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ADP - Q2 2017 Automatic Data Processing Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 revenue of $3b and reported net earnings of $511m and adjusted diluted EPS of $0.87. Expects FY17 total revenue growth to be about 6%.

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CORPORATE PARTICIPANTS

Christian Greyenbuhl *Automatic Data Processing Inc - VP of IR*

Carlos Rodriguez *Automatic Data Processing Inc - President & CEO*

Jan Siegmund *Automatic Data Processing Inc - CFO*

CONFERENCE CALL PARTICIPANTS

Jim Schneider *Goldman Sachs - Analyst*

Tim McHugh *William Blair & Company - Analyst*

James Berkeley *Barclays Capital - Analyst*

Gary Bisbee *RBC Capital Markets - Analyst*

Lisa Ellis *Sanford C. Bernstein & Co. - Analyst*

Tien-tsin Huang *JPMorgan - Analyst*

David Grossman *Stifel Nicolaus - Analyst*

David Ridley-Lane *BofA Merrill Lynch - Analyst*

Ashish Sabadra *Deutsche Bank - Analyst*

PRESENTATION

Operator

Good morning. My name is Nicole and I'll be your conference operator. At this time, I'd like to welcome everyone to ADP's second-quarter FY17 earnings call. I would like to inform you that this conference is being recorded.

(Operator Instructions)

I will now turn the conference over to Christian Greyenbuhl, Vice President, Investor Relations. Please go ahead.

Christian Greyenbuhl - *Automatic Data Processing Inc - VP of IR*

Thank you, Nicole. Good morning, everyone. This is Christian Greyenbuhl, ADP's Vice President, Investor Relations. I'm here today with Carlos Rodriguez, ADP's President and Chief Executive Officer; and Jan Siegmund, ADP's Chief Financial Officer. Thank you for joining us for our second-quarter fiscal 2017 earnings call and webcast.

Before we begin, you may have noticed in this morning's earnings release that we are now including a breakout of PEO segment, net revenue and pass-through revenue to assist you in updating your models ahead of your quarterly 10-Q filing. Please refer to Footnote B on the income statement for further details.

During our call today, we will reference certain non-GAAP financial measures which we believe to be useful to investors. A reconciliation of these non-GAAP financial measures to their comparable GAAP measures is included in our earnings release and in the supplemental slides on our Investor Relations website.

I'd like to remind everyone that today's call will contain forward-looking statements that refer to future events and as such, involve some risks. We encourage you to review our filings with the SEC for additional information on risk factors that could cause our actual results to differ materially from our current expectations.

And now, let me turn the call over to Carlos.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

Thank you, Christian, and thank you all for joining our call this morning. We appreciate your interest in ADP. This morning, we reported our second-quarter FY17results, with revenue up 6% to $3 billion, or 7% on a constant dollar basis. This quarter, we saw continued benefits of strong prior period of new business bookings and a strengthening in our retention metric, which helped to drive organic revenue growth across all market segments.

Our earnings growth exceeded our expectations this quarter with adjusted diluted earnings per share growing 20% to $0.87 per share. Jan will take you through the key contributing factors of our strong earnings performance in more detail shortly.

During the quarter, we experienced a decline of 5% in new business bookings compared to a strong second quarter in FY16. These results reflect a continued difficult grow over related to the tailwinds from our FY16 sales of additional modules related to the Affordable Care Act, which was expected.

Additionally, within the midmarket and upmarket in particular, we also experienced the effects of political uncertainty leading up to and following on from the November US elections, which slowed decision-making among some clients and prospects during the quarter. Our value proposition remains strong and we have a successful track record of managing change for our clients.

As you have seen with ADP many times in the past, change can provide us with significant opportunities to grow and expand our solutions that help deepen our client relationships. We expect that the environment in 2017 and beyond will be no exception and that this current uncertainty and related hesitancy will be a short-term phenomenon.

Accordingly, we continue to expect new business bookings growth in the second half of FY17, but in light of the second quarter decline, we have now revised our outlook and now expect to be about flat for FY17 as compared to the $1.75 billion sold in FY16.

The client experience means a priority for us. Whether it's through investments in our service model and innovation in the user experience or in our efforts to upgrade clients to the most appropriate strategic base platforms, we believe that we have the right strategy to address these continuously evolving needs and opportunities and we remain pleased with the progress we are making.

We continue to see the benefit of higher retention rates for clients on our strategic platforms and from our continued investments in service. Accordingly, this quarter, retention increased, in line with our expectations, by about 10 basis points as we saw the benefits of these ongoing efforts help drive further improvements in our client service metrics.

But at the same time, we remain cautious as we enter the time of the year when clients in our industry are most likely to change providers. In January, we completed the acquisition of The Marcus Buckingham Company, or TMBC, to expand our core talent portfolio. This relatively small but strategic acquisition brings together ADP's robust data set with TMBC's innovative talent solutions to help clients build a better and more engaged workforce.

TMBC and its founder, Marcus Buckingham, are cutting-edge innovators in using data and research to drive talent management practices. Their cloud-based performance and talent management solution, now known as ADP StandOut, couples applications with coaching and education to give leaders the tools, insights and data needed to improve employee and team performance.

Feedback on this acquisition from many of our mutual Fortune 100 customers has been extremely positive. We look forward to delivering new data-driven solutions to the market that bring together the unique capabilities of ADP and TMBC.

As we think about the future growth of ADP, we anticipate that investments, such as these, coupled with our ongoing organic investments in innovation, service and sales will enable us to continue to stay at the forefront of the HCM industry. Other examples of our innovative successes can be seen in the traction of our ADP DataCloud and our ADP Mobile Solutions app.

As you know, we introduced our ADP DataCloud to allow business leaders and HR professionals to generate actionable insights from the workforce data embedded in their ADP HCM solutions. Today, several thousand clients are using our DataCloud Analytics platform and we continue to advance the solution with new capabilities.

During the quarter, we added depth to the geographic benchmark data and added time and labor benchmarks, such as market-based absence and over time. These new benchmarks are unique within HCM and leverage our close to 30 million anonymized US employee records to assist HR professionals in developing and fine-tuning their strategies.

With respect to the ADP Mobile Solutions app, we recently announced a number of users has surpassed the 10 million mark. Our Mobile Solutions app is the most downloaded app in HCM market, with users spanning 200 countries.

We've continued to add new features and functionality to embrace the modern users' needs. From workers accessing stock profiles, editing team schedules or approving time-off requests to users changing their 401(k) contribution or viewing their account performance.

Organizations know that employees expect technology to be easy to use and accessible from anywhere, while simultaneously being powerful and secure. Our Mobile Solutions app is the first app of its kind and continues to be consistently among the top three business apps in Apple's App Store. For the last couple of quarters, we've been sharing our plans regarding our Service Alignment Initiative and I'm excited to highlight for you that we've been making great progress.

During the last quarter, I took part in the opening of our new service implementation facility in Norfolk, Virginia. We welcomed more than 400 associates to a new signature building and anticipate our presence in Norfolk will ultimately reach 1,800 associates. We are similarly on track in hiring in Orlando, where we expect to eventually have about 1,600 associates.

Also during the quarter, we announced our third new strategic service center in Tempe, Arizona. We anticipate opening that facility in the Spring of 2017 with a capacity of 1,500 associates in that location. These new centers are a critical component of our overall service strategy, and will enable us to significantly enhance ADP's service capabilities across the HCM spectrum.

Lastly, before I turn the call over to Jan I would like to add how gratified we are for the recognition we continue to receive from the HCM industry and the customers we serve. During the quarter, ADP received the Everest Group's highest recognition for our GlobalView HCM solution. The report recognized us for the scalability of our solution while noting ADP's Reporting Analytics and Mobile app are key differentiators for us.

In addition, ADP Data Cloud earned a Cloud Computing Innovation Award from Ventana Research, recognizing our ability to deliver positive business impact. In bestowing the award, Ventana noted ADP's ability to provide organizations with data that can reveal the workforce trends and provide the deep insights needed to make better business decisions.

In closing, despite the recent uncertainty in the US business environment, we continue to believe that change will be beneficial to us, as we are well-positioned to help our clients navigate the complexities of HCM. I remain confident in ADP's future and in the success of our strategic initiatives. In fact, I believe that we are in a firm position for sustained growth and success as we continue to make the technology and service investments to further increase the strategic value of the HR function.

With that, I'll turn the call over to Jan for further review of our second quarter results and an update to our FY17 outlook.

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Thank you very much, Carlos, and good morning, everyone. Before I begin, during the quarter, we completed the sale of our CHSA and COBRA businesses and realized a pre-tax gain of $205 million. The historical results of these businesses are reported in the Employer Services segment, and are not reported as discontinued operations.

Furthermore, we recorded a $1 million restructuring charge related to our Service Alignment Initiative. Certain non-GAAP measures in my commentary to follow exclude the impact of these two items, as well as certain other one-time items recognized in the prior fiscal year. A reconciliation of these non-GAAP measures can be found in this morning's press release and in the supplemental slides on our Investor Relations website.

As Carlos mentioned, ADP revenues grew 6% in the quarter to $3 billion, or 7% on a constant dollar basis. Net earnings grew 50% to $511 million on a reported basis, or 49% on a constant dollar basis. Adjusted earnings before interest and taxes, or adjusted EBIT, grew 17%, or 16% on a constant dollar basis. Adjusted EBIT margin increased about 180 basis points compared to the 18% in last year's second quarter. This increase was driven by operational efficiencies and slower growth in our selling expenses.

Adjusted diluted earnings per share grew 20% to $0.87, or 19% on a constant dollar basis, and benefited from fewer shares outstanding compared with a year ago. New business bookings this quarter were down 5%, partially due to the difficult selling compare in the second quarter of FY16, but also from an elevated level of buyer uncertainty around the November US elections leading to a slowing of buying decisions in our mid and upmarkets.

As Carlos mentioned, our retention was up by 10 basis points in this quarter and we are pleased with the progress that we have been making with our midmarket initiatives and the continued strength of our retention and our strategic platforms. I would like to caution you that retention on a quarterly basis remains a volatile metric. Our full-year guidance takes into account known losses and anticipated losses.

Overall, we are pleased with our results in this quarter, stemming from solid underlying revenue growth with better-than-expected margin growth and an improvement in our client retention. Although we are disappointed with our overall new business bookings performance this quarter, we continue to believe in the underlying strength of our distribution model, as well as our pipeline of market opportunities.

In our Employer Services segment, revenues grew 4% on a reported and constant dollar basis for the quarter. Our same-store pays for control metric in the US grew 2.3% in the second quarter. Average client funds balances grew 2% on a reported and constant dollar basis compared to a year ago. This year -- this growth was driven by net new business and increased wage levels compared to prior year's second quarter.

Outside the US, we continue to see solid revenue growth and margin growth, largely driven by the success of our multinational solutions, which continue to perform well. Employer services margin increased about 150 basis points in the quarter. This increase was driven by operational efficiencies and slower growth in our selling expenses, following on from the difficult selling compare in the second quarter of FY16.

PEO revenues grew by 12% in the quarter, with an average worksite employees growing 12% to 452,000. The PEO continued to experience slowing growth in benefit pass-through costs resulting from lower healthcare renewal premiums, which outweighed growth from higher benefit plan participation from our worksite employees during the quarter.

PEO margins continued to expand through operational efficiencies and slower growth in selling expenses, both of which helped drive approximately 120 basis points of margin expansion in the quarter. We anticipate we will return to a growth trajectory in new business bookings in the second half of FY17.

However, as a result of the second quarter decline, we are now forecasting FY17 new business bookings to be about flat compared with our prior forecast of 4% to 6% growth. As a result of this change to our expectations, we have updated certain elements of our FY17 forecast.

As a result of our revised new bookings guidance and slower growth in our PEO-related pass-through revenues, we now anticipate total revenue growth of about 6% compared with our prior forecast of 7% to 8%. This revised outlook includes almost 1 percentage point of expected combined pressure from the sale of our CHSA and COBRA businesses, which occurred towards the end of the second quarter and the impact from foreign currency due to the strengthening of the US dollar. We have adjusted our revenue forecast for the Employer Services revenue growth to 3% to 4% compared with our prior forecast of 4% to 5%, which included almost 1 percentage point of expected pressure from the sale of our CHSA and COBRA businesses.

Separately, as a result of the slower growth in our PEO pass-through related revenue, we now anticipate PEO revenue growth of 13% compared with our prior forecast of 14% to 16%. We continue to expect our consolidated adjusted EBIT margin expansion to be about 50 basis points, which includes about 20 basis points of pressure from dual operations pertaining to our Service Alignment Initiative which was not part of our non-GAAP charges.

On a segment level, as a result of our lower revenue growth forecast, we now anticipate margin expansion in Employer Services of 25 to 50 basis points compared to our prior forecast of about 50 basis points. For the PEO, we expect continued operating efficiencies and slower growth in our pass-through revenues as compared to FY16 to help drive margin expansion on a full-year basis.

Accordingly, we now expect FY17 PEO margin expansion to be at least 100 basis points compared to our previous forecast of about 75 basis points. We are also now expecting growth in client funds interest revenue to increase about $15 million compared to our prior forecasted increase of $5 million to $10 million. The total impact on the client funds extended investment strategy is now expected to be up about $10 million compared to the prior forecast of $5 million.

The details of this forecast can be found in the supplemental slides on our Investor Relations website. We continue to expect growth in the adjusted diluted earnings per share of 11% to 13% compared with the $3.26 in FY16, aided by about 1 percentage points from tax benefits related to the stock-based compensation accounting change, which is offset by about 1 percentage point of earnings impact from the disposition of our CHSA and COBRA businesses.

Our forecast now contemplates in return of excess cash to shareholders via share repurchases of $1.2 billion to $1.4 billion, subject to market conditions during FY17 compared to our prior forecast of $1 billion to $1.4 billion. This forecast includes any repurchases required to offset dilution related to employee benefit plans.

We believe that the adjustments we have made to our FY17 forecast reflect the impact of our planned investments, particularly through the year-end process as we work to grow over our strong FY16 new business bookings performance and execute against our strategic initiative.

With that, I will turn it over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Jim Schneider of Goldman Sachs.

Jim Schneider - *Goldman Sachs - Analyst*

Maybe to start with you, Carlos, in terms of the bookings pressure that you saw post-election, I think you highlighted that, that pressure mainly came in the mid-market and upmarket segments. Can you maybe talk about your level of confidence that you're going to see a recovery -- what you saw in January? And then also, was that a departure from what you saw in the downmarket and small business?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

It's a great question. We -- obviously, there's two factors that are affecting the growth in our new business bookings. One was the known factor, which is a difficult grow over and obviously, we had some sense of that and factored it in, in terms of our guidance for the year because we were obviously below our long-term 8% to 10% as a result of what we knew was going to be a more limited base to sell into since we had already sold half of our clients on ACA.

So that was a known factor but the reality is we didn't know exactly how much difficulty we would have in selling additional modules of ACA over what we sold last year. So, that is a factor that obviously has become more difficult to measure given the talk of the Administration of repeal and replace of ACA.

So, I guess in a nutshell, whatever we assumed about the difficult grow over, I think it became a much more difficult grow over as we think many companies in the mid-market and upmarket are probably -- have a wait-and-see attitude in terms of what's going to happen around the Affordable Care Act. I think that there's also this second factor which, obviously, we have no scientific way of measuring which feels like people are, in general, just delaying and waiting to see what happens, not just with ACA, but with a variety of other things that the Administration is talking about.

Having said all that there are also a lot of positive things and we see that reflected in some of the public markets, or the equity markets, in terms of anticipation of lower tax rates and fiscal stimulus and so forth. And in particular, one of the things that I noted -- I've seen a chart that shows, I believe it's the NFIB Confidence Index but Small Business Confidence Index is -- are off the charts positive. And in a strange way, it's a little bit reflective of what we are experiencing, which is continued success which we don't give guidance by segment but we have very good and strong new business bookings results in our downmarket and not so much in our mid and upmarket.

And of course, the PEO, we generally consider to be a downmarket business but that business does have, obviously, a relationship to ACA and what's going on around regulation and a variety of regulations that had been talked about previously that now may be subject to change on a go-forward basis. So, there's a lot of moving parts and hopefully that provides you a little bit of color but we don't have really great, precise, scientific tools to be able to ascertain how much of the weakness is coming from each factor.

Jim Schneider - *Goldman Sachs - Analyst*

That's helpful. Then, maybe just on a looking forward basis, you talked about some of the small business confidence indicators, NFIB, et cetera. Can you maybe talk about the broad effect of other potential Administration policies and Congressional action that might either be a tailwind or a headwind over the next few quarters?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

Sure. The most obvious one is this -- the discussion around the Affordable Care Act. So we -- as I mentioned in my prepared comments, ADP generally does well when there's change, but not when there's uncertainty about change. So, I think a protracted debate about what replacement means or what will be happening is probably not helpful to us in terms of our new business bookings results.

There are a number of other items out there around, for example, overtime rules, EEOC reporting around pay equity, and even the DOL rules around the fiduciary shared responsibility that affects our Retirement Services business. So there's a number of things that are in play by the Administration.

Generally speaking, over 67 years, we have benefited from, whether it's one particular party or another particular party or one philosophy versus another philosophy because generally, there is change. There is constant change and employers use services like ours to help them manage through that change.

So, we, on a medium- to long-term basis, are, I think, optimistic that whatever form comes of healthcare reform, whether it's more state-based or just a different way of providing -- because I think the Administration appears to be committed to maintaining the number of people that have insurance. So that will require some form of tracking and some form of enforcement or tax credits. And it may be more state-based, but that's something that we hope to be able to help our clients navigate through when the Administration and Congress, I think, get further along in terms of figuring out what they -- what exactly what they want to do.

There's a number of other regulations that are probably less public and less significant on an individual new business bookings basis but they all add up to quite a lot a bit of potential change, which I think would be very good for ADP.

Jan Siegmund - *Automatic Data Processing Inc - CFO*

And Jim, if I add, on the revenue risk that we might have for this year, I would consider that as minimal so our clients that are subscribing to our ACA Solutions, obviously, are preparing for their filings in this fiscal year and anecdotal evidence sees that our clients really look forward to ADP to help them through that change. So, the actual revenue risk for this fiscal year, I would describe as minimal.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

(multiple speakers) You can see from our retention, we haven't had -- I think Jan makes a great point, which is what is fascinating is obviously the challenge for us right now is in new business bookings but we haven't had cancellations or in fact, we have clients that are still being implemented on ACA but it's natural that once you've made a decision and you're committed and you are on a path. And it is the law, by the way, it's still is the law, it makes sense to go forward. But, I can see how some people, if they are doing it in-house or doing it themselves, might be hesitant to make a decision given the uncertainty around what's actually going to happen regarding the law.

Operator

Tim McHugh of William Blair.

Tim McHugh - *William Blair & Company - Analyst*

Just following up on the comments about the PEO business, I wasn't clear. Because I know you said downmarket, you did well and I consider that downmarket, but it also seems like you were saying that was another area where bookings growth was a little slower. Could you clarify and I guess, elaborate on that?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

I didn't say the new business bookings growth was weak. We don't give segment reporting or details of our bookings. I was just trying to give you a general flavor because, as you saw, we also had some weakness on the revenue growth. So that wasn't necessarily related to ACA, but just in general, I was trying to convey that there is some logical, I guess, explanation to something what's happening in a sense that there appears to be a lot of optimism on the part of small businesses and we are seeing that reflected in parts of our business.

In other parts of the business, the results are mixed because we do, I think, see as a result of the fact that 50% of the PEO's business comes from referrals of our existing payroll sales force to the extent that, that sales force is encountering some slower decision-making, particularly in the mid-market, and also encountering some slow decision-making as a result of uncertainty about ACA, that is expected to have and is having some impact on the PEO. But to be clear, the weakness in the revenue growth of the PEO was almost exclusively the pass-through revenues, and lower inflation in health benefits and a slight slowing in benefits participation, which is probably also related to a, quote-unquote, peaking of ACA implementations. By that, I mean that we have seen a several-year decline in benefits for participation rate. In other words, how many eligible employees of the PEO actually take benefits and that started the trend up again as we got closer to the ACA deadlines.

So over the last, call it, two years, right before ACA, given the fact that the law was intended to increase participation, and companies were coming to the PEO in order to comply with the law, we saw those participation rates trend up and now we saw the increase in the second quarter be a smaller increase than in the prior second quarter and in the quarters before that. So, that slowing trend of benefits participation, coupled with lower inflation of benefits per worksite employee is what led to slower growth, if you will, in the PEO but the 12% worksite employee growth is still very, very strong. So we're still very happy with what we consider to be net revenue growth in the PEO which is now growing almost in line with worksite employees whereas historically, they had grown a little bit faster because of this pass-through cost pressure.

So I hope that helps a little bit. Jan?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

I just have one piece of information for you, Tim, is the average client size in the PEO is now around mid-40s. So, it stands really the small business phase as well as our mid-market up to couple hundred employees per client. So, it's affected by performance down and mid-market in its growth.

Tim McHugh - *William Blair & Company - Analyst*

Okay, thanks. And then just following up on the comment about the mid- to upper markets, I understand retention was a little better overall for you so you retained existing customers, but do you have enough data to know that the -- I guess it was slower decision-making or a lack of decision by clients versus competitive win losses on new opportunities that had an impact this quarter?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Yes, we monitor, obviously, our competitive position in the market space and I think we have seen performance competitively according to our expectations. One element that Carlos had not mentioned is, I think, our sales force has reported relatively strong pipelines overall throughout these months.

So, it was really not due to a lack of interest but it was really what we felt slowing of decision-making process as we forecasted certain results. So, those things together saw a competitive position as well as the good pipeline gave us basically the basis for the forecast that we just made.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

And it's really just for lack of headcount. So we're in a very strong position from a sales force capability standpoint. And I think if your question was really around did our retention -- I think you started off by asking about retention. Did retention benefit from slower decision? That's possible.

So, it is possible that on the other side of the coin, if you will, people didn't make as many decisions and we were able to hold on to more clients. We'd have -- very difficult for us to measure that, but it's possible.

Operator

James Berkeley of Barclays.

James Berkeley - *Barclays Capital - Analyst*

Just real quick here, you've seen about 200 basis points of margin expansion through the first two quarters of the year, obviously compares to a guidance or up 50 basis points implies a meaningful contraction in the second half. Could you just walk us through the drivers of that and the contributions to margins perhaps that are tied to ACA products in the quarter or anything else that you'd like to call out?

And then just keeping with that theme, you've talked about pass-through pressure being better than anticipated, helping to drive margin expansion there. So just thinking about margins overall with PEO growing much, much faster than Employer Services, which is not a meaningful lower margin, how do we think about the sustainability of 50 basis points a year over time? Like what's ultimately driving expansion against the PEO headwind?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

That is a fairly comprehensive margin question, I would say. Let me start. I think you were isolating some of the factors that create more margin pressure in the second half of our fiscal year. So, number one is our -- the easier compare that we had in the first half of the fiscal year due to our ACA-related investments is clear.

So, at the beginning of FY16, we had largely selling implementation expense for ACA and then we started to receive revenues for these products in the third and fourth quarter of last fiscal year. So, the upcoming quarters don't have that easier compare so the margin expansion that we experienced in the first two quarters is not going to repeat itself due to the growing into our more steady ACA revenue base.

Secondly, we expect, of course, sales to grow, as we indicated in our prepared remarks and so that means, of course, also selling expenses anticipated to grow; in this case, contribute to the margin pressure. And we are also continuing our investments into product and innovation, which is, in this case, at an equal basis contributing to the margin pressure.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

I think we also have -- I think our expectation is a little bit of a return of the growth of the PEO pass-through cost which I think that just mathematically also adds -- I think the last part of your question was a broad PEO margin pressure question about ADP. But in this first half/second half, it is a factor based on our current forecast, just the expectation for our pass-through costs for the second half alone causes some pressure in the second half.

And I think your broader question about overall pressure is a very, very good question which we spend a lot of time looking at and talking about. But this year, in particular, because of lower benefits and inflation costs we actually, as you can tell from the first half the year, it actually helped us. It took some of the pressure that we historically had off.

Even though the PEO is -- has an absolute lower margin, the fact that its margin has been improving as much is it has, combined with a slower growth of pass-through costs made this a moot point for the first two quarters of this year. And what you have from us is a commitment to really make sure that we have a lot of transparency around because we do a lot of what if scenarios around the next two to three years, what the PEO margin expectation is versus the ES margin expectation in the overall ADP.

And we feel comfortable, at least right now, that we are in a place where we are able to still achieve the guidance that we provided on a long-term basis. But, over time, that could change. If we have a lot of inflation in pass-through costs, we might have to revisit that topic just because of the pure mathematics. Not because of the quality of the business or the strength of the business, just because of the math that I think you're implying. But I think for now, I think we are in an okay position.

James Berkeley - *Barclays Capital - Analyst*

Thanks a lot. That's really helpful. I know I threw a lot at you there.

Just real quick, a much shorter question. Just what's driving the unchanged EPS guide? Although it was obviously nice to see. You raised it last quarter and you were able to keep it steady here declining top lines. So just tax rate and step-up in buybacks versus prior expectations, or maybe some conservatism on your end in the past or something else that I'm missing?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

No, I mean, I think that Jan may have something to add that I think we had a great quarter, earnings-wise, so that helps. Because we obviously -- we provide guidance based on what we really think is going to happen and as -- I think we were clear in our comments, the second quarter exceeded our expectations.

So, in fairness, we got a little bit of tailwind from the second quarter going into, quote-unquote, maintaining our guidance for the year on earnings. So I think we feel good about where we are in terms of our expenses even though Jan described very well, this issue that we've lapped our ADCA revenues and we had already left our ACA expenses for the last two quarters.

So those kind of factors are what helped boost the margins in the first two quarters in the fiscal year which we don't get in the second two quarters of the fiscal year. But in general, when we look at the quality and trajectory of the business, we feel pretty good other than this issue in new business bookings which, ironically, helps our margin in the first half of the fiscal year. Other than that factor, we feel pretty good about where we are.

Operator

Gary Bisbee of RBC.

Gary Bisbee - *RBC Capital Markets - Analyst*

Let me follow that up with one more question about margins. Just can you give us a sense, how much of the margin improvement this quarter was the operating efficiencies versus the lower sales commissions? I noticed you said them in that order.

So, is that done by design based on the impact? And then, what were the costs in the quarter in the first half, I guess, for the Service Alignment changes and is it still that the vast majority of that cost is not happened yet and happened in the back half?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Let me start about this Service Alignment Initiative. The Service Alignment Initiative causes us in the fiscal year to take a restructuring charge of approximately $100 million throughout, and we took the first $40-some million dollars in the first quarter, just very little in the second quarter.

In addition to those restructuring costs, we incurred about a 20 bips pressure, margin pressure through the dual operations which is not part of the non-GAAP measure. And that is incurring throughout the fiscal year, so it's not a great variation in this throughout.

The second question to you, about -- 0.5%, a little less than 0.5% is of the margin improvement in the first half is due to our lower NDE -- our lower selling expense, and -- selling and marketing expense in the first half and then about 120 basis points of operating efficiencies to scale.

Gary Bisbee - *RBC Capital Markets - Analyst*

Great. And then just a quick follow-up. On the bookings, is there any way to have any confidence that this is really short-term driven related to uncertainty around the election, rather than the changes that come out of the new Administration dampening demand for the products?

So the overtime rules -- ACA, you've already been clear on it. I think we understand that, but do you get that kind of color from clients? Or is it more -- do you think just -- no one wanted to step up because there was and probably still is so much uncertainty?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Well, we have [noodled] at this question in a number of ways. I tried to add a few elements to it. If the changes in economic policy lead to sustained economic growth, that is the most important driver for our success in new business bookings. So, if the belief that is currently reflected in bullish equity markets and other things, business confidence comes through, I think that will be naturally a good thing because we are positively correlated to good economic environment and good employment health ADP. So, the fundamental -- that's the most important driver for our new business bookings is a healthy economic environment.

Now, economic changes in the regulatory environment contribute maybe to economic growth and they are also -- contribute to change in regulatory requirements in the HR space, which help ADP. I would guess that change will happen over time and the number of changes that are coming down to our clients is high.

So, I don't think there's a principal change in need for compliance solutions in the HR space to be foreseen in any near-term future. So net-net, I think if the economic positive outcome materializes, I think that will be good news for ADP overall and we remain confident in our ability to sell.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

I think, just to add to that, I think we have some historical data to support, I think, Jan's points like the -- obviously, we don't have historical data to really be able to ascertain what's happening, what month and with what regulation. But the first point about the economy is indisputable that when ADP is a -- obviously, from a recurring revenue model standpoint on our revenues and our profitability and so forth, we are a relatively defensive, steady Company but new business bookings is a little bit different.

And when you look at 20 years of data, our new business bookings growth over the course of rolling four quarters, because obviously, any one quarter can have issues like we just experienced. We can have a new regulation that requires some, new product. We had, for example, Y2K 20 years ago.

But in general, follows very, very closely, almost a smooth line what's happening with the economy, as does our pays per control growth. So our pays per control growth, when unemployment is going up, tends to go down, and vice versa. We are in new business bookings, I think, somewhat tied to the strength of the economy. So as Jan said, we are -- obviously, we try to be as transparent as possible.

We were sitting here talking about potentially entering a recession, we would have to, I think, temper our optimism based on that 20 years of history. But, since that doesn't appear to be the environment that we're entering, at least for now, we feel that we're going to rely on the historical data and I think plan on returning to historical growth rates in our new business and new business bookings.

In terms of this issue of specific regulations and change and so forth, there's also a lot of history in ADP. There's more than 20 years of history where, even though there are bumps along the road in terms of the amount of regulation and the type of regulation, in general, the trajectory has been in one direction.

And that's a global statement, not just a US statement, because governments try to affect public policy through employment and through employers whether it's around safety or taxes or a variety of healthcare, in this case. So, we like where we are. We like the space we operate in. And we are optimistic about, I think, the future although, obviously, we're not exactly happy about what is happening in the short term here.

Operator

Lisa Ellis of Bernstein.

Lisa Ellis - *Sanford C. Bernstein & Co. - Analyst*

Can you talk about the timeline and monetization model for the rollout of your reporting and benchmarking modules? Exactly where they are in terms of rolling out and just directionally, what the magnitude is that you expect coming in from those modules in terms of new business bookings and revenues over time?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Yes, our big data and analytics capabilities, we view as one of our strategic differentiators in our product set and we are planning, actually, to capture the benefit of this capability that is quite unique in a variety of methods. The most fundamental is that we are going to be incorporating many of those analytics benchmarking and predictive analytics into our core product and differentiate the core bundle with a better solution.

So, for example, data and data cloud is an integral part of our Vantage offering and is available to all Vantage clients and is a part of what makes Vantage a differentiated product. In the mid-market, we are selling it as an incremental module for now and clients buy it on a recurring revenue basis. We have a few thousand clients having bought the product in the last 12 months or so.

So, we are kind of in the very early stages of rolling out these capabilities to it. I encourage everybody to think about the data analytics capability as a broad, broad differentiator that will not only affect our core product for our clients. It will improve our service and implementation capabilities and will be -- we are kind of right now in the very beginning stages of seeing those benefits coming through.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

I think -- I'll just add that I think we are working on these types of products and others in order to drive not just incremental revenue from the products themselves but to gain market share and win more new business because the reality is that when we wake up every morning, we are thinking about how you grow over $1.75 billion in new business bookings.

And to give you a specific answer, like, in the next year or two, we don't plan on sharing on this call that we had the same impact as ACA. Because again, the numbers are just so large that unless we simultaneously generate incremental revenues from new products while driving using those new products to drive better differentiation and more net new wins in the marketplace to gain market share, then we're not going to be able to grow the business.

So it's -- I think Jan described it well, which is a very broad strategy around differentiation and strengthening our products as well as we don't mind earning a little bit of extra revenue and income from selling those types of products.

Lisa Ellis - *Sanford C. Bernstein & Co. - Analyst*

Terrific. Thanks. Just quickly for my follow-up, can you give the 22nd update on the Workforce Now migrations of whether you are still on track to finish them by the end of the year?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

We are still on track. We feel pretty good. I think Jan may have the --

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Jan Siegmund - *Automatic Data Processing Inc - CFO*

We have steered away from the digital numbers here but we are committed to substantially complete the migrations in our mid-market space by the end of the fiscal year. I think we're going to have a few stragglers into the first quarter, but substantially, we are on plan with those migrations.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

And very excited about it.

Operator

Tien-tsin Huang, JPMorgan.

Tien-tsin Huang - *JPMorgan - Analyst*

Just I guess on the bookings front, have you changed your assumption on bookings specific to selling additional ACA modules? I think in the past, you said that you sold about half of your ACA base already there. Does that -- does this shift to flat bookings cover that?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Yes, it does. So one big chunk, of course, is the adjustment to our selling expenses -- expectations that we had for that product. As you might imagine, that is significantly down. Our new guidance, I think, incorporates the same thing.

Tien-tsin Huang - *JPMorgan - Analyst*

Thanks Jan. And then just on the acquisition of the Marcus Research Buckingham, is it more of a people based? I get the technology side of it. It seems like they did some consulting and perhaps some people-based services as well at this Marcus Buckingham Company. I'm just curious if you can give a little bit more on the addition there. Thank you.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

That's why we like it so much because there's a service component in addition to the technology component which actually fits well with our business model. So you're right. There is a -- that's a -- they have deep, deep data analytics and insights in their own business and so there's a lot of research-based, data-driven, I guess, decision-making in how they deliver their products.

I think the belief by them and by us is that we have obviously a very big data set to be able to enhance the work that they do to really help people create a better workforce. And so I think the combination of the coaching, the data, and the analytics, along with combining that with ADP, I think we think that we could really do something special here.

So again, caution that given the $12 billion of revenue, if it wasn't obvious from our comments, this is not an immediate game changer from a revenue growth standpoint but it's an immediate game changer from a strategic standpoint and from a brand standpoint.

Tien-tsin Huang - *JPMorgan - Analyst*

Right. (inaudible) on top of your platform. Thank you.

Operator

David Grossman, Stifel.

David Grossman - *Stifel Nicolaus - Analyst*

Just to put the bookings revision in context, it seems that everything else being equal, the impact is less than $100 million of annualized revenue given the bookings status. Are we thinking about that right? I know it's still early, but is there anything else we should think about in the context of next year's revenue growth trajectory other than obviously the easier comparison?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

No, I think that's a good as math as -- for example, when we had some challenges with retention last year, that's the way to look at things is to use simple math to put things in perspective. So, we obviously fully expect to return to stronger new business bookings growth as these compares get a little bit easier and hopefully, some of this uncertainty wears off.

But I think that your math is dead on which is why I think you hear us still remaining optimistic. We obviously prefer to have $100 million than to not have $100 million, but I think in the context of what we are trying to accomplish as a Company from a value generation standpoint, EPS, share buybacks, et cetera, it really doesn't -- for now, it doesn't have a major impact.

Jan Siegmund - *Automatic Data Processing Inc - CFO*

David, while that quantitative estimate is -- it sculpts it but obviously, key assumptions for revenue growth are also impacted by your belief in retention as well as we pointed out in this point at time of year, in particular, around the pass-through revenue growth of the PEO. Those would be the two other factors that I think could have meaningful or somehow an impact on your revenue growth expectations for the longer term.

David Grossman - *Stifel Nicolaus - Analyst*

Right. Then just secondly, and I may have missed this. You may have mentioned this, but I was just looking at pays for control were roughly in line with trends. So, just trying to understand the context of where the weakness was. And if you can call this out. But was it primarily in unit growth or was it revenue per client? Or is it just both without any real noticeable trend?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

You're referring to new business bookings or --?

David Grossman - *Stifel Nicolaus - Analyst*

Yes.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

Not sure I understand, sorry, the question. The --

Jan Siegmund - *Automatic Data Processing Inc - CFO*

I think we indicated we had new visits bookings weakness in the mid and upmarket. That was stronger impacted by the slowing of the buying decisions. And if you refer -- I think I can tell you that our client growth continues to be very solid, mostly driven by our success in the downmarket.

So, really a very nice performance in the small business market with unit growth. So, mathematically, I guess, what it boils down is a mix of all of that together.

David Grossman - *Stifel Nicolaus - Analyst*

Okay. So then just looking at the mid and upmarket being down, was there any real distinction between unit growth and revenue per client in terms of the shortfall or was it just a combination?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

Not really, not a change. I think both fell a little bit short. Clearly, it's always clouded right now by this difficult compare about the ACA and we have emphasized this in a number of calls.

The ACA modules themselves are easy to identify but ACA has triggered a lot of buying decisions for broader product bundles and it's really hard to analytically differentiate because what was the true ACA impact and what was just enhanced buying cycles because this triggered a buying event and what was just regular course of business. So, we're a little bit hesitant to say it but overall in the mid- and upmarket, I think we have seen a continuation of trends and new logo growth, as we call it, and upselling. It's just at the lower level.

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

I think that the -- sorry, I was -- maybe I didn't at first understand the question but I did look last night at sales force productivity over the last few years and as you can imagine, now our average productivity per sales rep is down but largely driven by ACA. If you exclude ACA, our sales productivity is still in line with our expectations.

So, I think what we've had is, we had -- and I think been -- every quarter, I think, very, very clear. We haven't been pretending that it was either sustainable or that we had done something magical to all of a sudden create such a huge increase in productivity in our sales. I wish we had. Clearly, we got help from, and lift from ACA sales.

We had two years of 13% and 12% new business bookings growth, fiscal years. I don't know the last time that we had ever done that. Clearly, maybe we didn't emphasize enough how much help we were getting and certainly now it's difficult to go back to the sales force and remind them that we had help and now the help isn't there any more. We've got to now focus on fundamentals.

We've got to go back to selling new clients and the old-fashioned approach of ADP of having a reasonable mix of headcount growth and productivity growth and I think when I look through the numbers and try to normalize for ACA, we feel pretty good about where we are in terms of headcount and also sales force productivity.

Operator

David Ridley-Lane, Bank of America.

David Ridley-Lane - *BofA Merrill Lynch - Analyst*

Over the last few years, ADP has leaned pretty heavily on regulatory and compliance offerings. As the US labor market looks at to tighten and perhaps wage inflation ticks up, what are some of the more growth-oriented offerings that you have for clients?

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

That's a fantastic question because this afternoon, I'm actually going to speak to our mid-market sales force about some of the things that we can and need to do in terms of getting ourselves reset here for a different environment. I think, as we said multiple times today, we're not going from a -- to a zero regulation environment.

So, 99% of the laws and regulations that affect employers are still in place today that were in place two months ago and they are probably going to be place a year and five years from now and there may be new ones. So, we have always been there to help our clients with compliance and with regulation.

Having said that, we are clearly entering a period of time with tightening labor markets where, I think many employers' attention is going to turn to how to attract and retain a workforce. And this is something that we've been building to over the last four to five, six, seven years by investing in our Talent Management suites, by investing in tools to help our clients use data and analytics to run their business better and manage a better workforce.

So, we've been preparing, fortunately, for this strategic opportunity for many years. And it is coming and it's coming fast because I believe we reported the ADP Employment Report this morning. That's only going to add to, I think, the tighter labor markets because as we've seen multiple times in the last 20 to 30 years, as unemployment gets to the level that it's at now, and we understand that there might still be a little bit of slack as a result of labor force participation.

But that slack will also inevitably come out of the system, whether it's in 6 months or in 12 months and it may have already come out. We don't know. But besides higher interest rates, which are going to be beneficial to ADP, we think this is going to be beneficial to ADP's new business bookings and to our approach to the market which is to help our clients and across exactly with this topic, how do you attract and retain the best workforce when everybody else is trying to do the same thing.

So, we're not ready to say there's a war for talent yet, but clearly, there's pockets of that and I think when that happens, I think some of the products and solutions that we've developed, this acquisition that we've just done with TMBC, I think position us well to help our clients with that.

David Ridley-Lane - *BofA Merrill Lynch - Analyst*

Great. Then, I know that the revenue contribution from acquisitions is pretty small. But, bigger picture, you've been focused mainly on organic development over the last few years. Should we read this acquisition as potentially suggesting you're open to a bit more tuck-in acquisitions going forward?

Jan Siegmund - *Automatic Data Processing Inc - CFO*

I think we have always maintained a position that we view our balance sheet and our capital strength as one of our assets and we have been evaluating and looking at acquisitions all along. But and -- you should anticipate that we will keep an open mind around those going forward. And they will meet now a joint evaluation of meeting us strategically, like the talent management acquisition of Marcus Buckingham fits right into this talent search, management workforce better.

It's strategically fitting well. But also, not adding in a disproportionate way to the complexity of our operations, as we have focused so much to simplify our operating environment and we're going to be, as a management team, evaluating those acquisitions to maximize the value, really, eventually for the shareholder over time.

Operator

Bryan Keane of Deutsche Bank.

Ashish Sabadra - *Deutsche Bank - Analyst*

This is Ashish Sabadra calling on behalf of Bryan Keane. Just to follow-up on questions regarding the ACA, the new Administration is pretty keen on repealing the ACA. I was wondering if you could quantify what portion of ADP's existing revenue may be directly linked to ACA. Like the ACA module or other revenues which may be linked to ACA and could be potentially impacted by the repeal? Thanks.

Jan Siegmund - *Automatic Data Processing Inc - CFO*

We have recorded that last year, we filed for approximately 10 million employees 1095 forms. So, that gives you a rough revenue estimate between $150 million to $200 million of ACA revenue in our business. But, it is with very -- we have to be very thoughtful about what will happen to them. Clearly, it could go away.

But, it could also maintain different solutions and certain reporting requirements which are at the core of the value proposition value of the ACA. So we, at this point, are really not in a position to estimate what part of this revenue is at risk or if there could be even further growth in the ACA revenue. But to give you a rough estimate about the size of our directly ACA-related revenues, about $150 million to $200 million.

Operator

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

Carlos Rodriguez - *Automatic Data Processing Inc - President & CEO*

So as we mentioned, obviously, there are so many uncertainties that have been created as a result of this change in Administration and the talk about repeal in place of ACA are certainly not helping us in terms of our new business bookings here in the second quarter.

But, we still are pretty positive about our business model. I think you've heard that from us today. I think we are well-positioned for helping our clients with what are becoming very, very tight labor markets. And we are also optimistic that there will be some change.

We know there's going to be change. So, repeal is clearly a -- in the eye of the beholder, but I think given that there's a commitment to maintaining 20 million Americans on insurance, we believe there will be some new form of tracking the regulation and that we will have something that we can help our clients with, if not, the current ACA products that we have today.

In the meantime, we are going to rely on our historical track record of being able to navigate through obviously, these uncertain times and wait for the inevitable pick-up in the economic activity as well as government activity around some of these changes. We continue to invest in simplifying our portfolio, as Jan said, including using that as one of the criteria for acquisitions. You've heard us talk about how we are aligning our service model. I'm very excited about what that's going to do to the quality and long-term cost of our service.

And, as you heard from us today, we are certainly not backing down on our distribution channels. We continue to invest in our sales force and grow our sales force because we plan on continuing to grow. So, we appreciate your time today and thank you for joining us. And we appreciate your interest in ADP.

Operator

Ladies and gentlemen, thank you for participating in today's conference. That does include today's program. You may all disconnect. Everyone, have a great day.