

Alpha shares analysis

9 November 2023

Two stocks with very different outlooks

Our two stocks this week have very different outlooks. One is maturing and facing a more testing competitive environment while the other looks capable of driving attractive rates of growth through a dynamic operating strategy. Paychex has made very large returns for investors over 40 years, but its glory days look to be very much behind it – growth is still coming, but well below the historic and not really enough to support the rating. Franchise Brands is tiny by comparison (less than 1 per cent of Paychex's market cap), but is a business that feels capable of making a lot of its own luck, with the resulting forecast growth not adequately reflected in a sub-market rating.

- **Paychex (PAYX)** – Paychex has long been a key player in the US business process outsourcing market, providing payroll and HR services to SMEs. It has been a pioneer in many areas in this field, including replacing humans with software and moving its services into the cloud. However, despite making exceptional returns for investors over the very long term – average 28 per cent total shareholder return (TSR) over 40 years – its once wide and deep economic moat is draining. It increasingly feels hobbled by limited geography (basically US-only), its lack of a comprehensive financial software suite and incursion by more dynamic competition. This is a business still capable of decent mid-single-digit EPS growth but is largely being dragged along by underlying market growth, where it once used to trailblaze. It seems to have no analyst support, its share price is in the doldrums and, without substantial M&A, the shares look fully valued, maybe overvalued.
- **Franchise Brands (FRAN)** – a head franchisor for nine brands of largely industrial and B2B businesses with an increasingly international flavour. The business offers the unusual but attractive attributes of being both growth-oriented (thanks to a dynamic and aggressive drive to grow the operator base) and defensive because of the largely emergency/reactive nature of the work undertaken. The share price performance in 2023 can potentially look offputting (hugely transformative acquisition and then a halving in value), but we are happy the valuation here is too low relative to the growth strategy, the market environment generally for franchises and the ambition of management, who were responsible for the stellar growth at the franchised Domino's Pizza. A PE ratio in the low teens seems to reflect trading and financial risk that is not really present and there is ample scope for investors to see total shareholder return (TSR) double.

Paychex – eyes forwards, not backwards



Source: FactSet

Snapshot

Paychex is a human capital management (HCM – the modern term for HR) software provider servicing SMEs in the US and (a tiny operation – 1 per cent of revenue) in northern Europe. HCM software optimises traditional administrative functions in human resources (HR) operations – recruitment, training, total compensation (pay + perks) and performance assessment. This is a \$40bn market cap Nasdaq-listed business with revenues of around \$5.5bn and, typical of a software business, delivers high margins of around 40 per cent Ebit.

Growth has been steady at around 8-10 per cent over the past five years, but is decelerating, indicating a more mature and increasingly competitive marketplace in HCM. TSR in the past five years has averaged 14 per cent, but returns have been basically flat for the past two-and-a-half years. Unusually for a software business, PayChex pays a decent dividend, with the stock yielding a little over 3 per cent – this reflects its age and maturity.

It is a major player in its space servicing three-quarters of a million SME businesses, and its software handles the wages etc of one in eight US workers.

Operations and markets

Paychex operates in the business outsourcing space and was a very early player starting up in the early 1970s with a focus on HR resources. Initially it operated as an in-person service before building locally installed software tools and then becoming an early adopter of cloud services (SaaS) and the pay-monthly rather than periodic licence payments model. The available market in this subset of business outsourcing has an estimated annual industry income of around \$90bn, but Paychex is focused on the sub-1,000 employee market, which covers around 50 per cent of the US workforce by headcount but considerably more by company count. Historically, Paychex was seen only as a payroll business but now close to half of the group's revenues arise in other business services.

Overall, Paychex has a total market share of ~3.75 per cent in payroll and benefits, but closer to 14 per cent in the SME arena. It competes with close to 150 (and rising) competitors in the payroll and benefits category, where the market leader is QuickBooks Payroll (Intuit) at > 25 per cent, then Sage Business Cloud Payroll at c16 per cent and Paylocity at close to 10 per cent market share.

Paychex's operations can be broken down in a couple of ways, but the most comprehensive approach is to view the business in two parts: management solutions and professional employer organisation (PEO) & insurance solutions with these revenues split 3:1 in favour of the former in revenue terms (segmental details in the pie chart below).

Management solutions

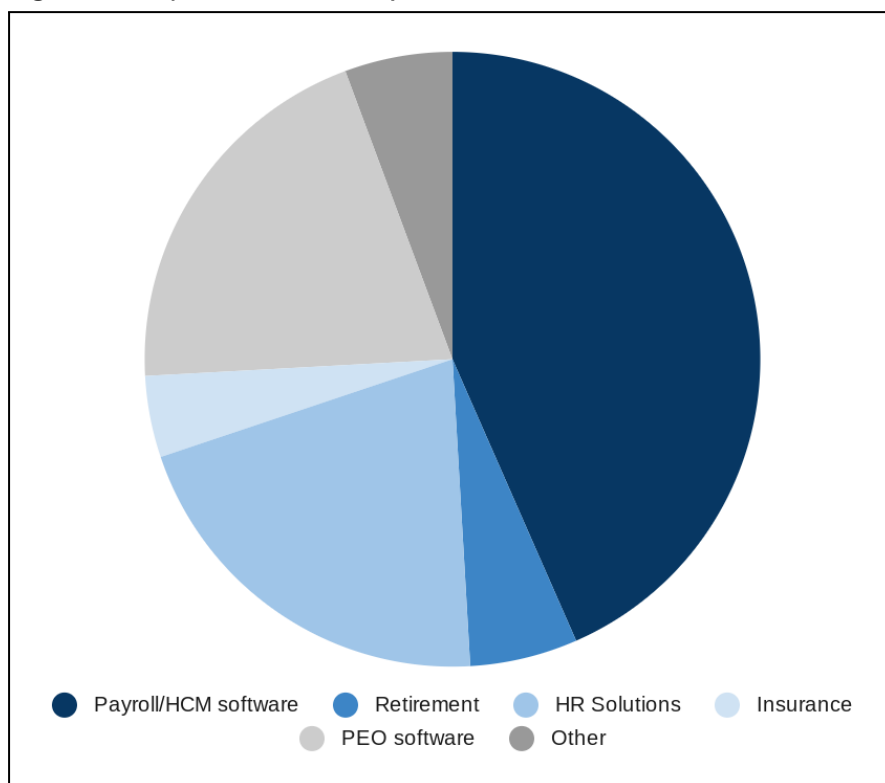
- **HR outsourcing** – this provides clients with a dedicated team of HR professionals handling HR compliance, employee relations, compensation, discipline and various other HR functions. This is still largely a service of real people dealing with SMEs' employees either in person or (increasingly) through remote access such as Zoom or Teams. HR staff can be placed either ad-hoc, part-time or full-time often at the business location. Paychex is the market leader in this space with >700 PR staff on hand.
- **Payroll & HCM** – the original core of Paychex (and still the largest part), this encompasses largely SaaS or cloud-based core payroll processing, benefits, health insurance, training, engagement & retention, tax, time & attendance tracking, recruitment, onboarding, day-to-day HR administration and, increasingly, compliance.

- **Retirement** – Paychex is the US market leader in third-party, direct 401k pension fund and retirement benefit management. It provides (increasingly) online tools for both employer and employee largely towards the small end of the SME segment where running a scheme directly is too expensive.

PEO and Insurance

- **PEO** – a ‘professional employer organisation’ is an outsourcing firm that provides services to SMEs within Paychex management solutions where the business is too small (or otherwise unwilling) to run them itself. The PEO forms a ‘co-employment agreement’ through which it becomes the ‘employer of record’ for tax and other filings. Such stand-in services are increasingly being replaced by lower-cost X-as-a-service (xaas) software, increasingly augmented by artificial intelligence (AI) which should be able to ‘understand’ the vagaries of a particular business. Increasing regulation and compliance standards should mean that PEO demand continues to grow, potentially at a low-double-digit percentage rate.
- **Insurance** – this is a general business insurance brokerage offering SMEs health, PCI (property and casualty), workers' compensation, commercial auto and liability cover as an up- and side-sell. It has more than 200,000 SME clients and last year pulled through over \$3bn in premiums.

Figure 1: Paychex revenue split – 2022



Source: Paychex

Analysis and conclusions

Paychex is one of those stocks that the tip sheets love – “if you’d invested \$1,000 in year X you’d now be a millionaire”. If you had bought these shares 40 years ago you would have paid \$0.21 (equivalent) and now the share price is \$112 – that’s a 25-30 per cent average TSR. However, the glory days for this stock now feel more behind than ahead. While it was a pioneer through the transition to online core business from in-person and the development of SaaS models, and has done very well from the rise of distributed workforces since Covid, growth looks set to be increasingly hard won. This is reflected in TSR more recently, which is close to zero in the past two years, and all of this has come from the dividend: the share price is stuck and range-bound.

Forecasts too are more cautious, with still decent growth in EPS at around 7 per cent per annum from 2023 to 2026, but down from the average 11-12 per cent seen across the previous 10 years. Partly this will be down to natural maturity, as we have seen a large amount of the transition from local to cloud, and the typical step-up (and greater predictability) in revenues that brings. There is still growth in the marketplace as small businesses become larger and new businesses arise, plus as SaaS tools become more sophisticated (and often cheaper) more customers are likely to adopt.

Periodically, regulations also provide a boost forcing more businesses to adopt more sophisticated tools – the ‘making tax digital’ programme in the UK is a prime example and the IRS this summer announced plans to go fully paperless (optimistically) by 2025 as part of the Inflation Reduction Act. The market for digital HCM and payroll is likely to continue expanding and industry forecasts suggest that it can sustain at around 7 per cent per annum.

So Paychex can be expected to grow, but its momentum looks likely to be no better than the carry it will get from market expansion, at best, assuming it is able to retain its current market presence. This is already a very competitive market space and, with the industry seeming to have relatively lowering barriers to entry, there are plenty of new and ambitious players and established cloud-based businesses that can move across into this market.

The key issues we see for Paychex:

US-only bias – this has not been a problem and will still allow Paychex to tap the local market potential but most of its competitors have an international footprint. This will allow faster growth and we see Intuit likely to triple Paychex’s EPS growth rate and Sage to double it. Even US-only rival Paylocity is forecast to grow almost three times faster than Paychex.

Lack of a full suite – one reason Sage and Intuit are doing so well is that they offer a full financial suite rather than just HCM and payroll. The risk is that SMEs will begin to adopt accounting software from one of these two (or other vertically integrated providers) and migrate to their integrated offering. It would be both hard and expensive for Paychex to broaden its offering in order to compete.

Strong competition – as listed earlier, Paychex is, in the overall marketplace, a relatively small player with less than a 4 per cent market share, albeit with closer to 15 per cent of the SME segment. This shows how congested the space is with well-established and newcomer businesses, many of which are cloud-only which makes them much more agile and not carrying likely shrinking legacies. In addition to its three major competitors, Paychex runs against the likes of ADP (the founder of this industry), TriNet, Insperity, Ceridian HCM, Gusto (new and aggressive), Paycom (cloud-only), BambooHR, Zenefits (cloud-only) and Kronos/Ultimate Software. Also at the large end of its client base there would be competition from Workday, Salesforce, SAP or Oracle.

Low barriers to entry – there seem to be relatively low barriers to entry, although trust, reputation and security are important, this does feel like a very price-sensitive market. We may also see more start-ups operating pretty well in Google Cloud and AWS or we may well see HCM and basic payroll tools added as modules to these platforms directly.

Economic sensitivity – this is still an economically sensitive space, with many SaaS offerings potentially feeling expensive to very small businesses. Cost benefit analysis does show that even paying \$30-\$60 per month for a cloud service more than pays for itself, but this is still a cost that some small players are likely to see as being at the sharper end of their discretionary costs.

AI & ML – unsurprisingly, AI and machine learning crop up here and have the scope to replace many of the functions now carried out by humans, still substantial in HR/HCM. The likes of CV screening, onboarding, performance management, training, basic HR Q&A, risk management and tracking could all become fully automated. This could be a sizable threat to the PEO arm and at least make it harder to sustain pricing.

Paychex is a great example of why one should always be wary of buying a stock by looking backwards. Even though this is still a business capable of putting through growth, it looks to be materially slower than its rivals, only capable of growing in line with its market (having historically been a trailblazer), limiting its relative potential by lacking global and integrated platforms, and operating in a sector where a once wide economic moat seems to be getting narrower and/or shallower.

This stock may look cheap compared with the likes of Salesforce, Workday, Sage or Intuit, but these businesses are a great deal more diverse and dynamic. On a PE of 23x (a premium of 20 per cent to the US market) Paychex looks fully valued and this is reflected in the generally neutral to cautious analyst opinions – of the nine analyst stock calls, seven are hold and two are negative: no buyers. As growth is not materially more than in the equity market overall, perhaps a fairer value would be a PE of closer to 20x, and this might only be worth another look closer to the \$100-\$105 share price range. Unless there is some fairly transformative M&A, at best this stock feels likely to continue to bob along either side of \$115 as it has for the past 20 months but, increasingly, the risk feels to be more on the downside than stability. Past glories often fade.

Franchise Brands – both defensive and growing?



Source: FactSet

Snapshot

Franchise Brands does just what it says on the tin. It is the head franchisor for nine brands operating through 650 franchise holders. This Aim-traded stock has a market cap of around £250mn and is forecast to generate £160mn of revenue in the 2023 calendar year, on which a high Ebit margin of 37 per cent is forecast. The shares have performed well and on a five-year view, the average TSR has been 12.5 per cent, but like our other stock this week has made no net return in the past two-and-a-half years. However, as we explain later, the share price performance more recently has been more complex, and this belies a more positive progression.

Growth has been impressive, with Ebit rising by an average 37 per cent for the past five years. EPS growth, however, has been less substantial and rather inconsistent with relatively little growth between 2018 and 2021, reflecting high interest costs and additional shares from the funding of expansion.

Operations

FB holds the head franchise for nine brands, split into business-to-business (B2B) and business-to-consumer (B2C) divisions:

B2B operations

These operations have a largely industrial bias and are focused largely on emergency, reactive, vital or legislated services. This accounts for more than 90 per cent of the 'system sales' (the revenues generated by the franchise operators) and direct revenue for the group. The share of revenue collected by the PLC varies considerably by the nature of the business, the country of operation, the revenue level and the number of franchises operated by a single business.

- **Pirtek** – this is the European market leader in on-site hydraulic hose replacement and allied services, added to the group in April 2023 (cost £212mn). Pirtek is a global franchise operator (originally in Australia) and FB owns the European operations. Historically, its work was primarily reactive and emergency in nature, but in future it aims to become more involved in routine and planned maintenance projects – lower margins but more assured workflows. There are 69 franchisees in eight countries, >200 depots and >800 mobile service vehicles.
- **Metro Rod** – provision of drainage repairs and unblocking for commercial customers in facilities management, construction, manufacturing, education, retail, insurance, water utilities and the public sector. There are 42 franchisees and 50 depots.
- **Metro Plumb** – emergency plumbing services for commercial and residential customers through 13 franchises. This was purchased in 2017 as a then newly established sister business within Metro Rod.
- **Filta** – commercial kitchen services specialising in fryer management, grease and drain management. In the UK, this brand operates as a Direct Labour Organisation (DLO) and franchisor. By far the larger part (90 per cent) is the international arm with 160 franchisees: 133 North America, 18 Benelux and nine Germany. The core services are expanding to include wider commercial kitchen cleaning, oil recycling and new, clean cooking oil supply. Prior to its acquisitions in 2022, Filta was also an Aim company.
- **Willow Pumps** – provision and service of 'water in, waste out' pump systems for emergency and temporary installations. This arm operates primarily as a DLO for public bodies and utilities but also runs through a couple of franchises.

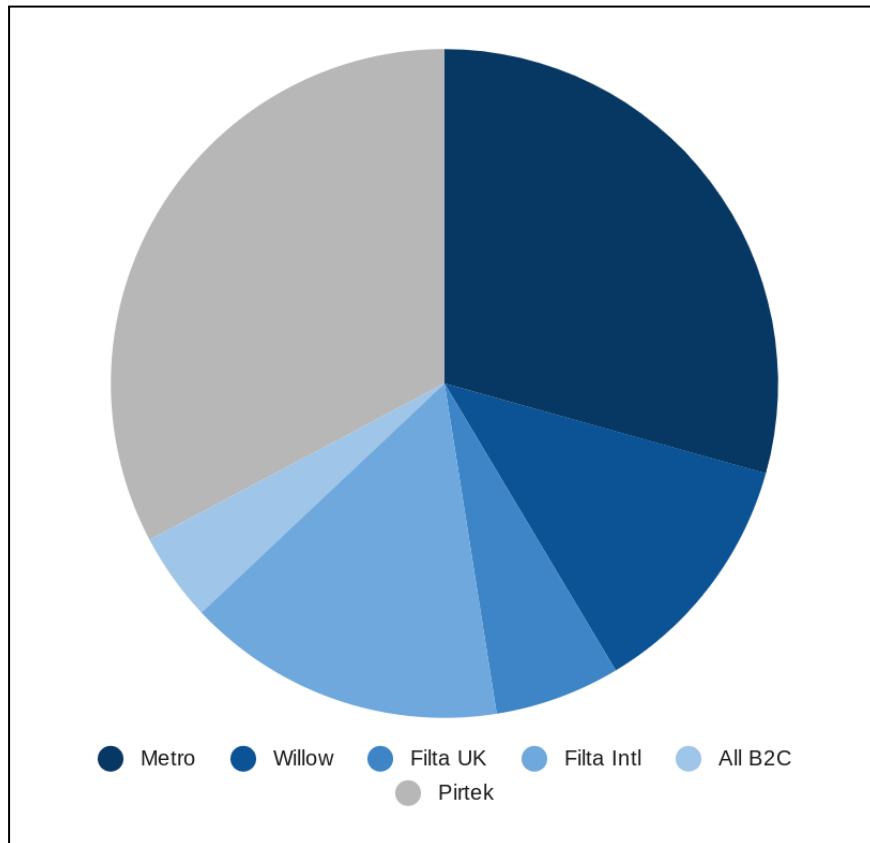
B2C operations

Only a small part of the business, this is the more exposed part of the group as its services are more discretionary and exposed to the now more pressured consumer purse. The Plc also collects a smaller share of the system revenue as more promotion and advertising

has to be carried out by the franchisee. However, the gross margins for that reason are much higher.

- **ChipsAway** – the UK’s leading repairer of minor automotive paintwork damage, wheel scuffs and small dents operating through 191 franchises.
- **Ovenclean** – cleaning services wholly in the UK for all domestic ovens (electric, gas, microwaves) hobs, extractor fans and barbecues. There are 100 franchises in operation.
- **Barking Mad** – a UK dog home-boarding, walking and day-care service with 58 franchises.
- **Azura Group** – a franchise management software system development business mainly internal to franchisees to help manage their operations, and used by 30 franchise customers. There is a drive now to sell to third-party franchise operators.

Figure 1: Franchise Brands pro-forma, annualised revenue split 2022



Source: Franchise Brands

Analysis and conclusions

Franchising is big business in the UK with franchisee revenues running out at an estimated £17bn-£19bn per annum (last good data was measured in 2018 by NatWest) with around 48,000 discrete businesses employing close to 750,000 staff (2.5 per cent of the UK workforce). The British Franchise Association (BFA) suggests that 93 per cent of operators are profitable and that only around 1 per cent fail each year, so running head franchises should be a very solid business. That said, success relies very much on the performance of the franchise operators, but good franchisors are going to be on top of poorer performance and will intervene early for corrective action – FB looks to be very quick to act on any sub-par performance.

The franchise model is simple and, if managed well, very profitable – third-parties do most of the heavy lifting. While the franchisor must promote the brand overall and be sure that franchisees are not soiling their patch, this can prove to be a solidly self-sustaining model.

No shortage of ambition

FB's management makes no secret of its desire to repeat the business value growth it delivered at Domino's Pizza, and this suggests that the objective is to see sufficient expansion to support a market valuation of closer to £1bn in due course. The target is to accelerate growth and deliver materially higher earnings and secure a premium rating in the process. Various lines of attack will be used:

- **More contracted work** – Pirtek in particular is mostly a reactive business but there are moves afoot to partner on planned maintenance programmes for the likes of large transport and commercial fleet operators and to secure programmed more work from UK and overseas utilities business.
- **'Max potential model'** – this is the active securing of new franchises by targeting good local markets, spotting local undersupply, drawing good existing businesses into the fold, and sharing best practice across brands and franchisees. The overall objective is to make substantial market share gains such as for Filta in the US to grow from below 1 to above 4 per cent market share and to at least triple the scale of the plumbing/drainage arm. The very successful Pimlico Plumbing is seen as a role model.
- **Recycling capital** – buying Pirtek shifted the business substantially more towards an industrial and B2B bias. It does not seem unreasonable to expect FB divest the B2C businesses and recycle £15mn-£25mn it could realise in the B2B arm.
- **Buying more strong brands** – FB has always bought strong and well-established brands and, in what remains a highly fragmented market, there is a lot of scope to

repeat this a few more times. One potential target could be the remaining part of Pirtek (mainly now Australia as the US operations have just been sold to private equity) to consolidate the brand footprint.

Defensive growth

This may sound like an oxymoron, but FB does possess both sets of qualities. It is defensive because its industrial services are critical to customers and, importantly, form part of clients' operational expenses (Opex) rather than capital spending (Capex). Opex is very hard to cut whereas Capex can easily be cut or deferred.

The growth characteristics come from the drive to expand and 'make its own luck' in what are still very fragmented end markets – Metro Rod has only 4 per cent market share and the US arm of Filtra has less than 1 per cent, but are close to market leadership.

The odd share price performance

The performance of the share price in 2023 could easily be off-putting – the group made a transformative acquisition yet the shares have halved. A few things were at play here: 1) while the Pirtek funding was in train, there was what analysts would call a 'technical squeeze' where a sizeable buyer of stock could not buy because too many existing holders were 'offside' because of the upcoming equity raise; 2) new equity was issued at 180p against the prevailing 200-240p level, which caused a 'right pricing'; 3) an enforced fund liquidation at a large hedge fund forced a large block of stock into the market; 4) Aim overall has been through a sizeable de-rating since the early summer.

This is somewhat technical and could easily sound like apologetics for a weak share price, but having been through the mechanics of this, the spike to 245p should never have happened and the share price correction should really be seen as taking place from 175-180p, not 245p.

Cheap stock or low QoE?

A slight problem for me here is that the current market value of the group is broadly the same as the money that it spent on the last two key acquisitions (Pirtek and Filtra) – £260mn – and what does this say about the market's view of these and the rest of the businesses? Either the whole show is very cheap (the growth potential has no value attached) or the market is saying that the acquired assets were overpriced and that there is a lot of risk here.

It does not really feel like the latter. Another part of Pirtek (the US operations) have recently been sold at a valuation at least one third higher than FB paid for the European arm back in April. Sure, the German construction market is not looking too healthy at the

moment, but this is only a quarter of Pirtek's profit and we are only looking at a small market slippage, not a slump. So, Pirtek's value is not a drag.

Debt is relatively high at present (unwelcome in a high rate environment), but debt reduction is the sole focus of the still high cash flow and it still looks likely that borrowings will be back at the low end of the target range (1x Ebitda) by early 2025 and close to zero a year later. So debt is not an issue, although it does mean that further acquisitions are off the table for now.

By continuing to push its franchisees to grow plus the addition of new partners, it should be reliably possible to grow the business by considerably more than gross domestic product (GDP) (there is also a useful maturity 'flywheel' effect from newer businesses optimising margins). It is even possible using the more aggressive add-on approach to grow the revenue base in a flat or even falling macro environment by persuading more small independents to convert their existing business to a franchised brand.

This business model also has the big advantage that much of the growth expense is met by the franchisee rather than the Plc and indeed its own costs and brand marketing expenses are likely to expand by less than any growth in revenue share. This means that free cash flow can be focused on large-scale additions of entirely new brands or buying smaller businesses to roll into one of the existing brands.

So, to answer the initial question – this looks like a cheap stock. The shares are trading on a Year 1 PE (to Dec 2024) of just under 13x against the FTSE Aim 100 index, which is closer to 15x. The growth outlook here is very solid and after forecast growth of 15-20 per cent in both 2024 and 2025, that gap relative to its benchmark index will only widen. There is a good case to be argued for a premium to the Aim average (maybe 17x the forecast 2024 EPS of 10.5p), which suggests that fair value could, today, be nearer 180p than 130p. Then, if the later growth promises can be delivered, 200p does not seem unreasonable. The delivery is, of course, not guaranteed but the dynamics look very supportive, management has delivered before and the record to date is also a solid ground for optimism.

A good model, well-run and looking undervalued.

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