

## Equities

9 April 2012 | 7 pages

# Discover Financial Services (DFS)

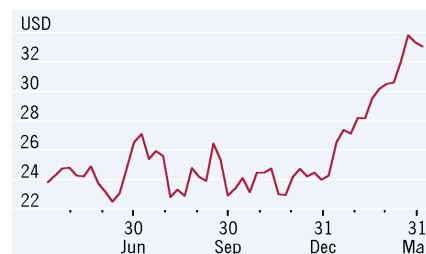
## Alert: March Master Trust – Further Improvement in Credit, While Card Balances Continue Seasonal Decline

- **Summary** – Today, DFS released their master trust data for the month of March ahead of the typical April 16 release date, due to the marketing of an ABS deal. Overall, balances declined 60 bps m/m to \$32.23B from \$32.42B, NCO's decreased 16 bps to 2.64%, and delinquencies were 10 bps better at 2.15%.
- **NCOs Improve Driven By Higher Recoveries** – March's 2.64% NCO rate was down -16 bps m/m. The key driver of the improved NCO was a higher recovery rate of 1.56%, above last month's 1.42%. The recovery \$ was \$25M, up +10% m/m. Recovery rates typically see a spike in March.
- **Delinquencies** – From a credit standpoint, 30+ day delinquencies improved 10bps m/m to 2.15% from 2.25%.
- **Loan Balances Down** – Balances decreased 60 bps during the month to \$32.23B from \$32.42B, following a -3.3% m/m decline in Jan and -2.6% m/m decline in Feb. March balances typically post a seasonal decline as consumers continue to pay off holiday spend. DFS' March 2012 -60 bps m/m decline is not out of line with their historical patterns of -30 bps in 2011, -80 bps in 2010, -90 bps in 2009, -101 bps in 2008 and -160 bps in 2007.
- **The Stock** – No major surprise in the March data. The positive is that delinquencies continue its downward trajectory. NCOs benefited from an elevated recovery rate which is typical in March. The balance decline m/m was in-line with seasonal patterns. DFS trades at 9x our 2013 estimate. While we believe the shares are fairly valued at current levels, we see good support for the stock due to their excess capital position and share repurchases. While DFS and other issuers are arguably over-earning due to lower than normal credit and post credit crisis rate re-pricing, we see this continuing for quite some time. We have concerns around downward pressure on card yields due to competition (and higher yield run-off) but so far issuers have been disciplined. See our recent note [Discover Financial Services \(DFS\) - Investor Day Highlights; Card ROA's To Remain Elevated](#) for further details. Reiterate Neutral.
- **Upcoming Catalysts** – JPM will present its quarterly earnings results, including segment details for its card business, on Friday, April 13. Also, next Monday (April 16), we will get master trust results for the card issuers.

### Company Update

|                              |             |
|------------------------------|-------------|
| <b>Neutral</b>               | <b>2</b>    |
| Price (09 Apr 12)            | US\$32.31   |
| Target price                 | US\$33.00   |
| Expected share price return  | 2.1%        |
| Expected dividend yield      | 1.4%        |
| <b>Expected total return</b> | <b>3.6%</b> |
| Market Cap                   | US\$17,135M |

### Price Performance (RIC: DFS.N, BB: DFS US)



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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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## Discover Financial Services

### Valuation

Our 12-month target price for DFS is \$33. Our target price is based on about 9x 2013 estimates and is checked by our tangible book multiple of 1.8x our 12-month forward tangible book value estimate of \$18.30.

For our valuation, we compare DFS to other credit card issuers (AXP and COF). However, we also look at: 1) the national and regional banks, 2) credit card networks, and 3) the payment processors.

Price-to-Forward Earnings – We arrive at our \$33 target price by applying about a 9x P/E multiple to our 2013 EPS estimate of \$3.65. By comparison, AXP is trading at 12.3x '13 and COF is also trading at 7.8x '13.

Price-To-Tangible Book Value Per Share – On a P/TBVPS, DFS trades at a 2x Q1's tangible book value of \$15.82, which is a significant discount to AXP trading at 4.6x and higher than COF trading 1.6x.

### Risks

DFS's business is sensitive to deteriorating credit and lower spending by consumers. Mitigating factors include: 1) strong relative performance of card spending & credit relative to the industry over the last recession; 2) history of solid growth; and 3) strong brand.

Changes in DFS's operating environment such as regulatory, economic, political, and market conditions are generally beyond the company's control. Please note that the risks delineated below may cause the stock to outperform/underperform our target price.

#### Positive Risks:

Economic conditions could improve dramatically in the short term, leading to lower unemployment and increased spending, driving earnings above our expectation. Or loan balances could increase driving higher earnings as well.

#### Negative Risks:

Economic and credit conditions could deteriorate, causing increased delinquencies and net charge offs above our forecasts and leading to higher loan loss provision rates.

Capital markets could shut down. This would significantly increase the cost of funding, which could negatively impact net income if price increases could not be passed along to customers.

Prime / LIBOR spread could compress or deviate from historical averages. Because DFS relies on net interest income for a greater percentage of income, relative to other credit card companies, this anomaly would more negatively impact the company.

If the impact on the company from any of these factors proves to be greater than we anticipate, the stock will likely have difficulty achieving our target price. Likewise, if any of these factors proves to have less an effect than we anticipate, the stock could materially outperform our target.

## Appendix A-1

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##### Ratings and Target Price History Fundamental Research

Analyst: Donald Fandetti, CFA



|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 1 | 19-Jun-09 | 2H     | *10.00       | 9.32          |
| 2 | 8-Sep-09  | 2H     | *16.00       | 13.75         |
| 3 | 17-Dec-10 | 2H     | *20.00       | 18.02         |
| 4 | 18-Jan-11 | *2M    | 20.00        | 20.74         |

\* Indicates change

|   | Date      | Rating | Target Price | Closing Price |
|---|-----------|--------|--------------|---------------|
| 5 | 18-Mar-11 | 2M     | *23.00       | 22.00         |
| 6 | 23-Mar-11 | 2M     | *25.00       | 23.44         |
| 7 | 23-Jun-11 | 2M     | *26.00       | 23.89         |
| 8 | 13-Sep-11 | 2M     | *28.00       | 25.08         |

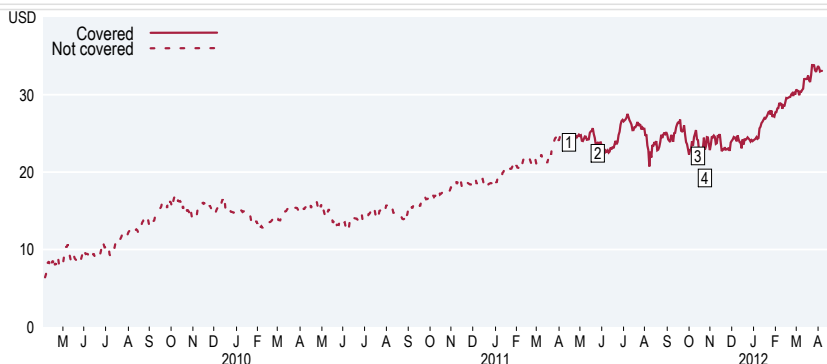
|    | Date      | Rating                      | Target Price | Closing Price |
|----|-----------|-----------------------------|--------------|---------------|
| 9  | 3-Oct-11  | 2M                          | *24.00       | 22.26         |
| 10 | 8-Oct-11  | Stock rating system changed |              |               |
| 11 | 8-Oct-11  | *2                          | 24.00        | 23.41         |
| 12 | 21-Mar-12 | 2                           | *33.00       | 31.64         |

Rating/target price changes above reflect Eastern Standard Time

#### Discover Financial Services (DFS)

##### Ratings and Target Price History Best Ideas Research Relative Call (3 Month)

Analyst: Donald Fandetti, CFA



|   | Date      | Rating  | Target Price | Closing Price |
|---|-----------|---------|--------------|---------------|
| 1 | 15-Apr-11 | *ADD LP | -            | 24.28         |
| 2 | 26-May-11 | *REM LP | -            | 23.80         |

\* Indicates change

|   | Date      | Rating  | Target Price | Closing Price |
|---|-----------|---------|--------------|---------------|
| 3 | 14-Oct-11 | *ADD LP | -            | 24.13         |
| 4 | 25-Oct-11 | *REM LP | -            | 22.92         |

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|--|-----------------|------|------|-----------------|------|------|
|  | Buy             | Hold | Sell | Buy             | Hold | Sell |
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