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American Express: Bullishness Will Certainly Prevail

Apr. 5.17 | About: American Express (AXP)

Summary

- American Express has seen a huge rally since November 2016.
- Can it surpass its 2014 high and get closer to the $100 level?
- I expect yes, driven by its unique business model and digital initiatives.

Despite the fact that American Express (NYSE:AXP) has rallied more than 25% over the past five months, the share price is still cheap compared to Visa (NYSE:V) and MasterCard (NYSE:MA). Visa and MasterCard enjoy far higher valuation multiples because Mr. Market thinks their business model is less risky, which is an illusion.

The valuation multiples of American Express should be higher than what it is enjoying currently, given the fact that the headwinds the company was facing in the past couple of years don't exist any longer. In this light, I believe smart money will flow from Visa and MasterCard to American Express. In this article, I will delve deeper into the topic.

American Express: Headwinds No Longer Exist

AmEx, along with Visa and MasterCard, is facing rising competition from players like online networks such as PayPal (NASDAQ:PYPL) and mobile wallets such as Apple's (NASDAQ:AAPL) Apple Pay and Google's (NASDAQ:GOOGL) (NASDAQ:GOOG) Android Pay. These new players are gradually expanding their presence in the payments industry with the help of new technologies. In addition, AmEx has lost its exclusive relationship with Costco (NASDAQ:COST) in the US in 2016, which will result in a decrease in revenue in the near term. Citigroup (NYSE:C) is Costco's new co-brand partner.

To fight rising competition, credit card issuers have changed their strategy this year. David Robertson, publisher of the Nilson Report, said:

> *Instead of aspirational rewards, such as free hotel stays and airline flights, issuers will focus more on "bread-and-butter rewards" this year, such as cash back. In 2017, we'll see much more offers aimed at people in the middle class. All the big issuers have already committed themselves to their upscale programs. They have nowhere to go but down.*

And this change will result in trouble for Visa and MasterCard indeed. But for AmEx, loss of Costco should be considered as a blessing in disguise because its co-brand relationship with Costco was primarily aimed at delivering low-margin "bread-and-butter rewards" rewards, as Robertson pointed out. Instead, its digital partnerships with Uber (Private:UBER), Airbnb (Private:AIRB), Amazon (NASDAQ:AMZN), Best Buy (NYSE:BBY) and Ticketmaster will more than offset the revenue loss from Costco in the long term. Clearly, the headwind in terms of losing Costco no longer exists.

Image Source: Company Presentation

AmEx has been able to resolve another headwind, which is increasing competition with online players, via expanding the degree of its millennial engagement exploiting digital channels. Nearly 40% of its new global consumer accounts were acquired through digital channels, such as PCs, smartphones and tablets. In addition, its new card members in the consumer and small business sectors in the US are on average younger by five years compared to what it was in 2010. The statistics show that millennial engagement is higher in the US compared to the rest of the world.

Image Source: Company Presentation

The millennial generation is gradually becoming the driving force of the US economy. According to a Wells Fargo (NYSE:WFC) economist who studies the millennial generation:

> *You have this big generation - bigger than the baby boomers now - and they have the potential to buy cars, buy houses, and the numbers do matter.*

Since AmEx is targeting this generation, also known as the Generation Y, which is thriving by embracing the digital and electronic technologies, its revenue will undoubtedly increase in the coming months and years. AmEx will certainly become a threat for Visa and MasterCard. While Visa and MasterCard will focus on offering "bread-and-butter rewards" to customers, AmEx will thrive by offering high-value rewards particularly to high-income group millennials for buying cars, houses and luxury items.

How American Express Is Competing With Emerging Players?

Among the emerging online players, the growth of Apple Pay remains significant in 2016, which grew 50%. Will AmEx be able to compete with such players? I believe yes. Its spend-centric business model, which works by leveraging modern technologies such as extensive use of analytics and algorithms, will allow the company to reach out to existing and potential customers with customized offers.

For example, for its "Travel & Lifestyle" services, the company is planning to offer personalized and streamlined services to its luxury traveler customers who expect immediate, one-stop-shop, customized travel experiences, the company said. It added:

> *We're seizing this growing demand by cultivating a team of lifestyle experts with unparalleled relationships and in-depth industry knowledge that can offer today's savvy global traveler elements of the trip beyond air and hotel - from VIP access to local insights on the newest restaurants to one-of-a-kind, extraordinary experiences.*

The unique business model of AmEx will help the company remain relatively immune from competition from emerging players in the payments industry. The question is why and how the business model is unique? Visa and MasterCard operate in open loop networks where banks issue cards bearing their logos. They only process payments. As a result, they don't have access to the card issuing end of any transaction, in which banks have access.

Compared to the open loop networks of Visa and MasterCard, the closed loop network of AmEx allows the company to access information at both ends, i.e., the ends of card members (as a card issuer) and merchants (as an acquirer). The company uses this information for targeted marketing and minimizing risk. The cornerstone of the AmEx investment thesis is that since its business model involves targeting customers leveraging sophisticated technology through exploiting digital channels, emerging players in the payments industry won't be able to out-compete it. These emerging players are posing a real threat to Visa and MasterCard.

Rising Interest Rate Not Favorable For Visa And MasterCard

Rising interest rate in the US will cause reduced usage of credits cards in the country. Visa and MasterCard will suffer more compared to AmEx due to their higher exposure to the middle-income group. Most of AmEx customers are affluent people, to whom an interest rate hike isn't a significant threat. Visa and MasterCard are offering higher cashback since the end of 2013, while lowering reward points issuance. However, people are more interested in getting cashback compared to redeeming reward points.

Offering higher cashback will certainly strain the balance sheets of Visa and MasterCard in this higher interest rate regime. For AmEx, though, this isn't a serious issue. If AmEx focuses on collaborating with companies like Square (NYSE:SQ), a POS (point-of-sale) provider, penetrating the cyber-market will be easier via expanding its relationship with smaller merchants.

American Express: Prudent Strategy Strengthened Fundamentals

The company's strategy for 2016 to remain competitive in the payments industry was accelerating revenue growth, optimizing investments and resetting cost base. The strategy resulted in improved fundamentals for the company. According to its most recent earnings call:

> *12 months later, we are pleased with the progress we made in 2016 and we ended the year in a stronger position than we started it.*

During 2016, its platinum, gold and delta portfolios witnessed strong growth in the US, which helped AmEx hike net card fees by 6% year over year. Despite fierce competition in the industry, AmEx was able to hike card fees, which is certainly encouraging for investors.

For boosting revenue, AmEx remained prudent in making investments. It significantly expanded its platinum portfolio in the US. In addition, it started offering various differentiated services, the most significant among which is offering lounge access to card-holders at major airports across the world. Such investments are already reflecting in its balance sheet.

For resetting its cost base, AmEx itself will undertake certain marketing activities from this year instead of offering those to external partners. This will significantly reduce operating costs going forward and improve the balance sheet further.

American Express: Risk Factors

Clearly, AmEx has built a significant digital advantage over Visa and MasterCard. Visa and MasterCard are also adopting digital transformation strategies to remain competitive. Although they can't surpass AmEx immediately because of their open loop networks, they're trying to overcome these shortcomings through embracing NFC (near field communication), which is a new technology that enables people to make mobile payments using contactless communication between a contactless card, card keyfob or mobile phone and a card machine. In addition, Visa and MasterCard are collaborating with mobile wallet players like Apple Pay, Android Pay and Samsung's (OTC:SSNLF) Samsung Pay to become digitally more active.

However, digital transformation is a complex and time-consuming process for traditional players like Visa and MasterCard. Identifying customers' spending trends/patterns needs a sophisticated digital framework, which would be difficult to maintain for open loop players like Visa and MasterCard. Why? Well, how would they gather customer-related information from the card issuing end of any transaction? Their open loop system is actually their competitive disadvantage, which Mr. Market hasn't recognized yet.

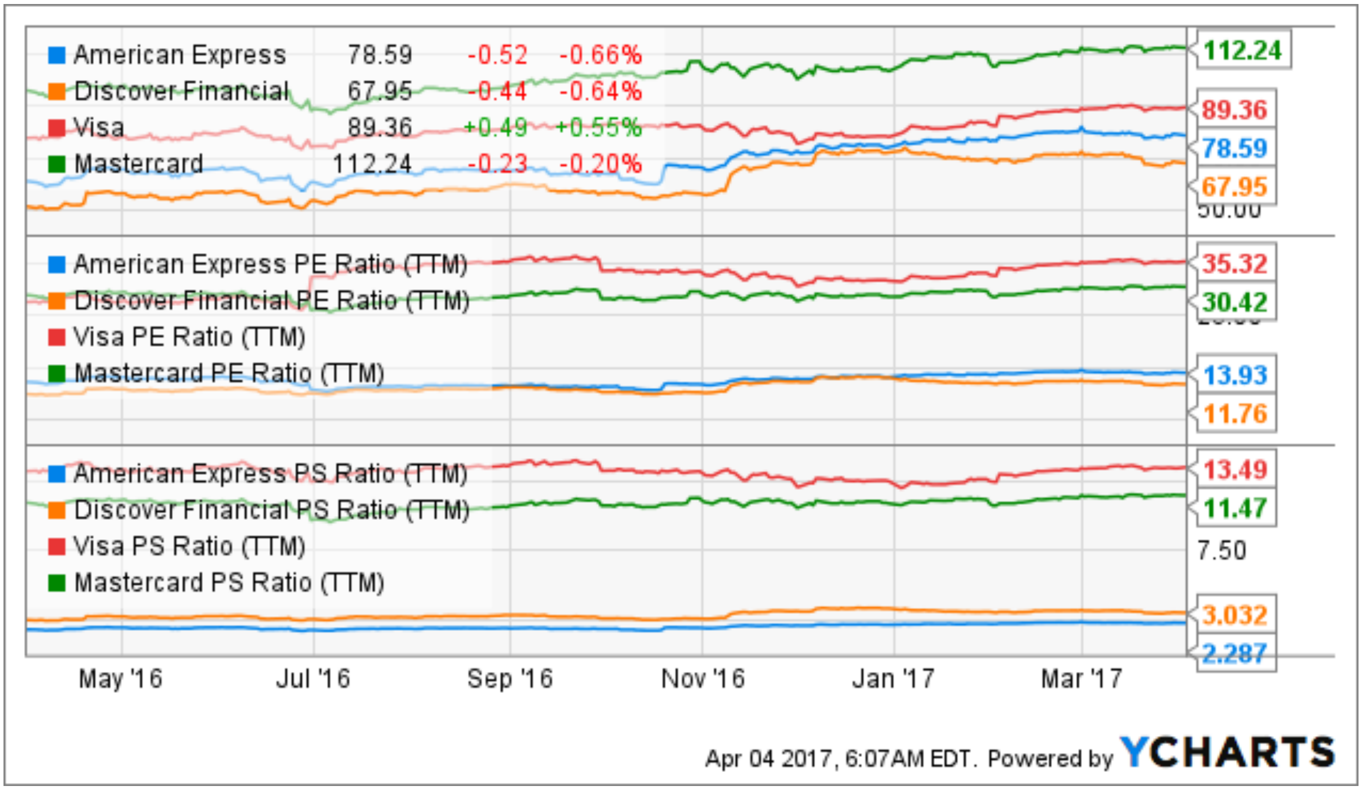
American Express: Valuation

During 2010-11, just after the end of the financial crisis of 2008-09, AmEx, Visa and MasterCard used to trade at similar valuation multiples. However, afterwards when QE (quantitative easing) was running at full speed, the valuation multiples of Visa and MasterCard skyrocketed due to the availability of easy credit at almost "zero" rate of interest.

AXP PE Ratio (TTM) data by YCharts

AXP PS Ratio (TTM) data by YCharts

Unfortunately, those golden days have gone for Visa and MasterCard. Meanwhile, AmEx has solidified its position in the payments industry via adopting prudent business strategies. Currently, AmEx is trading at a P/E multiple of 13.93x and a PS multiple of 2.29x. Its closest competitor Discover Financial (NYSE:DFS) trades at a P/E multiple of 11.76x and a P/S multiple of 3.03x. Although in terms of a P/E multiple, AmEx is slightly expensive than Discover Financial, in terms of a P/S multiple, it is significantly cheaper. Further, compared to Visa and MasterCard, both AmEx and Discover Financial are hugely cheap.



AXP data by YCharts

I expect AmEx to trade at high teens in terms of a P/E multiple, which will send the stock closer to $100. If that happens, it will trade at a P/S multiple Discover Financial is currently enjoying. Clearly, the upside target is certainly achievable. I strongly expect that smart money will flow to AmEx from Visa and MasterCard amid changed macro and industry conditions.

Final Words

The AmEx stock has seen a stunning rally over the past five months, and I expect it to take a breather in the near term, which would be a nice investing opportunity. Bullishness will certainly prevail.