

Integration of PRI Guidelines

JAN 2020:

Paycom

# Executive Summary

**Paycom Software provides a comprehensive, cloud-based human capital management (HCM) software solution delivered as software-as-a-service. It provides functionality to manage the complete employment life cycle from recruitment to retirement.**

**We opened our position in December 2018. The company exhibits strong fundamentals and a good business model. However, in completing our ESG analysis process some concerns have arisen that demand our attention, in particular:**

- A surprising lack of focus on the opportunities presented by the major industry tailwinds of artificial intelligence and the gig economy.
- There is a lack of broader ESG alignment with no pollution control efforts disclosed.
- Lack of diversity amongst management.
- Lack of patents or patent applications could lead to potential IP infringement litigation.
- Executive compensation does not have any pre-established policies regarding distribution between cash/non-cash and short-term/long-term incentives and is entirely reliant on the Compensation Committee's judgement.

We have identified these ESG concerns and will continue to monitor them. However, we are confident in valuing Paycom despite these concerns due to our belief that the underlying fundamentals that drive this business are strong.

Paycom draws alignment with sustainable ESG trends of:

- Focus on improving employee experience.
- People analytics becoming more accessible.
- Greater focus on reskilling of employees.
- Change management going digital.
- Increase in importance of data security.

We believe that Paycom is in an optimal position to take advantage of these tailwinds and that the company has a long wave of growth ahead of it. Some concerns persist and we will continue to monitor them, however, our overall ESG analysis strengthens our conviction in our valuation and subsequent investment in Paycom.

# Strategy

*This section focuses on ESG issues emanating from communications around the company's strategy of exploiting opportunities and managing risks. The rise of shareholder activism, public and media attention on corporate responsibility, and increasingly informed consumers requires companies to actively consider and manage ESG risks in order to successfully execute on their given strategy. We think in terms of fundamental company strategy.*

## HIGH LEVEL ESG RECOGNITION

### **How does the company act as a positive force for environmental concerns?**

*A list of significant issues that relate to maintaining and creating sustainable environmental outcomes. Examples include sustainable power use, reduction and reuse of water, sustainable end of product life considerations, and pollution mitigation during manufacturing processes.*

No data provided.

### **How does the company not act as a positive force for the environment?**

*This is a list of material outcomes that result in the company detracting from a sustainable environment and include examples opposite of those mentioned above.*

- By not providing sufficient ESG data.
- No information about renewable energy being used at any of its offices.
- No information on water or paper being recycled.

### **How does the company act as a positive force for social concerns?**

*Here we focus on sustainable outcomes for people. Does this company act for the betterment of individuals and society? These are broad ranging issues and topics, but some examples include improving mental health, providing engaging workplaces and appropriate remuneration, improving financial outcomes for customers, improving learnings outcomes, improving general health outcomes for customers, increasing access, and allowing human expression at a higher level.*

- By providing a comprehensive HCM solution Paycom helps its clients hire, engage, pay, manage and track the performance of its workforce better.
- It helps clients reduce exposure to violations, audits and penalties with respect to employment laws impacting their business.
- Maintaining accurate and complete company records.
- Providing clients "best-in-class" level of data security.
- Adhering to its *Code of Ethics* and *Business Conduct for Officers, Directors and Employees*.
- Promoting a positive and safe work environment that supports honesty, integrity, respect, trust and responsibility.
- Policy of treating each other equally regardless of race, color, sex, religion, gender, age, national origin, disability, gender identity or expression, sexual orientation, veteran or marital status or any other characteristic protected by law.
- Committed to providing a drug-free, safe and healthy work environment and observing environmentally sound business practices.
- Adhering to restrictions regarding employing current and former US Government employees.
- By leading initiatives to mitigate workplace violence with safety coalition, new legislation and free workplace threat assessment and response guide. They provided a downloadable guide, giving

employers a framework to assess and potentially preempt workplace violence incidents.

- Named a Top Workplace in Oklahoma for the seventh consecutive year.
- Named One of Glassdoor's Best Places to Work in 2020.
- Organises 'HoliDazzle', an annual one-day community coat drive in partnership with KFOR Oklahoma's News 4 Warmth 4 Winter Program benefiting The Salvation Army of Central Oklahoma. They collect new or slightly used coats of all sizes during the event.
- Barry Cladinos Memorial Perseverance Scholarship. Paycom partnered with the Edmond Public Schools Foundation to create the scholarship in 2018 in memory of Barry Cladinos, an Edmond North and University of Central Oklahoma alumnus, who was a beloved team member at Paycom where he served as a Supervisor in the New Client Setup department before his passing in 2017.
- Employees raised funds for Project AWARE's Ocean Conservation.
- Paycom Interns filled 600 backpacks with school supplies for OKC students.
- Paycom and its employees donated \$80,000 to The Salvation Army.
- Donated More than 6,000 pounds of baby supplies to Infant Crisis Services.
- Employees donated 3,983 pounds of clothing to Goodwill.

#### **How does the company not act as a positive force for social concerns?**

*Here we consider how the company meaningfully detract from the betterment of the individual and society over the long-term. For a business model to be successful it must act as a force for good. Items in this list are a real concern for us. Some examples include business models that serve to disconnect people from physical socialisation, are detrimental to physical health, or that disempower employees.*

Unknown.

#### **How does the company act as a positive force for governance concerns?**

*Good corporate governance is essential to long-term performance. Here we look at the structures of committees and oversight, and remuneration policy and its links to fundamental performance. High-level, meaningful issues are listed here.*

- Adheres to its Related Party Transaction Policy.
- The Compensation Committee oversees and advises the Board on the adoption of policies that govern the company's compensation programs, including stock and benefit plans.
- Whistleblower Policy intends to encourage and enable employees and others to raise serious concerns within the company prior to seeking resolution outside the company.
- Audit Committee appointed by the Board oversees the accounting and financial reporting processes of the company.
- The Annual Report highlights various risks which may have not been uncovered through independent research.
- Its Information Security department regularly performs penetration testing and Paycom retains a third-party penetration testing company to conduct penetration tests and periodic audits to identify and remediate any issues.
- Internal controls over financial reporting. Management evaluates and furnishes a report on the effectiveness of their internal control over financial reporting and their auditors must attest to the effectiveness of their internal control over financial reporting.
- Their Government and Compliance application helps clients reduce exposure to violations, audits and penalties with respect to the employment laws impacting their business such as the Fair Labor Standards Act, Family Medical Leave Act, Equal Employment Opportunity Act, and other state and federal regulations.
- The COBRA (Consolidated Omnibus Budget Reconciliation Act of 1985) administration application helps protect employers from COBRA violations and the associated fines and penalties by automatically initiating compliance measures upon entry of qualifying events into the application.

### **How does the company not act as a positive force for governance concerns?**

*Examples of points that might go here include appropriate remuneration both in terms of total amount and or incorrect alignment of incentives. We also look at the strength of the board and power of the CEO to influence governance. Another significant area is the appropriateness of response by management and the board to environmental and social issues as they arise.*

- Have employed the same independent auditor since 2009.
- No patents or patent applications regarding the proprietary software solution provided by Paycom to their clients. This could lead to potential litigation and IP infringement.
- No pre-established policy for the allocation between cash and non-cash compensation, nor for the allocation between short-term and long-term incentives. Executive compensation is wholly dependent on the Compensation Committee.

### **What external ESG factors affect the company?**

*This includes domestic and international government policy, market competition forces, and micro and macroeconomic drivers.*

Major ESG factors are:

- Changes in laws, government regulations and policies - introduction of new regulatory or licensing requirements, or new interpretations of existing laws or regulations can impact Paycom's ability to fulfill client requirements such as:
  - Modification or repeal of certain provisions of the Affordable Care Act (ACA) (The company generates ACA-related revenues).
  - Tax laws and regulations could be enacted, or existing laws could be applied to Paycom and their clients. This could result in Paycom incurring costs regarding platform modifications due to compliance issues.
- Highly competitive market.
- Increasing focus on employee experience with a shift from "How we can get the most out of our employees?" to "How can employees get the most out of us?".
- People analytics gaining in popularity.
- Focus on re-skilling of employees.
- Workforce planning becoming agile.
- Increased role of artificial intelligence in everything including HCM.
- More people in gig work than before.
- Organisational network analysis (ONA) and augmented analytics becoming mainstream.
- Change management going digital.
- Increase in cyber-crime, leading to increased focus on cyber-security.

### **How has the company demonstrated its awareness of ESG factors in the economy and within its industry?**

Paycom is aware of the risks any changes in laws, government regulations and policies could pose and has discussed it in the 'Risks' section of the Annual Report. They understand that such changes could reduce or eliminate the need for certain existing applications resulting in a decrease in revenue. Time and money would have to be spent to develop new applications and enhancements in keeping with the changes.

- The application of federal, state and local tax laws to services provided is evolving.
- Enactments of laws and regulations may adversely affect Paycom. They have discussed this in the 'Risks' section of the Annual Report.
- Highly competitive market - the Paycom Application development team works closely with clients to enhance their existing applications and develop new applications. Clients can suggest new applications and features. All enhancements to applications are released monthly. Paycom's

offering has evolved over the years, keeping up with and even staying ahead of their competition.

- Focus on enhancing employee experience. Paycom's software is user-friendly. They provide one-on-one personal assistance through trained specialists. Clients' employees are trained to use the app during implementation and provided additional training through client relations representatives.
- People analytics gaining popularity - Paycom provides functionality and data analytics that businesses need to manage the complete employment lifecycle, from recruitment to retirement.
- Focus on re-skilling of employees - Paycom's system allows employers to engage their workforce through learning management courses and training paths, surveys, performance goals and reviews.
- Workforce planning gets agile:
  - The solution's embedded analytics capture the content and context of everyday business events, facilitating fast and informed decision-making from any location. These tools help clients reduce administrative and operational costs and manage talent more efficiently.
  - The solution is based on a core system of record that contains payroll and HR information in one convenient database, thereby reducing costs and eliminating the need for multiple software products and vendors and the maintenance of employee data in numerous databases. This results in reduced redundancy and a more streamlined and agile process.
- Through time and labour analytics their software helps produce various reports which help clients track various metrics.
- Change management going digital - As organisations' requirements change, so does Paycom's system. With regular enhancements and monthly updates, Paycom keeps abreast of the changing requirements.
- Cyber-security:
- Paycom delivers feature-rich applications while maintaining excellence in Information Security and Quality Management Standards.
- ISO/IEC 27001:2013 certified security standards that provide clients with a "best-in-class" level of data security.
- Communication with servers that might contain sensitive information is encrypted with high-grade encryption algorithms before they leave the network.

#### **Where has management demonstrated its commitment to addressing ESG challenges?**

- By encouraging staff to participate in donations and volunteer events to help people in need.
- They voluntarily obtain third-party security examinations in relation to their internal controls over financial reporting in accordance with System and Organisation Controls Report, 1("SOC1").
- By investing heavily in training and development programs to encourage the development and promotion of their employees.
- Whistleblower policy is in place to provide a communication channel for employees to report any concerns relating to ethical business or personal conduct.

#### **How has management demonstrated its knowledge on the company's ESG risks?**

*Examples and quotes of management addressing relevant ESG risks.*

- By maintaining a high standard of corporate governance.
- By ensuring compliance with both local and international laws and regulations.

#### **How does strategy align with ESG opportunities?**

*A broad look at how underlying strategy fits or does not fit with ESG trends. For example, a battery manufacturer aligns with the movement towards stored energy, an online retailer aligns with the movement from instore to online purchases.*

- Employers see a greater return on their investment by leveraging HCM technology for their employees. Putting people first helps employees thrive.
- HR leaders are instigating more regular touch points with employees through pulse surveys and other tools; however, employee usage of HCM systems remains less than optimal. Paycom's vision is to see substantially greater usage of Paycom's software. It spends considerable time and effort in training clients' employees to use Paycom's software.
- Learning gets ubiquitous. Paycom helps clients to engage their workforce through learning management courses and training paths, surveys, performance goals and reviews. They are developing learning courses that are responsive to the needs of their clients garnered through ongoing client interaction and collaboration.
- With people spending more and more time using mobile devices, Paycom's mobile app provides all the functionality required for employees to access their information efficiently and securely. The mobile app is gaining in popularity with clients' employees.
- They continue to produce new functionalities to their offerings, improving their competitive position.
- They have increased their presence in existing markets and expanded into additional markets to meet the increasing demand for their HCM software.

**Is there evidence of the company reporting highlighting future ESG risks and does the strategy allow for these anticipated risks?**

- Yes. Company reporting highlights future ESG risks, both internal as well as external.
- Their strategy allows for future risks and risk management. For example:
  - Paycom continues to focus on, and invest in, technology and data security.
  - Their applications are secured using multiple libraries and secure coding practices. The IT infrastructure is secured and monitored using several best practices and tools at multiple layers of the physical and logical network. This security is also continually monitored by the information security department. All employees work in either the Oklahoma or Texas locations and, except for certain IT personnel, are not permitted to work remotely.
  - Access to servers and networks at each of their networks is strictly regulated.
  - Software Development team works closely with clients to enhance existing application offering and develop new applications in order to improve competitive position.

**What is the extent of ESG performance reporting?**

Minimal.

- The Annual Report does not have a sustainability section and neither does the website.
- The report/website do not provide any data on any measures taken by the company to reduce their carbon footprint.

**Do reports link ESG factors to financial performance?**

No.

**What is the company's position in relation to current and potential operational licences, supply chain, and resource bottlenecks?**

*We must consider these constraints as they represent a significant risk to business operations. Has the company given these current and or potential bottlenecks due consideration? Can we see any concerns?*

- Paycom's agreements with third parties are non-exclusive and do not prohibit them from working with their competitors.
- Establishing and maintaining relationships with third parties is critical. They rely on third-party financial and accounting processing systems, as well as various financial institutions, to perform

financial services in connection with their applications. Such as providing automated clearing house and wire transfers as part of payroll and expense reimbursement.

- Paycom relies on third parties to supply time clocks. They are purchased as finished goods which it issues to clients under a month-to-month operating lease.
- Paycom relies on a combination of copyrights, trademarks, service marks, trade secret laws and contractual restrictions to establish and protect intellectual property rights. They have several registered and unregistered trademarks.

**What is the extent of management involvement of customers, employees, government, and other stakeholders? How do they gather data on their sentiment/opinion?**

*Considers how well management engages these parties in seeking their input and feedback on ESG issues. In the second part we consider the mechanism for how this data is gathered.*

- Annual general meetings and other shareholder meetings, company website, press releases, annual reports, earnings calls, presentations, SEC filings and interim reports.
- There is one-on-one personal interaction between clients and CRRs, through whom clients personally suggest new applications and features.

**How responsive is the company to investor engagement?**

Metric hard to ascertain, however management is quite forthcoming in answering all questions posed on earnings calls.

**Does the board support ESG issues?**

*How supportive and engaged is the board on ESG issues? Without their support it will be very hard for management to progress on ESG issues.*

Yes.

- Through high social and governance standards.
- Executive remuneration is according to market standards.
- Focus on data security and regulatory compliance.

# Financial Reporting

## INCOME STATEMENT

### REVENUE

**Identify the main drivers of revenue for both volume and price.**

- Enlarging their existing client relationship - the use of additional applications by the existing clients will increase revenue.
- Larger clients - Paycom's solution requires no adjustment for larger clients. Larger employers represent a substantial opportunity to increase the number of clients and to increase revenues per client, with limited incremental cost.
- Maintain leadership in innovation by strengthening and extending their solution - developing and deploying new applications and updates rapidly is integral to retaining existing clients and attracting new ones.



- Competition from firms providing HCM solutions. The market is primarily based on service responsiveness, product quality and reputation, breadth of service, application offering and price.
- Improving client and employee experience.
- Maintaining high levels of privacy and data security.
- Recurring revenues include revenues related to the annual processing of payroll forms, such as Form W-2 and Form 1099, and revenues from processing unscheduled payroll runs (such as bonuses) for their clients. Changes to these forms could affect revenue.
- Changes in laws, government regulations and policies - Many of Paycom's applications are designed to assist clients in complying with government regulations that change continually. Therefore, changes in the regulatory environment would result in more companies opting to use the Paycom solution rather than their own in-house solution.
- People analytics has evolved from an obscure part of HR to an established, mainstream discipline. The Paycom solution's embedded analytics capture the content and context of everyday business events, facilitating fast and informed decision-making.
- Learning has become ubiquitous. Paycom's all-encompassing software includes 'Paycom Learning and Course Content' that formalises and standardises clients' training processes. The system allows employers to engage in their workforce through learning management courses and training and performance goals and reviews.

#### **How do these drivers align with sustainable ESG factors?**

- Adding new clients would result in more employers driving digital transformation in Human Resources. It grants their employees access to their own data throughout the employee lifecycle. It gives employees a direct connection with their pay stubs, W-2 forms and benefits, as well as performance reviews, surveys and e-learning courses.
- Enlarging their existing client relationship - When clients use the entire suite, they use one vendor, one software, and data is stored securely to meet retention requirements and is protected from unauthorised access.
- Maintaining privacy and data security - It is imperative that data is stored securely, and privacy is maintained. Paycom reviews the security of the software periodically to maintain clients' and their employees' records securely.
- The Government and compliance application help clients reduce exposure to violations, audits and penalties with respect to the employment laws impacting their business, such as the Fair Labor Standards Act, Family Medical Leave Act, Equal Employment Opportunity Act, COBRA and other state and federal regulations.
- Maintain leadership in innovation by strengthening and extending their solution - developing and deploying new applications and updates rapidly will allow clients to meet changing regulatory requirements while securely maintaining their data.
- People analytics helps employers engage their employees and improve employee experience. They can hire, train, upskill, monitor their performance and comply with various regulatory requirements and keep costs low.
- Learning has become ubiquitous as content became plentiful, cheap and accessible with online courses. Combining this with the global trend towards reskilling, the opportunities are immense.

#### **What are the future prospects for these drivers? Including the fundamental tailwinds that support their future growth.**

- People analytics is undergoing a seismic shift. It dramatically improves the way organisations identify, attract, develop, and retain talent. It helps managers and senior leaders unlock the power of data, increasing rigour, reducing bias and improving performance. The rapid digital transformation of companies will keep the demand for people analytics growing.

- Innovation in HCM software is uncovering new business opportunities for providers and transforming clients. More companies going digital will boost growth.
- Increasing focus on learning - employers are focusing on training and upskilling their employees. They want their employees to take control of their learning and grow within the organisation.

**What major risks exist in the potential of these future prospects to not become a reality?**

- New HCM software from competitors or the emergence of new competitors.
- Client satisfaction and employee experience will play a major role in the growth of HCM software industry.
- Changes in laws and or government regulations could negatively impact Paycom's revenues or increase costs.
- Breaches in security, unauthorised access to clients' or their employees' sensitive data could hurt Paycom's reputation. Their solution may not be perceived as being secure, and clients may reduce the use of or stop using their solution. It could result in lengthy litigation and affect their ability to source new business.
- Privacy concerns and laws or other regulations may reduce the effectiveness of their applications.

**How might ESG trends impact this company's core markets?**

- Strong uptick in demand for more stringent data privacy and security regulations.
- Rapid digitalisation will lead to an increased demand for comprehensive and secure HCM solutions.

**What legislative or regulatory change is anticipated?**

- There could be changes to the Affordable Care Act. On January 20, 2017, President Donald J. Trump issued an executive order stating that it is the policy of the new administration to seek the prompt repeal of the ACA. Despite multiple efforts, Congress was unable to pass legislation significantly repealing or replacing the ACA in 2017.
- Tax Cuts and Jobs Act of 2017, enacted December 22, 2017, eliminates the ACA's individual mandate penalty beginning January 1, 2019.
- Additional action to further weaken, repeal or replace ACA may occur.

**Are the company's key markets sustainable in terms of resource use and disposal?**

- No data available on their offices, data centres or R & D centres using renewable energy or sustainable waste disposal.
- Paycom's solution is completely digital with minimal usage of resources and low disposal requirements.

**Are the company's key markets sustainable in terms of consumer preferences and social trends?**

- Globally, employers are putting employees first. There's been an increased focus on improving employee experience.
- HR leaders are now instigating more regular touch points with employees through various means.
- Employees today are tech-dependent and like information at their fingertips including their own work data. It helps them interpret and analyse their own work.
- People analytics has gained in popularity as employers see its benefits. There's been a surge among companies with fewer than 3000 employees using people analytics and organisations see it as an increasingly urgent requirement.
- Employers are focused on providing their employees with the right training and opportunities to upskill.

## COSTS

### RAW MATERIALS

*Consider the scarcity of main inputs and whether supply chain risks are appropriately managed. Is it possible that the company is paying more for sustainable products, which will increase immediate costs but reduce future costs associated with changing supplier or of supply being restricted?*

*Access to materials can be a key determinant of company earnings, depending on the industry. We assess access to materials by evaluating the strength of stakeholder relationships with, for example, suppliers, host governments, local communities, and contractors.*

**Are raw materials scarce?**

No.

**Are operations energy intensive?**

No.

**Are employees sufficiently motivated in the context of peers and management?**

No information.

**Is there a risk input costs will rise?**

Slight risk. Targeting larger clients might lead to an increase in input costs to meet client requirements.

**Is the company aware of these risks?**

Yes.

**Do cost projections take into account these risks?**

Unknown.

**TABLE 1: GROSS INCOME AS A PORTION OF REVENUE**

Company	FY18	FY17	FY16
Paycom	81.30%	81.10%	81.20%
Workday	70.50%	70.60%	69.30%
Paylocity	67.10%	60.48%	58.67%

*Gross income as a portion of revenue. Source: Factset.*

Table 1 shows that Paycom has a stable operating margin that has been consistently higher than its competitors.

### LABOUR

*Labour costs can account for most operating costs and careful management is required to maintain competitive advantage. Employees will consider the reputation of a company in evaluating job prospects. Company profile includes its management of social and environmental responsibilities and companies will struggle to maintain competitive advantage if talented graduates choose not to work for them. Labour efficiency is a consideration and achieved through higher productivity or lower costs and both are often achieved through non-monetary benefits. We also look at staff turnover and look at staff training spend as a percentage of gross profit. Be sure to consider the context as to the business model and extent of technology use.*

In assessing a company's efficiency in labour and spend on R&D, we use these metrics as a portion of gross income. We use gross income instead of revenue as gross income are the funds available for these investments. If we use revenue, then a company could be running at a loss compared to its profitable competitor and still spend a similar portion. However, it would not be as sustainable as its competitor as it did not use cash flow generated from its own activities for these expenses.

Labour is measured in gross income above and in general and administrative expenses below.

**TABLE 2. GENERAL AND ADMINISTRATIVE EXPENSE AS A PORTION OF GROSS INCOME.**

Company	FY18	FY17	FY16
Paycom	21.00%	22.80%	22.10%
Workday	17.42%	14.74%	18.20%
Paylocity	30.16%	34.70%	35.30%

Table 2. General and Administrative expense as a portion of gross income. Source: Factset.

Table 2 shows G&A expense as a portion of gross income is stable with a slight increase in FY17. Higher costs are expected for a company with such a high growth rate, so we are comfortable with these figures. Workday has lower portion of G&A expenses as it is an established company with comparatively lower input costs while Paylocity is a relatively new company and is expected to have higher expenses.

## R&D INVESTMENT

In many industries R&D drives a company's ability to exploit ESG trends. We analyse R&D spend as a portion of gross income in order to gauge commitment to R&D and technological differentiation.

**TABLE 3. R&D SPEND AS A PORTION OF GROSS INCOME AND TOTAL (USD BILLIONS).**

Company	FY18	FY17	FY16
Paycom	10% (\$46.25)	8.66% (\$30.43)	7.8% (\$20.97)
Workday	60.7% (\$1,211.8)	60.22% (\$910.6)	62.4% (\$680.5)
Paylocity	16% (\$50.33)	16.5% (\$37.65)	16.53% (\$29.1)

Table 3. Investment in R&D as a portion of gross income and total in millions of USD. Source Factset.

Table 3 above shows Paycom has a conservative R&D spend percentage compared to their peers. Expenses might increase due to shifting focus on larger clients with greater technical requirements.

### What is the product development strategy? What is the percentage of sales from new products?

- Key to product development is interaction between clients and CRRs. Clients can suggest new applications and features through CRRs.
- Development and engineering teams and employees conceive new applications and enhancements, review requests, schedule development in order or priority, then develop applications or enhancements.
- New applications and enhancements are independently reviewed by quality assurance team before implementation.
- Enhancements to applications released on a monthly scheduled release date to coordinate the communication and release to clients.
- Paycom only offers one comprehensive HCM solution. Existing client requirements are met by either enhancing the existing applications or releasing new ones. Data on revenue generated from these applications is not provided.

**What are the pending patent applications and is there in-house venture capital?**

No patents or patent applications. No in-house venture capital.

**NON-RECURRING AND EXCEPTIONAL EXPENSES**

*Analysis of the company's exposure to risks such as litigation or weather events to quantify the threat to future earnings.*

**What are the organisational and incentive structures?**

- The company maintains the Paycom Software, Inc. Annual Incentive Plan, pursuant to which the company may grant incentive compensation to certain employees designated by the Compensation Committee of the Board of Directors. Awards under the Annual Incentive Plan are made based upon the achievement of performance goals (consisting of individual performance goals, business unit performance goals or company performance goals) relating to one or more performance criteria listed in the Annual Incentive Plan, including revenues, earnings per share, and adjusted EBITDA.
- When a new client processes payroll for an entire month, sales representatives receive a one-time commission based upon their estimate of future annual revenues from such client.
- When an existing client purchases and then utilises a new application for one payroll cycle, the CRR receives a one-time commission based upon an estimate of future annual revenues from such client.
- Executive sales representatives receive a higher commission rate and base salary based upon both current year and life-to-date realised sales.
- Employment agreements allow for annual compensation, participation in executive benefit plans and performance-based cash bonuses.

**What is the extent of stakeholder research?**

Extensive.

- Paycom has a blog where employees post articles on new and upcoming technology as well as the technical workings of the Paycom HCM solution and how it affects its users.
- The resources page on their website provides white papers, blog articles and webinars on various topics of discussion in the HCM industry.

**What is the company doing to mitigate ESG risks in regards to costs?**

- Mitigating litigation costs:
  - The company maintains a comprehensive security program designed to ensure confidentiality, integrity and availability of their clients' data, and to prevent the theft and misuse of that data.
  - Upgrading the applications regularly and monitoring any changes to laws, government regulations and policies, ensuring compliance.

No other data provided.

**Does the company report on these risks?**

Yes.

**What is the company's capacity to sustain or improve operating efficiency?**

Are operating margins improving vs peers?

**TABLE 4. OPERATING MARGIN VS. COMPETITORS.**

Company	FY18	FY17	FY16
Paycom	30.67%	29.95%	17.60%
Workday	-15.20%	-14.23%	-22.5%
Paylocity	12.10%	4.80%	2.40%

Table 4. EBIT/Revenue. Source: Factset.

Table 4 above shows increasing operating margin for Paycom over the last 3 years as input costs decrease, leading to an increase in operating efficiency. Workday is one of Paycom's biggest competitors, but their negative operating margin shows extremely high costs compared to revenue. Paylocity started turning a profit in 2017 and the last 3 FYs show high growth in operating margins. We are comfortable with Paycom's operating margin and confident they will maintain their superiority over their peers and competitors.

#### How is improvement being achieved: technology investment, energy and resource efficiency, new incentive systems, economies of scale?

- As Paycom has developed a single version of their solution which is supported and deployed across all their clients, updates/improvements can be delivered to all clients at the same time making it easier for Paycom to scale their solution.
- Paycom's CRR personally interact with clients seeking feedback. The product managers assign development requests based on research, trends and user feedback.
- The development teams review development requests and schedule development in order of priority and subsequently develop the applications or enhancements.

#### Is this sustainable? What is management doing to ensure continued efficiency?

Yes.

#### TABLE 5. CEO REMUNERATION FY2018

Company & Market Val	Base Salary	Cash Bonus	Option Award	Stock Award	Other	TOTAL
Paycom (\$18,385M)	\$667,133		\$1,309,092	\$13,973,050	\$989,570	\$16,938,845
Workday (\$42,796M)	\$65,250			\$9,759,805	\$1,950	\$9,827,005
Paylocity (\$7,421M)	\$525,000	\$766,500		\$5,860,110	\$34,271	\$7,185,881

Table 5. CEO remuneration compared to peers. Source: [www1.salary.com](http://www1.salary.com).

Table 5 shows Paycom's CEO compensation follows market standards and can be considered conservative compared to a company with a much smaller market cap (Paylocity).

#### Growth in Shares Outstanding

Shares outstanding have grown at a modest CAGR of 2.49% over the previous 5 FYs.

## BALANCE SHEET

### ASSETS

Some balance sheet assets are easily measured and audited while others, such as intangible assets, are harder to gauge. ESG analysis helps us to provide a greater degree of certainty in relation to the fair value of some assets, e.g., the impact of energy efficiency standards on property values and the effect that changing consumer perceptions, or regulations, related to sustainability will have on the sale of

inventory. ESG performance, such as employee engagement, environmental efficiency, and community investment, can indicate a company's commitment to its reputation and brand, and human capital. Integrating ESG factors highlights these issues.

#### What percentage of total assets are intangible assets?

**TABLE 6. INTANGIBLE ASSETS AS A PORTION OF TOTAL ASSETS.**

Company	FY18	FY17	FY16
Paycom	3.45%	3.40%	5.00%
Workday	31.20%	4.33%	6.70%
Paylocity	2.65%	2.90%	2.80%

Table 6. Intangible assets as a portion of total assets comparison to peers. Source: Factset.

Table 6 shows a stable and conservative intangible assets portion which indicates Paycom is not an acquisitive company and seems focused on organic growth.

#### What are the environmental provisions and are they sufficient versus the company's historical costs and those of its peers?

No data.

#### Do notes to the balance sheet recognise environmental risks to physical assets?

No.

#### Do notes to the balance sheet or management discussion recognise ESG risks to reputation?

Yes.

#### What percentage of total assets are intangible assets? To what extent do brand, reputation, human capital, management quality, and intellectual property compromise intangible capital?

Refer table 6 above.

#### How strong is the company brand?

Strong and getting stronger.

#### What is the strength of customer satisfaction and loyalty?

Strong. Annual revenue retention rate of 92%, 91% and 91% from existing clients for the years ended December 31, 2018, 2017 and 2016, respectively. These rates might be understating their client loyalty because the rates were adversely affected by former clients that were acquired or otherwise ceased operations.

#### Does the company have pricing power?

- No. Highly competitive market results in increased pricing and billing pressure.

#### How are employees incentivised and what is the degree of engagement and staff loyalty?

- What level of autonomy do employees have?

No data provided

- Are there flat or hierarchical structures in place?

No data provided

- How is the company recruiting talented graduates?

Data available only for their sales team. Most members of their captive sales force have a four-year degree. They recruit candidates who have sales experience in non-HCM industries.

**What is the structure (relevant committees) and diversity of the non-executive board?**

The Paycom non-executive board comprises of six independent directors with only one of them being female and the rest male. Relevant committees include:

- Compensation Committee.
- Audit Committee.
- Nominating and Corporate Governance Committee.

**How dynamic and committed is executive management?**

Very dynamic and committed.

**Are pension assets being managed by ESG aware practitioners?**

No data.

## LIABILITIES

*Most examples more appropriately included in the cost analysis section. However, we consider these points below.*

**Are liabilities short or long-term? An ability to negotiate long-term debt agreements can signal a trusted relationship and lender confidence.**

Long-term debt covering portion of construction costs at the corporate headquarters.

**How efficiently is working capital managed?**

- DSO moved from 8.9 in 2014 to 4.77 days in 2018.
- DSI moved from 2.29 in 2014 to 2.76 in 2018.
- DSP moved from 34.37 in 2014 to 21.72 in 2018.

The above metrics indicate that working capital is well managed.

**How reliable are relationships with suppliers and customers?**

In the past relationships have been quite reliable. No concerns have been mentioned regarding their suppliers or client retention in their financial reports.

**What is the extent of off-balance sheet commitments?**

No off-balance sheet commitments.

**Is excessive leverage eroding stakeholder trust and raising the cost of equity?**

No.

**Do debt covenants specify any aspects of ESG risk management?**

No.

## CASH FLOW STATEMENT

*Adjustments to sales, earnings and costs completed in the previous section impact directly on cash flow. To flesh this out further, we investigate how ESG factors can impact cash flows regarding operating expenses, working capital management, asset maintenance, and capital costs.*

**Cash Flow From Operations**

*Earnings quality: If CFFO is significantly less than net income then the income statement may have been manipulated in order to improve headline figures such as EBIT and net income growth. Earnings quality and transparency can indicate ethical and efficient business conduct.*



**TABLE 7. CASH FLOW FROM OPERATIONS (CFFO) AND NET INCOME (MILLIONS USD).**

Metric	FY18	FY17	FY16
CFFO	\$184.82	\$130.15	\$98.95
Net Income	\$136.91	\$123.17	\$53.51

Table 7. CFFO and net income. Source: Factset.

As seen in Table 7 above, CFFO is higher than net income every year, an indication of good earnings quality and transparency.

**Are operating expenses being reduced by investment in new resource-efficient technology?**

- Paycom offers a single version of their solution, supported and deployed across all their clients. Any change made to the solution is available to all its vendors. They do not have to update it at the Client's end leading to high efficiency of internal capital and high ROIC.
- There isn't much scope for reducing operating expenses by investment in resource-efficient technology.

**Is capital expenditure covering asset depreciation?**

Yes.

**Does capex investment in operational and resource efficiency today reduce the need for capex in the future and therefore point towards improvements in free cash flows?**

No information available.

**Does due diligence on acquisition targets cover long-term ESG risks? Is there a risk that inadequate ESG due diligence results in greater than expected environmental liabilities post-acquisition?**

Non-applicable.

**Are there favourable long-term debt facilities that indicate a good relationship with lenders? What are the available borrowing costs? Could the company qualify for a lower rate if it improved its management of ESG risks, specifically in the case of project finance?**

Yes.

- Term loans made after December 7, 2017 may be used to finance hard and soft costs related to the completion of construction of the fourth headquarters building and any landscaping, groundwork, parking lots and roads reasonably incidental thereto.
- The term loans mature on September 7, 2025 and bear interest, at either:
  - (a) a prime rate plus 1.0% or
  - (b) an adjusted LIBOR rate for the interest period in effect for such term loan plus 1.5%. The adjusted LIBOR rate is equal to the LIBOR rate for the applicable interest period multiplied by the statutory reserve rate.
- No data regarding qualifications for lower rates.

## Valuation

**Looking over the factors highlighted through the analysis above, how should the cash-flow projections be altered or what margin of safety do we require to be comfortable to make a purchase?**

We are comfortable with our valuation of Paycom and see no requirement to make any changes based on this ESG analysis.

## Who is Blue Oceans Capital?

Fundamental, value based investments.

Blue Oceans Capital is an investment fund driven to achieve exceptional results with meaningful purpose through dedication to uncovering truth and applying our understanding of what is known and not what is forecasted. We invest in listed equities across the globe.

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