



SCREENING CRITERIA REFINEMENT



Case Description

- To ensure high-quality new business investments, ADP adopts rigorous screening criteria but discovers that screens that are too tight reduce throughput of potentially good opportunities and leave new business development resources idle.
- To improve acquisition flow, ADP makes principled refinements to some, but not all, of its investment criteria and, as a countervailing measure, increases deal sponsors' accountability for post-deal success.
- The revised investment screens enable ADP to acquire successful new businesses that previously would have been rejected, while maintaining deal discipline.

Company Profile

Automatic Data Processing, Inc. (ADP) is the largest payroll and tax filing processor in the world, serving more than 500,000 clients. Although more than 60% of sales come from employer services, ADP also provides securities transaction processing to brokerage firms and inventory and other computing and data services to more than 16,000 auto and truck dealers. Other offerings include accounting, auto collision estimates for insurers, employment background checks, desktop applications support, and business development training services.

Selected Statistics

- *FY2003 Revenues:* US\$7.1 Billion
- *FY2003 Earnings:* US\$1.0 Billion
- *FY2003 Employees:* 41,000

LIMITED THROUGHPUT

With All Good Intentions

To communicate new business investment requirements across the organization, ADP develops a standardized list of criteria for organic or acquisition-led investments in new service businesses. ADP later determines that while the strict investment criteria discipline spending, they also unnecessarily restrict throughput of potentially good opportunities.

Searching for the Perfect Deal

Examining acquisitions alone, the corporate development team discovers that if all of the screens are applied to the universe of potential acquisition targets, virtually no new business deals would emerge. If a proposed deal did pass all of the screens, ADP found that the target was equally attractive to rival bidders, so the high premium required for such targets would destroy potential returns.

Member Takeaway

Avoid making screens too tight or too loose by setting realistic investment targets and focusing screens on the deal attributes most critical for meeting the organization's strategic goals.

SCREENS TOO TIGHT

ADP creates new business opportunity screens...

Requirements for Pursuing Major Service Businesses and Products*

Automatic Data Processing, Circa 1994

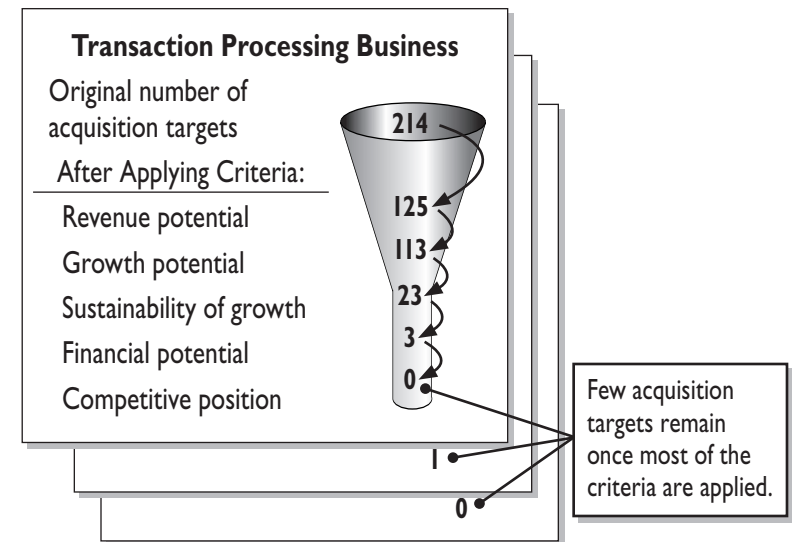
Screening Criteria

1. *Revenue potential*: US\$100 million or more in revenue
2. *Growth potential*: 15% or more long-term growth
3. *Competitive position*: Lead player in industry (first or second position)
 - Strategic fit
 - _____
4. *Product competency*: Focus on computer-related business applications
 - Scale economies
 - _____
5. *Sustainability of growth*: 20% or better operating margins
 - Good client life cycle and/or exit barriers
 - Very distinctive product/service position
6. *Strong management*: Experience and capability of management
7. *Financial potential*: GAAP earnings accretive in first or second year
 - High-confidence business plan
 - Clear development checkpoints and contingency plans

...but discovers they are too tight to produce meaningful throughput

Assessment of Opportunity Screening Throughput (Acquisitions by Business)

Automatic Data Processing, Circa 2002



NOTHING IS PERFECT

“We found that a business meeting all these requirements would be coveted by virtually everyone and would therefore have a very high premium attached to it and limited synergies.”

Dan O’Brien
Vice President, Strategic Development
Automatic Data Processing, Inc.

* See complete list of criteria at end of case.

Source: Automatic Data Processing, Inc.; “Automatic Data Processing: The EPS Decision.” Harvard School of Business (12 November 1999); Corporate Strategy Board research.

FINDING THE BALANCE

Don't Be Prejudiced by the Core

At times, a strong core business can cause companies to set the bar too high for potential new businesses that are strong in their own right but may not meet all standards of a high-performing core. For instance, holding potential new business acquisitions to the same scalability requirements as ADP's core payroll processing business caused the organization to screen out some attractive, though less scalable, businesses. ADP relaxed the criteria to permit acquisition of businesses with some nonscalable components as long as operating margins are strong.

Some, but Not All

To increase deal throughput, ADP refines some of its investment criteria but compensates by explicitly linking the relaxed criteria to strict financial and management requirements that are strengthened or remain unchanged. Some criteria are revised to reflect changes in the economic environment and within the organization, e.g., growth requirements are adjusted to reflect the realities of the economic environment in the late 1990s.

Member Takeaway

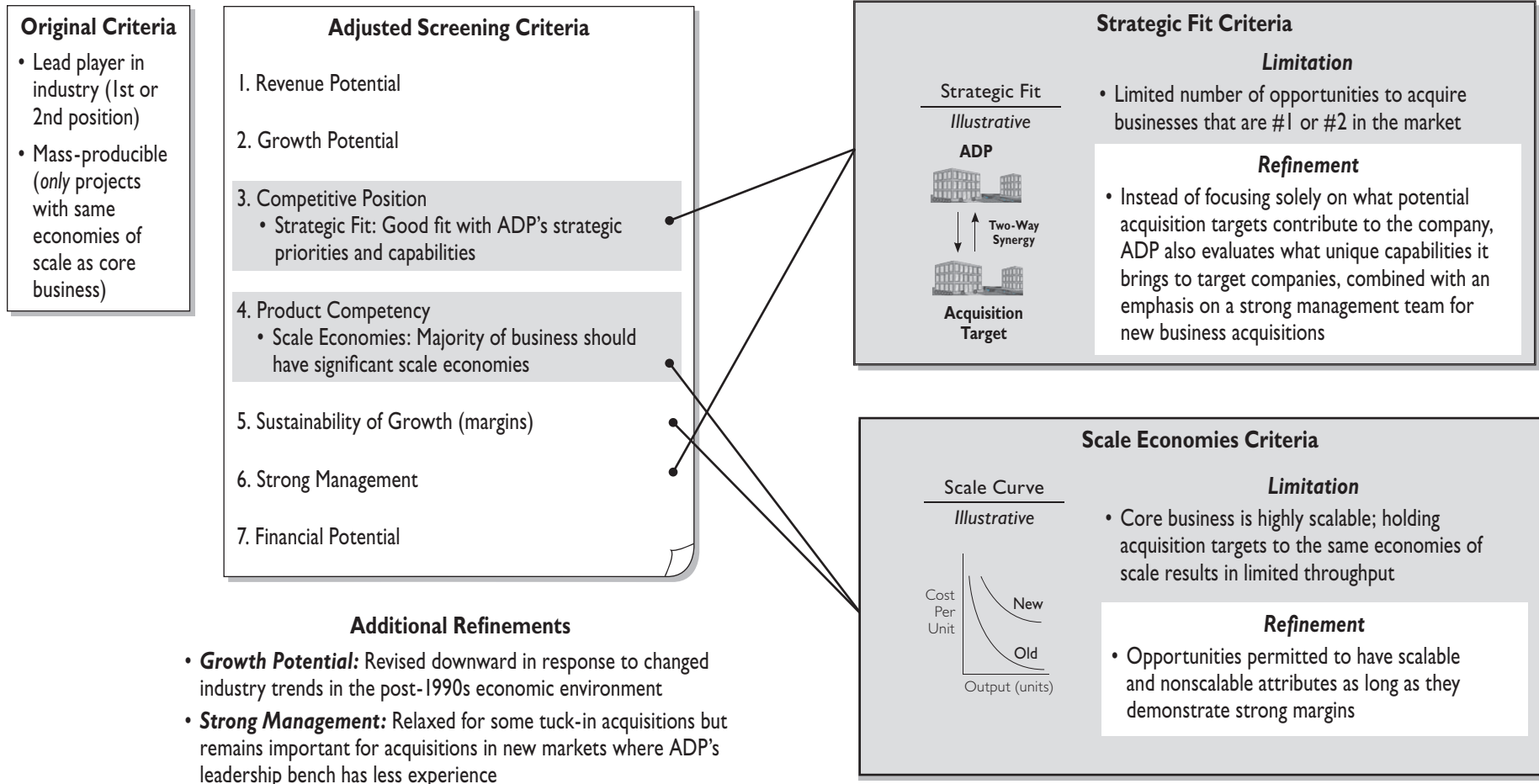
Refine screens to reflect market and strategic changes but maintain or strengthen other related criteria to preserve discipline.

LOOSENING SCREENS WITHOUT LOSING RIGOR

In Response to Low Deal Throughput, ADP Adjusts Some of Its Screens While Leaving Most Unchanged

Refined Requirements for Pursuing Major Service Businesses and Products

Automatic Data Processing, Circa 2002



Source: Automatic Data Processing, Inc.; Corporate Strategy Board research.



SCRUTINIZING THE NEW OPPORTUNITIES

Communicating the Change

In order to realize the value of the revised screening criteria, ADP had to broadly communicate the changes down to the businesses that are actively searching for new acquisition prospects. To ensure a common understanding across the enterprise, the executive team develops a new business case template that incorporates the adjusted investment criteria.

Countervailing Measures

As ADP relaxes the front-end screens to increase throughput, it increases focus on the early evaluation process and post-deal accountability. ADP trains idea sponsors to develop more rigorous business cases and holds them responsible for increasingly explicit business case assumptions. A portion of the sponsor's personal performance targets are connected to acquisition success metrics, the foundations of which are the very assumptions that the sponsor built into the initial business case.

Member Takeaway

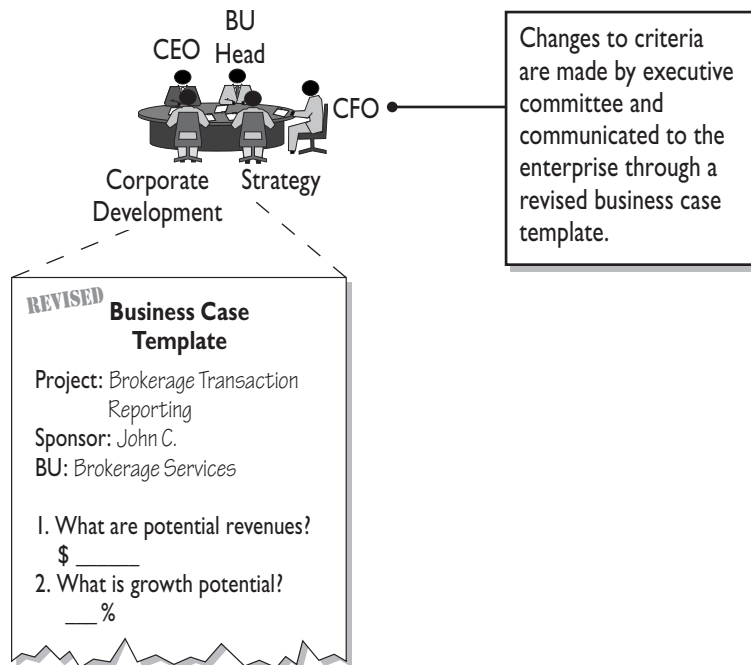
To prevent pipeline quality from deteriorating when you loosen front-end screens, increase business sponsor accountability for acquisition success.

CHECKS AND BALANCES

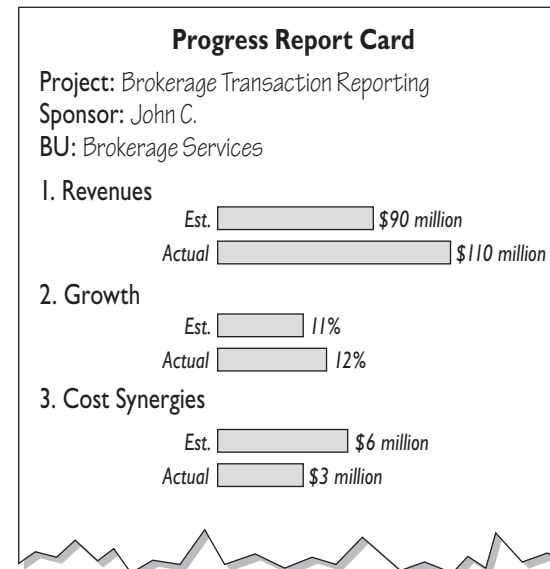
As screens are relaxed, ADP requires business unit sponsors to develop more rigorous business cases...

...and increases accountability for business case assumptions

Criteria Communication
Automatic Data Processing, Illustrative



Progress Report for New Business Acquisitions
Automatic Data Processing, Illustrative



TIGHTENING THE OTHER SCREWS

“As we loosened criteria for screening, we realized we needed to strengthen the back end—the business case development and the management approval processes. We have spent a lot of time training people on how to do a proper business case and we now hold them to a higher standard.”

Harry Durity
Corporate Vice President, Worldwide Business Development
Automatic Data Processing, Inc.

Source: Automatic Data Processing, Inc.; Corporate Strategy Board research.

SUCCESSFUL NEW BUSINESS DEVELOPMENT

Good Deals Getting Through

Using the refined criteria enables ADP to pursue acquisition opportunities and enter into successful new businesses it would not have previously considered. The two new businesses ADP acquired since refining the screening criteria are on a positive growth ramp and have enabled the company to expand its capabilities and offerings.

Not Opening the Floodgates

Overall, ADP's opportunity pipeline has grown since the refined screens were adopted and yield rate for completed acquisition has risen modestly, illustrating new business growth while maintaining continued deal discipline.

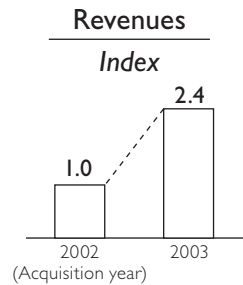
BROADER SCREENS—TIGHTER REINS

Refining its criteria enables ADP to pursue new business opportunities that would have been previously screened out...

...while continuing to provide rigorous criteria to filter out bad deals

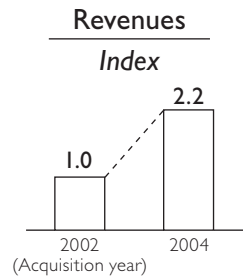
Brokerage Transaction Reporting Business Automatic Data Processing

- Acquired two businesses in 2002
- Did not create a leading market position, but enabled ADP to bring unique capabilities and distinctive customer relationships to the new business

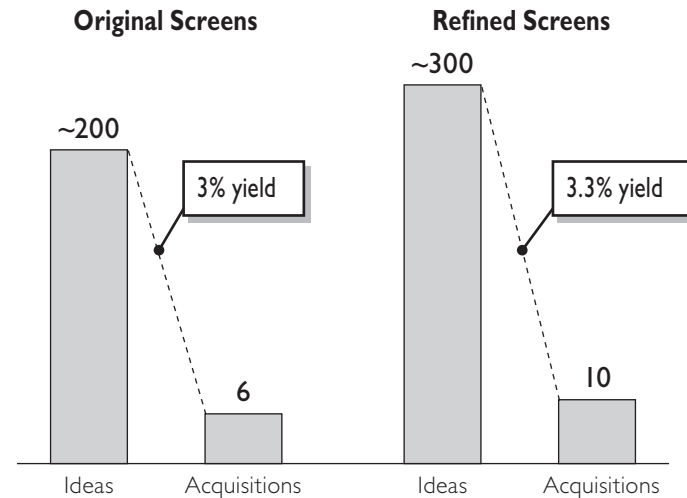


HR Screening and Selection Services Business Automatic Data Processing

- Acquired in 2002
- Requires taking on some fixed assets, while other aspects of the new business are highly scalable
- Acquisition target leverages ADP's distribution capabilities and enables new product development



Acquisitions per Number of Ideas Automatic Data Processing



GOOD OPPORTUNITIES GETTING THROUGH

“Fifteen years ago we would not have entered the brokerage transaction reporting business...However, now it is a successful, growing, and profitable business.”

Dan O'Brien
Vice President, Strategic Development
Automatic Data Processing, Inc.

Source: Automatic Data Processing, Inc.; Corporate Strategy Board research.





APPENDIX



THE “LIST” OF KEY REQUIREMENTS PRE-REFINEMENT

ADP’s Seven Key Requirements for Pursuing Major Service Businesses and Products

Automatic Data Processing, Circa 1994

Screening Criteria “List”

1. *Revenue Potential*
More than \$100 million of annual recurring revenue for an SBU, \$20 million for a line of business, and \$5 million for a product
2. *Growth Potential*
At least a continuing 15% growth rate, preferably over 20%, with good probability (and plans) Note: This might be less for defensive positions in existing business or where ROI is very high
3. *Desirable Competitive Position*
 - a. Fragmented current market (exclusive of ADP’s position)
 - b. ADP in #1 or #2 position (or #3, if fragmented market) with potential to be #1 within five years
 - c. There is no major (deep pockets) illogical player (usually zero profit objectives) whose pricing would likely undermine our profitability
4. *Product Competency*
Standardized Computer-Related Applications (Front- and Back-Office)
 - a. Mass-marketable (noncustomized potential for large number of prospects/transactions)
 - b. Mass-producible (noncustomized, near-level production for large number of transactions with limited labor)
 - c. Consistently superior direct client service features and performance, with clear client accountability
 - d. Extendable to additional integratable applications, particularly in front office
 - e. Influenced by a standardizing “Third Force” (i.e.,—regulations, licensors, peers)
 - f. Supported/recommended by influential third forces (i.e.,—banks, CPAs, peers, hardware partners, licensors, trade associations)
 - g. Leverages existing client/marketplace relationships (concentric circles)
 - h. Different from competition in noticeable/valuable sustainable ways (Unique Client Proposition/Unique Seller Proposition) that are not solely dependent on automation and technology

Screening Criteria “List” (Continued)

5. *Sustainability of Acceptable Growth in the Market*
Particularly critical for new, nonadjacent businesses to earn steady growth and premium pricing
 - a. Very distinctive product/service position
 - b. Potential and plans for significant client accretion
 - c. Good client life cycle and/or exit barriers (Do consider long-term lock-ins)
 - d. Entry barriers to strong competition (Long-term client contracts may be relevant)
 - e. High-net-value-add for client (i.e., client benefit versus ADP charges) versus client’s other alternatives (20% or better operating margins)
 - f. Stable client preferences habits and preferences (versus fickle consumer types)
 - g. Lowest cost producer (not lowest price seller)
6. *Strong Management*
Experience, commitment, focus, capability, credibility, conformity to key success factors
7. *Promising Financial Potential*
 - a. Accretive in first or second year
 - b. High-confidence business plan (good trends in margins, growth, life cycles, ROA)
 - c. High-confidence risk/reward relationship (no single client dependency)
 - d. High product frequency of use/repetitive revenue (stability/predictability)
 - e. Clear development checkpoints/contingency plans (and aborts, if warranted)
 - f. Feasible exit plan and absorbable exit cost (if needed)
 - g. Acceptable prospective return (ROI) on prospective investments
 - h. Keep client-site hardware off balance sheet, if feasible
 - i. New Business Expense (NBE) percentage should seldom exceed processing margin, except where there is a very long client life cycle, to provide an adequate return for the risk/difficulty and \$ of NBE investment

Source: Automatic Data Processing, Inc.; “Automatic Data Processing: The EPS Decision,” Harvard School of Business (12 November 1999); Corporate Strategy Board research.