higher pays per client, greater demand for solutions to recruit, retain and manage employee and higher yields of client funds.

Paycom's environmental, social and governance risk is low. Paycom handles high volumes of sensitive, personally identifiable information for its customers and their employees, exposing the company to data privacy and security risk, however we view this risk as low and immaterial to our uncertainty rating. If a data security breach or breaching of data privacy laws was to occur, Paycom would be exposed to regulatory fines, civil lawsuits and/or reputational damage. Paycom has moderate data privacy and security measures in place including external certifications and industry standard security protection technologies. While we view Paycom's procedures as less robust than competitor ADP, the company has had no material data privacy or security breaches. Though this provides some comfort, there is scope for Paycom to improve its procedures including through adopting binding corporate rules aligned to the European Union's General Data Protection Regulation that has become a baseline for global best practice for personal data protection and appointing executive management responsibility for data privacy and security.

Capital Allocation

We assign Paycom an Exemplary Morningstar capital allocation rating based on our assessment of a sound balance sheet, exceptional investment efficacy, and mostly appropriate shareholder distributions.

Paycom's balance sheet is sound. Aside from a portfolio of company-owned office buildings and data centers, Paycom operates a capital-light business model with strong free cash flow generation potential and typically boasts a net cash position. While Paycom does not rule out acquisitions, it has widened scale and built out its portfolio of HCM modules exclusively through organic investments to date. We expect Paycom could comfortably increase gearing to support further investment in internally generated software, or for tuck-in acquisitions. Given the uncertainty around timing and pricing, we do not explicitly forecast acquisitions. In the absence of attractive acquisition targets or internal investment opportunities, we would expect Paycom to return excess cash to shareholders through dividends or increasing share repurchases.

We assess Paycom's investment efficacy as exceptional. Through investment in internally generated software, Paycom has built out a portfolio of HCM modules and tools that encourage increased employee usage, automation, and reduce duplicative processes resulting in cost and operational efficiencies for its clients. The added features have been well received by clients, have resulted in increased employee self-service, and we think this has increased client stickiness, as reflected in the uplift in revenue retention. We anticipate the rollout of employee self service payroll Beti from fiscal 2021 onward will face similar success, driving greater employee usage and entrenching Paycom's solution further into clients' businesses. Through internal investment and potential tuck-in acquisitions, we expect Paycom will continue to expand its suite of HCM software to remain competitive and take greater share of clients' wallets.

Paycom's shareholder distributions are mostly appropriate. The company has returned nearly $590 million to shareholders over the seven years to fiscal 2022 through share repurchases. As a portion of these repurchases were executed at share prices above our fair value estimate, we would have preferred shareholder capital was either distributed through dividends or reinvested in the business. We expect Paycom to continue to repurchase shares under an ongoing buyback plan, but this will be partly offset by share issuance under employee-purchase and compensation plans.

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Stock Analyst Note

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Company Report

Paycom Continues on Impressive Growth Trajectory Despite Near-Term Cyclical Headwinds

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