

Payroll – Human Capital Management (HCM)

February 6, 2018

Information Technology

Industry Rating

Overweight

Investment Thesis

The Payroll – Human Capital Management (HCM) industry has been growing consistently for decades through cost-saving automation and new value adding services. There are still large growth opportunities, and many firms are in a strong financial position to take advantage of them. This industry is heavily exposed to the overall economy and is particularly impacted by the labor market. While there may be individual firms that could take advantage of large growth opportunities, we expect the whole industry see a moderate increase in revenue primarily from the passage of the GOP tax plan. For this reason, we recommend an overweight position.

Drivers of Thesis

- We expect the GOP tax plan that was passed in December 2017 to spur further job growth as companies invest in the United States and allow companies to invest in new HCM systems.
- Companies in this industry invest taxes withheld on paychecks in short-term loans before passing them to the IRS, making the Fed rate hikes in 2017 and the hikes we expect in 2018 highly favorable.
- The industry’s higher margin service, Professional Employer Organizations (PEO), is experiencing low double-digit growth within many of the largest firms.

Risks to Thesis

- The Payroll – HCM industry is heavily exposed to the overall labor market. We are currently a near full employment and experiencing a record bull market. If there is a market correction and heavy job losses, revenues in this industry will be impacted negatively.
- The Trump Administration has promised deregulation of companies, and further repeal of the Affordable Care Act (ACA). Regulation is a boon for new business as companies seek to outsource compliance, and deregulation could slow long-term growth.

Key Industry Statistics

Market Cap in Billions

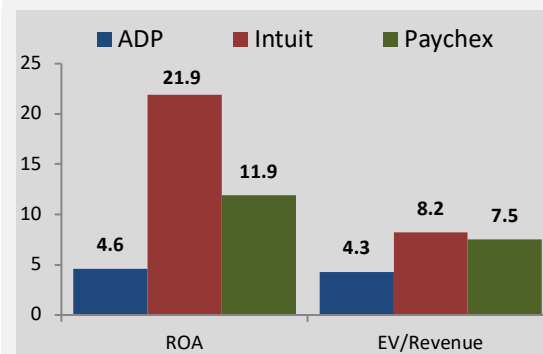
Auto. Data Process. (ADP)	\$54.83
Intuit (INTU)	\$42.92
Paychex (PAYX)	\$24.51
Workday (WDAY)	\$24.44
TriNet Group (TNET)	\$3.05
Insperty (NSP)	\$2.55

Beta

TriNet Group	2.95
Workday	2.14
Intuit	1.44
Insperty	1.15
Paychex	0.99
Automatic Data Processing	0.84

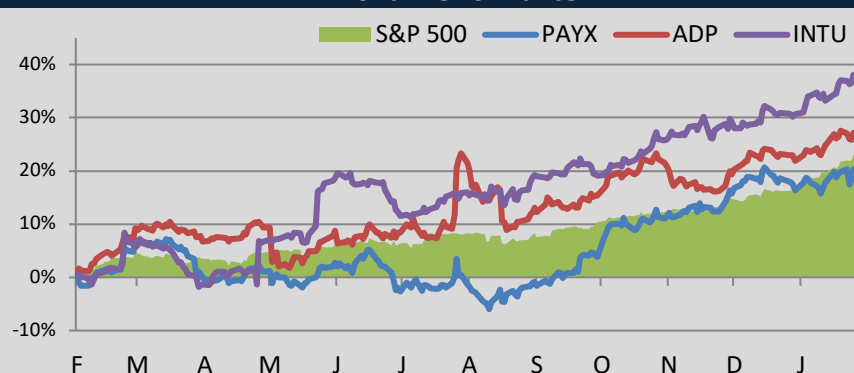
PE Ratio

Workday	101.28
Intuit	44.43
Insperty	32.29
Automatic Data Processing	31.51
Paychex	29.14
TriNet Group	23.14



Source: Yahoo Finance

12 Month Performance



Source: Yahoo Finance

Industry Description

This industry provides a number of services to help other companies focus on their core competency, and not on the back-office work. If a company doesn't want to do any administrative tasks (payroll, benefits, talent management, HR management, time and attendance management, insurance services, retirement, or tax and compliance services) someone from this industry will. There are many different service packages depending on what needs to be done, and how much help the client needs.

EXECUTIVE SUMMARY

The Payroll – Human Capital Management (HCM) industry has, historically, slightly outperformed the overall market, but mirrors its movement closely. The industry is particularly receptive to changes in the level of employment, due to a large percentage of its recurring revenue coming from their clients paying a per-employee fee. We expect the economy experience 2.75-3% real GDP growth but believe that the Payroll – HCM industry will grow between 5-6%, leading to our overweight recommendation.

We believe the Payroll – HCM industry will outpace the economy primarily because of the disproportionate benefits we expect it to gain from the passage of the GOP tax bill. With a lower corporate tax rate and over \$1 trillion in recently repatriated cash, we expect to see corporations investing in the United States and creating jobs. We also expect to see companies investing in internal systems, including new payroll – HCM software. This industry makes money by solving headaches that regulations and back-office tasks give to other companies. Any change in regulation, such as the new tax code, provides a reason for companies to outsource their tax and compliance work instead of taking the time to learn a new system.

The Fed hiked rates 3 times in 2017, and we expect them to hike rates an additional 2-3 times in 2018. Payroll companies invest money withheld from employees’ paychecks in short-term securities, before paying them to the IRS. Higher interest rates mean higher returns on those investments. While this typically makes up less than 3% of a Payroll company’s revenue there is virtually no variable cost, meaning that revenue is pure profit.

The highest margin service of a traditional payroll company offers is its Professional Employer Organization (PEO) segment. PEO segments are growing at a faster rate than other services. In 2017, ADP’s PEO business grew at 13%, compared to 5% for their other services. Insperity is a PEO company, and their revenues grew at 12.2% in 2017.

While there are downsides to this industry, we do not think that, in the event of a market correction, this industry would drop further than the rest of the market due to essential services it provides to clients and stable revenue model it enjoys.

INDUSTRY DESCRIPTION

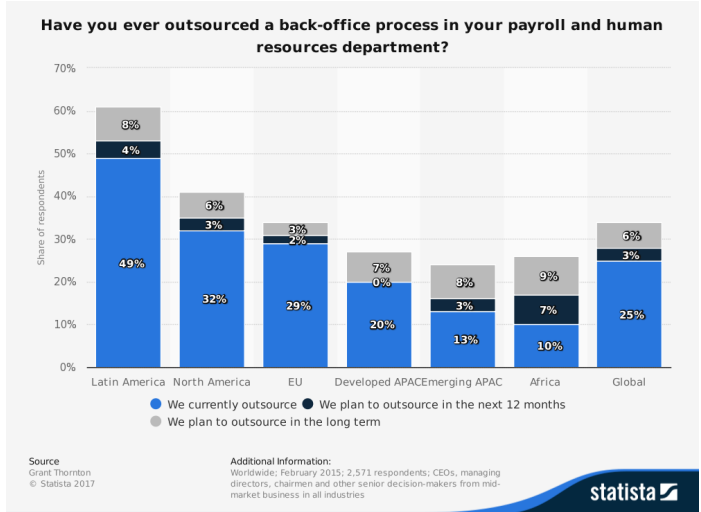
Businesses of every size and in every industry have to manage a lot of the same administrative tasks including payroll, paying taxes, and managing employee benefits such as healthcare and retirement planning. Out of these headaches an industry was born. The concept is simple: outsource the administrative work to allow companies to focus on what they do best. The payroll industry was created, and continues to be led, by Automatic Data Processing (ADP) who shares the space with other traditional payroll players such as Paychex (PAYX), TriNet Group (TNET), and Insperity (NSP).

	Market Cap	Sales	Profit Margin
ADP	\$ 50,360	\$ 12,380	13.47%
Paychex	\$ 22,910	\$ 3,151	27.22%
Insperity	\$ 2,790	\$ 3,300	2.56%
TriNet Group	\$ 3,260	\$ 3,275	5.43%
Intuit	\$ 43,240	\$ 5,177	17.48%
Workday	\$ 27,570	\$ 2,143	-14.99%

Source: Yahoo Finance

Intuit and Workday are two major players in payroll, but their payroll division is ancillary to their core competencies of tax help and corporate financial management. As you can see from the chart above, they are valued differently by the market than a traditional payroll company.

This is a growing industry, that has room to continue growing. In 2015, less than 1/3 of companies in the United States outsourced an administrative service like payroll, but that number has been growing [1].



Source: Statista

In 1949, ADP started as a pure payroll company that could not even help you withhold taxes from an employee’s paycheck until 1977. Today, each company in the industry offers a wide range of the products and services that attempt to differentiate themselves from competitors and create additional revenue streams. All together, these product offerings are called Human Capital Management (HCM).

When a client hires a payroll company they must decide between the two relationships; Employer Services or the more involved Professional Employer Organization (PEO). Around 1% of the US workforce is employed by a PEO [2].

Employer Services

Employer Services is the more traditional method of Payroll – HCM firms to provide services. There are many service offerings under this category including payroll, employee recruitment, employee benefits, tax help, and regulatory help.

Payroll

For companies like ADP and Paychex, payroll is their flagship product. It serves as the foot-in-the-door service that allows them to start a conversation about all the other services they provide. Every company offers similar payroll service including tax-withholding, end of year tax documents, direct deposit, and everything necessary to manage salaried, hourly, and contract workers.

Benefits

Retirement, healthcare, vacation days, and all the regulatory and tracking requirements to go along with them. Staying compliant with healthcare regulations is a significant draw. ADP, Paychex, Insperity, and TriNet Group all saw a spike in new customers in 2016, when they began offering services to ensure employer’s compliance with the “Employer Shared Responsibility” portion of the Affordable Care Act (ACA). Companies, not wanting to have to take the time to understand all the new requirements opted to outsource their compliance issues to Payroll – HCM companies.

Should the Trump Administration succeed in repealing the ACA, we expect to see slower new business bookings, but would not anticipate many clients leaving the HCM provider. Completely repealing the ACA does not seem to

remain a top priority for the Republican party, and we do not anticipate it happening.

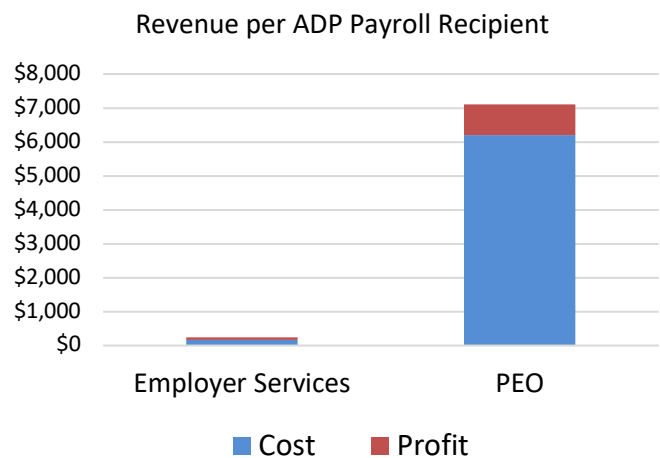
Employee Recruitment

One common additional service is employee recruitment and training. Workday, Paychex, and Insperity promote this as a competitive advantage. Help with employee recruitment varies from screening potential hires to taking care of all new employee paperwork. These Payroll - HCM companies begin building employee profiles from the moment they apply, keeping all personal information in secure location and streamlining the onboarding process.

Professional Employer Organization (PEO)

When a Payroll - HCM firm becomes a PEO for a client, they become a co-employer and assume liability for employee payroll, taxes, employee benefits, and anything else expressly stated in the legal documents. By co-employing the worksite employees, they gain a more complete ability to handle all administrative and HR tasks, allowing the client to focus fully on their core competency. The client assigns work to the employees, the PEO handles everything else.

There is obvious appeal for the client, but what is in it for the payroll – HCM firm? The chart below shows that ADP receives almost 8x the profit on a PEO payroll recipient compared to an ES payroll recipient. One PEO payroll recipient costs almost 24x as much as an ES payroll recipient, but that cost made up for by the increase in revenue. This is standard across the industry for a PEO. There is a much higher level of involvement, but, in the case of ADP, they make 29x more per client.



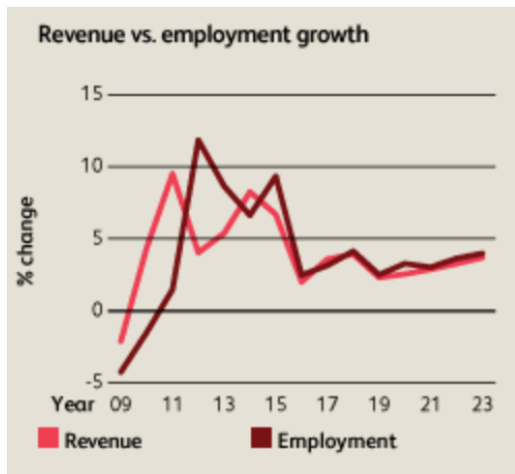
Source: ADP 10-K

The largest PEO is “ADP TotalSource®” which serves over 10,700 clients to co-employ more than 490,000 Americans [3]. The second largest PEOs is run by TriNet Group and serves 14,800 clients to co-employ roughly 325,000 Americans [4].

Sources of Revenue

Payroll firms generally charge clients a base fee in addition to a per-employee fee, but many service agreements are unique to individual clients based on a specific blend of services and potential price negotiations made by larger clients. While Intuit QuickBooks and some smaller players allow for easy point-and-click registration with transparent pricing online, most of the biggest companies require talking with a sales agent, obtaining a custom quote, and likely entering into a contract. Contracts vary in length, generally ranging from 1-7 years. With revenue tied so closely to the number of employees your client has, it makes sense that industry revenue is tied very closely with overall employment growth.

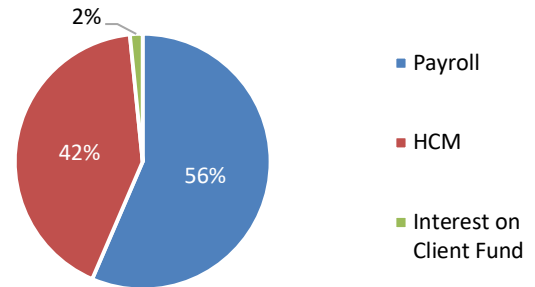
Payroll – HCM Industry



Source: IBISWorld

Payroll – HCM companies also earn revenue by collecting interest on Client Fund Accounts, which are populated with money withheld for taxes from paychecks. They invest this money in investment grade securities during the time between collecting it from the clients and paying it to the IRS.

Paychex 2017 Revenue Breakdown



Source: Paychex 10-K

Each company has unique business units including Payroll, HCM, Employer Services, PEO, Insurance Services, Tax software, Consulting, and Interest on Client Funds, that make it difficult to compare across firms. However, interest on Client Fund Accounts is consistently less than 3% of revenue.

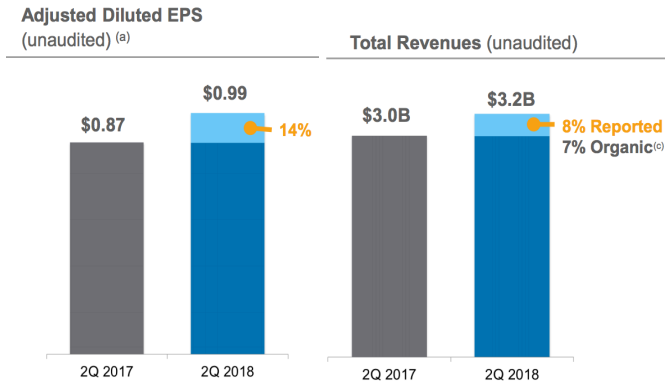
RECENT DEVELOPMENTS

Late 2017, the GOP and President Donald Trump passed a bill that made significant changes to the US tax code. Most notably were the changes to the corporate tax rate, dropping it from 35% to 21%, and the altering of individual tax brackets. Some changes to acceptable deductions and withholdings take effect immediately, while others will be rolled out over the next 7 years⁷. This tax reform will help the Payroll – HCM industry beyond simply a lower tax rate. The Payroll – HCM industry benefits from regulatory changes because potential new clients are enticed to outsource HR to a professional service that has taken the time to fully understand the requirements of the regulatory changes. In FY 2016 ADP helped clients comply with new healthcare requirements enacted by the Affordable Care Act by getting proper documentation from nearly 10 million client employees.

ADP acquired WorkMarket, previously valued at \$72M, for an undisclosed price in January 2018. WorkMarket is a startup that specializes creating a seamless software platform designed to managing an extended workforce of varying types of workers; full-time, part-time, contractors, free-lancers, etc. Varied employment types within a single company are a growing trend, as companies try to take advantage of low-cost employment options. This acquisition shows that ADP is serious about remaining agile, and in serving every customer they can.

ADP Q2 Earnings Release (2018)

ADP released their Q2 (Sept-Dec) on January 31, 2018 and their stock saw a one-day 3% spike before dipping back down. Their worldwide new business bookings were up an impressive 6%, EPS up 14%, and revenue up 8%, but their margins were down 25-75 basis points across their services [5]. This is reflective of an increasingly competitive marketplace.



Source: ADP 10-Q

Notably, their PEO segment was up 15% compared to the year before, but their margin declined 30 basis points. We expect that this will remaining a high margin and high growth segment for the coming years. Strong growth from the largest PEO shows the trend for small business to outsource the HCM to PEOs is not slowing.

The average yield on Funds Held for Clients was 1.8%, up 10 basis points. Management said they now expected the Funds Held for Clients to rise \$55-65 Million in FY2018, up from \$45-55. This hike reflects both average fund balance and rising rates.

Paychex Q2 Earnings (2018)

Paychex reported Q2 earnings on December 7. They reported a 7% increase in revenue, 7% increase in net income, and a 7% increase in EPS [6]. This strong growth is reflective of the historically low unemployment new business bookings.

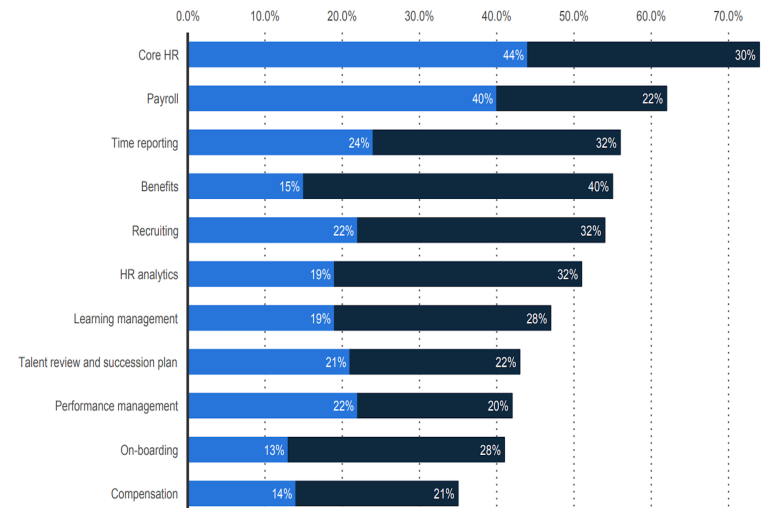
Intuit, Workday, TriNet Group, and Insperty have not reported their end of 2017 earnings as of the time of this report.

INDUSTRY TRENDS

Software as a Service (SaaS)

Unsurprisingly, the cloud and SaaS has revolutionized the payroll and HR outsourcing industry. In 1998 ADP launched a SaaS payroll product, before the cloud or SaaS were around. It was not until the mid-2000s, driven in part by the entry of Workday and Intuit, that SaaS payroll systems really took off. In 2009, ADP launched a mobile app for their payroll product RUN that is now used by 12 million people in 27 languages [3]. In 2015, SaaS was already a huge part of the Payroll – HCM industry and was growing quickly in every category.

Adoption of SaaS in HR, current and planned over 1-3 years, as of 2015



Source: Statista

To be competitive in this industry, one must have a strong software platform where companies can manage their own employee hours, payroll, benefits, track metrics, and have immediate access to friendly customer service 24 hours a day. Increasingly, it is also important to have a mobile application that is user friendly for both the client, and their employees.

Acquisitions

ADP

- Jan 2018 – WorkMarket (~\$72M): SaaS HCM for freelance employees
- Oct 2017 – Global Cash Card (\$460M): Digital payment including paycards

MARKETS AND COMPETITION

- Jan 2017 – The Marcus Buckingham Company (undisclosed price): Employee engagement/management consulting

Paychex

- Aug 2017 – HR Outsourcing Holding Inc (undisclosed price): PEO provider in the South East United States
- Sept 2017 – Experity (undisclosed price): Richmond, VA payroll provider

TriNet Group

- April 2016 – Teleboarder (undisclosed price): SaaS HCM for international employees

Intuit

- December 2017 – Tsheets (\$340M): Employee time tracking software
- October 2017 – Exactor (undisclosed price): Sales tax compliance and record keeping

Workday

- January 2018 – SkipFlag (undisclosed price): Uses artificial intelligence to organize an enterprise’s information
- July 2017 – Pattern (undisclosed price): Intelligent workspace for sales teams
- July 2016 – Platforna (undisclosed price): Helps businesses analyze big data to become more data-driven.

Source: *crunchbase.com*

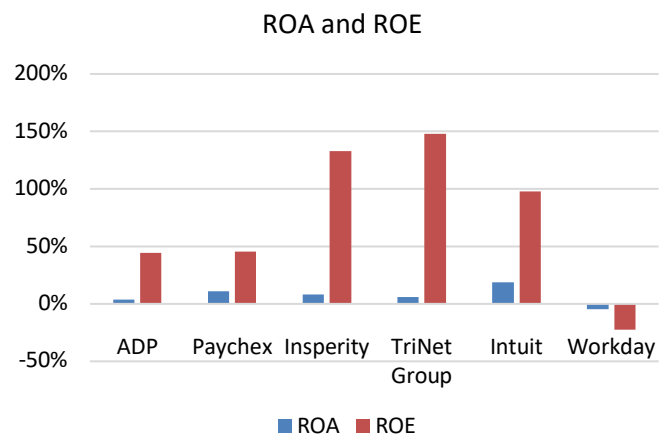
These are only the acquisitions since 2016, and they show that there is fierce competition in the payroll industry as companies fight to grow their market share as well as their portfolio of services to offer clients. Businesses in this industry are investing heavily in the future as they see opportunities for technological advantage and increased profitability.

Most acquisitions in this industry are of small startups, and there have been no mergers in the past 5 years. With so many companies not disclosing the price of acquisitions it is difficult to say how much growth in this industry is coming from acquisitions and how much is organic, but it is clear acquisitions are driving an insignificant amount of growth for ADP.

Top Competitors

Workday (WDAY)

Workday has an aggressive strategy for growth and high levels of debt, both of which make it difficult to compare to other companies in this industry. Workday is unprofitable and not yet cash flow positive. They focus on mid-sized to large companies and offer both corporate financial management and human resource software. Workday is building up a strong portfolio of high profile repeat customers, but their financials are cause for concern.



Source: *Yahoo Finance*

Historically, the only compelling HR options for a large company were to keep everything in-house or outsource to ADP. Workday is providing a compelling alternative, and companies like Johnson & Johnson, Visa, Toyota, and Sony have all brought Workday on as a partner. They focus primarily on the HCM side, and actually outsource their payroll service to other companies, including ADP [7]. Workday has an open API that makes it easy for large companies to use their own programmers to create a custom corporate finance & HR system, built on Workday’s platform.

Their poor financials make us worry that Workday will perform poorly in the event of an economic downturn.

Intuit (INTU)

Intuit has two flagship products, TurboTax and QuickBooks, with payroll being a feature of the

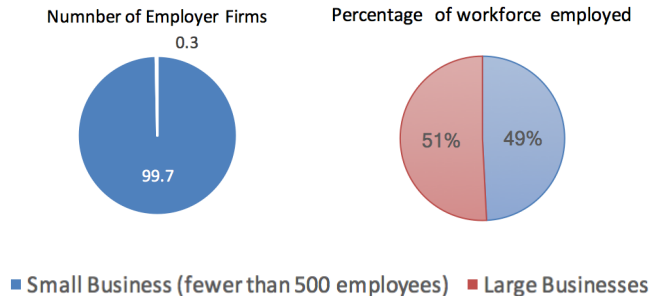
QuickBooks accounting software [8]. Intuit essentially backed into the payroll industry through QuickBooks and has earned a sizeable portion of the payroll industry because of it. While the other major players in this industry tend to lead with their payroll service, Intuit leads with their tax or accounting software. We believe that Intuit stands to gain the most out of the new tax law and is well positioned for the future.

Automated Data Processing (ADP)

ADP is the largest company in this industry and is the only company to serve clients of every size. They are in a strong financial position and earned \$1.7B in profit FY 2017, and are one of the elite companies to have ever had a AAA bond rating from S&P.

ADP's willingness to serve large companies has worked well. Roughly 1 out of every 6 workers in the United States is paid by ADP, however their largest client accounts for less than 2% of revenues. While 99.7% of employer firms are considered small business (less than 500 employees), the 0.3% of firm that are over 500 employees employ over half of the US workforce [9].

2017 United States Workforce

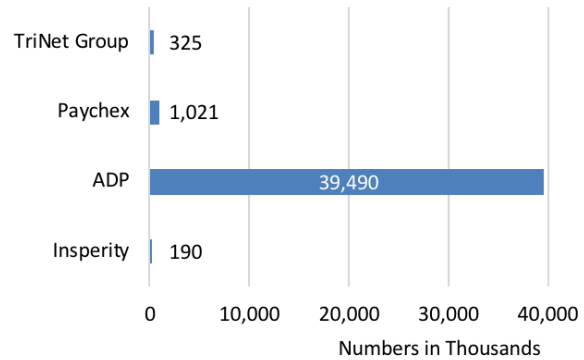


Source: SBA.gov

ADP benefits from its size. ADP DataCloud aggregates data from the 39 million people it processes payroll for to give clients industry insights and benchmarks. This is a unique value proposition that other payroll and HCM companies are not able to replicate across as many industries as ADP can.

ADP Research Institute compiles this same information to give quarterly updates about private sector job growth. While this division does not produce any revenue, it solidifies ADP as a trusted source of information, and increased brand awareness.

2017 Number of Worksite Employees



Source: Insperity 10-K, ADP 10-K, Paychex 10-K, TriNet Group 10-K

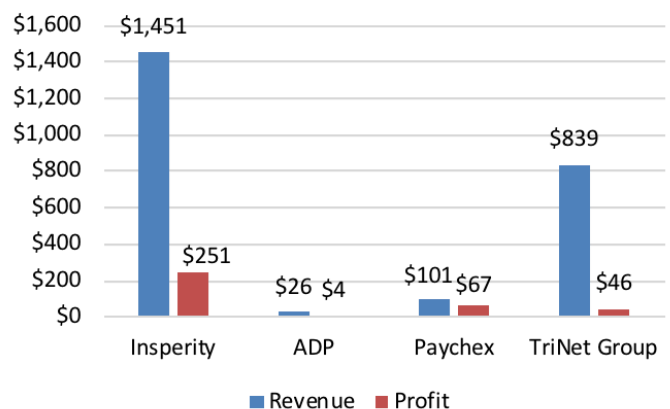
We believe that ADP has a strong and defensible strategic position in the market and is positioned to benefit well from rising interest rates and PEO industry growth.

Paychex (PAYX)

Focuses on small to mid-sized companies, carries no debt, and has issued dividends every quarter since 1988. Their decision to not carry debt allowed them to cut back operations and weather the Great Recession.

Paychex has a strong mix of both Employer Services and their PEO. Employer Services generates a much lower revenue and profit per worksite employee, which is why their numbers in the chart below are much lower than Insperity and TriNet Group, who primarily provide PEO services. ADP has a low revenue and profit per worksite employee because they have 39 million worksite employees total, and only 490,000 of them are in their PEO segment. This distribution of services drives their profit per worksite employee down.

Revenue & Profit per Worksite Employee per Month



Source: *Insperty 10-K, ADP 10-K, Paychex 10-K, TriNet Group 10-K*

TriNet Group (TNET)

Focuses on small to mid-sized companies and differentiates themselves by offering industry specific payroll and HR services. They are highly levered, with a debt-equity-ratio of 327 [10].

TriNet Group has a very strong ROE. This is because their focus primarily on their PEO service, which lends itself to a higher ROE because of the higher earnings per client employee. They have the second largest PEO in the world, co-employing 325,000 people.

Insperty

Insperty focuses on small to mid-sized companies and created the first PEO. They now offer a la carte services as well but remain focused on their PEO. This focus on their PEO has led to a very high, \$1,450 revenue per worksite employee. They are known for an easy to use interface.

By focusing on small to mid-sized companies, Intuit, Paychex, Insperty, and TriNet Group insure that they are not overly dependent on any one client.

Porter's Five Forces

Threat of Entry

Threat of new entrants is low, primarily because of the high start-up cost and high cost/ burdensome process of switching. To be a competitive player in this industry, you need to be able to offer an integrated software system to help companies manage multiple HR areas, and to offer those services at a competitive price you need to achieve a high level of economies of scale. In many regards, the payroll and HR business is pass/fail. Once a company finds an HR provider who meets all the requirements, it is difficult to entice them to switch providers. This is one reason for ADP's average customer staying with them for 10 years [3].

Threat of Substitutes

There is a high threat of substitutes. For many years, doing payroll in-house was expected across every industry, and there is still a threat of current buyers backwards integrating and managing payroll in-house. It is particularly appealing for some companies to bring, or keep, payroll in-house because they want to retain control over all their

financial information. This high threat of substitutes lowers the industry's profits. Roughly 1/3 of companies in the United States outsource their payroll or HR, meaning that 2/3 of companies are opting for the industry substitute of in-house accounting and Human Resources.

Rivalry

There is high rivalry in the payroll industry. In terms of market share, there are 6-10 significant players, and many smaller companies that compete in niche categories. It can be hard to differentiate between products offered by competing companies. High rivalry lowers the industry's profits.

Power of suppliers

There are very few suppliers to this industry, as most of the company's code proprietary software do not sell physical products. The power of suppliers is very low, making this a more attractive industry to operate in.

Power of Buyers

The power of buyers is moderate-low and depends largely on size. With multiple competitors and substitutes, every buyer has options, but most are relatively small and cannot use their size to get a favorable price. ADP and Workday have to deal with high buyer power more than other companies.

Five Forces Conclusion

Considering all Five Forces, this is a favorable industry for the incumbent firms. The high barrier to entry, lack of suppliers, and moderate-low buyer power means that the profits generated in this industry are largely staying with the firms. The best thing for industry profitability is for the substitute of companies keeping payroll and HR in-house to become less valuable in comparison. This could be from increased regulatory hurdles that make outsourcing more appealing, or from the Payroll – HCM industry becoming more valuable through better product offerings or lower prices.

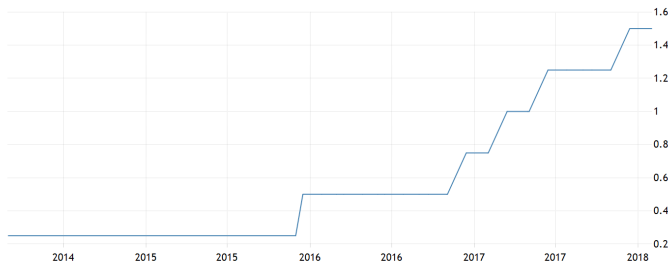
ECONOMIC OUTLOOK

Rising Interest Rates

Under Janet Yellen the Federal Reserve raised the federal funds interest rate 3 times to 1.5%, and it is expected that the Fed will continue to raise rates under Jay Powell [11].

This good news for the Payroll - HCM industry that earns revenue on short-term securities purchased with money collected to pay taxes, before they payout to the IRS. With higher interest rates, those investments could become a more significant part of their revenue.

US Fed Funds Rate

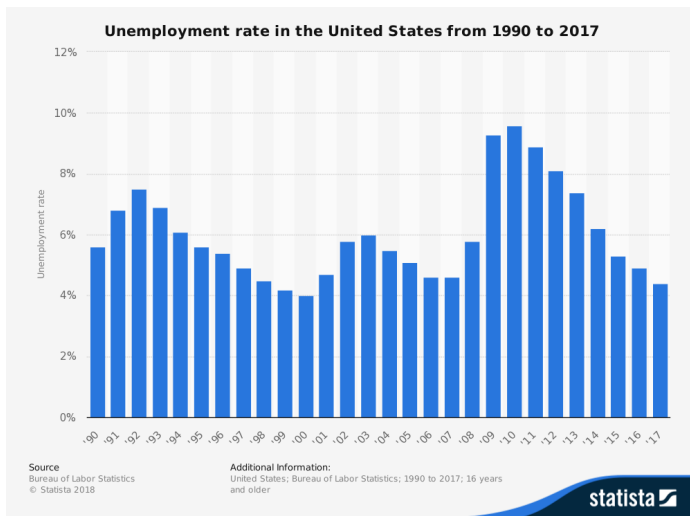


Source: tradingeconomics.com

Unemployment

The Payroll – HCM industry, more than most, benefits from high employment rates and job growth. As their client’s workforce grows, so does the revenue payroll companies collect from the per-employee fees charged to their clients. ADP attributed their 13% PEO growth primarily to the increase in average number of worksite employees, driven in part by growth of their existing clients.

For the past 7 years unemployment has been declining, and the Payroll – HCM industry has benefited from that¹. We believe that it is likely that unemployment will either stabilize or begin to rise.



Source: Statista

Political Impact on Payroll

This industry has a lot to lose if it doesn’t stay current on new regulations. They could be liable for their clients’ non-compliance, or they could generate new business from knowing how to properly handle new regulations and shouldering the responsibility and liability of complying with new requirements that other companies don’t want to shoulder. While the GOP and Trump administration have seen only scattered success in passing legislation, their public desire for repealing the ACA and deregulating other sectors makes the idea of outsourcing payroll and Human Resources less appealing.

The new tax bill, which lowered the corporate tax rate from 35% to 21%, sparked a number of large corporations to repatriate billions of dollars, including Apple who repatriated almost \$250B [12]. The sudden influx in cash, as well as the promise for increased cash from a lower tax bill, will likely cause increase capital expenditure and creating jobs. For these reasons, we expect that the Tax reform recently passed by the GOP and President Trump will bring new business to the Payroll – HCM industry.

CATALYSTS FOR GROWTH

- Job growth is key to this industry performing well. When current clients’ business grow, Payroll – HCM companies enjoy a free increase in revenue.
- Continual innovation and optimization of payroll and HR software systems. As these companies are able to offer better services, they will be able to better entice the 2/3 of companies that have kept the back-office work in-house.
- Increased regulation and compliance measures. The more hoops companies need to jump through the more likely they are to outsource their headaches to the professionals.

INVESTMENT POSITIVES

- The Payroll – HCM industry allows investors to monetize high employment rates and job growth.
- In a time of political division and uncertainty it can be helpful to be invested in an industry that benefits from changes in regulations, even if deregulation may hurt the industry long-term, any regulatory changes will drive short-term business.
- SaaS has allowed the industry to maintain the recurring revenue model while continuing to keep costs low through automation.

INVESTMENT NEGATIVES

- The Payroll – HCM industry is highly impacted by regulatory change, which incurs costs and creates a liability.
- This industry tracks closely with the market as a whole. While the economy and markets have been doing very well if a correction occurs this industry will not escape it.
- Companies keeping, or moving, payroll and HR services in-house remains the biggest deterrent for growth. That could become a more appealing option, especially companies seek to protect sensitive information for cyber security threats.

KEYS TO MONITOR

- The biggest driver for the Payroll – HCM industry is job growth. If the economy continues to thrive and jobs continue to be created, then payroll and HR headaches will continue growing for companies.
- Regulatory change, specifically to healthcare. If there are changes to healthcare requirements for companies, we expect to see an increase in new business for this industry. However, if healthcare requirement on companies are repealed, this could hurt the industry long-term.
- Technological innovation can shake up any industry. Significant advances in the technology of Artificial Intelligence or Blockchain could pose a threat to this industry long-term if they are on the wrong side of the technological advancement.

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17. Workday 10-K

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