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BEHIND THE NUMBERS
Quality of Earnings Analysis

March 5, 2021

Paycom Software, Inc. (PAYC) Earnings Quality Update 12/20 Qtr.

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We maintain our earnings quality rating of PAYC at 4- (Acceptable)

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

PAYC reported adjusted EPS of $0.84 which was 5 cps ahead of the consensus estimate. The quarter appears to have faced meaningful headwinds from higher-than-expected stock compensation and taxes. Capitalized costs to obtain contracts spiked in the quarter but we are not overly alarmed given what is going on in the business.

What was stronger?

- PAYC gives detailed guidance for the next quarter in its quarterly calls which typically includes expected tax rates and stock-based compensation. Management forecasted stock-based compensation in the 12/20 quarter to be flat with the third quarter, or about $20 million. However, the actual figure for the 12/20 quarter was over $33 million. This difference shaved about 19 cps off earnings.

- Likewise, the company forecasted a tax rate of 29% for the 12/20 quarter but the adjusted effective rate came in at almost 30%. This would have cost the company about a penny per share in earnings.

What was weaker?

- There was a sizeable jump in capitalized costs to obtain contracts in the 12/20 quarter. Costs capitalized in the period rose to over 12% of quarterly revenue versus 9% in last year's fourth quarter. We estimate that if the rate of capitalization had remained the same, it could have shaved about 10 cps off EPS. However, we are not especially concerned given 1) we are surprised the accelerated rate at which the company has signed new business has not pushed capitalized costs higher sooner and 2) the earnings beat is still intact after considering the one-time earnings headwinds mentioned above.

What to watch

- We remind investors that deferred contract costs exceed $430 million and the company amortizes this balance over the estimated useful client life of ten years. The company's earnings are very sensitive to this assumption which seems unrealistically long to us.

- PAYC has benefitted from new business signups during the pandemic. However, this has been offset some by reduced headcount at existing clients. Management estimates this lower headcount is costing it about $2 million in weekly revenue. This could reverse if re-hiring resumes in upcoming quarters.

- A key part of PAYC's model is collecting tax balances from clients and investing the balance prior to submitting to taxing authorities. Lower interest rates have been a key headwind which management has estimated to be $350 million per week. This could be another headwind that could reverse with a meaningful uptick in rates.

Supporting Detail

Jump in Capitalized Costs to Obtain Contracts

We noted in our initial review that PAYC capitalizes the cost to obtain contracts (such as commissions) as well as the costs to fulfill contracts (such as client training clients). It amortizes these costs over the estimated useful life of a client which is currently ten years. The combined capitalized balances of costs to obtain and costs to fulfill contracts currently exceeds $430 million, and we remind investors that the company's reported earnings are very sensitive to the assumed life figure.

We track the trends in both balances quarterly. For the 12/20 quarter, we saw nothing out of line with capitalized costs to fulfill contracts. However, there was a significant jump in capitalized costs to obtain contracts in the period. The following table shows the trends in the balance for the last eight quarters:

Capitalized Costs to Obtain Contracts	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Beginning Balance	$213.920	$209.462	$208.960	$194.964
Capitalization	$26.809	$12.174	$7.982	$21.184
Amortization	-$8.146	-$7.716	-$7.480	-$7.188
Ending Balance	$232.583	$213.920	$209.462	$208.960
	12/31/2019	**9/30/2019**	**6/30/2019**	**3/31/2019**
Beginning Balance	$183.439	$178.445	$172.655	$158.989
Capitalization	$18.156	$11.315	$11.811	$19.387
Amortization	-$6.631	-$6.321	-$6.021	-$5.721
Ending Balance	$194.964	$183.439	$178.445	$172.655

We can see the significant jump in amounts capitalized in the most recent quarter above. The size of the jump can be seen better in the below table which shows the amount capitalized as a percentage of quarterly sales for the last eight quarters as well as the amortization of the average outstanding balance:

	12/31/2020	9/30/2020	6/30/2020	3/31/2020
Capitalization % of Quarterly Sales	12.1%	6.2%	4.4%	8.7%
Amortization % of Avg Outstanding Capitalized Balance	3.6%	3.6%	3.6%	3.6%
	12/31/2019	**9/30/2019**	**6/30/2019**	**3/31/2019**
Capitalization % of Quarterly Sales	9.4%	6.5%	7.0%	9.7%
Amortization % of Avg Outstanding Capitalized Balance	3.5%	3.5%	3.4%	3.5%

Management stated in the conference call following the 6/20 quarter that the second quarter set a record for signing up new business as companies flocked to outsource HR functions in the wake of the pandemic. We noted in our review of the quarter that we were surprised not to see a jump in capitalized costs to obtain contracts given the uptick in activity as the company pays a one-time commission to its salespeople after the first month the new customer processes payroll. We did see a sequential increase in the capitalization rate in the 9/20 quarter, but it was still below the 9/19 quarter level. However, we finally saw an uptick in capitalized costs to obtain contracts in the 12/20 quarter as capitalization as a percentage of revenue jumped to 12.1% which was well ahead of the recent trend. Ordinarily, we would be very concerned to see such a jump in any capitalized costs, but given the new business activity, we are only surprised by the timing of the arrival.

For reference, even if the company artificially accelerated its rate of capitalizing costs, we estimate that it would have cost the company about 10 cps if the capitalization rate had remained the same as the year-ago quarter.

Explanation of EQ Rating Scale

6- (Exceptionally Strong)- Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises

5 (Strong)- Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.

4 (Acceptable)- Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement

3 (Minor Concern)- Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.

2 (Weak) Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.

1 (Strong Concern)- Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely

In addition to the numerical rating, the EQ Review Rating also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into upcoming quarters. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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