Paylocity Holding Corp. (PCTY)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/21/20):</th>
<th>121.19</th>
<th>Price Target ($) :</th>
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<td>52WK H-L ($) :</td>
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<td>L-Term Rev. Gr Rate Est:</td>
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<td>Shares Out (mil):</td>
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<td>Avg. Daily Vol (mil):</td>
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<td>P/E (Cal)</td>
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<td>Dividend ($) :</td>
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<td>Yield (%):</td>
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**Company Description**

Paylocity (PCTY) is a cloud-based provider of payroll and HCM solutions through a multi-tenant unified SaaS platform to mid-market companies, with a focus on the 20-1,000 employee space with a mean size of around 100 employees. Recently announced expanding down to 5-20 employee market which is in early rollout/testing. The platform is highly configurable and supported by an extensive partner ecosystem including insurance providers, 401k providers, and third party administrators. The core offering is payroll, Paylocity Web Pay, around which additional modules have been added over time in the areas of Talent Management, Time & Labor, Benefits and Core HR. The additional module and data integration offerings were developed to bundle with the core payroll offering, with all services accessing the same employee record. At the end of F'19, PCTY served 20,200 clients with an average employee size of ~120.

**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 middle market offering include ADP, CDAY, PAYX, PAYC, Paycor, and Ultimate Software. Payroll/HCM providers at the low end of PCTY's target market include Gusto, INTU, Patriot Software, OnPay, and Zenefits. Niche point solution providers include CSOD, Taleo, SuccessFactors, ICIMS, Kronos, Saba, etc.

**Quick Summary**

PCTY is in the early innings of its growth story with less than 4% penetration of its large and growing TAM. PCTY’s current portfolio represents a total revenue opportunity of $400 per employee per year with a new intermediate term goal of $500 as new modules are released. This includes the release of a learning module and the recent acquisition of BeneFLEX which allows PCTY to provide consumer directed health accounts such as HSAs/FSAs to small employers. Further, PCTY remains focused on the "Land" portion of its growth strategy with roughly 50% of its new clients coming from legacy providers like ADP and PAYX. These wins are a function of both the sizable "natural" churn opportunity from legacy providers and PCTY's unique positioning as neutral party between clients and health/insurance brokers (ADP/PAYX offer competing services). PCTY generates ~25% of new sales from broker referrals. PCTY's revenue is highly tied to PEPM which will serve as a headwind in the near term with unemployment rates ~20% but well
positioned for the future once the pandemic ends. Given minimal TAM penetration, +20% revenue growth seems sustainable over the intermediate term during periods of normal macro growth and model leverage should continue driving Adj. EBITDA margin expansion toward the company’s 30%-35% target if interest rates normalize.

**Investment Thesis**

Very early innings of growth story, positioned to benefit from the industry trend to adopt outsourced SaaS solutions and vendor consolidation. Increasing complexity from regulation encouraging companies to move to outsourced solutions. Companies with 20-1,000 employees typically have 1-2 full-time personnel dedicated to payroll who can easily become overwhelmed with the rapidly changing regulatory environment.

Increasing complexity of the regulatory environment a tailwind for the industry. New legislation at State and Municipal level and changing legislation at the Federal level, 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 44mn employees for the roughly 600K companies with 20-1,000 employees representing a TAM of ~$18bn for recurring revenue. By expanding to the 5-19 employee market, PCTY would add another potential 1.6 mn firms and 14.7mn employees to the TAM. 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% – PCTY at 92%.

Highly scalable business model offers material margin upside. Improving gross margin (71.9% F’19) and natural opex leverage support further Adj. EBITDA margin expansion to 30%-35% from Baird’s F’20E 28.6%.

Competitors provide ample annual revenue churn allowing PCTY to sustain its rapid growth. ADP and PAYX have over 1.4mn clients and churn more than 10% or 140,000 per year on a combined basis. PCTY only needs 5,000 new clients per year to maintain strong growth. From a revenue perspective, RWB estimates that ADP, CDAY, PAYX and ULTI will have a combined target market revenue churn of roughly $950mn in F’20 vs. PCTY ANRR estimate of roughly $130mn – ~14% of the churn. Typically, PCTY derives 50% of new revenue from ADP and PAYX.

**Risks & Caveats**

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.

Shift in market sentiment could lead to multiple contraction. PCTY, similar to other rapidly growing companies, has traded at a premium EV/Revenue multiple in the past, currently ~9.6x NTM. Should growth fall short of expectations or market volatility increases reducing investor appetite for higher multiple offerings, the EV/Rev multiple could contract, potentially down to 4x or 5x revenue.

Competition continues to increase. Payroll and HCM solutions are becoming a more competitive market, particularly in the under 1,000 employee space. Large competitors have considerable resources and are able to outspend PCTY to enhance their suite of offerings, improve their service support and ramp their advertising. This in turn requires PCTY to increase its investments to keep pace with the larger competitors.

Cyclical exposure. PCTY’s recurring revenue model growth rate will vary depending on cyclical conditions. A steep downturn could see employee headcount at clients decline as business slows. In addition, interest rates are a source of yield on float. A decline in rates will also negatively impact profitability as interest income on float has near 100% incremental margins.

Lack of liquidity leads to increased volatility. At times PCTY trades at high levels of volatility due to low liquidity. Founder Steve Sarowitz and Adam Street Partners hold ~29% of shares outstanding, a decision to sell a sizable stake by either party could drive the stock down significantly.

Potential for cyber security attack or data security breach. All players are subject to cyber attacks and potential fraud.

**Supplemental Information**

$148 price target reflects 11x EV/F’22 revenue a year out, at the top end of the 8x-12.5x range given lower risk free discount rate with 10-year at 1.6% and continued share gains driving 20%+ annual revenue growth with expanding margins.

**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 and other fees are primarily earned upon completion of the client implementation.
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 equity awards.
- Annual cash awards are determined by total revenue (60%) and Adj. EBITDA (40%) targets.
- Equity awards in the form of RSUs, which include both time-based and performance-based vesting terms, in order to foster focus on long-term objectives. RSUs typically vest over four years based on revenue CAGR and average Adj. EBITDA margin.

Management Experience
- Steve Beauchamp joined the company in 2007 and assumed the role of CEO.
- Michael Haske joined the company in 2007 and assumed the role of President and COO in 2017.
- Toby Williams joined the company in 2017 as CFO.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: Paylocity Holding Corp. (PCTY) as of 05-21-2020

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

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