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ADP.OQ - Q3 2023 Automatic Data Processing Inc Earnings Call

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OVERVIEW:

ADP reported 3Q23 YoverY organic constant-currency revenue growth of 10%. Co. expects FY23 consolidated revenue growth of 8-9%.

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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 Third Quarter Fiscal 2023 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. Danny Hussain, Vice President, Investor Relations. Please go ahead.

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

Thank you, Michelle, and welcome everyone to ADP's Third Quarter Fiscal 2023 Earnings Call. Participating today are Maria Black, 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 a 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.

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I'll now turn it over to Maria.

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Thank you, Danny, and thank you, everyone, for joining us. For our third quarter, we delivered strong results, including 10% organic constant currency revenue growth, 110 basis points of adjusted EBIT margin expansion and 14% adjusted EPS growth. Our continued solid financial performance underscores the power of our innovative and mission-critical HCM solutions that serve over 1 million diverse clients around the world as well as our highly recurring revenue business model.

As usual, I'll start with some highlights from the quarter. The demand environment was healthy overall. And in Q3, we drove another quarter of solid Employer Services, new business bookings growth, representing a record Q3 bookings amount. Bookings performance continues to be particularly strong in our down market portfolio. In Q3, we sold and started over 60,000 new RUN clients where a new user experience has helped us reach record level new client satisfaction rate these past few quarters. We also had strong bookings results in our insurance and retirement services offerings supported not only by legislative tailwinds but also by the competitive positioning of our down market HCM ecosystem.

Demand for our Employer Services HR Outsourcing Solutions remained high, and we recently reached the 10,000 client mark. We also saw continued booking strength in our compliance-oriented solutions, including tax remittance and wage payments, which have always been key differentiators for us on a year-to-date basis, we are within our bookings guidance range and are trending in line with our expectations from the outset of the year, and we look forward to finishing the year with a strong close.

Our Employer Services retention rate came in better than expected once again. While we continue to experience normalization in our down market out of business rates, this was offset by the strong retention rate in our U.S. mid-market and international businesses, both of which continue to benefit from years of improving client satisfaction.

As such, we're pleased to be raising our full year retention guidance. Our Employer Services pays per control grew 4% for the quarter and continues to decelerate at a very gradual pace. As we have seen for several quarters now, layoffs at many larger companies have been offset by the labor demand elsewhere, which in total has resulted in year-over-year employment growth. With this continued resilience, we're pleased to expect the higher end of our previous pays per control guidance range.

Last, on our PEO, while growth in revenue and average worksite employees continued to decelerate this quarter. We were pleased to see PEO bookings growth reaccelerate nicely in Q3, especially in March. This represented a much better performance than we experienced in Q2 and resulted in our largest quarter for PEO bookings ever.

Despite the current inflationary environment and broad-based macroeconomic uncertainty, we are focused on our PEO sales execution and on delivering continued strong client satisfaction, and we remain confident in the long-term secular growth opportunity.

Stepping back, while we are pleased to be on track to deliver very strong full year financial results. We are even more excited about how we are leveraging our unmatched scale and decades of innovation experience to drive continued progress on our important modernization journey. We are making our solutions more powerful and easier to use, and we are making our unparalleled insight and expertise more accessible than ever. In doing all this, we're delivering an experience that's better for our clients, better for their employees and better for ADP.

I mentioned the tens of thousands of new clients we onboarded in our down market, over 1/3 of those clients utilize our digital onboarding experience, yielding a faster time to start, happier clients and greater productivity for our implementation team.

We just completed our busy year-end period during which we helped our clients with over 75 million U.S. tax forms and to further enhance the client experience, we proactively service critical year-end data to our clients before they had to search for it. This not only reduced friction for them but also reduced the number of calls and interactions with our service teams.

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For years, we have directly engaged and served our clients' employees through channels like wisely. As we focus on the overall employee experience we can offer, we continue to add valuable functionality like a savings envelope that employees have used to move more than $1 billion into savings over the last 12 months and a new financial wellness hub with its tools and education to drive better financial outcomes.

With our new intelligent self-service solution, we are already interacting with over 3 million client employees per month through our Action Card feature. And our Voice of Employee solution is helping thousands of clients attain better insights from their employee population, which can drive higher engagement and satisfaction for those employees.

The opportunity to continue creating value and efficiency in the world of work is meaningful, and we believe these modern approaches that reduce friction and exceed client expectations will help us deliver on that in the coming years.

With that in mind, I want to provide some perspective on how we are strategically positioning ourselves to invest over the near term given the economic backdrop. As we shared earlier this year, in fiscal 2023, we were impacted by higher wage inflation. We also added to our service and implementation capacity to meet the expectations of our growing client base, and we invested throughout the year in sales and products.

As we position for potential economic slowdown beyond this fiscal year, we are being thoughtful about how we prioritize our investments. At the same time, we are very much committed to our ongoing modernization journey, which is critical to our sustainable growth and that will require continued steady reinvestment into the business. In the coming quarters, I look forward to updating you on near-term growth priorities for ADP. Before turning it over to Don, I want to take a moment to recognize our associates for their continued focus on helping our clients through the many challenges they face each day, especially amid these uncertain times. Resiliency and partnerships represent core components of the ADP brand promise and are among the many reasons businesses around the world choose to partner with a leader in the industry. Our unrelenting support through years of growth, years of challenge and the years in between is something they've grown to count on, and we are honored to support them.

With that, I'll turn it over to Don.

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Thank you, Maria, and good morning, everyone. I'll provide some more details on our Q3 results and update you on our fiscal '23 outlook before briefly touching on fiscal '24.

Let me jump straight into the segments starting with Employer Services. ES segment revenue increased 11% on a reported basis and 12% on an organic constant currency basis, which is the strongest ES revenue growth we've experienced in quite some time. As Maria shared, ES new business bookings were solid and kept us on track with our full year outlook. We believe the full range of bookings outcomes is still on the table given the relative importance of Q4 bookings to our full year results. So we're not making any change to our guidance, but we do believe the middle of our guidance range feels most likely at this point.

On ES retention, following another quarter of better-than-expected results, we're again revising our outlook, and we now expect retention to be down only 10 to 20 basis points for the full year compared to our prior outlook of down 20 to 30 basis points. This again will be driven by retention decline in our down market from normalized out-of-business losses and is mostly offset by improved overall retention elsewhere.

Pays per control remained strong in Q3 and we are raising our outlook to now assume about 4% pays per control growth for the year compared to our prior outlook for 3% to 4% growth. Client funds interest revenue increased in Q3, in line with our expectations, and we're updating our full year outlook utilizing the latest forward yield curve, which, in this case, resulted in no major change. And on FX, we had about 1 percentage point of ES revenue headwinds in Q3, and there is no change to our outlook for a full year headwind of between 1% and 2%.

Following our strong Q3 ES revenue growth, we're pleased to be raising our outlook once again to now expect about 9% growth, up from 8% to 9% before. Our ES margin increased 80 basis points in Q3, which was in line with our expectations. We are narrowing our full year outlook to now

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expect about 200 basis points of margin expansion and we still see significant opportunity to invest in sales, product and elsewhere throughout the organization to capitalize on the growth opportunity in front of us, which we are choosing to do at this juncture.

Moving on to the PEO. We had 5% revenue growth driven by 3% growth in average worksite employees. As a reminder, this deceleration is driven by a few factors, including slow pays per control growth, difficult comparisons versus record retention levels and softer recent bookings growth that we experienced in the last 2 years.

For this fiscal year, we now expect PEO revenue growth of about 8% and with growth in average worksite employees of about 6%, both at the lower end of our prior ranges. Maria mentioned the bookings reacceleration in Q3 and we are feeling upbeat about reaccelerating the revenue growth in the coming several quarters. This guidance update is mainly due to a tweak to our pays per control assumption within the PEO, as it decelerated a bit more than we previously assumed, somewhat different from what we experienced in the ES segment. We are separately lowering our outlook for revenue, excluding zero margin pass-throughs to a range of 7% to 8% due mainly to lower SUI rates in Q3, than we previously anticipated.

PEO margin increased 140 basis points in Q3, which was better than expected due primarily to continued favorable workers' compensation reserve adjustments, which we had not assumed as well as the lower SUI costs I just mentioned. And we are raising our outlook for PEO margin to now expect it to be up 50 to 75 basis points for fiscal '23.

Putting it all together, we still expect consolidated revenue growth of 8% to 9% in fiscal '23, but now believe it will be towards the higher end of that range. We are maintaining our outlook for adjusted EBIT margin expansion of 125 to 150 basis points and for a fiscal '23 effective tax rate of about 23%. And we now expect adjusted EPS growth of 16% to 17% compared to our prior outlook of 15% to 17%.

I also want to provide some early high-level color on what to expect for next year. We are still going through our annual planning process but there are a few things to consider at this point. First, assuming a slowing economic backdrop, pays per control could be at a below normal growth rate next year, among other potential macro considerations.

I would also point out that while client funds interest appears positioned to give us some contribution to growth, based on the latest forward yield curve, it will likely be very modest. At the same time, we have good momentum in our ES bookings performance and ES retention, and we are feeling upbeat about the continued opportunity to build on our decades of success. Thank you.

And I'll now turn it back to Michelle for Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will take our first question from Bryan Bergin with Cowen.

Bryan C. Bergin - *TD Cowen, Research Division - MD & Analyst*

So Don, maybe just building on those last comments you had there, I'm curious, just any indications or call-outs worth mentioning as it relates to fiscal '24? Really in the context of the medium-term outlook that you've given in the past, just how should the Street consider the magnitude of potential impacts across some of these KPIs from a potentially slower macro environment?

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Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes, Bryan, thank you for the question. It's still early. We're still in the middle of our planning process. I think we have a lot of things going in our favor sales. We're -- we still have relatively high client fund interest. Pays per control have been good and strong. Bookings continue to be strong as we said earlier. So as we get into '24, I think we're going to be in a pretty healthy spot with what we know today. I guess the challenge we all have is trying to guess what's coming in terms of the broader macro situation. We continue to see strong demand, retention to think is pretty good, although it's normalizing a little bit in the down market, as we did expect. But I think things feel pretty good at this juncture. So I'm going to have to ask you to bear with us a little bit as we make our way through our plan, and we stay tuned to what's going on in the macro environment even closer as we get forward or closer to our July 1, beginning of the year.

Bryan C. Bergin - *TD Cowen, Research Division - MD & Analyst*

Okay. That's fair. And just on the PEO. So worksite employee view downtick, and I think you were down sequentially in average worksite employees. Can you just talk about what you're seeing in kind of the pays per control versus the retention aspect in the PEO? And with bookings reaccelerating, how long does the reconnection to improve growth take?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

So the -- we did have, as you as you mentioned, we had a particularly strong PEO bookings month in March, which we're optimistic is going to continue and help us as we go forward. Certainly, we're going to have to see how those bookings continue through the balance of the year, trying to anticipate how those are going to actually result in revenue. Things do start relatively quickly in the PEO business, but it's going to take some time once again to see how that stuff rolls from bookings into revenue. But we're pretty optimistic about how things went in the third quarter, especially with the finish, and we do expect to see that reacceleration as quickly as we want to. And by the way, back to your earlier question a little bit, we talked about high single-digit growth in our midterm view, and we won't be happy if we don't get something like that.

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. I think, Bryan, if I can just comment on the quarter-over-quarter real quick as I think you mentioned the sequential growth Q2 to Q3 and worksite employees. That is something that, obviously, we noticed as well, and as Don mentioned, from a medium-term perspective, we are definitely still committed from the medium term to the works on employee growth that we have guided to for that. However, as it relates to kind of the quarter-over-quarter, we noticed the same thing that you noticed. And obviously, that's not the ideal situation, and we're hopeful that won't be the case if you look sequentially quarter-to-quarter, Q3 to Q4, but also year-on-year. And I think that's really a byproduct of timing, and that timing is really about retention, right? So it's really about, call it, third quarter retention results, which we've cited before were a bit softer than we expected. And as a result of that, you see the sequential piece to the quarter-on-quarter.

Bryan C. Bergin - *TD Cowen, Research Division - MD & Analyst*

Okay. Is that just a function of the type of client within PEO?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

In terms of the typing.

Bryan C. Bergin - *TD Cowen, Research Division - MD & Analyst*

Like more white collar?

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Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

I don't know that it's a function of more white collar. I think it's really a function of some of the feelings that we have post pandemic as the renewals have really been kind of, call it, rippling through the business of the PEO. So it's really a byproduct of some of the post-pandemic impact that we saw in the PEO so it's really byproduct of the retention softness that we saw in the first quarter and the second quarter and then quarter-on-quarter this past quarter. So I don't think it's necessarily a byproduct of -- because retention continues, albeit it's normalizing a bit in the down market. We do have very strong retention in the mid-market. We also have strong retention, albeit tiny bit less than last year in the down market. So I don't really think it's a byproduct of the client base or white collar, I think it's really a byproduct of kind of a post-pandemic environment in the PEO.

Operator

Our next question comes from Bryan Keane with Deutsche Bank.

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

I guess just trying to look at Employer Services, really strong growth in the quarter, 12% organic. If you back into the guidance for fourth quarter, it looks like a little bit of a deceleration. I think you get to something around 8% growth. So just trying to understand the puts and takes there for the fourth quarter guide versus the strong results in the third quarter?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes, thanks for the question. The biggest impact, I guess, in terms of growth would be we are going to continue to see strong growth from client fund interest in the fourth quarter. But certainly, Q3 is by far the strongest quarter just given the seasonality of tax receipts, et cetera, for us. So I think that would be one of the key drivers. And of course, we did mention as well that we expect to see pays per control growth coming down and softening a little bit, even though a bit higher than we expected to see. Last quarter, it is coming down. It's certainly starting to moderate.

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

Got it. Got it. And then on the bookings side, although bookings were strong. I think you commented maybe towards the lower end of the range of 6% to 9% and -- and just can you help us maybe think about how bookings will translate into future revenue growth for the Employer Services? If you can just remind us, just as we get our models set or start thinking about fiscal year '24.

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. So I'll let Don comment on the -- how the bookings kind of relate to the models on the revenue side. But from an overall bookings perspective, what we cited in the prepared remarks is that we do anticipate the middle of the range. So we did keep the range constant. So it's constant with the outset of the year, it's also constant with last quarter's guidance. So we are keeping that 6% to 9% range. We do anticipate at this point, the middle of that range.

And we feel pretty confident heading into the fourth quarter when we take a look at how we exited March, but also taking a look at the number of sellers we have, the investments we've made into the ecosystem and as those sellers ultimately gain tenure because we're actually lapping a lot of new hires that we had, if you will, a year ago. So pretty excited as we step in the other part of that.

Confidence is really about what we're seeing as it relates to the overall pipeline. So pipelines are strong. That's more of a, call it, enterprise and international or large deal type of comment. We're seeing tremendous activity in the top of the funnel still upmarket. So the down market continues to shine for us, and that's really supported by what we're seeing in continued increases in new business formations. We're also seeing those new

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business formations generate inbound leads. So we're seeing good activity on the digital side. So feel confident as we step into the fourth quarter, and then I'll let Don comment on how the -- ultimately where we land in the fourth quarter and how that translates into revenue for us next year.

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes. So on the modeling side, roughly a 1% change in ES bookings growth impacts us in the $17 million to $20 million annually on revenue growth. So that's kind of how we think about your models. I think that's been pretty consistent.

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

Yes. And Bryan, the timing is -- it depends on the business. Obviously, strong performance in the down market will impact revenue much more quickly. And if you have strong global view sales at the other end of the extreme, that can take several months to even more than a year, in some cases, to roll in. So typical rule of thumb for us is a couple of quarters to see the full impact. But of course, the bookings throughout the year have been pretty consistent for us. And so I wouldn't expect any real callouts from the revenue timing standpoint.

Operator

Our next question comes from Eugene Simuni with MoffettNathanson.

Eugene M. Simuni - *MoffettNathanson LLC - Analyst*

Maria, I wanted to pick back up on your comments about the break down market. Maybe elaborate on that a little bit, what are the macro factors, your competitive positioning that's still supporting that? And if you could contrast that for us a little bit with what's going on in the mid-market. I know it's still doing well. But if the question is, is there a path for mid-market to get to as strong of a point with down market? And what are the levers that maybe you're able to pull to get you there?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Absolutely. So I'll start with the down market, just to kind of reiterate the strength we're seeing there top of funnel. So we are very pleased with what we saw in the performance of the down market. That's also inclusive of the down market ecosystem. So I think this is our RUN platform. I talked about the third quarter onboarding 60,000 clients. It's pretty incredible. Those clients also, many of them have attach rates of our retirement services offering, our insurance services offering.

So the entire down market portfolio, it's definitely performing well for us and has for quite some time. It is driven by what we're seeing macro. And so you just kind of reiterate what we've seen as new business formations are up year-on-year, 8%, by the way, they're still up year on pandemic, as I call it. So they're actually if you look at current new business formations versus the year of 2019, right? So pre-pandemic, it's actually 8,000 or so a week. This is all from the U.S. Census Bureau. So from the standpoint of what we're seeing that kind of emanate into the pipelines and into the top of the funnel. We do have double-digit growth in our digital inbound leads, right? So I think these are SEO/SEM ads where ultimately, clients are coming to us, and we're meeting those clients with our inside sellers and the demand is there and demand is strong.

In terms of the mid-market, the mid-market was a bit softer this quarter than it was last quarter. That said, we also are very excited about the pipelines that we're seeing in the mid-market that specifically call it the, the tech only, we do have strength in our Employer Services HR Outsourcing offering, which also touches the mid-market. So combined, your question around, is there a path to see tremendous growth there between those businesses, we are seeing growth, and we are excited about our overall mid-market position from a competitive landscape. We do have our next-generation payroll engine that's attached to about 30% to 40% of our mid-market new business sales. And what I will tell you is it's resonating incredibly well in the market. It's resonating with the sellers. That's always a good sign when they like to talk about it and they like to demo it. It's

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also resonating in terms of the competitive landscape and more wins. And so we feel that there's definitely a path. That's what we're investing in, both in product and the ecosystem to have the mid-market be as an exciting of a story as the down market is for us.

Eugene M. Simuni - *MoffettNathanson LLC - Analyst*

Got it. Very helpful color. And then for my follow-up, I want to quickly come back to the PEO. Can you talk a little bit about the kind of the macro headwinds for the PEO order? I think we discussed last time, specifically the insurance attach rates, insurance premiums, kind of blocking PEO growth. Is that still a factor or not any longer?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. What I would say is that the PEO demand remains strong. And so we're bullish about the secular tailwinds of the PEO. We're bullish about the value proposition. As it relates to benefits and benefits attached. I know there's a lot of discussions, there are a lot of surveys out there from the likes of Kaiser, et cetera, as it relates to our clients making different choices. I think what we see within our base is perhaps some asks of that. And on the peripheral kind of on the margin, perhaps there's price sensitivity as it relates to benefits. What that really allows for our sellers just need to be, call it, more surgical as they go to market.

But in terms of the value proposition of the PEO and benefits still being a big component of that, that is the case. We skew definitely a bit more white collar in our PEO. In addition to that, our model with a fully insured model is a little bit different. And so the companies that we attract our PEO are still companies that want to be employers of choice, and employers of choice especially in a macro environment, such as this one, where talent is still the name of the game. They want to offer benefits and benefits are a piece of that.

So what I would say is we're not seeing huge signs. I think even if you take a look at the revenue [ex VNPT], you'd be able to see kind of what's happening with benefit revenue. So there's not huge signs that there's a shift in benefits attractiveness. I think the shift that we see is just the sharpness that our sellers need to have as they position the value proposition and, call it, the right plans and the right rates to the right clients.

Operator

Our next question comes from Kevin McVeigh with Credit Suisse.

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

Maria, I think you talked about 60,000 new RUN clients in the quarter. Can you help us dimensionalize that? Where would that typically be? And how should we kind of expect that to evolve going forward?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

So the 60,000 clients that I mentioned are specific to our down market, specifically the RUN platform. So that's actually 60,000 clients that we started. So where would they be? They would be all over the United States, if you will, from a -- and I'm not trying to be funny about it, but it's really pretty amazing effort if you think about the volume of clients, the throughput, if you will. They come to us through some of the things that we talked about today, new business formation, they also come to us through our channel ecosystem. So we've made a lot of investments into the relationships we have with our CPAs, with our banks.

In terms of what does it look like quarter-on-quarter, stating the obvious the third quarter for us is obviously the highest volume quarter. So that's why it's kind of fun to give that shout out this quarter because, arguably, I would say that's not a typical quarter for ADP as it relates to a number of units and the throughput because many of the starts do happen in January in that business. But they're kind of all over the place, and they come to us through the strength of our distribution model and the strength of our overall ecosystem. Does that answer the question, Kevin?

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

It did. I guess I was just -- I know Q3 is a high watermark. How should we think about 60,000 maybe relative to Q3 of last year? Was it 40? I mean, just trying to understand like how the momentum is accelerating there? And then just what's the profitability? Because it sounds like a third word digital onboarded, like the ones that are digitally onboarded, how much more profitable are those than a traditional client that's onboarded? Just trying to get a sense of if we're at an inflection point in terms of the growth there.

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. Listen, I -- fair enough. I don't know that I meant to trip myself into giving a quarter-on-quarter number. What I would tell you is it's higher than last quarter. It's higher both in revenue, obviously and the performance. It's also higher in share unit volume.

So I suppose I'll kind of leave it at that. In terms of the third that comes through the digital onboarding, what that yields is a few things. Kevin, one of which is better experience for the client, right? So our digital onboarded clients have very high, what we call, new business client NPS results, right? So -- and when a client starts with us happier, it yields to a happier client long term, which yields to a happier and more retentive clients. So I think in terms of what the, call it, margin profile or lifetime value of those clients look like over time, we're still learning a bit about that, but it's very optimistic for us as we're seeing the results.

I think the other is, it also yields efficiency for our implementation organization, right? So if you think about having the ability to have these clients digitally onboarded allows the more complex onboardings, if you will, perhaps clients are coming to us with more complications around their taxes or maybe from a competitor or something that's actually demands an implementation, the person to be involved at a much higher level, it allows their focus to remain there, which also should yield a better experience for those clients. So we're also seeing that.

So overall, we are seeing, and I cited it in the prepared remarks, we're seeing new clients come on board happier. The digital ones are happier than the non-digital, but they're all happier than they were last year, which is a good thing for us as it relates to the retentive nature of those clients over time and what they will bring to us in terms of lifetime value.

Operator

And our next question comes from James Faucette with Morgan Stanley.

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

Great. I wanted to quickly, Maria, ask a clarifying question. On the mid-market, you kind of talked about some of the things that you're doing there. But just to be clear, it sounds like from your perspective that it's more issues or things that ADP can do to address versus macro? I just want to make sure I'm understanding kind of your list of objectives and things to do in that segment.

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Absolutely. The mid-market for us still has -- and we're still experiencing solid mid-market sales, right? And so I don't -- from my vantage point, I don't think it's necessarily the softness that we saw in Q3 versus Q2 with a byproduct of a macro type of environment. We're paying close attention to demand cycles. We're paying close attention to pipelines. In terms of -- there are some cycles that are perhaps a tiny bit elongated, maybe, there might be some more approvals or approval layers involved, and there may be a little bit of cycle elongation. I would tell you, we're not seeing that much of that in the mid-market, and it really looks more like '19, it looks more like pre-pandemic than it does necessarily something that would give us a belief that there's a macro concern in the mid-market.

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What I would say is on the macro side, it's not getting any easier in the mid-market to be a client, right? And so if you think about the complex environment for the mid-market customers and clients, it does continue to increase. And so they're solving for hybrid work, they're solving for talent, they're solving for compliance, regulation. And they're turning to HCM providers such as us, to help with all of that. So I think the macro supports a very strong environment for the mid-market and we do continue to expect to have mid-market growth, including our HRO.

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

Got it. Got it. And then I guess maybe dovetailing with that, can you speak a little bit about the competitive environment? And any changes you're seeing there? Or what are you seeing from customers? Is there a flight to quality versus maybe some of the regional players and what is the impact of newer entrants? Just can you give us kind of a state of the competitive landscape?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Sure. I would say the competitive landscape, one way to think about it is it actually hasn't changed that much. So is there a flight to quality, sure. We've seen some of that, but it's not material at this time as it relates to clients calling us and asking about the macro and what's happening in the world. We've had a few of those calls just recently based on some things that have happened in the environment. But what I would say -- when I think about the competitive environment, we look at this very closely. We just completed our strategic plan process, and we've been looking at our competitive position against all the major players, mid-market and others over the last handful of years in a surgical way. What I would offer is a few items, one of which is we have strong retention, specifically in the mid-market. We also have very strong retention in international. We have a near-record highs in NPS.

And so I would say that our value proposition and our competitive positioning -- it's proof, if you will, if you look at the retention, from a balance of trade, we are also winning more away from our competitors than we have in years past. And so again, I think our position is about the same when I look at it year-on-year, but it's getting perhaps a little bit better on the wind side. And I think that a lot of that does have to do with the quality that we're providing, so inside kind of the NPS results. Certainly, the investments we've made, the investments into our organization to serve our clients better. Some of the things I talked about, new products that we're leveraging. The likes of AI to actually drive self-service, to drive better experience for our clients, their employees and drive friction out. So I would say, investments into product. And then lastly, again, investments into new products that is creating better wins for us.

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*

Don, I know you gave preliminary FY '24 guidance. And one of the things you talked about is obviously pays for control moderating. But do you think -- could there be an offset because inflation is still running high and there is a pricing opportunity for the company, especially on the payroll side?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes, Kartik, it's a good question. So certainly, talked about pays per control growth decelerating. We called that out. And we've also -- I mentioned earlier, for '24, I think there's a risk that it decelerates further. So we'll have to watch and see what happens there.

On the inflation side and pricing, we're still in the early days of our FY '24 plan. So we're watching it carefully. I think we can say that we are happy with the impact of the results of the price -- pricing decisions we took in '23. We had those readily accepted, I guess, with -- reflected by our higher NPS scores by our continued strong retention. So we have an ability to take price. But as we always come back to, we're in this for the long haul

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with our clients, their long-term retention is the most important thing to us. So we need to make sure that we continue to have that good value proposition between what the absolute prices, how much price we can take, et cetera. But once again, Kartik, it's definitely something we're looking at and trying to evaluate as we get closer to putting the plan to bed.

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

And then, Maria, just on the PEO side, could -- is any of the attrition related to maybe customers deciding that they had a PEO and it just got too expensive for them. So they've decided to move out of the PEO for a while until they can get a better understanding of what's happening in the economy. Any changes like that?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

I would say that's always the case. I think every year, as we go through renewals, as we go through the year-end cycle, you have clients that are choosing to buy into the PEO and you have clients that are choosing to exit the PEO. When I look at where we get our clients from, obviously, I think we've cited multiple times that about 50% of the new business that comes into the PEO comes from our existing ADP base that would suggest that at least 50% come from a non-PEO environment, and we somewhat tend to return them the same way. So that's not to say that clients don't, at times, we don't trade customers between us and the other PEOs. But generally speaking, I think that's always the case. I don't believe there's a larger trend toward that this time than there has been in the past. I think, really, in the end, it's really a byproduct again of kind of what we saw with the renewal post pandemic and what the impact of that as we headed into this selling cycle, if you will.

Operator

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

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

I also wanted to follow up on the PEO and particularly on the bookings reacceleration. I'm just curious how much of that reacceleration is sort of from a better kind of external demand environment versus changes in your sales strategy? I'm just trying to figure out how much is sort of push versus pull when it comes to that recovery. And I guess the underlying question is your confidence level that this reacceleration is a sustainable trend?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Fair. Thank you, Ramsey. We are excited about the PEO reacceleration, specifically what we saw in March and obviously, how we feel stepping into this final stretch. I think it is too early to comment on the finish, but the pipelines are strong. What I would tell you is that I'm bullish about the demand in the market for the PEO and the overall value proposition. So all things being equal, I think we're positioned well as well as anybody else as it relates to the overall PEO. I guess, demand, if you will, right?

So I don't think it's a -- the reacceleration was really, in my mind, more a byproduct of top of funnel filling the pipelines. We made a lot of investments into our seller ecosystem and the PEO. We have incentives that we can pull. In addition to that, we've invested into -- and I think I've talked about it a couple of times on these calls. We've invested into artificial intelligence that actually looks across our base to a project where we're actually looking at the ADP base to try to serve up the right, call it, PEO seller at the right time to the right ADP clients. So we're getting smarter. I'm not doing a good job saying it outside of we're getting smarter in terms of who we are actually targeting on the PEO using technology today that didn't exist. So I think all of that has kind of yielded to what I would say is a strong execution by the PEO sales team to drive the reacceleration that we would expect and that we are excited to see and optimistic that it will continue.

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

Okay. Great. And a quick follow-up. When you look across the business, are you seeing any vertical-specific areas of softness, maybe tech or commercial real estate or financial services? Are there any worrisome kind of verticals that you're keeping an eye on?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Are you referring to the PEO specifically or the overall macro?

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

I know. I should have been more clear. Just more broadly across the business, are there any -- you guys have a pretty broad macro view. And I'm just curious if there's any specific areas that are causing any concern in terms of recent trends?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes, maybe I'll jump in. I think in terms of verticals, certainly seeing all the reports and reading all the things about commercial real estate that everyone else is. That's -- we look at the breadth and the distribution of our client base, it's pretty broad. So I'm not so sure that we're seeing any particular verticals that are causing us any undue concern at this time. I would say, it has been reported, Maria mentioned it in the prepared remarks, certainly, the enterprise space, the upmarket space is where there's been a lot more layoffs announced, et cetera particularly in tech. So we are looking at that. We've said in the past though that's not the biggest part of our business. So even though there's some more softness in that end of the market, it's being more than offset by the success we're having in the down -- in the mid-market. So from a particular vertical, nothing in particular.

Operator

Our next question comes from Samad Samana with Jefferies.

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

Maybe first one, Maria. Just I wanted to maybe get a better understanding when you're talking about a change in maybe the investment -- investing philosophy of the company just as you're adjusting to the macro environment evolving as well. Is that more around maybe pulling back on hiring? Is that more about maybe redirecting where resources are? Can you maybe just help us better understand what that translates into? And maybe how we should think about that impacting both the top and bottom line?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. Thanks, Samad, I'm happy to talk about modernization. It's one of my favorite topics as all of you are probably learning from my prepared remarks. And I think it's important to think about the modernization journey we've been on and how it really can set us up for kind of future growth and future margin, if you will, as a company. And that's really what it's all about for us. I think we've been undergoing transformation. We've been undergoing modernization for years. I would actually suggest that ADP has been modernizing for the last 73 years as we've invested in technology to make things better for us as a business to become more efficient, and we've been investing in our clients and in product to make it easier for them. And so I think that's not a new cycle. The way I think about modernization is really a client first lens, right? So it's really about all the things that I cited. It's about taking out friction.

The way I think about the investment, which is your question, Samad, is, it's an imperative for us to continue to invest in modernization because it's the modernization that over time has really allowed us to reinvest in growth and reinvest in the business. And we are committed to a continued

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journey of growth and margin. And as a result of really the way we've been able to do this. So for us, it's really about both. It's really about the (inaudible), right? So it's about growth and margin expansion. And I think this virtuous cycle that we've been on really as a company for a very long time, which is we make things easier, we make them better. We become more efficient. We make things better for our clients, and that allows us to invest in growth and it allows us to invest in -- back into our shareholders, if you will, in margins. So it's really (inaudible) an and story and it's key to who ADP is and it will be a key for us as we go forward.

In terms of the commentary that I made around how we're thinking about it in the macroeconomic backdrop, it is an important time to make sure we're making the right choices and the right trade-offs I mentioned earlier, we've been in the middle of our strategic planning process the last quarter. And as we've gone through the business, if you will, end-to-end, rest assured that we are trying as a company to make the very best decisions to have the very best outcomes as it relates to growth and margin.

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

Great. I appreciate that. And then just one quick follow-up for Don. I was just looking at the guidance by segment and the margin for ES, it looks like you settled it out at the -- within the range at the lower end. I'm just curious maybe what drove that? Is that -- is it purely float contribution driven? Or is that more the result of just bookings being better, so expenses being pulled forward? Just help me understand why that was narrowed to the lower end of the range, please?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

Yes. I think there's a couple of things going on. One, certainly, we're continuing to benefit from bookings growth, retention, price pays per control, and all are a little bit stronger. And we certainly are getting lots of tailwinds -- we have lots of tailwinds in Q3, in particular, from client fund interest. So that's been very helpful for us.

The things slow a little bit from a client fund interest perspective in Q4. So that certainly is not as helpful as it was. And we are, of course, as Maria just mentioned, we are taking advantage of some of those extra flow funds that we have to invest -- reinvest in the business or continue to invest in the business on modernization. So it's all about, I think, trying to find the right balance and still delivering the -- as we mentioned, higher end of the earnings per share prediction or guidance. So it's all to find the right balance, and we will continue to invest in modernization and deliver improvements as we go forward.

Operator

And our next question comes from David Togut with Evercore ISI.

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

Could you walk through the 140 basis points of PEO margin expansion in Q3? It seems pretty notable given the deceleration in PEO revenue growth. And in particular, could you unpack the size of the workers' compensation reserve release in Q3?

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

It was $17 million. You'll see it in the[Q] compared to $7 million last year. So it wasn't a huge amount.

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Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

But those are the 2 impacts. So the biggest impact was the reserve adjustment on workers' comp. And the other big item there is the lower SUI costs. So there's virtually no margins on SUI. So SUI comes down at the top, it certainly improves the margins. So those would be the 2 major impacts on the margin improvement in PEO.

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

Got it. And then just as a follow-up, Don, could you walk through your strategy on managing the tax filing float going forward? We've got a pretty steeply inverted yield curve right now, which means it's actually more expensive for you to borrow in the commercial paper market and invest flow medium-term duration bonds. Are you thinking of shifting the investment portfolio at all in the year ahead?

Don Edward McGuire - *Automatic Data Processing, Inc. - CFO*

We had that strategy in place for some 20 years or so. And we've realized about $2.8 billion of incremental benefit from that strategy. And so we have a strategy in place. We always revisit these strategies and look at them. It's true that the yield curve is inverted for the seventh time in 50 years. How long that continues, I'm not sure. But we'll continue to look at that strategy and see what we need to do, if anything, to change it as we go forward. But it is something we've been committed to and we follow closely. Near term, certainly, we have benefited this quarter because of the inflow of funds in calendar Q1. There's a big balance -- a big benefit there to us. So as we go forward, we'll continue to look at the opportunities and decide if we need to make any material changes to the investment strategy.

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

David, one point worth clarifying because this has come up before. If you look at the last slide of our earnings presentation, you'll see a disaggregation of client short extended and long. And one thing I think is worth emphasizing is that, we are net long exposed to the client short. In other words, if short-term interest rates went up and up and up, that would actually be beneficial to our earnings and our margins. It just shows up in 2 different places, which can often cause confusion. But it's actually not hurtful to us to have these higher borrowing costs because we have more dollars invested long in the client short portfolio.

Operator

Our next question comes from Mark Marcon with Baird.

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

Maria, you talked about modernization. Can you talk about the areas of emphasis? And one area that I'm particularly interested in is international and what you're seeing there in terms of opportunities?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Sure. So overall, I think modernization is really about end-to-end. So think of it as product and continuing to make investments in ensuring our products are next generation, if you will. And that's certainly the case across many pieces of our portfolio, and you're well aware of the investments we're making in next-generation technology. I think product is a big piece of it. I think other is the internal modernization. So that would be everything from go-to-market to call it, the seller ecosystem modernization. I think I've spoken to that quite a bit in the past as well as how we actually serve our clients.

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And again, we reference that today. So kind of going back to modernization specifically in our opportunity in international. We're very excited about our position in international. Very excited about the opportunity that we have. And this is definitely an area that we have been modernizing. So if you think about each and every country that we serve over 140 countries today that we have offers over time. We have been modernizing the platforms, and we've been consolidating platforms. But to your point, Mark, that work is not done.

And so we still have that journey that we've been on is the journey that we're going to continue. But as we do that, we're also focused on ensuring that we continue to make the investments to the platforms, and we continue to make the investments into the overall ecosystem of how we serve our clients international to really drive further, call it, opportunity.

And so there's still places in international, and I'll probably leave it with -- we'll be back next quarter to talk more about things such as our growth strategy. But I think as it relates to international all of that modernization should also yield a growth opportunity for us because it's still a big world and there are places that we -- even though we're in more countries than anybody else, there are countries that we don't exist there, segments within certain countries where our offer still has opportunity. And so we were incredibly excited about the overall international space where we are, the work that we're doing and where we're going.

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

That's great. And Maria, can you talk a little bit about just what the appetite is? And obviously, it's diverse across the globe. But broadly speaking, are you seeing a greater level of interest in terms of modernization of HR and HCM systems across the globe? Certainly it's been an ongoing trend in the U.S. for quite some time. But just I'm hearing from others that there is a pickup in terms of RFPs that are occurring things of that nature and that we could be at the early stages of higher levels of growth, international, macro notwithstanding?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

What I would suggest, Mark, is that over the last few years, the conversation in the international space has definitely shifted a bit, and I could suggest the same thing, which is that it's picked up. And so that conversation today tends to lead with more of a global offer, global system of record kind of conversation. So we walk in today and we have a conversation with a client more often than not about how many countries are you in and where can we help serve you and how can we tie it all together to make an ability for that client to really see across multiple countries and have more of a unified experience versus, I would say, perhaps 5, 10 years ago, it was more of a country-by-country conversation. Today, it's more -- it starts with a multi-country conversation. And so I think all of that suggests what -- it appears you've heard from others, which is the narrative in the international is shifting. I think there is greater demand for HCM offerings in international as it relates to companies now that are more global than they've ever been.

And certainly, the hybrid environment has accelerated that a bit. And the ability for companies to be able to see their workforces and make talent decisions, headcount decisions across multiple countries. That's a very different conversation today than it was just a few years ago. And we see that when we have, we just recently, actually, this quarter, we had all of our international clients together at an event. And the topic is about their transformation. It's about their HCM transformation and the partnership that we have with them to solve for them. And I think the beauty of ADP is that we have the ability to solve the MNC, the multi-country piece. And we also have the ability to solve the in-country. And a lot of times, for clients, it's a mix of both. And so it's really about the flexibility we have in our partnership options to serve these clients in a very unique way.

Operator

We have time for one more question. And that question comes from Tien-Tsin Huang with JPMorgan.

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

You covered a lot already. I just wanted on the down market side, given the success in the bookings here. Just curious if that's changing your thinking and investing more or even less, maybe in ASO versus PSO then the digital sales versus the seller ecosystem? I'm curious as we're going into fiscal '24 here, if there's any -- maybe change in thinking in prioritization there?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

So we have leaned into the down market in terms of the investments we've made. So when I -- I think I referenced earlier the seller headcount as we head into the final stretch here and how pleased we are with the investments we've made in headcount and the ecosystem around them, so investments into the channels, things of that nature. And as all of that turns into more productivity because the headcount is actually gaining tenure. It is primarily setting those investments have been in the down market. So again, think our SBS platform, the retirement services, the insurance services, most of that also comes into our digital sales organization, also known as the inside sales. So we are making investments into inside sales to really serve the down market. And what I would suggest is that -- from our viewpoint at this point, the demand is there. We've leaned into that demand, and we will continue to lean into the demand to drive the growth that we're driving out of the down market as long as it exists, if you will.

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

Yes. No, I'm glad to hear it. If you don't mind one more question. Just I have to ask you since you mentioned, Maria, with AI. We've been getting a lot of questions on generative AI and ChatGPT. You mentioned being smarter around serving up PEO when necessary at the right time. But just broadly speaking, how are you thinking about generative AI and how that might help you run your business better, both from a sales perspective, but also from a delivery perspective, support standpoint?

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. Thank you, Tien-Tsin. I'm actually -- I'm thrilled you asked this question because I was counting on it during this call because it definitely seems like it's the topic du jour. But the real answer is, just like everybody else, we're incredibly excited about generative AI. We have been very excited about AI for quite some time. You mentioned what we've been doing for our sellers in the PEO, that's broad-based work that we've been doing for a long time and continue to invest in AI into making us more efficient. That example is about our sellers. We are making similar investments even with the new technologies that are out there to really look at how we can make our service associates as well as our sellers more productive.

So you think about all the things that an agent, if you will, does today to support a client and some of the generative AI tools that can drive a different level of efficiency. And we're very excited. We have I think it's something around like 44 different work streams that are underway currently to take a look at different ways that we can leverage these tools internally. That's also notwithstanding the opportunity that it creates for our industry, right?

So if you think about the HCM industry, there are still very many things inside of HCM that are administrative in nature in terms of whether it's job descriptions, performance reviews, things that are maybe handbook, things that are very tactical that really at times pull back the practitioner from doing what they want to do, which is be a strategic partner. And so we're really excited to put these tools also into our product for our clients and our practitioners to be able to lean into.

So all that said, we're very excited about the opportunity. One thing I would point out because it's important, and it's also very topical right now, which is that the good news is we've been doing a lot of this work. And as such, we have standards. We have a way to think about the ethical nature and that kind of comes at parity with who we are, given that we have the big data, if you will, behind ADP and the 40 million wage earners that we pay. And so when we think about all of this, with also with the lens of doing it the right way and making sure that it's applicable, it's secure, it's compliance, all the things that you would expect from ADP. But no doubt, Tien-Tsin, that we are excited about the opportunity it creates for us

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internally and the opportunity that it creates for us in our product to really serve the industry, right, and make this entire industry that much more strategic and that much more exciting. So great question.

Operator

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

Maria Black - *Automatic Data Processing, Inc. - President, CEO & DIrector*

Yes. Thank you. So first and foremost, thank you, everybody, for joining today. Really appreciate the questions and the interest. As you can imagine, I sit here 1 quarter into my new role as CEO and I get a lot of questions. Just last night, I got another text that said "how were the first 100 days?", "How is the first quarter?", "What have you been up to?" And here's what I would offer. The third quarter for ADP, and you heard it in my tone today, you've heard it in my excitement about some of the volumes and throughput but the third quarter is really where you see ADP shine. And it is our finest quarter. You have year-end, you have busy season, you have selling season that all kind of come together.

In this quarter, what I would say is adding some economic strangeness and questions about what's happening in the world, and I would say that sitting here 1 quarter in, I couldn't be more excited. I couldn't be more pleased. I couldn't be more grateful for the share execution of our associates. So I felt the breadth and depth of ADP this quarter at its finest.

And with that, I just want to take another minute to thank our associates for everything that they do to power this great company. I'd also like to thank all of our partners and stakeholders and everyone on the call listening today. I couldn't be more proud and more excited about this company.

And with that, we will wrap up the call.

Operator

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

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