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ADP.OQ - Q1 2022 Automatic Data Processing Inc Earnings Call

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OVERVIEW:

Co. reported 1Q22 YoverY reported revenue growth of 10%. Expects FY22 revenue growth to be 7-8%.

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PRESENTATION

Operator

Good morning. My name is Michelle, and I'll be your conference operator. At this time, I would like to welcome everyone to ADP's First Quarter Fiscal 2022 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, Michelle, and good morning, everyone, and welcome to ADP's First Quarter Fiscal 2022 Earnings Call. Participating today are Carlos Rodriguez, our President and CEO; and Don McGuire, our CFO.

Earlier this morning, we released our results for the quarter. Our earnings materials are available on the SEC's website and our Investor Relations website at investors.adp.com, where you will also find the investor presentation that accompanies today's call.

During our call, 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 the reconciliation of non-GAAP measures to the 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 with that, let me turn it over to Carlos.

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

Thank you, Danny, and thank you, everyone, for joining our call. I'd like to start by welcoming Don McGuire, our new CFO. Don has been with ADP since 1998 when he joined the ADP Canada team as a VP of Finance. He's held a series of roles with increasing responsibility, most recently serving as President of our International business, where he's done a phenomenal job of driving growth and profitability in a very complex environment. I know he's looking forward to meeting all of you.

Now moving on to the quarter. We are pleased to have delivered a very strong start to the year with 10% revenue growth and 140 basis points of margin expansion, resulting in a 17% increase in adjusted diluted EPS. While we did expect our Q1 revenue growth to be above our prior full year guidance range, this result was still above our initial forecast and underscores the strong position we are in as we emerge from the pandemic. I'll let Don go through the details after I cover some highlights.

Our ES new business bookings results were very strong, representing another record Q1 bookings amount. And we're ahead of our expectations with outperformance driven by continued strength in our HRO portfolio and our international business. With this impressive bookings performance across the enterprise, we're pleased to raise our ES bookings guidance for the year after just 1 quarter as we're now feeling even more confident about our sales momentum.

Even stronger was our PEO bookings performance, which was also well ahead of our expectations and a key reason that we're raising our guidance for average worksite employee growth for the year, as Don will outline for you. As you will recall, we've been sharing our sales productivity trends over the course of the pandemic, and I'm pleased to report that in Q1, we were well above pre-pandemic levels. We reached this result several months sooner than we expected, and we expect this to continue as we look ahead.

Our ES retention remained incredibly strong as well. As we shared last quarter, we believed it was reasonable to assume a slight step back in retention from the record 92.2% level we experienced last year. But in Q1, we did not see meaningful deterioration.

Instead, we actually saw further improvement in our overall ES retention to a new record Q1 level despite a modest decline in our small business division, where out-of-business losses started to trend back to more normal levels compared to the below-normal levels last year. We're continuing to assume a slight decline in our retention outlook for the year. But clearly, we are pleased with our performance so far, and the upward revision in our retention outlook reflects the strong Q1 performance.

Our ES pays per control was solid with 7% growth in the quarter, about in line with our expectations. We fielded a number of questions these past several months about what we think might drive workers back into the labor force. While we don't have an answer to that question, what we can tell you is that we continue to see positive trends.

Our clients are eager to hire, and we are seeing workers return to the labor force, even if it's gradual. As a result, we expect to benefit from above-normal -- an above-normal level of pay-per-control growth over the course of the year.

In addition to the very strong ES performance, our PEO delivered another stellar quarter with 15% revenue growth and 15% average worksite employee growth, even better than the high expectations we had coming into the quarter. There were multiple drivers to the outperformance in the PEO, including the strong level of hiring within the client base, resilient retention and the improved bookings performance I mentioned earlier. We're very pleased with the momentum we see building in the PEO, and we're raising our full year guidance accordingly.

In addition to the financial highlights, there are a few product highlights I wanted to share with you. First, I'm excited to share that we completed the initial rollout of our new user experience for RUN. As we shared with you last quarter, this represents the most comprehensive refresh we've done since the launch of RUN. And we're very proud that in a matter of a quarter, we were able to seamlessly move hundreds of thousands of clients to a new and better user experience. Early signs indicate that client satisfaction scores should trend even higher than the record levels we already have in our small business division. So it's a really great outcome and represents a very strong execution by the team.

I'd like to also share that at the annual HR Tech conference a few weeks ago, our innovative diversity, equity and inclusion tool on the DataCloud platform was named a top HR product. This recognition adds to ADP's long-standing history of award wins at the conference, marking an

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unprecedented seventh consecutive year ADP has been honored for its innovative HCM technology. You can probably tell from the number of times we've highlighted DataCloud that our velocity of innovation has increased significantly there. With this DE&I solution as an example, we've seen over 50% of active users of this solution take action and realize positive impact on their DE&I measures.

I'm proud that we provide solutions that drive real positive change for our clients. This 7-year track record demonstrates that innovation is part of ADP's DNA and that we have a strong, growing, agile R&D team committed to delivering solutions in the market that continue to push the boundary of what HCM solutions can do for employers and their employees. As I said before, we're very pleased with the fantastic start to the year. We look forward to sharing even more of the ADP story with you at the upcoming Investor Day in November.

And now I'll turn the call over to Don for more detail on the quarter and the outlook.

Don Edward McGuire - *Automatic Data Processing, Inc. - Corporate VP, CFO & President of Employer Services International*

Thank you, Carlos, and to everyone on the call, good morning, and nice to meet you. Our first quarter represented a strong start to the year with 10% revenue growth on both the reported and organic constant currency basis.

Our adjusted EBIT margin was up 140 basis points, much better than expected, and was supported by higher revenue and overall cost containment. Our tax rate was up slightly in the quarter versus last year, but we also benefited from an elevated pace of share repurchases following our debt issuance in May. Combined, those factors contributed to a 17% increase in our adjusted diluted earnings per share.

Moving on to the segments. Our Employer Services revenue increased 8% on a reported and organic constant currency basis. Our strong Q1 ES bookings performance and record retention contributed to this performance. Though as a reminder, we did continue to lap some of the lower revenues we had last year in some of our volume-related businesses, including recruiting and background screening.

Our clients fund interest represented only a slight headwind in the quarter as our 40 point -- basis point decline in average yield was offset by fantastic balance growth of 22% driven by client growth, employment growth, higher wages and the lapping of the payroll tax deferral last year. ES margin increased 150 basis points on strong revenue performance and overall cost containment.

As Carlos mentioned, our PEO had another terrific quarter. Average worksite employees increased 15% year-over-year to 629,000. And revenues, excluding zero-margin pass-throughs, grew 20%, supported once again by favorable mix trends within the PEO employee base as well as improving SUI rates.

Total PEO revenue grew 15%, which included a modest drag from lower zero-margin pass-through growth and worksite employee growth as expected. PEO margin was up 70 basis points in the quarter driven by operating leverage. Overall, our Q1 results reflect a very strong start to the year and delivered ahead of our expectations on practically all fronts. Let me now turn to our updated outlook for fiscal 2022. For ES revenues, we now expect growth of 5% to 6%, which we're raising 50 basis points at the midpoint. This is driven by several underlying factors.

We're raising our expected range of ES new bookings growth to 12% to 16%. As we mentioned, we had a better-than-expected performance in Q1 and reached pre-pandemic productivity earlier than we had forecasted. We haven't made significant changes to our rest of year outlook at this point, but if momentum remains as strong as we've seen it, then we may see opportunity to deliver additional upside. We're also raising our ES retention, and we are now assuming a decline of 50 basis points off of FY '21's all-time highs versus our prior outlook of a decline of 75 basis points. As with bookings, this is primarily a function of the strong Q1 performance.

Our continued assumption is that as clients continue to reengage in the marketplace, we may experience a slight decline over the course of the year. We expect to have significantly more clarity once we get through the calendar year-end period, where we typically see most of the switching activity. For U.S. pays per control, we're making no change to our outlook of 4% to 5% growth. We continue to expect a gradual recovery in the overall labor market, and the 7% growth in Q1 was about in line with our expectations.

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And then for our client funds interest revenue, we're raising our outlook by about $15 million to a range of $420 million to $430 million as we're raising our balance growth assumptions by about 4% to growth of 12% to 14%. Our outlook for client funds yield, meanwhile, is unchanged despite the improvement in the yield environment primarily as our stronger balance performance actually created a temporary mix shift to overnight investments until new securities are gradually purchased. But that said, the favorable shift in the yield curve is clearly helpful to us and will certainly benefit our multiyear client funds outlook, all else equal.

For ES margin, we now expect an increase of about 75 to 100 basis points, up from our prior range of 50 to 75 basis points. While we did outperform meaningfully on margin in Q1, we are also seeing some additional expenses over the rest of the year, including higher headcount in our outsourcing businesses. Meanwhile, we continue to expect transformation initiative benefits, including our digital transformation, to offset a year-over-year increase in facilities, T&E expenses and other return-to-office expenses.

Moving on to the PEO. We now expect PEO revenues to grow 11% to 13%; average worksite employees to grow 11% to 13%; and revenues, excluding zero-margin pass-throughs, to grow 12% to 14%. This 2 percentage point raise across the board is a function of both our strong Q1 bookings and overall performance as well as an expectation from stronger hiring within our PEO base to contribute over the remainder of the year. Our PEO is very well-positioned to capitalize on growing levels of client demand coming out of the pandemic. And if we continue to drive outsized booking performance over the rest of the year, that could represent further upside to our outlook.

Following our strong start to the year, we now expect a range of flat to down 50 basis points for the year for an improvement from our prior expectation of down 25 to 75 basis points on our margin. As a reminder, we are growing over a very strong margin result in fiscal 2021 and are also expecting elevated selling expenses this year from strong bookings performance.

Turning it all together for our consolidated outlook. We now expect revenue to grow 7% to 8%. Following the strong 10% Q1 performance, we now expect the remaining quarters to grow closer to 7%, which is higher than our prior forecast. For adjusted EBIT margin, we now expect an increase of 50 to 75 basis points. As we shared last quarter, we expect our margin improvement to be back half-weighted, most specifically in the fourth quarter. Our current expectation is for a slight margin decline in Q2 and Q3. We're making no change to our tax rate assumption. And with these changes, we now expect growth in adjusted diluted earnings per share of 11% to 13%.

As I think you've heard us say a couple of times now, we are very pleased with our Q1 results, and we're happy to be raising our guidance this early in the year. This is still a dynamic environment, and there are a wide range of potential outcomes. And we believe our guidance is appropriately balanced given these conditions. However, should our associates continue to drive better-than-expected sales results, client satisfaction, efficiency, and service and implementation, we would see opportunity to deliver additional upside to our outlook.

Before we move to Q&A, I wanted to share two things. First, I look forward to meeting everyone, perhaps virtually for now, but eventually in person as we get back out on the road to meet our shareholders and the investment community. And second is that we are very much looking forward to our upcoming Investor Day in a couple of weeks on November 15. Having run one of our largest businesses for years, I can tell you there is always much happening here at ADP on the ground. And although it all tends to roll up to a very stable financial picture, I can tell you there is really a lot of excitement among our associates for the things they're working on. We hope to share some of that -- I hope to share some of that excitement with you in November.

And with that, I'll now turn it back over to the operator for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

We'll take our first question from the line of Samad Samana with Jefferies.

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Samad Saleem Samana - *Jefferies LLC, Research Division - Equity Analyst*

Congrats on the really strong start to the new fiscal year. So Carlos, maybe I want to unpack the drivers of the strength on the new bookings side. I know productivity is clearly one, but how should we think about the product side and within the product portfolio, where that strength was in terms of driving new bookings?

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

So we -- even though what we really talk about is ES bookings, I just want to start off by saying that the PEO bookings were incredibly strong. I don't know how else to put it. So kind of, call it, orders of magnitude in terms of growth rate higher than even the ES bookings growth for the quarter. So that was really good to see. So that's kind of a sign to your question about products that I think the market is really searching for solutions coming out of this pandemic that help them with, obviously, people issues and so, but there's also a talent crunch. So people are looking to obviously attract and retain people in this environment. I think every company, including ADP, is going through some of these challenges in terms of attracting our own internal talent.

And then you have another dynamic, which is if there are shortages of labor in various categories there, we're hearing that there's also shortages of talent in kind of the HCM category in general. That should create a little bit of an advantage for the "outsourcers" right? So as you know, our model is we provide great technology and software, but we also do the back-office work and we take accountability for outcomes. And I think when people are struggling to hire people to do the work in their HR department or their payroll department or their benefits department, we're here to help. And so I think those outsourcing solutions are getting a lot of tailwind.

We also saw because, of the easy comps, and I think you heard it in Don's comments, some of the things like our recruitment process outsourcing business and our screening and selection business, which were really at very low bookings levels last year at the same time, have rebounded for obvious reasons incredibly well. But having said that, it was really across the board that we had very strong growth in Workforce Now.

We had very strong growth in the upmarket. We had strong growth even in the downmarket, although last year, at the same time, I think we mentioned that we had what we call a client-based acquisition, which is not technically an M&A deal, but we were able to buy a large book of business that we converted that really some of that flowed through our bookings. So it made that comparison a little harder on the SBS side. But if you back that out, it was equally strong on the SBS side as well. So I would say that, that could give you a little bit of color, but it really was across the board.

It just shows how connected we are to the economy and the GDP when it comes to bookings, which is something that we've had as a theory here for some years now. And we just have a very strong recovery in a very strong economy, and it's a great environment for our sales force.

Samad Saleem Samana - *Jefferies LLC, Research Division - Equity Analyst*

That's very helpful. And then, Don, maybe one for you on the retention side. So obviously, it's really impactful and to raise the outlook one quarter in, I think signals the strength that you're seeing. But just help me unpack the slight uptick in the SMB side moving a little bit more towards normal in terms of business failure. Should we think that, that -- the offset there is even better than expected retention in the mid-market or on the enterprise side? Can you maybe help us think about it across the customer size spectrum, how to balance those different moving parts?

Don Edward McGuire - *Automatic Data Processing, Inc. - Corporate VP, CFO & President of Employer Services International*

Yes, sure. I think it's fair to say, and we commented on it that the retention is at an all-time record for Q1. So that's fantastic and better than we had expected. The expectation as we went into the year was to see, particularly in the smaller business segment to see that slip back a little. And indeed it has, but it hasn't slipped back nearly to the extent that we had anticipated. So we're even better there against what we had previously thought.

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Of course, then that means that we did have and continue to have good retention levels in the mid-market and the upmarket. So we expect that to continue. However, as you know, the cyclicality of our business and the seasonality of our business, we will need to get through the calendar year-end, which is when we see most of the switching activity because of the drivers and the new starts of the year, et cetera. So we are positive, and we did take our retention estimate up for the year. And we'll see if it holds and perhaps is better than we expected.

Operator

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

Mihir Bhatia - *BofA Securities, Research Division - Research Analyst*

This is actually Mihir Bhatia on for Jason. Don, firstly, congratulations on the role. Maybe you can talk a little bit about your priorities in the CFO role and how they could maybe look a little different than under Kathleen? And then just relatedly, should we expect to update the multiyear targets at next year's Analyst Day? And then I have a follow-up.

Don Edward McGuire - *Automatic Data Processing, Inc. - Corporate VP, CFO & President of Employer Services International*

Yes. So I guess what I would say is I've been with ADP for a long time now. And I guess what I've observed in the roughly 23 years I've been with this company is that ADP has always had a very strong financial organization with a strong finance leader. And I want to make sure that we continue that, and so I'm sure we will. I think that the priorities that we have are well set out in our strat plan, previous Investor Days, et cetera. So we'll provide everyone with an update on those things when we get together on November 15. But let's wait till then. And I don't think you're going to see any dramatic changes. We pretty much have a well-discussed and well-disclosed trajectory and plan. And we'll update you on that on November 15.

Mihir Bhatia - *BofA Securities, Research Division - Research Analyst*

Understood. And then just if I could ask about just your sales force plan. You're clearly seeing some very strong momentum in the market. So I was wondering if you have any plans for sales force growth in fiscal 2022, and which part of the market those adds would be concentrated in? Also anything notable to call out in terms of just the mix of new logos versus cross-sell in your bookings for the quarter or in the forecast?

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

I think in this kind of environment, given the very first comments we made about the economy, and you have both the economy of the tailwind, and you have now in the U.S., I think, an administration that is kind of more inclined to regulation and to particularly employer regulation. And so you have, I think, a very strong backdrop for what I would say is the foreseeable future. In that environment, historically, what ADP would do is we would add as much sales capacity as possible. That doesn't mean that we indiscriminately hire because we have people to hire and onboard and train and so forth. And we have to make those people effective.

But I would say that we have a strong appetite for growing our sales force, but also for growing our investment in marketing, whether it's digital marketing or more traditional advertising. And that's exactly what we plan to do. Having said that, I would tell you that we've had challenges, I think, like everyone else in terms of hiring. It's a very difficult labor market. So I hope that we can fulfill those expectations or those dreams, if you will, of growing our sales force as fast as possible. But that's the only thing that I could see getting in the way.

We obviously have the capital. We have the, I think, the desire. And we have, I think, the experience to be able to execute once we hire those people to get the sales, get the clients implemented and then hopefully, derive the benefits of that revenue for, in many cases, 15, 20 years, depending on which business unit we're in. So I guess, I would say strong appetite for both headcount growth, but also other investments in sales, whether it's marketing, digital marketing, sales tools, all across the board.

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Operator

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

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

Good results here. Just on the PEO side, I'm curious how much of the general improvement there is secular versus cyclical. And I know, Carlos, you talked about putting more sales energy there as well. So just curious what's changed.

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

So at the risk of -- because I think it's -- we had a strong feeling that the PEO business was going to be strong coming out of this pandemic because it's been strong coming out of prior "recessions." And those are a different recession. So I have to be careful about any specific predictions. But we had some challenges, I think, coming out of the pandemic with the clients we were selling in the PEO were slightly smaller and just ballpark it around 10% smaller. So let's say that the average -- I'm just going to make up the numbers. Let's say the average new clients over the PEO was 30 worksite employees. And all of a sudden, prior to the pandemic, and that has been "growing" slightly over the years. All of a sudden, it came down to like 27. So a 10% decline.

So even if you sell 10% more units if the units are 10% smaller, you basically end up in the same place. So that's a little bit of what we were expecting. We believe that's 100% related to the economy and to what was happening with the pandemic. Now what we've seen in the recovery is both the unit growth is still strong as it was prior year, and now our unit size has recovered. And so the combination of those two things has created really, really strong growth in the first quarter in the PEO.

The only caveat that I would add also is that we did have a kind of a transition into a new year. As you know, our fiscal year ended on June 30. And in some cases, our businesses tend to perform really extremely well in the first quarter when they come out of a year where, I wouldn't call it underperformance because it was still a good year last year given the circumstances. But clearly, the PEO, we were very, I think, clear that the PEO had been trailing in terms of recovery when it comes to bookings what we were seeing in ES.

And now as we expected, the horse race now, the horse in the lead has changed. So now the PEO is the one leading the race.

Operator

Our next question comes from Kevin McVeigh with Credit Suisse.

Kevin Damien McVeigh - *Crédit Suisse AG, Research Division - MD*

Great, and congrats on the results. And Don, welcome. Hey, I wonder, could you give us a sense, Carlos, from a sales perspective, despite the tight environment you're still delivering, is there any way to think about the go-to-market strategy this cycle as opposed to last? And how maybe technology and maybe more of a mixed downmarket helps drive that process? I guess what I'm saying is there more leverage in the sales force today than you've ever had? Is there any way to maybe put some parameters around that?

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

I think there is definitely more leverage in the sales force than we've ever had because, I mean, I think maybe what you're alluding to, our sales force, like a lot of other of our competitors, had to go to 100% virtual for a number of months. And I'm sure every competitor handled it differently in terms of how long they were virtual versus when they went back in the field. But that process, which we had been learning about for 20, 25 years,

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like we had almost 1/3 of our sales force already selling what we call inside sales, so they were able to sell virtually. They had been in a building, but it didn't really matter whether they were in a building or in their homes, they were still able to sell very effectively. So that was an easy transition for that portion of our sales force.

And then we -- really with the appropriate tools and some training and some learning from our inside sales force, we really moved our entire sales force to sell virtually. So I'd say now we're really in a period where we're going to sell based on however the client wants to be sold. And so if the client wants a combination of an initial video call on Zoom or Webex, we'll do that. If the client wants an in-person visit, we'll do that. If they want to close the deal with an in-person but start with a video, we can do that.

So I think there's no question that sales force leverage has increased for us, but admittedly, probably for our competitors as well. Our reach has definitely been extended. There's no question about that in terms of tools, but also philosophically. I think our -- we are now, I think, able to sell in a -- I mean, to use a cliche, an omnichannel way. We're also investing heavily in digital marketing. So you mentioned the downmarket. I would just add that because of some of the comparisons that the downmarket had, that was not what drove the sales results this quarter. It was actually all the other businesses.

So -- but we do see the underlying strength in small business, but because of the difficult comparison, it's not reflected in the percentages. So not trying to minimize the strength and the momentum in the downmarket, I'm trying to emphasize the strength everywhere else in the portfolio. And the rest of the portfolio also can benefit from digital tools, digital marketing, but it's not quite as leveraged as it is in the downmarket. So I think it's a combination of a lot of different things. But the overall, I think, comment would be, there's no question that there's increased leverage in the sales force. And you're seeing it in terms of the productivity numbers.

I mean, we are, frankly, very positively surprised by the rebound in kind of what we call average sales force productivity. So the actual sales rep level, how much are they selling today versus what were they selling in fiscal year '19, and that is back to and above that level, which is very, very pleasing to us.

Kevin Damien McVeigh - *Crédit Suisse AG, Research Division - MD*

That's helpful. And then just one real quick one on retention. Was the boost kind of all of Q1 overperformance because I know the Q2 December is a big quarter in terms of retention, things like that? Or is it just more optimism over the balance of the year or a little above? If you any way to frame how much of that boost was maybe Q1 overperformance as opposed to how you're feeling over the balance of the year.

Don Edward McGuire - *Automatic Data Processing, Inc. - Corporate VP, CFO & President of Employer Services International*

Yes. Maybe I'll take that. I think our retention -- certainly, we're very happy with the Q1 record we have. But I think it's also typically linked to the success we've had over the last few years with our improvement in NPS. And as our NPS continues to go in the right direction and improve, we're seeing general increases in retention to go along with that. And I think that's what we would expect and that's what we want to see happen. So I think there is some relationship there.

The -- but no doubt that the retention is very good. And we're benefiting still, I think, from a little bit of some of the concerns coming out of the pandemic that clients may have about switching during a time of still virtual for many. So we're benefiting from that as well, and we acknowledge that. But as I said, we're very happy with the retention and the progress we're making with our products, and our service that go along to driving those retention numbers. We will see a little bit of a step back perhaps in a downmarket. But as we said so far, it's holding up better than we expected.

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

Kevin, this is Danny. And just to clarify, because we did share in our prepared remarks that the raise was primarily a function of the Q1 results. Obviously, we have visibility into October as well.

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Operator

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

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

I wanted to ask about margins. And forgive me if you addressed this in some detail, I missed a bit of the call earlier. But it came in really strong this quarter, well above our model. Can you speak to the drivers of the beat and also to their sustainability as we move forward?

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

Sure. Let me start off by saying that the margin in the first quarter was a record for us, and it was above last year as we just reported. But if you go back to last year, last year was above the prior year. And so it's quite impressive that we had margin improvement last year, given that we were one quarter into a pandemic. But it's even more impressive that we had margin improvement again. Having said that, that's the victory lap. So then the other part of the comment is we had way higher revenue than we had anticipated, which is incredibly gratifying. We're very happy about that. And it was really in both ES and PEO. And it was in a bunch of different places, slightly better pays per control, retention was better. You heard all the comments. We have just a lot of things working in our favor here.

The expenses have not caught up to the revenues. And so right now, we are trying to add capacity both for implementation and service, particularly ahead of our year-end period. And so like other companies, the most important thing for us is to be able to execute on our commitments to our clients and to be able to start all the business that we've sold. And so I would say that, that's a dynamic that factored into the margin performance. But I don't want to take anything away from the organization or anything away from the operating leverage because it's pretty impressive what the organization was able to accomplish. But had we known where we were going to be in terms of top line and volumes, we would have more headcount today than we have, and there is some catching up to do.

Now to put a fine point on that, don't think we have to add hundreds of millions of dollars of expense. We're just a little bit behind, and that's why you see in case -- someone hasn't asked it yet, I may as well address it head on that for the rest of the year, when you look at the EPS and the guidance, we're really not raising by much more than what we have in terms of our performance in Q1.

And that's because we are going to continue to invest in both sales and distribution, but also in service implementation. And that delay in hiring or deferred hiring helped us in terms of the margin in the first quarter. I strongly believe we still would have had a very strong margin performance in the first quarter, even had we hit our headcount numbers for service implementation and volume-related businesses. But I thought I should kind of put that out there because it seems like an obvious question as well.

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

That's great, and I appreciate your candor there. A quick follow-up for me. I was wondering about the human resources and human capital management products. Can you talk about how the cross-selling process into your base of kind of payroll customers is organized? I'm just trying to figure out sort of how you go about that cross-sell process. And I guess, how much of a runway do you see for attach rates with those products?

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

There really isn't a simple answer to that. So the first part, let me -- we'll come back to the, I think, the second question about the attach rates. Let me answer that one first. The attach rates are -- there's a couple of products where we have what I would call good attach rates, acceptable, let's just say, the CEO speak for they could always be higher. Like our benefits to admin tools, our time and attendance systems, but most of our product and our workers' compensation tool in the downmarket also has a high attach rate. But almost everything else that is "beyond payroll." So HCM,

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in addition to kind of our core payroll solutions, we're way underpenetrated in terms of attach rates. So there's a lot of potential, I think, for that to improve as well.

So on the first part of your question in terms of how we cross-sell, as I started saying, there isn't a simple answer because there isn't a simple answer. In some of our businesses, we have very distinct organizations like in the downmarket, we have a large downmarket sales force that works with accountants and other kind of third-party channels and also sell directly. And then we have a sales force that sells our retirement solutions, our 401(k) product and our insurance services solution. Those are distinct sales forces that basically share leads with each other, and they have incentives to do so. That downmarket business also feeds business to our PEO, through also incentives, but there's a separate and distinct sales force in the PEO as well.

When you get into the upmarket and into the mid-market, you start to get some portion of our sales force which is able to sell multiple products or what I would call bundles. But even then, you still have specialized sales forces in certain circumstances depending on, I think, the specialization or the complexity of the product. But in all cases, we have primary sales, what I would call primary salespeople. So the quarterback, if you will, on an account. Now I'm talking about upmarket and mid-market.

And those quarterbacks are really in charge of making sure that when it's appropriate, and when a client has a need, that we bring in our specialized salespeople that have specific knowledge about some of our other HCM solutions. So I wish I could give you a simple answer, but that's actually part of the secret sauce, right, in terms of our ability to grow and outperform some of our competitors is to be able to do that well.

And I'd like to say that I invented this, but this is something that goes all the way back to the Frank Lautenberg days and to my predecessors Gary, Art and Josh. And this is a well-oiled machine in terms of our sales and distribution and specifically on what you just described about the cross-sell. And again, to put a fine point on it, roughly 50% of our bookings come from cross-sell, and roughly 50% of our bookings come from new logos each year.

Operator

Our next question comes from Kartik Mehta with Northcoast Research.

Kartik Mehta - *Northcoast Research Partners, LLC - Executive MD, Director of Research, Principal & Equity Research Analyst*

Carlos, I just wanted to get your thoughts. You've talked obviously a lot about new sales. And I'm wondering outside of this wage inflation that you're seeing, is the cost to acquire clients going down, especially on the SMB side, now that there's a new way to sell to them? Or do you think the cost to acquire clients as we move through this pandemic will go back to what it was?

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

I wish I had a crystal ball in terms of answering where it's going to go, but I think just from a mathematical or a technical standpoint, the cost of sale is definitely going down because of this productivity increase, right? So this is the same leverage that you're seeing in so many industries and so many businesses, including ours, on the revenue happens on the bookings as well, right?

When you get higher volumes, it basically indicates higher -- unless you add a lot of expense, by definition, you get higher productivity. So you see this being reported in the press all the time about how worker productivity is up. Well, part of the reason why work on productivity is up is because revenues have recovered, volumes have recovered, and it's the same people, right, or you're adding a few more people now.

What maybe people are focusing on is that worker productivity went down, right, as the pandemic kind of set in and people's revenues went down. So I mean, I hate to make it so simplistic mathematically, but some of that is what's happening now. So you do have to be careful about jumping to any medium- to long-term conclusions because right now, our cost to sale compared to last year, and the year before, is definitely coming down

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as a result of a very large increase in bookings without a similar increase in expenses. We still, though, are not back to where our cost of sale was pre-pandemic. And we hope to get there, but that will require even a little bit more productivity during this year.

But that would be -- our expectation is that whether it's the GDP or interest rates or employment, there's a regression to the mean is a very large economy. ADP is a large company, but the economy is massive, and it tends to regress to the mean on a lot of things, and we also tend to regress to the mean. So I think some of these things will work themselves out. And then you have to just get past the base effects and the comparisons and so forth to really understand where you are. And we won't know that until we're on the other side, unfortunately. I hate to say it.

Operator

Our next question comes from James Faucette with Morgan Stanley.

James Eugene Faucette - *Morgan Stanley, Research Division - MD*

Yes. I guess maybe I want to ask the obvious headline question. And just wondering how the reported current tightness in the labor market is factored into your guidance? And how are you anticipating that, that changes through the coming fiscal year? And I guess maybe a product and service-related question tied to that. Are you seeing incremental sales opportunities with some of the tech that you can provide to your clients for hiring, et cetera? And is that having any impact on how you're thinking about your outlook and forecast?

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

Thanks for the question. The second part of your question, I think kind of answers the first part. The answer is yes. Like I think part -- again, hard to separate how much is just pure GDP growth, new business formation, et cetera. But the last part of your question, there's no question that part of our growth is driven by what you are alluding to, which is everyone now is looking for help in terms of hiring, attracting people and frankly, also trying to hold on to them. This is a great environment for us.

The combination of strong GDP, an administration that is more inclined towards regulation, and then a tight labor market for people who do the things that we do. By that, I mean, payroll staff and HR staff at prospects and at clients, that's all a very good backdrop for us. So I'm assuming that this is not going to resolve itself overnight in terms of the tightness in the labor market. So we should anticipate some tailwinds here and some help for some period of time until that changes.

And I hate to use the R word, but someday, at some point in the future, doesn't seem anywhere near future given what's going on with government stimulus and government policy, but someday, that might change. But we don't see that on the horizon right now. On the very first part of your question, though, in terms of the tight labor markets, I would say the overwhelming impact of tight labor market is positive on ADP. I mentioned one of the challenges we have, which is tight labor market affects our own internal associates, in terms of we have to hire service people, implementation people. So it's harder for us like it is harder for anyone else.

But that pales in comparison to the upside. Like a tight labor market drives new bookings, as we just talked about, the last part of your question. But it also could create inflationary pressures, which drives our balance growth. It should drive interest rates higher, which is one of the most underappreciated stories, I think, of ADP is the potential upside in our float business. And the reason it's underestimated because it's done nothing for 10 years. Because I've been here for 10 years, and there's been nothing but pain and headwind. And just when I thought we were coming out of it, we go into a pandemic. And we get more pain, and rates go even lower than they were before. But I'm pretty sure they're not going any lower now, although I think we may have to file an 8-K after saying that, right? I'm making a statement on interest rates.

But yes, they may, whatever, hover around here and go down a little bit there, but it feels pretty certain that the long-term -- medium- and long-term trend now for interest rates will be, at least, for gradual increases. I'm not suggesting that -- there's still underlying demographics that may keep us from getting back to the same kind of 10-year rate that we had 15 years ago or 10 years ago. But I think everyone knows when you look at real

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interest rates that there is upside on interest rates. So the tight labor market helps in a number of ways. It creates activity for our sales force. Every time there's activity and there's conversations, we're going to win our fair share. So that's a great backdrop.

It creates opportunities for our balances. I think it creates opportunities for the PEO because some of our billings are actually driven as a percentage of wages. And whenever you have wage inflation if you're billing on percent of wages, to some extent, that will help. That's not like an infinite thing because we won't just allow our revenue to go up indefinitely. We'd have to adjust those rates. But in the medium term, we will see, I think, some tailwind from -- in the PEO from higher wages and wage growth, which is an inevitable outcome of a tight labor market.

Operator

Our next question comes from Bryan Bergin with Cowen.

Bryan C. Bergin - *Cowen and Company, LLC, Research Division - MD & Analyst*

I had a follow-up first on retention. Curious, within the record 1Q retention performance, can you just dig in a little bit more as far as the drivers there between the still lower out-of-business closures versus potentially better competitive win rates? And anything broadly you can comment on around client switching behavior or client reengagement to assess HCM Solutions?

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

On the first part, I'm not sure how much more color we could give you. We have a fair amount of detail in terms of losses and retention around what we call noncontrollable losses, which are broadly speaking, out of business, bankruptcies, et cetera. And those have started to trend back up again. They're not back to normal levels, but they started to trend back. I think that's not surprising because there's still a lot of liquidity and still a lot of stimulus, if you will, even if it's not new stimulus. So when you have consumer spending doing what it's doing and you have activity doing what it's doing, it tends to be supportive of small businesses rather than the normal turnover that you have that's natural in the small business sector.

So I guess with hindsight, like if 3 or 6 months ago when we were putting together our plan we had a crystal ball, we would have probably -- and we had experience with the pandemic, we probably would have planned the downturn in retention to be slower. So we've been positively surprised by how long it's taking for those losses to regress back to normal. Having said that, we don't know that they're going to regress 100% back to normal because there's other parts of our retention that are controlled, what we call controllable. And on our controllable losses, we see those going down as well.

And I think Don made a comment that -- it should not be lost on you, which is that our client satisfaction scores as measured by NPS are the highest they've ever been. And I give credit to the organization for, during the pandemic, being able to get through what was an incredibly difficult time for them personally in terms of they were trying to help our clients. We also had a huge increase in volume because of all the government stimulus programs and the PPP loans, et cetera. And this happened all over the world. It wasn't just in the U.S. And fortunately, we maintained relative stability in our head count. We didn't do mass layoffs and let a bunch of people go.

So the combination of maintaining investment and also being able to have people -- I don't know how to describe it, but make heroic efforts to help our clients, we were able to maintain those NPS scores and actually have them go up. And they're staying at very strong levels, and we believe that there is a correlation between strong NPS and retention. So we may be able to see kind of new record highs for retention on a permanent basis, but it's way too early to make that prediction.

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Bryan C. Bergin - *Cowen and Company, LLC, Research Division - MD & Analyst*

Okay. And then just a follow-up on Next Gen HCM platform. Can you provide an update on new sales there, maybe the pipeline of sold clients versus live clients? Any metrics or updates you're willing to share?

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

Sure. I think we talked about over the last couple of quarters as we kind of entered into the pandemic, we obviously had a couple of particularly large clients that were in industries that were particularly hard hit. So we got thrown a little bit off course, if you will, in terms of our implementations and our starts.

We also, I think, started to focus on implementation tools. I think we had -- I don't know how many we said we had sold. And as we started implementing and starting these clients, we recognize that we still have some work to do in terms of implementation tools and making sure that if and when we want to use third-party integrators to help us with that, that we need to build out those tools.

So there's been quite a lot of focus on that effort, and we feel good about it. We actually -- I think we also talked about investments in the last quarter that we made to bring in some third parties to help us with the evaluation and in some cases, the build of that to make sure that as we now kind of enter hopefully a period of time where we can really accelerate the implementation and the growth and the starts of those clients.

But it's fair to say, and I think we said in the last couple of quarters, that our focus turned more to making sure that we have a strong foundation and that we had the right implementation tools to be able to get the business started that we intend to have in the next year or 2, which is hopefully quite a lot of business. And you'll hear more details about this when we get to our Investor Day on November 15.

Operator

Our next question comes from Eugene Simuni with MoffettNathanson.

Eugene M. Simuni - *MoffettNathanson LLC - Analyst*

I have just a couple on the PEO, so I'll ask them upfront. One is if you look broadly at your HRO offerings, so PEO and non-PEO, can you compare and contrast for us a little bit the kind of the PEO solutions and the non-PEO fully outsourced solutions? How are you seeing them growing relative to each other, the demand? And are you seeing any switching between clients who might be using HR solution without benefits switching into the PEO? So that will be the first one.

And the second, I was curious how you're positioning the PEO franchise to really win market share in a post-pandemic environment, given the secular growth seems to be very favorable. But how do you actually make sure that ADP wins share?

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

So on the first question, I think I said it in my early comments that all of the HRO solutions, the "outsourcing solutions" are very, very strong across the board, right? Upmarket, because we have HRO solutions in the upmarket. We have them in the mid-market, and we have them in the downmarket. In the downmarket and in the mid-market, we have PEO. But we also have what you're alluding to, which is a non-co-employment, what I would call -- we call it comprehensive services. As the name implies, it provides a kind of broader assortment of services in addition to our traditional software and our traditional tax and other services.

There is, to my knowledge, a lot of switching from clients that are what I would call typical clients of ADP that have payroll benefits admin, maybe TLM, et cetera, whether it's in the downmarket and the mid-market into these HRO solutions. There is not a lot to my knowledge of switching across because it typically -- again, if we're doing our job from a sales standpoint, you're really trying to find the right fit for the client.

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In some cases, the client wants you to do their benefits, admin and provide their benefits, provide their workers' comp and their 401(k). In other cases, the client wants you to only do the administrative back office of the payroll department and the HR department, which would be the non-PEO solution.

So I think if we do our job well, which I think we do in the sales process and in the upgrade process, those clients tend to stay on those -- on whatever solution they have chosen. But to be clear, both of them are growing at this point at rates that are multiples of our growth in Employer Services. And so it's quite impressive in terms of the tailwind and the growth rates that we have in all of the HRO businesses.

On the last part of your question, which I think was about positioning PEO in terms of market share and so forth. We have 600 -- I think 630,000 roughly, we reported worksite employees, average worksite employees this last quarter. That's triple what it was 10 years ago in the first quarter of fiscal year '11. And so -- and that's a higher market share than it was 10 years ago. So I don't know what -- how else to answer that question other than to say that we have a proven track record of execution to continue to drive growth in the PEO that's faster than the market. So I don't think there's any question about our positioning or our ability to drive market share as evidenced by our ability to execute.

Operator

And our last question comes from Mark Marcon with Baird.

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

Don, look forward to working with you. On Next Gen Payroll, can you give us an update in terms of the rollout there, please?

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

So Next Gen Payroll, we're equally excited as we are about Next Gen HCM in terms of what this holds for the future for ADP. The challenge for us in terms of -- as we communicate and on November 15, we'll try to figure out a way to address this issue, like we have $15 billion in revenue.

So as well as Next Gen HCM are going and Next Gen Payroll is going, it just doesn't -- this is a future impact for ADP. So it's not in the next quarter. I know you're not asking a question necessarily about the next quarter, Mark, but I think it was a good opportunity to kind of throw that out there that what's driving the performance of ADP this quarter, this year and for the next 2 to 3 years is not going to be that from a financial standpoint.

But in terms of positioning the company for the future in terms of growth and creating competitive differentiation and ability to drive new bookings, they're absolutely critical. So I would say that on those measurements, we're still happy and excited by the progress we're seeing with both Next Gen HCM as well as Next Gen Payroll.

We have not gone to general availability. So we're selling a lot of Next Gen Payroll, but we're only selling in what we call the core of major accounts right now of the mid-market, which is kind of 50 to 150. And this is no different in terms of the playbook that we use with our transition from our old platform to RUN, in a downmarket, and some of our more legacy platforms in mid-market to then our Next Gen Workforce Now version, which we're on now.

So we're doing the same thing with Next Gen Payroll and the same thing with Next Gen HCM, which is we're doing it very carefully. We have a very large installed base, and we are not -- we're going to eventually move some of those clients and begin to move some of those clients. But we're happy with the business and the cash flow that we have and the client satisfaction score that are on record levels on our existing platform.

So we do not have any -- this is not -- we're not panicking. There's no sense of crisis, and there's no -- we have urgency, but no crisis because I want to make sure people hear that. Like I don't want you to think that we don't have a sense of urgency because the faster we get these two solutions to scale, the faster we beat the competition.

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

Appreciate that. On the PEO growth, can you talk a little bit about two different dimensions? One would be the growth that you're seeing kind of in the established states relative to some of the less mature states. And to what extent are you seeing less mature states really catch on, particularly given the legislative and regulatory backdrop?

And then secondly, how should we think about just health insurance costs now that elective surgeries are starting to come back, elective procedures are starting to come back? What sort of impact would that end up having just on the overall pricing? I know that you're not necessarily impacted directly from a margin perspective, but just thinking about the demand environment.

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

Yes, it's a great question. I'll take the second part of the question. So hopefully, you'll forget about the first part because we don't have -- we try to prepare for everything and that one, we'll have to follow up with you on in terms of what regions or what states we're strongest in terms of our -- I'm going to suspect that they were all strong because honestly, like the PEO results were off the charts. So there can't be any state that wasn't in strong double-digit growth. But we'll follow up on that question.

On the health care rates question, you're right that we're not directly impacted, but you're also right to imply that we're indirectly impacted because it does matter, right? It matters to our clients, what they're paying for health care.

And I hate to be so simplistic, but I think what -- back the regression to the mean and large economies, the health care world and insurance companies are also similar in terms of -- they regress, right? So losses have an uncanny way of regressing to the mean.

That's why I always caution people when all of a sudden, someone thinks that they have this big decline in either workers' comp costs or health care cost, it usually doesn't work that way. There's usually something that explains it, and it usually regresses back to the mean.

So I think if I can try to answer what I think is the implication of your question, there was a temporary decline in things like elective surgery and frankly, health care in general. People even stopped going to their primary care physicians and so forth. That decreased health care costs temporarily. And I hate to use that word, transitory, that is now the favorite word it seems to talk about inflation. But it's very clear that, that was transitory and that health care costs will come back.

And so I think to the extent you had below-normal renewals, which would be our situation, right, because we don't take risk on health care. So we wouldn't see it in our margins and in our cost structure. But to the extent that we had below-normal renewals, we would expect those renewals to go back to normal because we would expect as health care costs go back to normal slowly, that those costs would have to be passed through.

When you look at the health care insurance companies as much criticism as they get, they are largely pass-through entities. They're paying hospitals and providers and other health care costs, prescription drugs, et cetera. And it's really not a business where you can say, "Oh, we can't pass this 10% increase in health care cost because their margins aren't even 10%."

And so that business is very, very straightforward, which is they try to earn a markup or a margin for doing what they do in terms of managing networks, et cetera. But in the end, they have to pass those costs through. We have to also because we're a pass-through entity as well. And I think those who take risk on health care, we'll probably see those costs go up over some period of time.

Operator

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

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

So there's not much more I can say because we really had terrific results. I want to thank Don for joining, and I think you're all going to be very happy to meet him and get the benefit of his experience in ADP more broadly besides just in the finance organization because he has kind of real-world business experience within ADP as well.

The -- I just want to end the way I usually end, which is thanking our organization and particularly our frontline associates because I'm not sure what's going on in other companies, but we would not be able to get our goals accomplished without people going above and beyond. I think we mentioned the tight labor market and that we're a little bit behind in terms of our hiring. That means our people are working extra hard.

An economist says that's an increase in productivity. I'd say that's just people working hard. And we really appreciate it. Our clients appreciate it. I think our shareholders appreciate it. I don't think a lot of them listen to this call, but you should be aware that whether it's here and other companies, there's a lot of people out there that are pushing really hard to deliver. And many of us, whether we are as consumers or buyers of products and businesses and so, we're frustrated by what's happening in terms of supply chain and some of these other things.

But all I see is a bunch of people working really, really hard to try to like fulfill the needs of our clients. And I think that's happening across the whole economy. And I think we need to show a little bit of patience with each other because this will all, I think, normalize as this variant now recedes. I mean you're seeing already in some of the mobility data, things will slowly get back to normal. People will come back into the labor force. And this great economy that we have will function the way it's supposed to function.

But in the meantime, I want to thank our associates for what they've done so far, whether it's this last quarter and what they're going to have to do to get through this year-end, which is going to be very challenging, given the volumes we have and the capacity we have. So for that, I thank them, but I also thank all of you for listening and for being supporters of ADP. Thank you.

Operator

This concludes the program. You may now disconnect. Everyone, have a great day.

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