This article is excerpted from a call featuring Arif Karim, senior investment analyst at Ensemble Capital Management, based in Burlingame, California. Visit Ensemble's Intrinsic Investing website for additional insights.

We recently hosted our quarterly client conference call. Below is an excerpt from the call discussing our investment in Paychex, Inc (PAYX).

Excerpt (Arif Karim speaking):

We've long held Paychex, a business that we believe is a fantastic one because of the stickiness of its service, its strong cash generation, and its relative stability through economic cycles.

We last talked about Paychex on our client call exactly three years ago, so here we'll provide an overview and update since our last comments. One of the biggest ways that Paychex has changed is that it has become the second-largest PEO (Professional Employer Organization) administration services firm in the US, just behind market leader ADP. We'll talk about what that means later.

Of course, we love the parts of the business that haven't changed since we last talked about it, which is that Paychex provides mission critical payroll and employee management services to its target small and mid-size businesses customers, commonly referred to as SMBs, in addition to the more comprehensive PEO service.

While properly managing employee payroll, benefits, and regulations are critical for all firms to operate, these are not the core skills or critical value-creating activities of most SMBs. Hence outsourcing those functions to a reliable payroll and HR services partner like Paychex makes a lot of sense so these SMBs can then focus their limited resources on their core value creation and competitive differentiation to grow their own businesses.

In addition, given the amount of personal confidential information that SMB employers will share about their employees and the need to deliver payroll and provide benefits without a glitch at every pay period means the vendor switching costs are very high. These customers are highly likely to stick with Paychex so long as their needs are met reliably, comprehensively, and at sufficient service quality levels. This is at the heart of what we think of as Paychex's moat.

Finally, the payroll and HR services business lends itself to very high returns on invested capital and high cash margins because of its low capital intensity, making it what we call a "cash machine". In other words, Paychex does not have to reinvest a substantial proportion of its earnings into growing the business at its targeted mid to high single digit growth rates, which frees up earned cash to either distribute to shareholders or add capabilities opportunistically via M&A.

So, Paychex has this great sticky payroll business, the founding service offering, which it grew to great success in its first couple of decades. Over the last decade it grew its HR management services, which wrapped employee management software and services around its core payroll offering. The revenue from HR services accounted for 80% of all revenue growth over the past decade and doubled its share of revenue to 50% of total revenue.

The PEO administration services are even more integrated with customers' employee management and benefits programs, with their employees actually considered co-employees of the PEO service provider. This allows Paychex to aggregate the employees of all its SMB customers into a larger pool and then provide benefits to them at a much reduced cost, particularly health insurance and workers' comp costs, which benefit from the much larger risk sharing pool.

It's the type of benefit that would cost considerably more to provide employees at the 5-10-20 employee level than at the 10,000 or 100,000 employee level. With Paychex PEO surpassing 400,000 covered employees, it creates substantial value for its clients and their employees on benefits costs, a portion of which is then shared with Paychex PEO. This savings can literally mean the difference between an SMB being able to affordably provide healthcare benefits to its employees or not, impacting its ability to hire and retain employees in today's tight labor market as well as the wellbeing of those employees and their families.

We saw this benefit firsthand at Ensemble when we moved to a PEO service a couple of years ago. As a firm with 15 employees, getting the best rates on health insurance premiums and other benefits wasn't possible. But by switching to a PEO, we saw significant cost savings to both Ensemble Capital as well as to the out of pocket costs of our employees that far exceeded the cost of joining the PEO.

The revenue opportunity from PEO services is multiples of the core payroll services revenue and presents a pathway to a larger market and faster growth opportunity since adoption is still low nationally at just over 10% but growing quickly. We believe it will also make switching costs even higher for customers, thereby improving retention.

Paychex's PEO administration service more than doubled in size with the strategic acquisition of Oasis in 2018, its largest deal ever valued at $1.2 billion. The combination makes Paychex the second largest PEO business after ADP's and now represents over 20% of total revenue.

Since the PEO business' economics are tied to scale in risk sharing and resource pooling, Oasis structurally transforms Paychex's opportunity by improving its competitiveness while also expanding its geographic reach across the US. Only about 3.7 million of the 30 million SMB employees nationally are covered by a PEO arrangement leaving a huge opportunity going forward, especially now that consolidation in the industry means only five companies control half that market.

Having said that there have been some initial slip ups as Paychex works to integrate Oasis, which has meant that its revenue growth targets (but not profitability targets) have slipped a bit recently. However, given management's long-term operational acumen and experience at running its own sizable PEO business, we believe management will get past the integration hiccups and start to show strong results in the form of higher growth and better margins in the combined PEO business.

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