BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Paychex, Inc. (PAYX)
Earnings Quality Review

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

We are initiating earnings quality coverage of PAYX at 5+ (Strong).

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

Summary

PAYX's business model appears to have three sources of growth: small to mid-sized businesses restarting growth after COVID and bringing back employees; cross-selling customers on new services such a retirement, insurance, regulation training; and government's never ending ability to change various laws and regulations as well as create new ones that make it onerous for employers to maintain current knowledge of the maelstrom.

The company beat forecasts each of the last four quarters by 4-cents, 7-cents, 8-cents, and 1-cent. The beats were solid in all but fiscal 4Q20 (the 1-cent beat and the first period of COVID) when PAYX realized more gains on securities than normal which added almost 2-cents. Non-GAAP earnings are actually slightly lower by 1-2 cents than GAAP. PAYX does not have a myriad of adjustments and does not add back amortization of acquired intangibles. Rapid amortization rates boost earnings quality and a high ROI limits impairments.

Looking at several issues such as capitalizing customer acquisition costs (mostly sales commissions), potential risks to rising interest rates on the bond portfolio, and insurance reserves – we believe the risks are very low – 1 or 2 cents vs. EPS of essentially $3.00.

What is strong?

- GAAP and non-GAAP earnings are essentially the same. Paychex has some excess tax benefits from stock compensation that generally lowers non-GAAP EPS from GAAP figures and the difference is normally about 1-cent. The only other adjustment in the last eight quarters was some cost savings actions during COVID to consolidate office space and a small reduction in headcount. The costs of 6-cents were added back.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
GAAP EPS	$0.97	$0.75	$0.59	$0.61	$0.98	$0.72	$0.73	$0.64
Excess Tax benefits	$0.00	-$0.02	-$0.02	$0.00	-$0.01	-$0.01	-$0.02	-$0.01
Cost Saving Program			$0.06					
Non-GAAP EPS	$0.96	$0.73	$0.63	$0.61	$0.97	$0.70	$0.71	$0.63

We looked back at the period of 2016-2020. The only time the difference between GAAP and non-GAAP EPS was more than 4-5 cents was in 2018 when the tax laws changed and PAYX adjusted the valuation of deferred tax liabilities. This very narrow spread related to one item that actually had PAYX reporting non-GAAP EPS lower than GAAP which is a good sign of quality in our view.

- ROI before COVID was 55%. It is still basically 50% during COVID. That ROI does not add back amortization of intangibles or depreciation. The operating income figure is actually very close to free cash flow, which does add back the depreciation and amortization and would reconcile working capital needs and capitalized costs and subtract capital spending. Thus, the ROI is very strong in our view and supports the value of intangible assets such as $1.8 billion in goodwill and $300 million of intangibles. The ROI is helped with the $3.0 billion equity balance growing slowly because PAYX pays a large percentage of net income out as dividends and share repurchases:

	2021 ytd	2020	2019	2018	2017
Net Income	$834.5	$1,098.1	$1,034.4	$933.7	$817.3
Dividends	$670.5	$889.4	$826.8	$739.7	$662.3
Share Repos	$76.0	$171.9	$56.9	$143.1	$166.2
Equity Balance	$2,976.4	$2,781.4	$2,619.5	$2,024.5	$1,955.3

- Revenue recognition is conservative in our view. For example, insurance commissions earned are not reported as revenue until the premium is billed and collected. Revenues are reported net of the pass-through components such as wages, FICA, income taxes, IRA contributions etc. Thus, if a client's total payroll is $200,000 and Paychex earns $1,000 – revenue at Paychex is $1,000 not $201,000 with a cost of goods sold of

$200,000. Also, PAYX bills for its fees with the payroll processing and pulls its fees from the bank account at the same time as the payroll transfers are made. So the lag between revenue being recognized and cash being received is often less than 5 days. Only in the case when PAYX retains risk such as worker's compensation does it report gross amounts in revenue. Set-up fees paid by clients are deferred and recognized over 3-4 years.

- Acquired assets and internally developed assets have similar lives. One of our most common complaints with companies making acquisitions is when internally developed assets are expensed as incurred or over 3-5 years while acquired assets are amortized over 20 years. That allows acquisitions to inflate profitability. PAYX buys assets and the largest component of intangible assets that are amortized are customer lists. It is amortizing those with an accelerated method over a weighted average life of 10-years. PAYX also incurs costs to acquire customers when it grows organically. It capitalizes some of those costs and amortizes them on an accelerated method over 8-years. It is also important to note that PAYX does not add back the amortization of either in non-GAAP EPS making that higher quality too. It is also important to note that if PAYX changed the acquired amortization life by 1-year, it would only impact EPS by 0.7 cents per year.

What to Watch

- There are some moving parts that can conceivably generate a few cents in EPS for PAYX that we identified. We found little evidence of any problems here with items like deferring customer set-up costs and recognizing them as revenue over 3-4 years. Bad debt reserves jumped as COVID restarted employee hiring and was actually a headwind to EPS of more than 1-cent last quarter when PAYX beat by 4-cents. For discussion, 1-cent in EPS at PAYX is $4.8 million in pretax earnings. Fiscal 4Q20 (last May) did see a large amount of realized gains on securities that added 2-cents and could be a slight headwind for 4Q21 earnings in a few weeks.

- Interest on client funds does not look like a sizeable risk. PAYX notes that a 25bp move in rates has a $3.0-3.5 million impact on net earnings or less than 1-cent per year. We see a very low duration with 40% of assets maturing in less than 30-days and the rest 2.5-3.75 years. The credit quality is also high.

- Capitalized costs to obtain new business look reasonable. The cash spent for commissions is nearly equal to the amortization of capitalized expense. The difference is often only 1-2 cents +/- in quarterly EPS. When it's negative, it indicates the company is actually growing. PAYX does not add back the amortization from non-GAAP EPS which also boosts earnings quality in our view.

- Insurance reserves for workman's compensation and some limited vision and dental policies pose a risk but appear manageable. Thus far, adjustments have been immaterial for reserves based on historical experience and independent actuaries. The reserves are only 7% of book value.

Supporting Details

EPS Beats Look Solid. Areas Where PAYX Could Pick Up 1-2 Cents in EPS from Unsustainable Sources Look Tame

There are some moving parts that can conceivably generate a few cents in EPS for PAYX that we identified. We found little evidence of any problems here other than one area to watch. For discussion, 1-cent in EPS at PAYX is $4.8 million in pretax earnings.

	3Q21	**2Q21**	**1Q21**	**4Q20**	**3Q20**	**2Q20**	**1Q20**	**4Q19**
Deferred Rev	$38.4	$40.6	$39.6	$39.2	$38.8	$42.2	$41.3	$40.3
Bad Debt Reserve	**$20.3**	$13.8	$11.5	$12.5	$12.1	$10.8	$10.6	$7.5
Prepaid Exp.	$244.9	**$241.3**	**$252.9**	$244.8	$250.0	$240.9	$242.3	$233.9
Realized Gains	$0.3	$0.4	$0.3	**$8.9**	$0.6	$0.9	$0.9	$0.1

- Deferred Revenue arises when clients pay set-up fees to PAYX. These fees are minor and longer-term sources are deferred and amortized into income over only 3-4 years. The level of deferred revenue has held around $40 million per quarter for some time. We see little issue with this and compared to quarterly revenue of about $1 billion, small changes in this area look immaterial to us.

- Bad debt reserves did jump last quarter and actually hurt EPS by about 1.4-cents and PAYX still beat forecasts by 4-cents. We think this was the result of COVID ending. One of the bigger sources of Receivables at PAYX are Purchased Receivables. PAYX has arrangements with temporary staffing companies where it helps their cash flow by buying their receivables and earning fees. The receivables turn every 35-45 days. At the end of 3Q21 (February), total receivables were $695 million with the purchased receivables at $616 million. During COVID, these purchased receivables fell to the low $300 million range in 4Q20 and 1Q21 (May 2020 and August 2020). The recent surge is what led to bad debt reserves being raised. We think this represents a snap-back to employers looking to add staff and we will watch to see if this receivable figure goes much higher or if it falls to normal levels and the bad debt reserve could actually help EPS by 1-cent.

- Prepaid expenses had a noticeable drop in 2Q21 after a rise in 1Q21 that was largely a wash. This is where some of the deferred costs to acquire customers are located and we did not see a change in that area during this time (we'll discuss below). There was no explanation for this, and it was likely some COVID-related timing and it was in 1Q21 when PAYX did some minor cost savings plans on employees and real estate. So it was a tailwind 4Q20, headwind 1Q21, tailwind 2Q21 each time for 1.5-2.0 cents in EPS and it's back to normal levels now.

- Realized gains net of losses on securities have been modest in all recent quarters except 4Q20. That added about 1.7 cents to EPS in a period PAYX beat by 1-cent and it gives PAYX a small headwind for 4Q21 results.

Interest on Funds Seem at Low Risk from Rising Interest Rates

One of the income sources for PAYX comes from collecting taxes and insurance premiums before they are due. It invests the cash and earns interest for PAYX until the cash needs to be remitted, often once a month or quarterly. It also invests its own cash in similar investments – basically AA or better muni bonds and some very minor other ventures.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Funds Held	$4,211	$3,393	$3,314	$3,431	$4,356	$3,735	$3,769	$3,804
Interest Earned	$15.1	$14.8	$14.9	$25.3	$21.2	$19.9	$20.5	$22.2
Other,Exp	-$7.0	-$4.7	**-$7.9**	**-$8.0**	-$5.9	-$4.7	-$4.8	-$4.0

- Other, expense is a combination of interest expense, income on corporate investments, and a small miscellaneous other item. In 4Q20 (May 2020), the company had more money borrowed and that boosted interest expense. In 1Q21 (August 2020), the income on corporate investors declined with the market. In both cases this cost PAYX 0.6-0.8 cents in EPS.

- There is some potential headwinds to earnings if interest rates rise. A change in interest rates of 25bp is about $3.0-$3.5 million in earnings according to management or 0.8-1.0

cents in EPS per year. It can also move the value of the portfolio by about $25 million. There are several risk abatement items at work here:

  - Credit quality is very high AA or better ratings

  - The duration is low – with 40% of investments with duration of less than 30-days. VRDN (Variable Rate Demand Notes) are another 5% of the portfolio which Paychex can demand repayment at any time so the duration there is short if interest rates increase. The remaining portfolio has a duration of 2.50-3.75 years.

  - Offsetting loss potential – PAYX had $63 million of unrealized gains as of April 2021.

- COVID lowering rates hurt the interest income at PAYX. With so much of the portfolio with very low duration, PAYX may actually benefit from some higher rates. Just looking at pre-COVID to COVID periods, PAYX was losing about $5 million per quarter in interest income or 1-cent in EPS

- Overall, we do not see material risk to earnings +/- from the investment portfolio.

Capitalized Costs to Obtain Business Do Not Look Aggressive

Capitalized costs to obtain contracts and fulfill future obligations on contracts also do not look too nefarious. PAYX pays commissions, bonuses, and ancillary costs when it signs up new customers. It capitalizes these costs and amortizes the account over an accelerated eight years, which matches the attrition rate and historical customer retention. At the end of 3Q21, the amounts capitalized were $476.1 million to obtain contracts and $68.6 million for future obligations. These intangible assets are 18% of shareholders.

There are three reasons why we think this situation is not a serious or material issue

- PAYX is not adding back this amortization to GAAP or non-GAAP results. Thus earnings reflect this actual cash cost.

- The amortization is reducing the book value too.

- The difference between what is being capitalized (new cash costs) against what is being amortized (non-cash expense) is actually very small and when the level of new capitalized costs is larger, it indicates the company is growing.

	3Q21	2Q21	1Q21	4Q20	3Q20	2Q20	1Q20	4Q19
Cost to Obtain new K	$49.9	$40.4	$37.2	$49.0	$49.4	$37.4	$35.9	$48.3
Amortz Obtain costs	$41.9	$41.7	$41.4	$41.0	$40.7	$40.5	$40.2	$39.6
Difference	-$8.0	$1.3	$4.2	-$8.0	-$8.7	$3.1	$4.3	-$8.7
Cost to Fulfill K's	$7.2	$6.0	$6.1	$6.2	$6.7	$6.0	$6.0	$5.9
Amortz Fulfill K's	$6.0	$6.1	$5.9	$5.9	$6.0	$5.9	$5.8	$5.8
Difference	-$1.2	$0.1	-$0.2	-$0.3	-$0.7	-$0.1	-$0.2	-$0.1
EPS Impact	-1.9c	0.3c	0.8c	-1.7c	-2.0c	0.6c	0.9c	-1.8c

This is typically a 2-cent headwind to GAAP and non-GAAP earnings or at best a 1-cent tailwind. The cash spending is close to equal to the amortization so PAYX is being conservative by not adding back the amortization for non-GAAP earnings. Yet at the same time, it's simply not a material part of earnings looking at the difference between cash spending and non-cash amortization.

Insurance Reserves Have Some Risk but Look Manageable

Part of PAYX's business involves workman's compensation insurance and to some clients dental and vision insurance. In these cases, PAYX retains some risk and is not simply acting as an agent earning a commission from a third-party insurance company.

PAYX has good annual disclosure on this business and the maximum payouts of individual claims. The company notes it uses its own historical experience and independent actuarial analysis to determine the size of the liabilities that it carries for this business. PAYX adjusts these forecasts often and the changes have been immaterial for years. There is always a risk that the reserves for this business prove too low. We believe this risk is worth following, but it appears unlikely to be a game-changing issue:

- Total reserves in this area are $210 million. Book value is $3 billion. Free cash flow after dividends and share repurchases has been about $250 million per year from 2018-2020. Even if their estimates are off by 100% in one-year, the company could absorb the hit.

- Thus far, experience has shown that adjustments have been immaterial.

- This type of insurance renews frequently. Pricing can be adjusted if necessary. This is not 20-years of flat premium term insurance. If claims are rising higher than expected, the pricing can be adjusted likely in less than 12 months.

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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