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ADP.OQ - Q4 2020 Automatic Data Processing Inc Earnings Call

EVENT DATE/TIME: JULY 29, 2020 / 12:30PM GMT

OVERVIEW:

Co. reported 4Q20 revenue of \$3.4b and adjusted diluted EPS of \$1.14. Expects FY21 total revenue to decline 1-4%.



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PRESENTATION

Operator

Good morning. My name is Crystal, and I will be your conference operator. At this time, I would like to welcome everyone to ADP's Fourth Quarter Fiscal 2020 Earnings Call. I would like to inform you that this conference is being recorded. (Operator Instructions)

I will now turn the conference over to Mr. Danyal Hussain, Vice President, Investor Relations. Please go ahead.

Danyal Hussain - Automatic Data Processing, Inc. - VP of IR

Thank you, Crystal. Good morning, everyone, and thank you for joining ADP's Fourth Quarter Fiscal 2020 Earnings Call and Webcast. Participating today are Carlos Rodriguez, our President and Chief Executive Officer; and Kathleen Winters, our Chief Financial Officer.

Earlier this morning, we released our results for the fourth quarter of fiscal 2020. The earnings materials are available on the SEC's website and on our Investor Relations website at investors.adp.com, where you will also find the investor presentation that accompanies today's call as well as our quarterly history of revenue and pretax earnings by reportable segment.

During our call today, we will reference non-GAAP financial measures, which we believe to be useful to investors and that exclude the impact of certain items. A description of these items, along with a reconciliation of non-GAAP measures to their most comparable GAAP measures, can be found in our earnings release.

Today's call will also contain forward-looking statements that refer to future events and involve some risk. We encourage you to review our filings with the SEC for additional information on factors that could cause actual results to differ materially from our current expectations. And as always, please do not hesitate to reach out, should you have any questions.

And with that, let me turn the call over to Carlos.



Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Thank you, Danny, and thank you, everyone, for joining the call. This morning, we reported our fourth quarter and fiscal 2020 results. Although we ended the year -- this year against significant headwinds related to COVID-19, we believe we executed well over the course of the last 12 months. And our product offerings remain well positioned to support sustainable long-term revenue growth as we continue to help companies and their workforces through all types of environments.

For the quarter, we delivered revenue of \$3.4 billion, down 3% reported and 2% organic constant currency, which was better than our expectations. And for the full year, we delivered revenue of \$14.6 billion, up 3% reported and 4% organic constant currency. Our adjusted EBIT margin increased 10 basis points in the quarter and increased 60 basis points for the full year, well ahead of our expectations as we managed our expense base prudently to absorb the impact of a decline in revenue in the fourth quarter while simultaneously providing an elevated level of service to our clients. With this revenue and margin performance, our adjusted EPS growth was flat for the quarter and up 9% for the year. Considering the unprecedented and evolving macroeconomic situation, we are very pleased with our execution in the quarter and our current positioning as employment continues to gradually recover from the steep declines our clients have experienced.

The global health crisis from COVID-19 has clearly evolved over these past few months. And I'll start today's discussion by providing a brief update on the trends we've experienced. When we reported our fiscal third quarter results in April, we were just starting to see some preliminary signs of stabilization after weeks of rapid deterioration. More specifically, across our own data sources, including weekly payroll, clock-in volume, job postings and background screenings, there were multiple indications that we were reaching the trough. Now 3 months later, we do believe we saw conditions bottom in late April. Whereas our pays per control was trending down mid-teens in April, it has since improved to be down about 10% as we exited the quarter. And for the full quarter, pays per control was down 10.8%, better than we had contemplated in our outlook.

Last quarter, we also discussed our expectation for elevated out-of-business losses in May and June. Those losses ultimately developed in line with our expectations. This yielded a decline in our retention rate of 20 basis points to 90.5% for the full year. Though if not for the elevated out-of-business losses in Q4, we believe our retention rate would have been up for the year. In fact, despite these losses in Q4, for fiscal 2020, we tied an all-time-high retention for our mid-market and hit a multiyear-high in our upmarket.

Looking ahead, while we have been encouraged by signs that the economic distress brought about by COVID-19 has started to ease in certain countries in several U.S. states, we are seeing continued or even increasing distress in others. And over the past several weeks, we've seen the pace of employment recovery slow. Accordingly, as we set our expectations for the coming year, we believe that the worst is behind us, but the global economic recovery over the coming quarters will be gradual. Kathleen will discuss some of our specific macroeconomic assumptions in more detail.

I'd like to turn now to Employer Services new business bookings. We reported a decline of 21% for the year, which was in line with our revised outlook despite the limited visibility we had in making that forecast. And although this represents a significant decline, the actual execution by our sales force was better than what this reported growth rate suggests. As we mentioned last quarter, there are 2 components to our bookings figure: our gross bookings we actually sold in the quarter and adjustments for previously recorded bookings.

Our gross bookings sold in Q4, while down significantly, came in ahead of our forecast and most importantly exited the quarter with improving momentum. This gives us confidence that buying behavior is continuing to trend in the right direction, which we believe will drive further bookings recovery in the coming quarters. Furthermore, our sales force has continued to adapt to this virtual sales environment as we've invested in training, stayed agile on sales messaging and continued to foster our channel relationships. We are also continuing to see week-on-week improvement in leading indicators, such as referrals, appointments per salesperson and demos scheduled.

In addition to these gross bookings, we regularly adjust bookings we have previously recognized if, for example, a client is no longer expected to start within the original estimated time frame or starting with fewer employees than originally anticipated. These backlog adjustments are ordinarily immaterial to our bookings growth. But as we said last quarter, COVID-19 is causing some clients to delay implementations or to start with fewer employees than we originally signed. We made a larger backlog adjustment in Q4 than previously planned. And this offset the better underlying sales performance we experienced.



Looking ahead, we expect we will likely see negative bookings growth in the first half of fiscal 2021 as we are still selling into an unfavorable macro environment. But we expect growth to be flat to positive in Q3 with much more substantial growth in Q4, driving full year bookings growth of flat to up 10%. Beyond fiscal 2021, a key priority will be getting our sales productivity back to or above its previous level.

Within our control are the investments we make. And in fiscal 2021, we are planning to continue investing in product innovation, digital sales capabilities and leading-edge sales tools to drive sales productivity higher. In addition, at this point, we are planning to add modestly to the size of our sales force. And together, we believe these investments will position us well to return to our previous -- to our prior new business bookings growth trend line as client buying behavior continues to normalize. Factors beyond our control, including overall GDP trends as well as the timing and scope of workers returning to their job sites, will, in the meantime, likely continue to impact our bookings.

Moving on, service has remained critical to our clients. Our clients look to us for support and guidance in navigating through the complexities of key HR challenges and regulatory change. And our goal has been to serve as a trusted partner as they faced COVID-19. Our clients have responded very positively to the robust service we have provided. And that, in turn, has led to record NPS scores in June as a direct outcome of our commitment to providing this exceptional level of service. And we expect this favorable NPS trend to have positive implications for us in the years ahead.

In response to initial surge in service volumes related to COVID-19, we redeployed hundreds of sales and implementation associates to help meet the service need. While average resolution time spent per service request remains elevated as our clients work through complex issues, we have now seen our service request volume return to more normal levels. And we are happy to report that we have now deployed most of these associates back to their sales and implementation roles. We continue to keep watch on proposed legislation that could drive another surge in client service demand. And we remain prepared for such a scenario.

We also continue to serve our clients through product innovation. During the quarter, we rolled out a range of solutions to help our clients through the crisis and prepare for the recovery. We implemented over 1,000 feature changes in response to 2,000 legislative updates in 60 countries. And we also had over 400,000 clients run over 2 million Paycheck Protection Program reports for a total loan volume of approximately \$115 billion. Many of those clients have also now run the necessary reports to apply for their loans to be forgiven. Looking ahead, a key product focus is enabling a safe return to the workplace. And we're offering tools, including touchless and voice-enabled clocking, health attestation and enhanced scheduling and analytics to help clients manage their workforces as they resume workplace operations.

We continue to make progress on our other major product initiatives, including the rollout of our Next Gen HCM platform and Payroll engines. 2 weeks ago, we won yet another award for our Next Gen HCM solution, the Ventana Annual Digital Innovation Award. And we remain excited about its rollout. Perhaps more importantly, despite shifting our workforce to a remote environment, we remain on track to hit our R&D development road map milestones. And just this quarter, we piloted Next Gen HCM and Payroll in Australia. Our product team also launched our new workforce management solution in the downmarket, launched a new time kiosk in the Apple App Store. And we went general availability with Wisely Direct in our mid-market and downmarket.

Now taking a step back, I'd like to say that in every challenge, there is a potential for upside and COVID-19 is no exception. We believe that the nature of this shock in which businesses of all sizes have faced major uncertainties in managing their employees has made the HCM partnership they have with ADP that much more valuable. And as companies emerge from this crisis, we expect them to see even more clearly the benefits of investing in robust, secure HCM offerings that include expertise and service to support their mission-critical activities. So although COVID-19 has created temporary headwinds in our growth, past experience has taught us to stand firm regarding our investments in strategy as part of our commitment to drive long-term sustainable growth. The strength of our business model and balance sheet allow us to do exactly that. And we are well positioned in our product, service and go-to-market strategy.

Last, before turning it over to Kathleen, I'd like to quickly touch on our plans for our own associates. Last quarter, we discussed having over 98% of our workforce operating virtually, including our sales force. And we've been pleased with that transition and their overall performance in this environment. While we are well positioned to continue operating this way, we are in the early stages of bringing back a small portion of our workforce to the office on a volunteer-only basis. And I'm actually pleased to join you today from our Roseland headquarters, which we opened just this Monday. Our sales force will continue to primarily engage with prospects and clients virtually. But they are beginning to conduct face-to-face meetings in some geographies to the extent that they and our clients and prospects are ready to do so.



And with all that said, I'd like to once again take a moment to recognize our associates for their outstanding effort and the sacrifices they've made. I understand the monumental task of managing work and home life is a complex situation. And I also know it's not easy. A heartfelt thanks to our associates and leaders for their commitment.

I'll now turn it over to Kathleen.

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

Thank you, Carlos, and good morning, everyone. During the quarter, our revenues declined as we felt the full brunt of a double-digit decline in employment among our clients, combined with other recession-driven headwinds. But we believe we executed well and are well positioned to do so for the quarters ahead.

For the fourth quarter, our revenue decline of 3% reported and 2% organic constant currency was ahead of our expectations as pays per control and PEO performance were better than we had planned. Our adjusted EBIT margin was up 10 basis points in the quarter, also well ahead of our expectations. We took certain cost actions in the quarter, continued to benefit from cost savings related to our ongoing transformation initiatives and also benefited from lower selling expenses, which together offset the margin impact from the loss of high-margin revenues related to COVID-19.

Our adjusted effective tax rate decreased 210 basis points to 22.9% compared to the fourth quarter of fiscal 2019. And our adjusted diluted earnings per share was flat at \$1.14 as lower year-over-year revenues were offset by modest margin expansion, a lower tax rate and a lower share count compared to a year ago. We ended fiscal 2020 with revenue growth of 3% reported and 4% organic constant currency, adjusted EBIT margins up 60 basis points and adjusted EPS growth of 9%. All-in, a solid year, particularly given the significant decline in economic activity and employment that we faced over the last few months.

As I move on to ES segment results, it's important to emphasize how resilient the business performance was in the context of unprecedented headwinds, including a 10.8% decline in pays per control and a 22% drop in client funds interest revenue. During the quarter, our Employer Services revenue declined 6% on a reported basis and 5% on an organic constant currency basis, in line with our expectations as better underlying growth was offset by incremental FX drag.

Our client fund balance declined 8% in the fourth quarter, reflecting lower pays per control, lower state unemployment insurance rates, payroll tax deferrals among some of our clients and the continued lapping of the closure of our Netherlands money movement operation in October 2019. Combining that balance decline with a 30 basis point decline in average yield drove our client funds revenue to decline by 22% to \$115 million. For the full year, our ES revenue was up 1% reported and 2% organic constant currency, a solid performance.

Employer Services margins were flat for the quarter, well ahead of our most recent expectations. We had the impact of lower revenues at relatively high incremental margin as we discussed last quarter, offset by prudent cost control measures across all categories. ES margins were up 60 basis points for the full year.

Moving on to PEO, also solid performance, given the circumstances. Our total PEO segment revenues increased nearly 4% for the quarter to \$1.1 billion and average worksite employees declined 3% to 548,000. This revenue and worksite employee growth were both ahead of our expectations, driven by better retention performance and pass-through revenue. Same-store employment at our PEO clients performed in line with our expectations of a mid-single-digit decline and, as expected, was more resilient than the average client in our ES segment.

Revenues, excluding zero-margin benefits pass-throughs, declined 5%. And in addition to being driven by lower worksite employees, it continued to include pressure from lower workers' compensation and SUI costs and related pricing. PEO margin declined 450 basis points in the quarter. This included about 530 basis points of unfavorability from a net expense in ADP Indemnity of approximately \$34 million, which contrasts to the \$22 million benefit we had in last year's fourth quarter. As a reminder, we had experienced favorable workers' comp claim trends over the past several years, which translated to favorable reserve adjustments in ADP Indemnity. Those trends remain positive but not as much as what was factored in our most recent reinsurance agreements. And as a result, we had a slight true-up the other way this year.



Let me turn now to our outlook for fiscal 2021. I'll start by discussing some of the specific U.S. macro-driven assumptions that underpin our guidance. The basis for these assumptions is a combination of our own trend data and third-party macroeconomic forecasts. And we believe we are utilizing a balanced outlook.

First, our pays per control outlook. We are assuming a decline in average pays per control of 3% to 4% for the year, driven by a decline in the high single-digit range for the first half of the year, improving to a decline of mid-single-digit by Q3, followed by a rebound to positive mid- to high single-digit growth in the fourth quarter. This outlook corresponds to a gradual improvement in the employment picture through the fiscal year. So it does not contemplate a full employment recovery. To help translate this trend into a single number you can anchor to, our guidance contemplates the U.S. getting to approximately 7% unemployment by June of 2021.

Second, out-of-business losses. Our retention was negatively impacted by losses in this most recent quarter as we had a number of clients turn inactive that, after monitoring and assessing, we decided to write off as losses. While we believe government stimulus programs have helped many small businesses, we continue to see some companies in an inactive state, where they are not paying employees. And we expect continued elevated losses in the early part of fiscal 2021 as restrictions and lower demand in certain industries continue to drive fallout. As a result, we're setting our expectation for ES retention to decline by another 50 to 100 basis points over this coming fiscal year.

Lastly, on client funds interest. As discussed last quarter, our client balance growth is being impacted by the combination of a decline in pays per control, lower new business bookings and out-of-business losses, and we had some modest pressure from companies taking advantage of the payroll tax deferral provision of the CARES Act. We are assuming a client funds balance decline of 6% to 8% for the year. And like pays per control, we expect it to be negative for the first 3 quarters and then return to growth in Q4.

We expect our average yield to decline as well. As a reminder, in Q4, we temporarily suspended our purchases of new securities and reinvestment of maturing securities in our client funds portfolio. And earlier this month, we resumed reinvesting. We have over \$5 billion in securities maturing in fiscal 2021, yielding on average over 2%. And we expect to reinvest them at prevailing yields that are well below that level. As a result, we expect our average client funds yield to be down 50 basis points to 1.6% for the year.

With this combination of lower balance and yields, we expect interest income on client funds to be \$390 million to \$400 million, down about \$150 million versus fiscal 2020. And we expect interest income from our extended investment strategy to be \$430 million to \$440 million, down about \$125 million versus fiscal 2020. With that said, without the benefit of our client investment strategy, which utilizes laddered maturities, we believe the headwind to fiscal 2020 would have been even greater.

Having covered the major macro topics for fiscal 2021, let me share with you how we are deploying our downturn playbook to manage expenses. We've concentrated on areas where we have excess capacity and on reducing discretionary costs while maintaining investment in sales, product and our associates. And as we emphasized last quarter, we continue to have the strong cash flow profile and balance sheet strength to withstand impacts to our revenue without taking immediate actions on our investments. We said we would be thoughtful and strategic in assessing the most prudent path forward, a path that balances positioning for a recovery against near-term margin performance.

We have now had a quarter to assess our business capacity and needs. And during the fourth quarter, we identified businesses across ADP, where, unfortunately, we didn't believe a recovery was likely in the near term, and therefore, had excess capacity in service and implementation. In addition to taking specific headcount actions, we have further tightened our nonessential spend, including T&E and other discretionary spend.

We are also continuing to move forward with our transformation initiatives. For the past few years, we have highlighted for you some of the discrete material initiatives that we have worked on and their estimated level of benefits. In fiscal 2019, we executed on our voluntary early retirement program, which yielded over \$150 million in annual run rate benefits. In fiscal 2020, we executed on our workforce optimization program and a procurement initiative, which together yielded approximately \$150 million in annual run rate savings against our original expectations of \$100 million.

For fiscal 2021, we have 2 important initiatives to call out. First, we are moving forward with a digital transformation initiative that leverages many of the capabilities we highlighted at our February 2020 Innovation Day, primarily to optimize our implementation and service, in addition to



enhancing efficiency in other parts of the organization. As examples, we're further utilizing automation in the implementation process, deploying additional self-service features throughout our platforms, broadening the use of guided assist tools and expanding the use of chat and chatbot. We expect this to be a multiyear effort as we work to optimize large parts of our service delivery model. Our innovation agenda is running full speed ahead. And that includes innovation in our client engagement.

We also expanded our procurement transformation initiative and expect further benefit for fiscal 2021. We've reassessed our real estate footprint. And although we had already closed over 70 subscale locations as part of our service alignment initiative in recent years, we recently closed several additional locations, including a large office in New Jersey. We will continue to evaluate whether there is further opportunity for location consolidation. Between these 2 initiatives, our digital transformation initiative and the expansion of our procurement initiative, we expect to realize a combined \$125 million in savings during fiscal 2021 with over \$150 million in run rate savings exiting the year.

Let's now turn to our outlook for fiscal 2021. We'll start with the ES segment. We expect a decline of 3% to 5% in revenue for the full year, driven by our outlook for a decline in pays per control, balance and yield pressure in our client funds interest portfolio as well as pressure from new business bookings and elevated out-of-business losses. Compared to what we just experienced in the fourth quarter, we expect the first half of fiscal 2021 to experience a slightly greater revenue decline as the incremental impact from lower sales, out-of-business losses and lower client funds interest more than offset the gradual recovery in pays per control that we're anticipating.

We expect revenue growth to improve modestly in Q3 and then turn positive in Q4. We expect our margin in the Employer Services segment to be down about 300 basis points for the year. And as a reminder, the revenues we lose from pays per control, out-of-business losses and client funds interest are all high margin. As with revenue, we are expecting a decline in ES margin during the first 3 quarters and an increase in the fourth quarter.

For our PEO, we expect revenue down 2% to up 2% for the full year with average worksite employee count flat to down 3%, driven by similar factors as our ES segment, namely headwinds in same-store employment, out-of-business losses and bookings pressure. We expect average worksite employee growth to be negative during the first 3 quarters and turn positive in Q4. Our revenues, excluding zero-margin pass-throughs, are expected to be down 1% to 4% and we continue to expect lower workers' compensation and SUI pricing. For PEO margin, we expect to be down about 100 basis points in fiscal 2021, driven in part by drag from higher zero-margin pass-through revenues, partially offset by a favorable compare for ADP Indemnity.

With these segment outlooks, we now anticipate total ADP revenue to decline 1% to 4% in fiscal 2021 and we anticipate our adjusted EBIT margin to be down about 300 basis points as the benefits from our continued expense management and transformation initiatives are partially offsetting the decremental impact -- margin impact of expected lost revenue due to COVID-19 as well as the investments we continue to make. We anticipate our adjusted effective tax rate to be 23.1%. This rate includes less than 10 basis points of estimated excess tax benefit from stock-based compensation related to restricted stock vesting in Q1 of fiscal '21. But it did not include any estimated tax benefit related to potential stock option exercises, given the dependency of that benefit on the timing of those exercises.

Last quarter, we temporarily suspended our share repurchases as we decided it would be prudent to wait for stabilization of the overall environment. At this point, we anticipate resuming our share repurchase program at some point this fiscal year, subject to market conditions. And we have a slight net share count reduction contemplated in our guidance. And as a result of our outlook for lower revenue and margins and higher tax, offset partially by lower share count, we currently expect adjusted diluted earnings per share to decline 13% to 18% in fiscal 2021. As most of you are aware, we also have \$1 billion in notes due September of this year. At this point, we expect to issue new debt in the coming weeks or months, depending on market conditions.

I'd like to conclude by saying that although COVID-19 is putting pressure on our financial performance, we believe this is transitory and the long-term prospects for ADP are in no way diminished and may even be enhanced by the current environment. For fiscal 2021, we are remaining focused on opportunities for innovation and growth while taking a deliberate balanced approach to managing expenses. And we are confident in our long-term growth prospects. I look forward to updating you on our progress.

With that, I will turn it over to the operator for Q&A.



QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Mark Marcon from Baird.

Mark Steven Marcon - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

One key one is just from a bookings perspective, as you look out over the coming year, and you gave us a bit of a sense for the cadence that you expect, which of the new solutions do you expect to see the greatest traction from? Which ones are you the most excited about? And which ones could be the most incremental from a really long-term perspective?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Well, I think from an incremental standpoint -- to start off with the last part of the question, from a long-term standpoint, I think some of the investments we've made in some of our Next Gen solutions I think, for me, has to be where I'm the most optimistic in terms of potentially moving the needle from an incrementality standpoint, right? Because we already have a very large, as you know, bookings number. And anything that we can add on top of that goes into the top of the funnel in terms of revenue growth. And that's really was the reason for these investments is to really move the needle competitively and to improve our position from a differentiation standpoint. And so the early signs, of course, now somewhat temporarily interrupted by COVID-19, were positive in terms of the traction we were getting both with our Next Gen HCM platform as well as with our Next Gen Payroll platform. So that's kind of where I feel the most optimistic in terms of the long term.

In terms of kind of the cadence and more kind of the short to medium term in terms of next year is really the fourth quarter is an important part as we've kind of been alluding to here in our prepared comments. And some of that is really clearly the pace of the recovery. So there's -- we have an expectation, which I think is in line with generally accepted, I think, forecast, if you will. And you heard kind of, as a proxy, the expectation that unemployment reach a certain stage by the end of the fiscal year. And those things were all proxies for GDP growth. And you guys all have plenty of access to your own firm's economic forecast and so forth. So the second half is really the key for us from a bookings standpoint. And there, aside from the incrementality question, this issue that we have around, for example, adjusting to our -- adjustments to our gross bookings is an important one. Because to the extent that the recovery continues on the pace we expect, it would help us a lot if we would be -- if we can start and continue to implement clients that were previously sold and at that -- so clearly, one positive would be that, that doesn't degrade any further. Because in full transparency, we mentioned that in our prepared statements, that's a concern under this kind of environment. But there's potential upside as well there. So there's downside and there's upside there as well.

But when you see the incredible decrease in activity in just a couple of months following the beginning of the crisis, it takes a while for that -- those buckets to get filled up again in terms of leads, then turning into first appointments, then turning into presentations to clients. So that whole process of how the sales evolution goes is critical for us in the second half. And the places that were hurt the most, which, in our case -- and some of it is perhaps just because of the nature of the crisis that the downmarket was hit very, very hard in terms of pays per control and also just declines in activity but also came back, frankly -- surprisingly, you can't call it strong because it's still down year-over-year. But I think the bookings performance in the downmarket has been, I think, gratifying. And so if we continue on that trend, that will be good news for the second half of the year. And then we expect, based on the current trends, that the mid-market and the upmarket will then kind of follow suit as the kind of pipeline leading indicators that we mentioned translate into actual bookings and actual sales.

So I guess the short story is the things that were the hardest hit are the things that in the initial stages are the things that should have, in our opinion, the biggest rebound in the second half. And then on top of that, obviously, our new product investments, I think, are a source of optimism for us. We've also invested in -- I think you heard us mention workforce management in the downmarket. And we have a lot of things going on. You can see it in our investments in technology over the last 4 to 5 years. And obviously, some of those things are longer term, like the Next Gen stuff. Some of it has been -- we've been in the investing phase for 6 to 12 months and we expect those things to translate now into new sales. So I don't know



if you've heard our tone over the last several years, but we pivoted to investing more in product and particularly more around agile technology. And that hopefully gives us some firepower here in terms of our bookings incrementality going into this year but also into the following years as well.

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

Mark, yes, just to add a little bit more there in terms of by each segment. For sure, we're expecting sales growth across each of the segments in fiscal '21. And as Carlos said, downmarket seems to be resilient and has trended up since we were at the low point several weeks ago. But downmarket has been trending up earlier. And then during the latter part of the year, we'd expect upmarket and international, for that matter, to continue along those lines, but for sure, expecting sales growth across all segments. And to Carlos' point, from a long-term incremental perspective, certainly expecting Next Gen HCM to be a driver there. But our strategic platforms in the near term, RUN and Workforce Now, have been performing really well in the market. And we expect them to continue to perform really well in the market as we recover through this.

Mark Steven Marcon - Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst

Great. And just as a follow-up, can you just give us an update in terms of where we stand in terms of the number of implementations on Next Gen HCM or sometimes known as Lifion and also Next Gen Payroll as a percentage of the client base that's been converted?

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

So on Next Gen HCM, you probably appreciate, for 2 to 3 months, that wasn't really something that a lot of companies were focused on or, for that matter, us. Unfortunate, but the good news is we did actually start a client just a week ago. So that is a ray of sunshine in what was otherwise a lot of dark cloud. So we had a number of clients that were set to be implemented in our fourth fiscal quarter, which delayed. And one of those actually started here already in the early part of the first quarter. So that's encouraging. But we're not that different from where we were before. So call it still a handful, I think, we have like 7 or 8 clients live, somewhere in that neighborhood on Next Gen HCM.

On Next Gen Payroll, there, the target at the beginning from a piloting standpoint really was clients are not quite the same size of Next Gen HCM. So it's a slightly different dynamic and it's -- and we're making, in terms of numbers of clients, more progress. But it doesn't mean that the product necessarily is making more products, it's just the difference between the markets we're serving. Next Gen HCM is really in the early stages aimed more at the mid-market, if you will, than really the upmarket. Even though we expect it to be our Next Gen Payroll engine across our mid-market and upmarket in the initial stages, it's really mid-market. So I think we have somewhere around 100 clients sold. And I think maybe that, that same number implemented if I'm not mistaken?

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

That's right.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

So we're making some good progress there. And there, the pace is a little bit better in the sense that we didn't come to a complete stop on Next Gen Payroll and we continue to implement clients there and kind of move forward. But this is a very challenging situation for our clients. And we really need to kind of help them get through the situation and the crisis, not necessarily press them to get started as quickly as possible, although that's obviously our desire from our standpoint.

Operator

Our next question comes from Ramsey El-Assal from Barclays.

Ramsey Clark El-Assal - *Barclays Bank PLC, Research Division - Research Analyst*

Can you hear me now?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Yes, we can hear you. Yes. Go ahead.

Ramsey Clark El-Assal - *Barclays Bank PLC, Research Division - Research Analyst*

Hello?

(technical difficulty)

Operator

And we'll move on to our next question. Our next question comes from David Togut from Evercore ISI.

David Mark Togut - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Could you characterize the gross bookings performance in the June quarter prior to the backlog adjustment?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Yes. I mean I think we're just trying to give a nod to our sales force in terms of that they were -- they performed better than we clearly had forecasted and that we gave in terms of color commentary during this same earnings call or during the earnings call of the last quarter. But they were still down significantly. So at the end of the day, we just want to make sure that you guys got the right impression that we weren't disappointed and that we didn't do worse than we expected. But from a mechanical number standpoint, think still down somewhere around 50%, like if that's a fair characterization. I don't know if Kathleen has any more color to add to it.

Kathleen A. Winters - *Automatic Data Processing, Inc. - Corporate VP & CFO*

Yes. No, the gross bookings were slightly positive to what we had expected, the -- approximately down 50% is right, which is what we had been anticipating and then the backlog adjustment, which actually is part of our normal process, factored into the overall bookings number being down slightly more than that for the fourth quarter.

David Mark Togut - *Evercore ISI Institutional Equities, Research Division - Senior MD*

Got it. And just as my follow-up, assuming the employment recovery proceeds, as you've laid out, Kathleen, negative 7.7% unemployment by the end of FY '21, would you expect to be back on your sort of normalized growth path by FY '22?



Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

Yes. Go ahead, Carlos.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

Go ahead.

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

It's a great question in terms of when do we return to previous levels of growth and profitability? And as you pointed out, a lot really depends on the shape of the recovery. And look, we've taken the best view we can and tried to share with you what we're thinking about that in terms of the shape of that recovery. But it really is going to depend on that. Last recession, it took a couple of years for sales and retention and revenue growth to return to the prerecession levels. Now is it going to look exactly like it looked the last time? We don't know. This crisis is different. The makeup of ADP is different. So I hate to say it, but it's going to depend on a lot of factors. But returning to those previous growth rates certainly will not be in fiscal '21 based on what we see right now. And we'll update you as things change and as we go through the current year.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

I think maybe just to add a little bit of -- just in terms of my own observations from looking at the kind of the quarterly cadence, if you will, and how -- what the implications are for FY '22, it really depends on are we thinking about sales? Are we thinking about revenue? Or are we thinking about profit growth? And they're all kind of different buckets. But I guess -- and to Kathleen's point, it really all depends, if this is unlike the financial crisis, not a 2 or 3 -- the financial crisis really was when you go back and think about it, the kind of mini-crises that occurred over the course of the following 2 or 3 years, remember, we had the European debt crisis. We had a number of things that elongated that situation. But that could happen here as well. And we are, of course, not scientists. And we don't know exactly what's going to happen. But we're using kind of the same forecast that, I think, all of you are using.

And if you make those assumptions around when the health care crisis passes, i.e., vaccines and therapeutics and so forth, if you follow that path, then FY '22, when we exit in the fourth quarter of FY '21, from a mathematical standpoint, I think you used the term growth rates, the growth rates are going to look pretty good in terms of as you exit from a booking standpoint and then starting maybe with profitability in the first quarter of FY '22. Because in the fourth quarter of FY '21, we saw some NDE expense. But some of that, frankly, is really the comparison. So we're going to have 3 quarters in FY '22 that are going to look pretty good. Because if we still think that the first couple of quarters of FY '21 are still impacted pretty significantly by COVID, and by the first couple of quarters of FY '22, you don't have that impact, you're going to have some, I hope, some really good tailwinds on some of these growth numbers.

But the key for me was looking at absolute booking dollars in the fourth quarter of '21 compared to the fourth quarter of '19. Because obviously, '20 is not a good comparison, and looking also at our absolute profitability in the fourth quarter of '21 and our revenue in the fourth quarter of '21. And again, I feel some sense of optimism about '22 based on those exit rate assumptions with a capital A and a capital S-S-U-M-P-T-I-O-N because this is a -- we're a long way away from having certainty. And you've seen how fluid the situation has been. But I think the math, I think, works kind of favorably once we get through fiscal year '21, and particularly when we get through the first 3 quarters of fiscal year '21.

Operator

Our next question comes from Jason Kupferberg from Bank of America.

Jason Alan Kupferberg - *BofA Merrill Lynch, Research Division - MD in US Equity Research & Senior Analyst*

Just wanted to start with the kind of a high-level question on the fiscal '21 guide. I mean we've got revenue down modestly, but obviously, EPS down quite a bit. And that's being driven by a little bit of tax but really the 300 bps of EBIT margin decline. And I guess it looks like the transformation savings should largely offset the hit to float income. So are we really just down to kind of isolating this against decremental margins that maybe people didn't appreciate the kind of the severity of? Or are there other factors there? Because I just think at a high level, people were surprised to see how much EPS is going to be down relative to revenue for the current fiscal year?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Let me take a crack at a couple of high-level things and then Kathleen probably can provide some additional maybe detail to help in terms of quantifying some of this stuff. But we -- and I'm not sure if it was clear from our comments last quarter or this quarter, but having been through these types of -- not through a health care crisis, but I personally have been through dot-com downturn, Y2K at ADP, 9/11 and the global financial crisis. And our Board is a Board that is long-term-oriented. And it feels like despite how horrible the situation is, it feels like this situation is transitory.

And so one of the things that we have as a first principle is to maintain our level of investment. That doesn't mean that we're not prudent around our expenses. And I think we have been. And I think Kathleen gave you some examples of some of the things that we're doing. But we're going to add to our sales headcount next year, which might surprise some people and maybe not something that you were expecting. And the problem is that when you model only 1 fiscal year for a company like ADP or a recurring revenue model, if you decrease your sales cost or even your investment in product and technology, it actually looks quite favorable. And you can probably offset quite a bit of revenue decline. The question is, is that really the right thing to do long term? And we don't believe that it is. And so that's one factor philosophically.

Second factor is that even though we clearly have some decline in the number of clients, the nature of revenues that are going down is very high margin. So you mentioned client funds interest. But we also have another decrease from a comparison standpoint, 20% to 21% in pays per control, which is, call it, 100% margin as well. And there's very little work related to the number of worksite -- sorry, the number of employees paid by our clients. Our workload is generally driven by number of clients. And then as we've all now observed in the last quarter, also driven a lot by the regulatory environment. And so the amount of work has not decreased much and, in some cases, has increased on behalf of our clients. And again, that's a place where we could cut some of that support and then it would lead to lower NPS scores, and we probably would have retention go down.

But the single most important driver of financial value for ADP is client retention and lifetime value. To lose clients and then have to go sell them again and implement them again makes absolutely no sense. And all the experience we -- that I have and we have and our Board has tells us to kind of stand firm and make sure that -- that doesn't mean that we ignore the realities around us. If we thought that this was a permanent decrease in capacity of the economy or in terms of the global outlook and then it was going to last 2, 3, 4 years, we probably would be behaving differently. But that's not our expectation. That's not our -- that's not the way that we're managing the company. There's also a couple of other items, I think, that mathematically may be not helping us. And maybe Kathleen can help a little bit with some of those.

Kathleen A. Winters - *Automatic Data Processing, Inc. - Corporate VP & CFO*

Sure. Yes. Look, on the surface, the 300 -- the guide to 300 basis point decline on the surface may sound like a lot. But there's a lot going on in there. When you pick it apart, I think it's really -- and you put it into these kind of buckets, I think you'll see how we arrived at that guidance and that expectation, right? As we've talked about and as you know, we've got obviously a substantial impact from loss of very high margin revenue, right? We've got that high-margin revenue. We've got client funds interest, which is a hurt on margin year-over-year. We also have growth in zero-margin pass-throughs, which falls right to the bottom line from a margin perspective. That's going to be a significant hurt for us, where it hasn't been as much in the past. And the continued investment along the lines of what we think it's prudent and smart to take to continue our long-term view and to continue to invest in sales and in product, we're committed to that level of investment. So that's a perspective.

And then you do have, as you pointed out, the transformation and other cost actions that we've been taking that only partially offset that. So I would think about it in those buckets in terms of, look, you've got this high-margin revenue. You've got some other things that fall right to the

bottom line, like zero-margin pass-through and client fund interest. You've got the commitment to continuing to invest. And quite frankly, I think we've been executing really well from a transformation perspective and also in terms of looking at, as we navigate through this period, the exit capacity costs that we have and being really smart about addressing those.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

But I guess let comment just to provide a little bit of color on kind of our view. Because I learned the hard way from my 2 predecessors about some of these things. So if you just look at the sales engine aspect of our business and you look at it over multiple years, you can actually do the math that if our -- if we decreased our headcount, call it, 5% or even if we just kept it flat and you assume that productivity continued on kind of its normal trend, which is a big assumption, but even if you assume that, you can see the impact that has on revenue growth from multiple years down the road. So obviously, if you expect that you're not going to be able to ever return to the same kind of sales productivity you had before, then you have to do something differently. But that's not the expectation we have right now. And it's critical to our growth in '22, '23 and '24 for us to maintain our investment in our sales engine, not to mention in our product and our technology and a few other places as well.

Jason Alan Kupferberg - BofA Merrill Lynch, Research Division - MD in US Equity Research & Senior Analyst

Okay. Yes, that's really good color. For my follow-up, I wanted to ask just about retention. I know you're forecasting the 50 to 100 bps decline this year. I wanted to see if we can get a sense of how that compares to how you exited the June quarter on that metric. And I'm really just trying to get a sense of whether you're forecasting acceleration in churn over the next few quarters or more of just kind of a stable and steady pace of churn.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

Again, let me give you some maybe philosophical, high-level comments. And then Kathleen maybe can give you some color on the fourth quarter and some of the assumptions. So in general, we've been -- and I've been -- again, having been through multiple downturns and crises, I've been surprised by the resilience of our retention. And we think there could be a number of factors here. One of them could be all of the government stimulus, the Paycheck Protection Program, all these things might -- these are all new things compared to the past that might be helping. There's also the potential that some clients are frozen in place, if you will, like we've talked about how difficult our bookings have been. I think logic would tell me that, that's probably happening across multiple industries and multiple competitors.

And so we would be intellectually dishonest not to assume that, that might be helping our retention in some parts of our business like the mid-market and the upmarket. Because in the downmarket, it's really driven more by out-of-business. So having said all that, I would say that a lot of these things are really about timing. Because if there continues to be government stimulus and there continues to be optimism about this being transitory, then I think this kind of holds and you have probably some additional fallout in the downmarket as a result of out-of-business and so forth. But you don't have kind of a major downturn or a collapse in retention. So -- and that's kind of where I am today that we're expecting, what I would say is -- I would consider these to be reasonable and modest declines in retention when you compare them to other downturns that we have some data on and some history about.

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

Yes. And we did do a lot of work around and analysis around what happened in the last recession and what happened to retention and by segment. And I think we've got a pretty balanced view. If you look at the decline in retention that we experienced in Q4 and what we are guiding to and expecting and planning for in fiscal '21, it's basically in line with the retention pressure that we had during the last recession. So we'll see. I mean it's really hard to predict and to tell what level of support the PPP program has had and is going to have. But that's our best view right now.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

And I think I don't -- we normally don't give it. But I think I feel like this is an environment where transparency is probably not a bad idea just to give you -- like that's why we gave you kind of the gross bookings number besides the net bookings number. Because you guys need to model this stuff, so you can understand what's happening here. But think the fourth quarter is somewhere around couple hundred basis point decline in retention, which I think, again all things considered, I thought was -- and most of that decline, frankly, came in the downmarket. So that, to me, feels like better than I would have expected 3 months before that.

Operator

Our next question comes from Tien-Tsin Huang from JPMorgan.

Tien-Tsin Huang - JPMorgan Chase & Co, Research Division - Senior Analyst

Just on the transformation initiatives, I caught all the details there. How about looking beyond those 2 initiatives? Are there any other potential actions that you could take? Anything that could be material over a similar size?

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

Again, I'll maybe give some high-level comments and let, I think, Kathleen give some additional detail. We have a very large menu of things that we can do. This company has a very, very long history of navigating through multiple changes in environments and multiple economic circumstances. And now I think we will add to our repertoire, managing through a major health crisis and a pandemic. And so we have -- I don't know how else to put it. We have a huge number of things that we could do if necessary and when necessary. This is an incredibly resilient business model. I recognize that it is unusual for ADP to be down the way we are. But it is what it is in terms of the economic circumstances around us. But believe me, we have a number of levers. So as I said, like some of these things are -- in our business model are somewhat self-correcting.

If in the unlikely event, there was a belief that there was a permanent impairment of kind of global economic GDP or growth vis-à-vis other industries or other companies, I think that we are in somewhat of a better place. Because the amount of money that we spend on NDE and on implementation alone would, at least for the short term, would certainly enhance our bottom line and help us from a margin standpoint. That's not what we want. Because the real value to be created here is through growth, right, through profitable growth, not by kind of shrinking our way into profitability. But we have no intentions of allowing ourselves to underperform, if you will, on a long-term basis, below what we have delivered for many, many decades. And that's what '21 is all about. But if circumstances change, we have a very long list and quite a lot of variable expense in our P&L and a very strong balance sheet and a very strong cash position.

Kathleen A. Winters - Automatic Data Processing, Inc. - Corporate VP & CFO

So Tien-Tsin, thank you for the question. It's a logical question because when you think about kind of the path and the history over the last several years, right, in terms of what we've been driving from a transformation perspective, you can see that we've had these several kind of big major initiatives over the last several years, right? We had service alignment initiative, first. We have a voluntary early retirement program. We told you about the workforce optimization and then the procurement. And now the procurement continues, and we've shared with you our work that we're doing around digital transformation. The question, what comes next? Quite frankly, I think there's a lot of runway, and we have a lot to do from a digital standpoint and also from a procurement standpoint. It does get harder as you go, I will say. But there's a lot to do there.

And a lot of the digital projects -- first of all, the digital is certainly focused on our service and implementation because there's opportunity there. But it is across the entire company. So every single segment and every single department, whether your front office or your back office, is tasked with thinking about digital transformation, automation, how do you make the work more efficient, how do you take work out. There's runway there. So I expect that you will hear us talking about that for some time to come. The procurement, while it does get harder as you go, what I would



say is, in an environment like this, that we're in right now in a downturn, it does present some procurement opportunities that maybe didn't exist a year ago. When you go back and you're negotiating with vendors and suppliers and so forth. So we've got real work to do there.

And as you heard us say in the prepared comments, we've expanded procurement to make sure we're capturing all of the opportunities from a real estate perspective in terms of, look, the environment has changed, the way the world is working has changed. Let's make sure we are thinking about our real estate footprint in a fresh, modern, forward-looking way to ensure we're utilizing the assets that we have to the fullest extent possible. We're understanding how we're going to get work done in the future. We're understanding how we can utilize mobility models where it makes sense to do that. So we've got a lot of work and some really good work to do here from a digital procurement real estate perspective.

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

And just one last comment on that. The other thing that maybe is underappreciated, but it's worth mentioning here because again we're typically not talking about these things because they're more longer term. But if your question was really more about what's potentially next longer term and not just in '21, our Next Gen investments are the largest potential digital transformation effort we've ever undergone. And we always focus on them around what they're going to do in terms of our winning in the marketplace and our sales growth and our revenue growth. But trust me when I tell you that the business cases for those investments and the progress we've been making over all these years, there is an enormous expectation for, call it automation, call it efficiency, whatever you want to call it.

And we don't usually talk about our tax engine. We talk about HCM and Payroll. But one of those Next Gen investments is our tax engine, which, again there, the early signs, we already have a couple of hundred thousand clients migrated onto that platform. And when you see how quickly we were able to make these legislative changes in that platform and the cost structure and the cost of support, again I would be very optimistic that one of the largest transformation efforts we'll be talking about in the future when we look backwards is these next-generation investments. I'm hoping they're also going to lead to big growth incrementality and winning more market share in the marketplace. But do not underestimate the value of these investments in terms of our back office and also our cost structure.

Tien-Tsin Huang - *JPMorgan Chase & Co, Research Division - Senior Analyst*

Yes. That's a very complete answer. And if you don't mind, just one quick follow-up. You mentioned the legislative changes and a lot of the work and effort that you put into that. And Carlos, I know I ask you this all the time, so I'm going to ask you again. Could we see more demand? I know you mentioned improved bookings momentum that you started to see. But could you see more demand for the service model in general here? I don't know where you're seeing maybe some switching from or more demand for work. But again, election year, a lot of complexity, probably more changes coming, could that help you here?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

I mean I don't see how it can't. So usually, I'm not that optimistic or that definitive. Because if it were only the election, I would say we'll have to wait and see. But I don't -- again, I'm not usually a pontificator, but I just don't see how companies after all this don't reassess, not just kind of how they do HCM and payroll and so forth, but so many other parts of their business model, where continuity and resiliency and so forth are critical. And that applies to the smallest client to the very largest clients. I think that for a lot of us, I don't think we're the only ones or the only industry or space where that's going to be a tailwind, but it's hard to believe that this isn't a positive. Now in what quarter and how do I quantify that? Because you have GDP going down, I don't know, 30-something percent in the second quarter, even if people were thinking about that, that wasn't really going to be a factor in -- certainly in the fourth quarter.

The question is, how does that net out in the math, right? Because you want to somehow be able to parse that out and understand how much of it is incremental. And I can't necessarily do that scientifically. But intellectually, it's hard to believe that it isn't a tailwind going forward for us. And then on the election side, we like -- we generally like change because -- and it doesn't matter whether one party versus the other, we're apolitical as a company. But usually when there's change, there is change for employers. Employers are an instrument of policy of the government. It's how public policy gets effectuated, whether it's through tax or all the various safety policies -- you're seeing all these changes in leave policies now to

help manage through the health crisis. And so that's all incredible, I think, opportunity for us to help our clients. And when there's opportunity to help clients, that's opportunity to sell new business as well.

Operator

Our next question comes from Bryan Keane from Deutsche Bank.

Bryan Connell Keane - *Deutsche Bank AG, Research Division - Research Analyst*

I just wanted to ask, take another crack on the margin question and looking at it from this perspective. The fourth quarter margin in ES was impressive to bring it to flat. And you took a lot of the brunt of the hit. Just thinking about that fourth quarter versus the guide of down 300. I guess I'm a little surprised that it doesn't hold up better. Can you just contrast the margins in the fourth quarter being flat versus down 300 from that perspective?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

Sure. I mean I think some of it is -- and Kathleen will go through some of the math. But the client funds interest impact is much bigger, I think, going forward than it was in the fourth quarter because of the laddering that we do in our portfolio. The impact, for example, of bookings, we still had a lot of business starting. Because remember, there's a lag between bookings and starts. So I think you would all be very surprised by how much -- even though we had some delays in some -- particularly for larger clients, we started a lot of business in the fourth quarter also. And as kind of the bookings decline, now the starts and the amount of revenue that goes into the run rate declines as well as you move forward until you get that sales number back up again. So I think there are a number of just kind of mathematical realities that, I think, that hit us in the next 2 or 3 quarters in comparison to the fourth quarter.

But I think that, again you -- we're not going to do that. Like we're not going to provide quarterly guidance. But I would encourage you to attempt to do either a first half or a second half based on the tone that you're hearing from us or even attempt to do it by quarter because the view that we have of the fourth quarter, again assuming the assumptions are correct, I think paints a very different picture than the picture maybe that you're getting by looking at a '21 number. I would also argue that when we talk about '21, it's fiscal '21, which happens to be only 6 months of '21. For every other company out there, when you talk about '21, you're talking about the beginning of January of '21, where everybody expects everything already to be back to normal. And that is in terms of assumption of things being back to normal. So it's a little bit maybe tricky in terms of the thought process and the math. But I don't know if Kathleen has anything to add on that.

Kathleen A. Winters - *Automatic Data Processing, Inc. - Corporate VP & CFO*

Yes. I mean, yes, it's a little bit hard to say, okay, compare 1 quarter to a full year, particularly in a year like this, when there's so much going on and there's so much linearity aspect in fiscal '21. But what I will say is in Q4, we did have sales expense. Our NDE was actually a little bit of a help in Q4 versus it ends up being a hurt. So that's kind of one difference one to the other. And the other thing is from a transformation perspective in terms of benefits and how the benefits flow, while certainly being a favorable and a help for us in each year in fiscal '20 and in fiscal '21, in Q4, there is a pretty substantial impact favorability from transformation, if you were to compare it to a full year of fiscal '21.

So it's kind of the math of how it all falls out in a quarter versus in a full year. But again, think about fiscal '20 as -- sorry, fiscal '21 as, look, you've got this high-margin revenue. You've got top line stuff that flows right to the bottom line being the zero-margin pass-through and the client fund interest. You've got continued our commitment to investment. So you've got that hurt from sales expense, partially offset by continued transformation work.

Bryan Connell Keane - *Deutsche Bank AG, Research Division - Research Analyst*

Got it. That's helpful. And then just a quick follow-up. The elevated out-of-business losses, just trying to get a sense of how that's compared in past recessions. And then how much more do we have to go on that? I mean have you written down the majority of it and there's just a little bit left over? Because I know in FY '21, you're saying there'll be some more losses. I'm just trying to get an impact of magnitude of previous recessions and how much is left.

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

So that really comes through in the retention. So it's not really -- we don't "write it down," right? So that really comes through in terms of the losses from a retention standpoint. We have, like maybe others, some clients that have "stopped processing" and -- but they're still there. And so there's a question of which of those clients come back and which of those clients don't come back. But we've modeled in, in the downmarket -- this is really a downmarket issue. We hope that it's a downmarket issue. At least in prior economic cycles, that's been the case. And I think you see it reflected in our retention rate.

But it's very, very hard for us to say with any level of certainty how that's going to exactly play out in the future. We've looked at all the prior downturns. And we know that there's probably some out-of-business that's still there that's going to occur. And a lot of this, in this case, is going to depend on government stimulus and whether there continues to be some support for small business or not and also just the overall level of GDP and obviously the overall pace of recovery in terms of people going back to spending on products that help small businesses survive.

Operator

Our next question comes from Lisa Ellis from MoffettNathanson.

Lisa Ann Dejong Ellis - *MoffettNathanson LLC - Partner*

I apologize, I am going to ask one more question on margins. Just a clarification on the back side. Because I think that maybe the effect of the deleveraging related to pays per control is maybe a little bit steeper, [is maybe something that we're] expecting, et cetera. Is the implication of that coming out of this as we get back to better employment levels late in '21 that you would see a sort of similar snapback? Is that the way we should be thinking about it as unemployment improves, so meaning when we're looking out into FY '22? Or are there reasons that we wouldn't expect that to happen?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

No, I think that's right. And again, I hate to go back to -- because I think I would encourage you, like I'm doing the focus on both growth rates but also because I know they're important in terms of models and so forth, but absolute numbers as well. Because if pays per control doesn't grow in the fourth quarter of fiscal year '22, we have a serious problem. Like if there's not a big snapback of that number, like if there isn't a huge snapback of bookings, we have serious problems. And so the only thing that we think is not something that we want to model improving is interest rates. Because it just doesn't feel like there's a basis for doing that.

But I think if you take reasonable assumptions based on economic forecasts, you do have a fairly significant snapback in terms of growth rates, if you will, or improvement percentages. The question then is what does that mean in terms of absolute numbers? And so if you still have 7% unemployment, by definition, that unemployment rate is still higher than it was in the, call it, third quarter of FY '20. And that has some implications in terms of absolute level, if you will, of pays per control. And we've kind of modeled that in to our assumptions. But for sure, there's a snapback in the numbers. There's no denying it.

Lisa Ann Dejong Ellis - *MoffettNathanson LLC - Partner*

Good. Okay. All right. And then just my follow-up is related to the PEO. As you're seeing -- because I know you don't -- your bookings are ES-related bookings. So just a kind of question on demand -- the demand environment for the PEO. As you're seeing companies adjusting now to the crisis and to the recession, how is demand acting for the PEO, meaning, is it positive because companies are looking to variabilize costs? Or are you seeing some companies move away from the PEO because they're reducing benefits? What does that demand outlook look like?

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

I think the demand -- so far, our experience in the PEO has been that it was kind of in line with the rest of the business. It looked a little more resilient in April, which you may have heard that tone from us. But then May and June, pretty much in line with what was happening across ES in terms of bookings demand. And I think some of that is because of just the sales cycle. If you think about the PEO, the sales cycle resembles more the upmarket, the lower end of the upmarket than it does the downmarket, even though the average client size is small. And that's because it's a high-involvement product and high-involvement sale because you're basically turning over all of your HCM, including your benefits, your workers' comp, et cetera. So I think that's what we've seen in the short term.

If you look at again 20, 25 years' worth of history, I can't even believe I've been doing this for that long, but I started my career in the PEO, and every time there's an economic cycle or a change, whether it's dot-com or financial crisis or whatever, there's a lot of theories. And I think the secular demand and growth of the PEO doesn't seem to be impacted by many things. So I would still expect that kind of solution to have a lot of legs for small- and mid-sized clients for a long time to come. In the interim, there could be ups and downs. Because as you said, if companies are "hunkering down" and don't want to offer benefits, at least in our PEO, part of the value proposition is benefits. And so -- but so far, when you look at sales results, lead generation, activity, et cetera, there's no reason to believe that the PEO won't recover in the same way that we expect the rest of the business to recover from a booking standpoint.

Operator

Our next question comes from Steven Wald from Morgan Stanley.

Steven Matthew Wald - *Morgan Stanley, Research Division - Equity Analyst*

Great. So just coming at some of the implicit assumptions under the guidance, another angle. Just curious what your guys thoughts are in terms of what you're seeing conditions on the ground-wise in terms of geographic concentration. I mean, certainly, some parts of the country are more open than others. Some industries are doing better than others. I guess I'm just curious if you guys could sort of separate out how you guys are thinking about that on a go-forward and the unevenness of the recovery and what that means for your client base. I know you've talked about being diversified. But certainly, there's a quite disparate experience level across the country right now.

Carlos A. Rodriguez - *Automatic Data Processing, Inc. - CEO, President & Director*

It's a great question. I think you probably saw in our comments that we said that we observed in our data that there has been a slowdown in the last few weeks. So we are looking at the data weekly and we do look at it geographically, both globally in terms of by country but also within the U.S. by state. And as you would expect, part of the challenge in the last several weeks and month has been in the places where you've seen some of the comeback in terms of the virus or the resurgence of the virus in kind of the Southern states and also Texas and California, but nothing back to kind of the full shutdown that we saw in April, which is in line with what you're all seeing as well in the news and so forth. So this is more about a leveling-off of growth rather than kind of a decline. So we've seen it in the same metrics that I talked about in the last quarter. So I can see it in like the number of job postings and screenings and so forth that have -- that we're on an upward trend line. And frankly, it was certainly not a V. But it was a nice, upwardly sloped trend line, which then was translating into improved employment, both in our numbers but also in the government reported numbers. But we have seen a plateauing of that as of the last 2 or 3 weeks.

And so that's something that we -- fortunately, when we relooked at our assumptions for fiscal year '21, the assumptions we have for pays per control for the first quarter are around where -- what the pays per control exit growth rate was for the fourth quarter. And based on this kind of plateauing, that feels like the right place for us to be. And the problem is we don't want to necessarily go tweak the second quarter or the third quarter and the fourth quarter. Because as you've seen over the last 3 or 4 months, 3 or 4 months ago, we were actually thinking about opening our office in Orlando, in Maitland, Orlando because everything was fine in Florida and nothing was happening in Florida. And we didn't know what the hell we were going to do in New Jersey and New York. And as we sit here today, I'm sitting in the office in New Jersey and we're not opening anything in Florida. So I think it's, unfortunately, a very fluid situation. And you just have to keep an eye on all of these assumptions, both at the macro level. But as you said, we have very detailed information and a heat map by state. And I would say that what you're hearing and seeing in the news is what we're seeing in the data. And -- but what's that translating into is a plateauing or a leveling-off of employment short term so far, not a decline.

Steven Matthew Wald - Morgan Stanley, Research Division - Equity Analyst

That's very helpful. Maybe if I could just squeeze a quick follow-up in here. Carlos, I think you guys laid out at your Innovation Day earlier this year that the addressable market ADP sits in, it's about \$150 billion of revenue a year, growing at 5% to 6%. Obviously, that's changed given COVID. But I'm just curious to get any updated thoughts you have around maybe where that stands today. But if you can't really speak to where that stands today, given the fluidity of the situation, how you're thinking about it coming out of it, given your comments and Kathleen's comments about the enhanced opportunity for the space you're in.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

Listen, there's a lot of smart analysts out there and industry analysts out there that would probably be better at answering that question. And they probably are going to need a little bit more time and information to answer that question. But I would answer it the same way that I answered it earlier today, which is I don't know by how much, but it's hard to believe that past the transitory nature of the situation that, that growth rate for the industry isn't at least what it is, if not higher, because -- and again, I'm not trying to be arrogant that, that is only for HCM. But there are other industries that I think have -- should have tailwind from these events, where the acceleration of people to using cloud services and using what I would consider to be outsourced services so that you can focus on your core business but also have resiliency, I think -- and also so that you can improve efficiency and you can improve productivity of your workforce and improve engagement of your workforce, all of those things, I think, are going to get tailwind. And it's across multiple technology sectors that, I think, are going to probably benefit on a longer-term -- on a medium-term and a longer-term basis from this unfortunate situation.

Operator

This concludes our question-and-answer portion for today. I am pleased to hand the program over to Carlos Rodriguez for closing remarks.

Carlos A. Rodriguez - Automatic Data Processing, Inc. - CEO, President & Director

Thanks. So just a couple of final thoughts. One is, I know I said it before, but we have navigated through a lot of issues over many decades. I've had the experience of being through several myself, whether it's the dot-com recession, what happened after 9/11, the global financial crisis because in that case, it was really a synchronized global downturn and now this health crisis. And the one thing that I would say about ADP's business model, regardless of -- I know the focus here is on the short term. But if you stay focused on the long term, it's an incredibly resilient business model, financial model but also business model, the value of our products and our services is key.

And one small anecdote, I think we may have mentioned it in the last call. But as kind of this crisis unfolded, we had to become, like many other parts of the economy, we had to go and talk to governors and leaders, including the White House, to make sure that we were deemed an essential service because we needed to stay in operation. And so I don't know what better sign there is of a resilient, long-term model than to be considered an essential service because we definitely are. We're glad we were there to help our clients. We'll still be there to help our clients. But I think that

speaks volumes to the long-term viability and also upside of the business that we are a critical service, an essential service to the economy and to our clients. We're proud of that. And I'm proud of what our associates did to live up to that expectation.

And as to the next year, again I would just encourage everyone to think through kind of first half, second half or even by quarter. Because at least for me, assuming that we stay on the trajectory that we're on, which I realize is fluid, but with those assumptions, the fourth quarter exit rate of FY '21 is really what I'm focused on and not necessarily the short-term results of the first few quarters of FY '21, although we're going to do our best to perform as well as we can throughout that as well. And lastly, I know Kathleen said in her comments, but we're very proud to have delivered \$1.5 billion in cash back to dividends and \$1 billion through buybacks, too, which I think is also another sign of the incredible resilience and I think cash flow generation capability of this business model. And this kind of short-term hit that we're having to revenues and to profitability, I don't believe will impair our ability to continue that tradition of returning cash to our shareholders.

And for that, I want to say that I appreciate the patience of our shareholders as well and all of you. And I thank you today for listening to us and for all your questions. And I wish you all a very safe summer as well. Thank you.

Operator

Ladies and gentlemen, thank you. This concludes today's conference call. Thank you for participating, and you may now disconnect. Everyone, have a wonderful day.

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