FEATURE

Discover: A Credit-Card Stock With a Rewards Program for Investors

If the company can grow its loan book just a little bit faster, the shares could offer a 12% return within 12 months.

By ROBIN GOLDWYN BLUMENTHAL
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Give Discover Financial Services a bit more credit.

In 2016, for the third year in a row, the credit-card issuer and consumer lender ranked first in the J.D. Power survey of card-member satisfaction, ahead of better-known rivals such as American Express (ticker: AXP). Based on Discover's stress-test results, the Federal Reserve this year allowed it to raise its quarterly dividend 7%, to 30 cents a share, and buy back as much as $2.05 billion worth of shares.

Even as subprime lending creeps up, Discover has been disciplined, focusing on prime customers. Investors have rewarded Discover (DFS)—its shares' 23% return this year easily tops the KBW Bank Stock index's 15%—but not enough. At $64.60, the stock trades at 10.6 times next year's expected earnings, compared with the index members' average of 13.3. That doesn't reflect the potential of Discover as consumer spending rebounds and individuals' revolving credit volume expands. Like other bank stocks, Discover shares jumped once investors began to factor in the deregulatory stance of President-Elect Donald J. Trump. Lower corporate tax rates also would have an outsize benefit for Discover, which has a particularly high rate.

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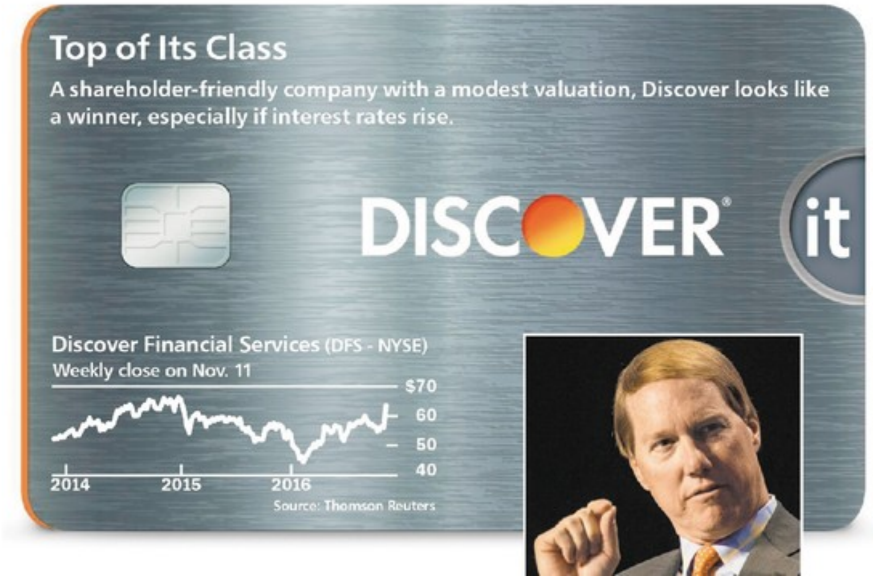


CEO David Nelms *Inset: Jacob Kepler/Bloomberg*

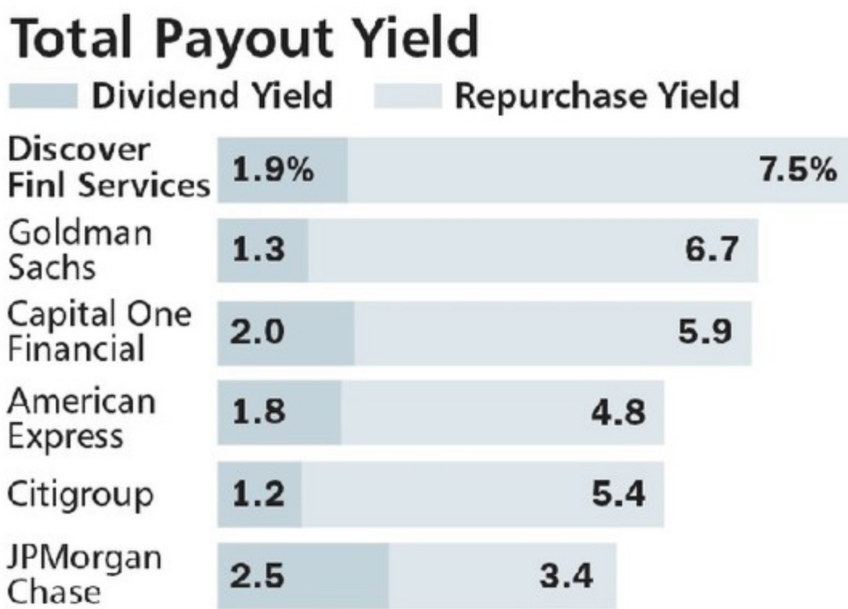
After the recent gains, the shares could still return more than 10% in the next year, including a 1.9% dividend yield. "The reality is the stock is cheap relative to its peers and historical averages," says Wells Fargo analyst Jason Harbes, who rates it Outperform.

Discover seems to be hitting a sweet spot as far as the consumer is concerned. The Census Bureau reported that real median U.S. household income surged 5.2% last year, the first gain since 2007. Meanwhile, the jobless rate remains low, at 4.9%.

John Wilson, CEO and co-chief investment officer of Discover shareholder Sprott Asset Management, also cites the U.S.'s 2.9% gross-domestic-product growth rate in the third quarter, more than twice that of the second quarter. "If people become convinced that we're growing closer to 3%, they will be less worried about the credit cycle turning," he says.

DISCOVER'S LOAN GROWTH, which was up by about 4% a quarter earlier this year, accelerated to 5% in the third quarter. That has helped earnings per share—$4.37 through three quarters—rise. Analysts expect them to hit $5.72 for the full year, an 11.5% gain over last year's. Revenue should be $9.1 billion in 2016, up 4.1%.

Overall consumer credit-card debt should top its all-time high this year, according to David Robertson, publisher of the Nilson Report, which tracks the business. Revolving credit, in which consumers roll over debt rather than paying off all of it monthly, is the most profitable segment, and it's growing at its fastest pace since the Great Recession. Credit-card loans made up $58 billion, or 80%, of Discover's $73.6 billion portfolio at the end of the third quarter. The rest is student and personal loans.



Sources: FactSet; Wells Fargo Securities, LLC estimates

The Bottom Line

If Discover can grow its loan book a little faster, its stock will merit a higher valuation. Shares, yielding 1.9%, could reach $70 from $64.60 in 12 months.

"If Discover can meaningfully accelerate loan growth to the 6% range, you're going to see an uptick in EPS and the multiple," says Etienne Bordeleau-Labrecque, an analyst with Sprott. The firm has an above-consensus projection of 2017 earnings at $6.40 a share, with the multiple rising to 11 to reflect that growth. That would put the stock at $70 in the next 12 months.

Although analysts say Trump's election makes a Federal Reserve rate hike next month less likely, the general increase in rates should help Discover. Net interest income climbed 8%, or $140 million, in the third quarter as the loan portfolio and net interest margin grew. Discover Chairman and CEO David Nelms tells *Barron's* that an eventual Fed rate hike would help boost income, though probably less than it would for typical banks. "The bigger benefit could be what it says about how the economy is doing," he adds.

Discover was founded in 1986, part of retailer Sears' foray into financial services. Discover invented cash-back rewards, which give consumers money back on purchases. That, and charging merchants lower fees than do Visa (V) or Mastercard (MA), spurred growth. In 1993, Sears spun off the company, which merged with Morgan Stanley in 1997. Morgan Stanley brought Discover public in 2007. By 2015, it had 7% of the credit-card market, making it the sixth-largest player.

The company is known for its customer service. For example, 100% of its call centers are in the U.S., an attribute it plays up in ads featuring customers chatting on the phone with employees who look and sound like them. Contact with customer service representatives is always available. The ads' tagline: "We treat you like you'd treat you."

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Discover is winning a reputation for treating shareholders pretty well, too. Since 2013, it has lifted dividends and buybacks. Its payout ratio of net income allocated to common shareholders has risen to 95% from 52% in that span, notes investment bank JMP. As the table at the left shows, Discover has the industry's highest dividend plus buyback yield, at 9.4%.

Although the subprime space has been growing faster than the prime segment, Discover has stuck to its knitting, costing it some market share. "We aren't chasing unprofitable volume," Nelms said on the company's third-quarter earnings call. Whereas Capital One (COF) reported its highest domestic delinquency rate in several years, 3.68%, at the end of the third quarter, Discover's rate was just 1.79%.

Card issuers' high delinquencies reflect heated competition. Discover is now offering new card holders double the normal rewards level for the first year of membership. That, plus higher marketing expenses, have put some pressure on earnings.

While it's worth keeping an eye on those expenses, the credit cycle is benign. Employment is strong; household debt relative to total assets was the lowest in 2015 since 2000, and consumer spending rose 0.5% in September. The risk in the stock seems modest, given the potential reward.

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Mike Buchholz 2 days ago

when i was in college in 1990 i had a Discover Card and an American Express. Both are not in my wallet anymore. Discover Card not sure why I cancelled it I think the cash back just got old. America Express when they lost Costco and the customer service is HORRIBLE at AMEX. Chase Customer Service seems outstanding so that is my main card. (US Bank also horrible service) I really forgot about Discover over the years interesting article.

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