Paycom, Inc. (PAYC)

Shares Likely to PayBomb

We are short shares of Paycom, a $19 billion SaaS-based payroll services company that has been one of the best performing large capitalization software stocks since it went public in 2014. Even after the market turmoil of this year, Paycom trades at more than 70x the consensus estimate for this year’s free cash flow, a testament to the fact that, while unprofitable tech companies and temporary pandemic winners have been justly punished in the markets, there’s still plenty of froth left in allegedly higher quality fare. Paycom’s valuation, in particular, doesn’t come close to reflecting the near term headwinds of slowing employment growth, meaningful TAM saturation, and increasing competitive intensity.

Paycom’s steady and robust growth over the past decade has come by way of taking market share from payroll industry behemoths ADP and Paychex. Paycom has been accompanied in this quest by high-tech peers Paylocity (PCTY) and closely held BambooHR, and has been buttressed by secular job growth trends in the US small and medium business sector. But Paycom is no longer a $100 million annual revenue upstart, and neither are its peers. At $1.4 billion of run-rate recurring revenue, the company is a scaled business, and combined with Paylocity, Bamboo, and other dynamic tech companies in the sector, the group’s share of the SME payroll market is north of 40%. That’s a lot more than the blue-sky implications of Paycom’s 5% market share claim, and it means that further market share gains will be a lot more difficult going forward.

At the same time, ADP is fighting back, increasing its customer retention rate and growing its employee rolls. Rippling and Gusto, two rapidly growing startups in the space, have also recently raised capital at $10-billion-plus valuations, and are actively fighting for market share. All this means that the competition faced by Paycom is about to get a lot tougher. If that weren’t enough, US employment growth looks to be decelerating at a fairly significant clip, which means that all the payroll players will be fighting in a smaller field. For a SaaS company with an astronomical valuation like Paycom’s, price cutting is probably not something investors are accustomed to thinking about, but they might soon have to.

The corporate culture at Paycom is cutthroat. That’s partly reflected in the aggressive accounting strategies employed by the company that we believe materially overstate the profitability of its business. It’s also apparent in Paycom’s sales culture, which features questionable sales tactics (some of which have led to regulatory settlements), rapid sales rep turnover, and bare-bones customer service. That may have served Paycom well as a small unknown taking on industry giants, but as the pieces of a slowdown come together and competition intensifies, increased customer service costs will likely hamper margins. Yet the stock’s current valuation leaves little room for error. When a bubble pops, as the tech bubble has over the past year, not all stocks crash simultaneously. Some former darlings, like ZM, DOCU, TWLO and many more, have already seen their multiples decimated as investors transition to more realistic business expectations. Other darlings, like PAYC, still remain in bubble territory. The national job losses that are likely to accelerate over the remainder of the year may very well serve as the catalyst to bring PAYC’s share price back to reality.
# Table of Contents

I. INVESTMENT HIGHLIGHTS .................................................................................................................. 3

II. COMPANY BACKGROUND ............................................................................................................... 5
   - The equity market context for Paycom is particularly unfavorable .................................................. 5
   - Paycom is deceptively but egregiously overvalued ............................................................................ 7

III. PAYCOM'S TAM IS MUCH SMALLER AND MORE SATURATED THAN IT ADMITS, WITH
     RAPIDLY ESCALATING COMPETITIVE INTENSITY AND AN EMPLOYMENT
     SLOWDOWN PRESENTING NEAR TERM HEADWINDS .................................................................. 9
     - Slowing US job growth will exacerbate Paycom’s revenue headwinds ............................................. 12

IV. PAYCOM’S QUESTIONABLE ACCOUNTING AND AGGRESSIVE SALES PRACTICES
    REFLECT A LARGE DEGREE OF OVEREARNING IN THE COMPANY’S FINANCIAL
    RESULTS .............................................................................................................................................. 13

V. CONCLUSION .................................................................................................................................... 15

FULL LEGAL DISCLAIMER .................................................................................................................. 17
I. Investment Highlights

Paycom’s valuation is absurd and fails to reflect the ongoing SaaS retrenchment. Paycom trades at about 75x the consensus estimate for Fiscal 2022 free cash flow, which itself is probably too optimistic. This year has seen the collapse of no-profit tech stocks along with their Covid beneficiary peers, but the relatively predictable and cashflow-positive companies – Paycom included – have been largely spared. We don’t expect that to last, as the slowing economy and tech-stock rout result in decelerating sales growth and operational deleveraging. Additionally, institutional investors that were mocking traditional fundamental valuation methodologies have become much more sober in their optimism, now looking to fundamentals to guide their capital allocation. The companies most at risk in that context are the ones with valuations that are most disconnected from their intrinsic fundamentals, and Paycom tops that list, with its valuation on both free cash flow and EBITDA richer than any of its peers, while its sales growth and profitability metrics are mostly just in line (and that’s before considering aggressive accounting or its overearning).

Paycom faces significant near term challenges including escalating competitive intensity, slowing employment growth, and a butting up against the limits of its TAM. If an unfavorable equity market context isn’t enough, we expect Paycom to face some fundamental challenges in maintaining its revenue growth rate. The first will be slowing employment growth, which is happening as we speak. Given the company’s leverage to payrolls (it does sell SaaS-based payroll processing services after all), we expect the decelerating employment environment to filter through into Paycom’s revenue growth. At the same time, a detailed analysis of Paycom’s customer base and end-market shows that, in contrast to the company’s insistence on a still-long runway for market share gains, a more realistic definition of the company’s TAM implies that the market is a lot more saturated than management has claimed. While management estimates Paycom is just 5% penetrated in its TAM, we think that number is a lot closer to 20%, with Paycom’s rapidly growing SaaS competitors also having captured about 20%. At the same time, the dominant legacy leader in the field, ADP, has retrenched and gone on offense, with early signs indicating that its new client wins and current-client retention are both looking up.

It’s also worth noting that several of Paycom’s SaaS competitors – particularly Rippling and Gusto – are privately held companies that recently raised capital at astronomical $10 billion-plus valuations. They are now putting that newly raised money to work, aggressively trying to win customers.

Overall, Paycom finds itself in a field that’s smaller than investors thought, with upstart competitors more aggressively fighting to gain territory, while the legacy giant that just ceded some of its own territory has begun to fight back in earnest. It should be unsettling for Paycom shareholders, especially given the resilience of the consensus estimate trajectory, which looks to be vulnerable to a rapidly worsening jobs backdrop.
**Paycom’s corporate culture is aggressive to a fault, resulting in misleading financials and overearning operations.** Among its software peers, Paycom converts its EBITDA to free cash flow at the lowest rate. A close look at its accounting methodology reveals that as it relates to management’s discretion to make critical accounting estimates, Paycom takes some very aggressive positions. In particular, we think its accounting for deferred contract costs and capitalized R&D overstate the company’s EBITDA margins by over 10%, making operating profitability seem much better than it actually is. EBITDA itself is overstated by approximately 50%, relative to an EBITDA that would be reported if Paycom employed a more reasonable and industry-standard approach to deferred contract costs and capitalized R&D accounting methodologies. As a result, headline EBITDA multiples for PAYC are misleading, and on a free cash flow multiple basis, the company is much more expensive relative to comparable companies than it is on an EBITDA multiple basis.

It also reflects a clearly uncompromising corporate culture that has sometimes, in our view, come too close to the thin line between questionable practices and something more nefarious. Indeed, the company’s aggressive culture is also manifested in its high-octane sales organization, which, while it has been wildly successful growing the company, has also left behind it a trail of questionable practices, including overbilling, decrepit customer service, and high sales rep turnover. The customer service aspect is interesting because it suggests that Paycom’s real sustainable earnings levels are even lower than they seem because as growth matures, customer service spend will have to increase substantially.

Within a slowing employment growth context, facing increasing competitive intensity, and trading at a precarious valuation, that’s a risk Paycom’s shareholders may become acquainted with sooner rather than later.
II. Company Background

Paycom: Capitalization and Financial Results

<table>
<thead>
<tr>
<th>Capitalization</th>
<th>2020</th>
<th>2021</th>
<th>TTM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share price ($)</td>
<td>$319.88</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully diluted shares (mm)</td>
<td>60.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fully diluted market cap (mm)</td>
<td>19,274</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: net cash</td>
<td>$361</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprise value</td>
<td>18,913</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EV/TTM revenue</td>
<td>16.6x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EV/TTM Free Cash Flow</td>
<td>87.0x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P/E (TTM)</td>
<td>84.0x</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Financial Results</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consolidated Revenue</td>
<td>$841</td>
<td>$1,056</td>
<td>$1,137</td>
</tr>
<tr>
<td>Adjusted EBITDA</td>
<td>251</td>
<td>333</td>
<td>359</td>
</tr>
<tr>
<td>Free cash flow</td>
<td>133</td>
<td>199</td>
<td>217</td>
</tr>
<tr>
<td>EPS</td>
<td>2.48</td>
<td>3.35</td>
<td>3.81</td>
</tr>
<tr>
<td>Platform Users (mm)</td>
<td>5.0</td>
<td>5.7</td>
<td></td>
</tr>
</tbody>
</table>

Source: PAYC company filings, Kerrisdale Analysis

Founded in 1998 by Chad Richison in Oklahoma City, Paycom was one of the first companies in the business of human capital management (HCM) to have accomplished payroll processing entirely online. Richison took Paycom public in April of 2014, and since then Paycom’s revenue has grown from $107 million in 2013 to just over $1 billion in 2021. Over that time, Paycom’s shares have risen by about 20-fold for a compounded annual growth rate of about 45%.

Paycom, and other HCM companies that operate a SaaS business model, have been able to achieve this astounding revenue growth mainly by taking market share from the large payroll service providers, which have historically been dominated by ADP and Paychex. Paycom attributes the success it has had in gaining market share to its user-friendly software, which allows for easy and quick adoption of its solution by its customers’ employees, who can manage their HCM activities seamlessly in the cloud, thereby reducing the administrative burden on employers and increasing employee productivity. The company has also long highlighted its single underlying database as a competitive differentiator as it removes the need to integrate, update or access multiple databases, which are common issues with competitor offerings that are frequently cobbled together from multiple third-party systems in order to link historically disparate HCM offerings.

Paycom’s securities filings have most recently designated its addressable market as US employers with 50-10,000 employees, though management has more realistically quantified its target customer as any employer with 50-2,000 employees. As of the end of 2021, Paycom stored data for approximately 5.7 million employees among 34 thousand clients on its platform, for an average of about 168 employees per client.

The equity market context for Paycom is particularly unfavorable

The general equity market has seen significant dislocation in recent months, partially as the result of uncertainty with respect to the inflationary environment, but perhaps more so as the
category of high-growth unprofitable technology companies has collapsed. It’s now a consensus view that the mania surrounding unprofitable growth had become unsustainable, and that market prices in many instances were reflective of an unrealistic blue sky business trajectory in the wake of fleeting success that was an artifact of the pandemic.

For the most part, we believe that much of the damage in the tech sector has been done. Companies whose share prices have declined dramatically, and which now trade at relatively reasonable valuation multiples, can begin to reverse those declines through cost cuts and strategic recalibration. Pandemic winners with exponential booking growth that has decelerated or even reversed have seen those trends reflected in their share prices. The opportunities to profit from these retrenchments have largely passed.

But we don’t believe this to be the case with a few of the more profitable and seemingly higher quality SaaS businesses. The robust valuation premiums among consistently profitable companies with predictable revenue growth and favorable unit economics are likely fertile ground for finding impending disappointments. These companies have little in the way of costs to cut given already high margins, yet they are still highly exposed to macroeconomic headwinds across the broader information technology sector. For companies like Paycom whose businesses suffer in economic downturns, the operating predictability they’ve boasted over the last decade is vulnerable to a rude awakening.

The recent experience at ServiceNow is instructive, as a media appearance in which CEO Bill McDermott merely alluded to the already obvious pressures on the sales cycle timeline resulted in the company’s shares tumbling 15% in a single day. We don’t expect very much to change at ServiceNow, but it’s hard to deny that the abrupt acknowledgement of macro headwinds carries with it significant risk that has yet to be appropriately reflected across similar companies.

This cautionary sentiment has made its way to some of the more prominent cheerleaders of the tech boom over the last few years. Orlando Bravo has presided over the software acquisition juggernaut of Thoma Bravo and its breathtaking growth in assets under management from almost nothing to more than $100 billion over the past decade. Just months ago, Bravo was insisting that the tech boom couldn’t possibly be compared to a party because “a party has a finite end” and that “software companies are not pandemic stocks…the world experienced the potential of digital assets and we’re not going back.” More recently, Bravo has been seen touting valuation based on “after-tax free cash flow” (see below). Similarly, Bill Gurley, famed venture capitalist and Benchmark partner, has been pontificating about the potentially painful “unlearning process” regarding the relevance (or lack thereof) of valuations to technology investing.
Comments like these from Bravo and Gurley are highly relevant because they’re reflective not necessarily of what “thought leaders” are thinking, but of what influential institutional investors are doing. The latter is critical in our view because the same investor flows that were chiefly responsible for the melt-up in technology valuations have become reticent to deploy capital without significantly stricter valuation criteria. That puts companies trading at absurd valuations – like Paycom – at risk.

**Paycom is deceptively but egregiously overvalued**

In the context of the universe of US-based Application Software companies with a market capitalization of over $10 billion, Paycom stands out as absurdly overvalued, even among companies that are already widely perceived to be valued richly (see below). Paycom is by far the most expensive among its peers on a free-cash-flow (FCF) basis, even as its revenue growth (which we expect will imminently decelerate, as we discuss at length later in this report) and profitability are not particularly exceptional.
Application Software Sector Valuations

<table>
<thead>
<tr>
<th>Ticker</th>
<th>EV/EBITDA</th>
<th>EBITDA Margin</th>
<th>Revenue Growth</th>
<th>Price/FCF</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSNC</td>
<td>11.3x</td>
<td>37.7%</td>
<td>8.2%</td>
<td>12.1x</td>
</tr>
<tr>
<td>ZM</td>
<td>22.8x</td>
<td>26.1%</td>
<td>54.6%</td>
<td>20.0x</td>
</tr>
<tr>
<td>ROP</td>
<td>19.7x</td>
<td>36.0%</td>
<td>19.0%</td>
<td>22.8x</td>
</tr>
<tr>
<td>WDAY</td>
<td>78.6x</td>
<td>5.4%</td>
<td>19.0%</td>
<td>26.0x</td>
</tr>
<tr>
<td>ADSK</td>
<td>38.9x</td>
<td>20.7%</td>
<td>15.7%</td>
<td>26.2x</td>
</tr>
<tr>
<td>DOCU</td>
<td>701.5x</td>
<td>0.5%</td>
<td>45.0%</td>
<td>26.5x</td>
</tr>
<tr>
<td>ADBE</td>
<td>26.3x</td>
<td>41.2%</td>
<td>22.7%</td>
<td>27.3x</td>
</tr>
<tr>
<td>INTU</td>
<td>30.5x</td>
<td>29.3%</td>
<td>25.4%</td>
<td>29.5x</td>
</tr>
<tr>
<td>CRM</td>
<td>36.4x</td>
<td>17.1%</td>
<td>24.7%</td>
<td>30.0x</td>
</tr>
<tr>
<td>SNPS</td>
<td>31.5x</td>
<td>31.1%</td>
<td>14.1%</td>
<td>31.6x</td>
</tr>
<tr>
<td>PTC</td>
<td>24.1x</td>
<td>28.2%</td>
<td>23.9%</td>
<td>32.8x</td>
</tr>
<tr>
<td>CDNS</td>
<td>40.4x</td>
<td>32.8%</td>
<td>11.4%</td>
<td>38.4x</td>
</tr>
<tr>
<td>ANSS</td>
<td>31.5x</td>
<td>34.6%</td>
<td>13.4%</td>
<td>39.0x</td>
</tr>
<tr>
<td>VEEV</td>
<td>52.9x</td>
<td>28.4%</td>
<td>26.3%</td>
<td>42.8x</td>
</tr>
<tr>
<td>BSY</td>
<td>60.1x</td>
<td>17.1%</td>
<td>20.4%</td>
<td>46.9x</td>
</tr>
<tr>
<td>TYL</td>
<td>40.2x</td>
<td>20.7%</td>
<td>42.6%</td>
<td>50.4x</td>
</tr>
<tr>
<td>HUBS</td>
<td>655.9x</td>
<td>1.2%</td>
<td>47.3%</td>
<td>75.4x</td>
</tr>
<tr>
<td>PAYC</td>
<td>51.3x</td>
<td>31.6%</td>
<td>25.4%</td>
<td>84.0x</td>
</tr>
</tbody>
</table>

Median: 37.6x 28.3% 23.3% 30.8x

Source: Bloomberg, Kerrisdale analysis
All valuations and financial data are for the trailing twelve months

In particular, if investors consider that valuations should be linked to fundamental operating performance, Paycom’s valuation places it farther outside software industry norms than any other company, which is an especially high bar for this group of businesses (see the chart on the next page).
In light of Paycom’s almost comical relative valuation, it’s worth appreciating – as we elaborate on further below – that the company’s fundamentals are weaker than they seem.

**III. Paycom’s TAM is much smaller and more saturated than it admits, with rapidly escalating competitive intensity and an employment slowdown presenting near term headwinds**

Paycom’s meteoric share price performance since its IPO has been primarily a reflection of its heretofore superb operating performance. In the last decade, SaaS solutions in general – and payroll and human capital management in particular – have experienced a kind of golden age of adoption within small and medium size enterprises (SMEs). This increase in SaaS penetration at SMEs predictably followed the adoption of similar solutions at the large-enterprise levels in
prior years. In retrospect, the software beneficiaries of this trend enjoyed the combination of displacing legacy on-premise incumbents, as well as the slow and steady post-GFC expansion in the US economy.

Paycom is undoubtedly a posterchild of the beneficiaries of these trends, claiming to have a $20 billion total addressable market (TAM), of which it argues – at just over a billion dollars in revenue in 2021 – to have only scratched the surface. Having generated compounded annual revenue growth of about 25% in the five years ending 2021, while simultaneously exploiting the inherent operating leverage in its business model by expanding operating margins by 12 percentage points (from 24.7% to 36.7% in that time), the story that Paycom shareholders would like to believe is that there’s still a lot of runway left to travel. Management reiterated this view in its most recent earnings call, reminding investors that “we only have approximately 5% of a very large and growing TAM and a long runway for rapid growth for many years to come.” But we are skeptical.

The $20 billion TAM estimate Paycom asserts is calculated by taking a $400 annual revenue opportunity per employee on its platform, and multiplying by the 50 million America employees in the company’s historical “sweet spot” of SMEs with 50 to 2000 employees. Somewhat unsurprisingly, Paycom’s closest competitor Paylocity makes very similar TAM claims in its investor presentations, which have included the slide below fairly consistently in recent years.

In our view though, that $20 billion figure massively overstates the opportunity. To understand why, it’s worth dwelling on the characteristics of Paycom’s current customer base, and the changes that base has undergone as the company increased its revenues 10-fold.
As the table above clearly indicates, Paycom has not really successfully achieved its oft-stated aim of “going upmarket” and capturing clients with larger employee bases. In fact, from 2017 through 2021, with the exception of pandemic-impacted 2020 (which we exclude from this analysis), the average new client that Paycom has onboarded employed just over 200 people. On the whole, the average number of employees at Paycom’s clients has been stagnant over the last 5 years. This is especially important in the context of Paycom’s TAM claims and ambitions. According to the U.S. Bureau of Labor Statistics (BLS), the number of employees in the private sector belonging to companies with 50 to 1000 employees is approximately 37 million, or about a third less than Paycom’s traditional 50 million employee TAM claim and about half of its more recent 70+ million employee TAM estimate. Considering that Paycom’s average new client has consistently been on the lower end of the 50-to-1000-employee BLS bucket, we think it’s disingenuous to claim that much larger employers are a realistic target market.

Paycom is also not the only simplified SaaS solution going after this market. When adding the employees on the platforms of Paycom’s competitors – chiefly Paylocity (~3 million) and Bamboo HR (25,000 clients, 2 million users), but also Rippling, Gusto, recently combined TriNet-Zenefits, and Workday – upstart SaaS companies have already captured over 40% of the total market, making further market share gains a lot more difficult than they were just 5 years ago when the only real competition in the space was the ADP/Paychex duopoly.

Beyond the overstated end-user TAM, Paycom’s $400 annual per-user revenue bogey also seems fanciful. Historically, Paycom has been able to grow this number at a mid-single digit rate, and that was with the help of interest rate hikes that padded average revenue per employee by increasing the company’s earnings on its payroll float. While 2022 will surely see a further bump in that number considering the spate of Federal Reserve hikes that have taken (and will in the future take) effect, the underlying ability of Paycom to continue to upsell further services (rather than simply hiking price) in order to get closer to the $400/year revenue/employee goal doesn’t look very robust. We think it’s perfectly rational to model
continued low-single-digit growth of this metric, but simply multiplying $400 by the total American employee count in order to obtain an unrealistically optimistic TAM-based valuation is ludicrous.

In the meantime, market share gains for Paycom are set to become a lot more difficult. First, as the more formidable competitor in the former payroll duopoly, ADP has been stepping up its competitive intensity. In its most recent earnings call, management’s remarks concerning client retention and new client growth were noticeably positive:

Our Employer Services retention was also very strong this quarter. As you know, our third quarter is especially important for retention since we typically experience elevated switching with the start of the new calendar year. Accordingly, we were very pleased that rather than decreasing the quarter towards pre-pandemic levels like we anticipated, our retention actually increased further into record territory driven by incredible performance from our mid-market and international businesses, among others.

As we’ve discussed for several quarters, the strong employee and client growth we’ve experienced have increased the demands on our implementation and service organization. We added to our headcount to keep up with this demand ahead of our busy year-end period. And as a result, we were able to maintain strong overall client satisfaction scores despite ongoing pressure from this elevated demand.

With retention having outperformed our expectations so far this year, we believe we are now on pace to hold on to most of last year’s retention gains and expect to remain at 92% retention for the year, down very slightly versus last year’s record retention level.

Carlos Rodriguez, CEO, ADP
2022 FQ3 Earnings Conference Call

Strong operating performance in the mid-market and record retention at ADP are not the only competitive headwinds Paycom will face. Closely held startups like Rippling and Gusto have in the last year raised capital at astronomical valuations, both exceeding $10 billion. As ADP battles to reassert itself in the SME market, and Rippling and Gusto fight to justify the astronomical valuations at which they’ve recently raised capital, we expect average selling price (ASP) pressure to begin in earnest, especially as the private startups will be looking to shore up liquidity in a business with low marginal costs. The combination of market saturation and competitive pricing will present significant challenges for both new client recruitment, as well as per-customer pricing for the foreseeable future, making Paycom’s TAM narrative even less credible than it already is.

**Slowing US job growth will exacerbate Paycom’s revenue headwinds**

Compounding the issues of rising competitive intensity and a market that’s more saturated than Paycom lets on is the current slowdown in employment growth. Paycom’s recurring revenue
base is dependent on its clients' employee payroll, so it's easy to see that the company is directly exposed to the expansion or contraction of broader domestic payrolls. The most extreme demonstration of that relationship occurred in the early days of the pandemic, as employment growth turned negative, and recurring revenue growth at Paycom decelerated from 30% year-over-year to merely 6% in just a few months.

![Total Nonfarm Payrolls Added (monthly)](source: St. Louis Fed)

US non-farm payroll growth for the last 4 months has averaged about 380 thousand, more than 30% below the 561 thousand average employees added in the 12 months prior. There has been a mounting consensus that job growth is slowing, seemingly confirmed by high profile hiring freezes in recent weeks by several major technology companies. In addition, significant job losses in housing-adjacent sectors are expected to materialize. Given Paycom's exposure to this trend, we'd expect some measure of disappointment to become reflected in the stock price in the near term, particularly as consensus revenue estimates for both the second quarter and the fiscal year have been increasing, even adjusted for the expected positive impact of interest rate hikes on payroll float income.

IV. Paycom's questionable accounting and aggressive sales practices reflect a large degree of overearning in the company’s financial results

Part of the attraction of SaaS investing is the ability for cloud software firms to convert an extremely high proportion of their operating earnings – frequently more than 100% given the nature of the cash conversion cycle – into free cash flow. Indeed, Paycom's peer group that we alluded to previously has converted an average of close to 100% of its EBITDA into free cash flow over the past 12 months. Paycom, on the other hand, has managed to generate only about 60% of its EBITDA as free cash flow. It's worth exploring the reasons for this anomalously low cash conversion ratio.
In our view, there are two primary factors responsible for this phenomenon at Paycom:

**Deferred contract costs:** Paycom capitalizes the cost to obtain and fulfill a contract and then amortizes that over ten years. For FY2021, Paycom capitalized $174 million – or 17% of total revenue – in contract acquisition costs. The net cash flow impact of these costs came out to $103 million, or about 10.4% of total revenue, which is substantial when compared to, say, a direct up-market SaaS competitor like Workday, where the same phenomenon results in an impact of about 3% of revenue. The discrepancy is directly related to the ten years over which customer acquisition costs are amortized. In what has been a rapidly growing revenue base, the difference between the amortization expense and the capitalized cost has grown commensurately.

We also don’t believe that the accounting is a credible economic representation of the reality. First, Paycom doesn’t sign long term customer contracts. As the company has consistently disclosed in its filings,

The contract period for substantially all contracts associated with these revenues is one month due to the fact that both we and the client have the unilateral right to terminate a wholly unperformed contract without compensating the other party by providing 30 days’ notice of termination.

This is not uncommon for SaaS purveyors, almost all of which use estimated customer lives that are greater than the initial contract term when capitalizing their customer acquisition costs. But most of these companies use much more conservative estimates: Workday and ServiceNow, for example, use 5 years, while Salesforce.com uses 4 years, and Paycom’s closest competitor Paylocity uses a still-aggressive 7 years. The larger payroll processors like ADP, where the substantially lower growth rate mitigates the effect on operating earnings, use a varying period of 3 to 8 years with an average closer to the lower end of that range.

We’re not the only ones who think Paycom’s accounting in this matter is highly aggressive. The company’s auditor, Grant Thornton, highlighted the contract cost amortization period as a “critical audit matter” that it communicated to the audit committee. The clear implication of Grant Thornton’s disclosure is that Paycom’s accounting of deferred contract costs is questionable.

**Capitalized R&D:** Paycom capitalizes and amortizes an abnormally large proportion of its “software acquired or developed for internal use” and it does so over a three year period. The three-year amortization is fairly standard for SaaS companies, so it’s the amount of these costs that Paycom capitalizes that is a bit suspicious in our view. In 2021, the company capitalized $53 million in research and development costs, or about 31% of its cash R&D costs. We couldn’t find any other company that even comes close to this level
of capitalized R&D, except for Paylocity, which capitalizes a similarly absurd 25% of its R&D budget.

The effect for Paycom is large, as it artificially inflated EBITDA by about 5% of total revenues (of course, in addition to removing the capitalized R&D costs from current year expenses, capitalizing them has the benefit of also removing them from future years’ EBITDA, which excludes any amortization).

In short, investors that are used to evaluating software companies using cash-flow-based earnings proxies like EBITDA should pay careful attention to the fact that not all EBITDA is created equal, and that there are some good reasons why Paycom’s EBITDA metrics are especially misleading. Optically, PAYC trades at a much smaller premium on an EBITDA multiple basis to its profitable SaaS peers, yet on a free cash flow multiple – ultimately, the metric that matters more – it trades at an exorbitant premium.

Accounting is not the only thing that Paycom does aggressively. About a year ago, the company settled with the SEC in an administrative proceeding in which Paycom admitted that it systematically overbilled customers by “upselling” software for which the customer was already theoretically subscribed. A deep dive through internet forums that feature former employees as well as current customers indicates that turnover among sales reps is astronomical, sales reps routinely overpromise and underdeliver, and that customers are not infrequently manipulated into buying additional software modules that they aren’t interested in. Former employees are also brutally honest in detailing the cutthroat sales culture in which contract wins are the metric that matters and customer service is an afterthought. We don’t think any of this is particularly nefarious; after all, Paycom has been an extraordinarily successful growth machine, and borderline sales tactics are a feature of that kind of growth rather than a bug.

But one implication of the corporate culture at Paycom is that, besides the aggressive accounting, another way in which Paycom is probably overstating its earnings is that customer service costs are understated. Yet as competition is increasing, customer service will become more closely scrutinized by clients as more alternative options have become available to both current and prospective customers. The result is lower overall margins as customer service expenses trend higher as a percentage of revenue, or reduced growth as more customers switch to or opt for alternative players with better reputations. The picture that emerges with Paycom is an aggressive execution culture that’s apt to crash badly when it inevitably hits the wall (which is only a question of “when” rather than “if”) of slowing growth.

V. Conclusion

While Paycom may be, for the most part, a perfectly decent company, it faces substantial near-term headwinds: slowing job growth, increasing competitive intensity from both SaaS upstarts and rejuvenated legacy behemoths, and an imminent clash with the limits of its TAM. That’s a dangerous combination to face for a company whose shares are by far the most egregiously
valued among its peer group, and which hasn’t yet experienced the wrenching rerating that the more speculative unprofitable SaaS group has undergone. In our view, the complacency on the part of institutional investors throughout the decade-long SaaS bull market has played a significant role in such valuation anomalies, and as that complacency has been unwound, the full effects have yet to be felt. At merely 50x forecasted 2022 free cash flow, Paycom shares would trade over 30% lower than yesterday’s closing price. At a more sane valuation, there’s still greater downside. Paycom may be one of the best performing software stocks since its IPO, but its industry is becoming saturated and commodified, and competition is becoming ever more brutal. From current levels, the downside is severe.
Full Legal Disclaimer

As of the publication date of this report, Kerrisdale Capital Management LLC and its affiliates (collectively "Kerrisdale") have short positions in the stock of Paycom, Inc. ("PAYC"). In addition, others that contributed research to this report and others that we have shared our research with (collectively with Kerrisdale, the “Authors”) likewise may have short positions in the stock of PAYC. The Authors stand to realize gains in the event that the price of the stock decreases. Following publication of the report, the Authors may transact in the securities of the company covered herein. All content in this report represent the opinions of Kerrisdale. The Authors have obtained all information herein from sources they believe to be accurate and reliable. However, such information is presented “as is,” without warranty of any kind – whether express or implied. The Authors make no representation, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results obtained from its use. All expressions of opinion are subject to change without notice, and the Authors do not undertake to update or supplement this report or any information contained herein. This report is not a recommendation to short the shares of any company, including PAYC, and is only a discussion of why Kerrisdale is short PAYC.

This document is for informational purposes only and it is not intended as an official confirmation of any transaction. All market prices, data and other information are not warranted as to completeness or accuracy and are subject to change without notice. The information included in this document is based upon selected public market data and reflects prevailing conditions and the Authors’ views as of this date, all of which are accordingly subject to change. The Authors’ opinions and estimates constitute a best efforts judgment and should be regarded as indicative, preliminary and for illustrative purposes only.

Any investment involves substantial risks, including, but not limited to, pricing volatility, inadequate liquidity, and the potential complete loss of principal. This report’s estimated fundamental value only represents a best efforts estimate of the potential fundamental valuation of a specific security, and is not expressed as, or implied as, assessments of the quality of a security, a summary of past performance, or an actionable investment strategy for an investor.

This document does not in any way constitute an offer or solicitation of an offer to buy or sell any investment, security, or commodity discussed herein or of any of the affiliates of the Authors. Also, this document does not in any way constitute an offer or solicitation of an offer to buy or sell any security in any jurisdiction in which such an offer would be unlawful under the securities laws of such jurisdiction. To the best of the Authors’ abilities and beliefs, all information contained herein is accurate and reliable. The Authors reserve the rights for their affiliates, officers, and employees to hold cash or derivative positions in any company discussed in this document at any time. As of the original publication date of this document, investors should assume that the Authors are short shares of PAYC and stand to potentially realize gains in the event that the market valuation of the company’s common equity is lower than prior to the original publication date. These affiliates, officers, and individuals shall have no obligation to inform any investor or viewer of this report about their historical, current, and future trading.
activities. In addition, the Authors may benefit from any change in the valuation of any other companies, securities, or commodities discussed in this document. Analysts who prepared this report are compensated based upon (among other factors) the overall profitability of the Authors’ operations and their affiliates. The compensation structure for the Authors’ analysts is generally a derivative of their effectiveness in generating and communicating new investment ideas and the performance of recommended strategies for the Authors. This could represent a potential conflict of interest in the statements and opinions in the Authors’ documents.

The information contained in this document may include, or incorporate by reference, forward-looking statements, which would include any statements that are not statements of historical fact. Any or all of the Authors’ forward-looking assumptions, expectations, projections, intentions or beliefs about future events may turn out to be wrong. These forward-looking statements can be affected by inaccurate assumptions or by known or unknown risks, uncertainties and other factors, most of which are beyond the Authors’ control. Investors should conduct independent due diligence, with assistance from professional financial, legal and tax experts, on all securities, companies, and commodities discussed in this document and develop a stand-alone judgment of the relevant markets prior to making any investment decision.