Paycom Software, Inc. (PAYC)

Company Description
Paycom is a rapidly growing SaaS provider of payroll and HCM solutions to roughly 26,527 clients with a focus on companies with 50-5,000 employees. Paycom’s platform continues to add functionality and currently provides solutions in five categories: Payroll, Talent Management, Time & Labor Management, Talent Acquisition and HR Management. Paycom was founded in 1998 and is headquartered in Oklahoma City, OK.

Revenue Profile

Competition
Payroll/HCM space consists of a handful of competitors with the resources to offer a comprehensive national offering and niche point solution providers. Those with a comprehensive national offering include ADP, Ceridian, PAYX, PCTY, Paycor, and Ultimate Software. Niche solution providers include CSOD, Taleo, SuccessFactors, ICIMS, Kronos, Saba, etc.

Quick Summary
PAYC is a rapidly growing and very profitable provider of a simple and intuitive SaaS payroll/HCM solution with a large and growing TAM. Results remain excellent and PAYC, along with the broader payroll/HCM industry, continues to benefit from a combination of regulatory complexity, tight labor market, and a broader suite from tech innovation (though lower yields on float a modest drag for the industry in 2020). With less than 5% of its TAM penetrated, PAYC has significant runway to gain market share as it scales its sales force — currently 50 sales teams. Further, the company’s focus on employee usage is a significant differentiator in the marketplace and is seeing good traction among its client base. Increased usage drove ~1% increase in revenue retention per year over the last two years, from 91% in 2017, to 92% in 2018, and 93% in 2019. From the beginning PAYC has had an intuitive solution...
and focused on increasing self service usage among its existing client base. Now the company is now embedding this differentiator as key tenet of its pitch to prospects in national advertising driving increased leads. Increased usage has the potential to help sustain solid growth and potentially increase retention further, particularly as the company is pulled up market. Covid-19 will reduce future growth with spiking unemployment and lower yields, but the company has an aggressive sales team that is tailor-made for work from home, so likely to generate much stronger growth than most competitors during this period of macro pressure. PAYC is poised to continue its rapid growth with high margins once the economy stabilizes.

**Investment Thesis**

Very early innings of rapid growth story, gaining share in a growing market. PAYC has less than 5% penetration of its addressable TAM and has significant runway to expand its sales force nationally and drive deeper penetration of the market. It currently has 50 sales teams across the top 50 MSAs -- the company eventually expects to have 120 sales teams.

Increasing complexity of the regulatory environment a tailwind for the industry. New legislation at the state and municipal levels, combined with changes to federal legislation continue to increase the compliance burden on employers compelling them to seek an outsourced solution.

Large and growing addressable market that is economically attractive. There are roughly 49mn employees for companies with 50-5,000 employees representing a TAM of ~$20bn for recurring revenue. This potential TAM continues to grow for several reasons: 1) additional modules for the platform increase the cost for the full suite; 2) increasing complexity in the regulatory environment compelling employers to seek outsourced solutions – to include those with in house solutions; and 3) stable macro environment results in declining unemployment as companies add headcount. Further, pricing power remains with the provider, particularly once the relationship is established. Higher module attach rates increase the stickiness of the relationships, resulting in industry retention rates above 90% – PAYC at 93%.

Competitors provide ample natural annual revenue churn allowing PAYC to continue its growth. Baird estimates that ADP, CDAY, PAYX and Ultimate Software had a combined target market revenue churn of ~$980mn in 2019 vs. PAYC ARR estimates of ~$210mn, ~22% of churn.

Dynamic management has significant skin in the game. Highly talented/driven founder/CEO Chad Richison owns ~14.1% of shares outstanding.

**Risks & Caveats**

Shift in sentiment could lead to multiple contraction. PAYC, similar to other rapidly growing companies, trades at a premium EV/Revenue multiple. Should growth fall short of expectations or market volatility increase reducing investor appetite for higher multiple offerings, the EV/Revenue multiple could contract, potentially down to 7x or 8x revenue.

Level of competition continues to increase across the board. Payroll and HCM solutions are becoming a more competitive market. Large competitors are able to outspend PAYC in R&D to bring new functionality to the market and address new client needs/opportunities quickly. Increasing competition requires PAYC to continue to invest and innovate in its platform to remain competitive. PAYC has been growing R&D spend rapidly to remain competitive in the market, but larger competitor spending could require an even more rapid growth of R&D spend in the future.

Interest rate sensitivity. Revenue model includes interest income on client tax filing float. Every 25 bps in lower interest rates equals $3mn in annual revenue of which 100% drops to the operating line. Fed has recently reduced rates by an additional 75 bps which creates a drag on this highly profitable stream.

Dependence on key management. PAYC’s unique culture and vision have been shaped by several key senior executives, particularly the Founder and CEO Chad Richison. The loss of one of these individuals could be a risk to future execution as they have successfully driven execution against the long-term vision and shaped the company's culture.

COVID-19 impacts on the global macroeconomic environment. Stimulus actions have been implemented to mitigate downside during the downturn as mandatory lockdowns are in effect. The longevity and severity of economic impact depends on the effectiveness of stimulus and the health care response paired with policy to open the economy back up.

**Supplemental Information**

Price target of $250 is equal to an EV'/22 revenue multiple of 12x a year out, slightly above the EV/NTM multiple average for PAYC over the last four years of 11x and equal to best-in-class SaaS players.

**Revenue Model**

- Payroll/HCM fees are generally earned on a per employee per month basis varying based on number of modules utilized and size of client.
- Implementation fees are earned during the client conversion process and revenue is deferred to be recognized over the estimated life of the clients (~10yrs).
Interest income is earned on the tax filing float on client funds.

Management Compensation Structure
- Executive compensation has three main components: base salary, annual cash bonus and RSU awards.
- Annual cash awards are determined by revenue, Adj. EBITDA, and retention rate targets.
- RSUs which vest on EV targets (~55%) and over time (~45%).

Management Experience
- Chad Richison founded the company in 1998 and continues to serve as chairman and CEO today.
- Craig E. Boelte joined the company in 2006 to serve as CFO.
- Jeffrey York joined the company in 2002 and assumed the role of Chief Sales Officer in 2007.
- Jon Evans joined the company in 2014 and assumed the role of COO in 2018.
- Brad Smith joined the company in 2005 and assumed the role of Chief Information Officer in 2018.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: Paycom Software, Inc. (PAYC) as of 05-21-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of PAYC.

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