

## Discover Financial (DFS)

**\$60.62** (As of 06/05/20)

Price Target (6-12 Months): **\$52.00**

Long Term: 6-12 Months

**Zacks Recommendation:** Underperform

(Since: 04/26/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

**Zacks Rank:** (1-5)

**3-Hold**

Zacks Style Scores:

VGM:D

Value: B

Growth: D

Momentum: F

## Summary

Discover Financial's shares have underperformed its industry in a year's time. Expenses are expected to increase going forward, which will put pressure on margins. Increasing provision for loan losses due to higher net charge-offs, rise in reserve build and constant supply-driven normalization in the consumer credit line continue to be concerns. The company withdrew its guidance for 2020 due to current market volatility. Nevertheless, its revenues continue to grow on the back of higher interest income and solid Direct Banking business. Further, the company has undertaken several cost-cutting initiatives. Its strong balance sheet is another positive. The company's sound capital and cash position facilitates efficient deployment of excess capital through share repurchases and dividend payouts.

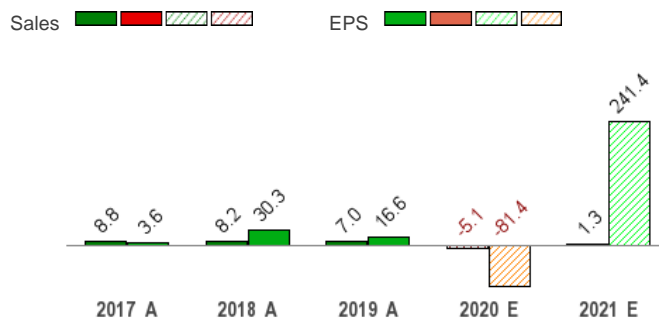
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	\$92.98 - \$23.25
20 Day Average Volume (sh)	5,372,467
Market Cap	\$18.6 B
YTD Price Change	-28.5%
Beta	1.87
Dividend / Div Yld	\$1.76 / 2.9%
Industry	<a href="#">Financial - Consumer Loans</a>
Zacks Industry Rank	Bottom 6% (239 out of 253)

## Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-118.4%
Last Sales Surprise	0.8%
EPS F1 Est- 4 week change	-14.4%
Expected Report Date	07/28/2020
Earnings ESP	-49.2%
P/E TTM	9.1
P/E F1	35.9
PEG F1	4.8
P/S TTM	1.3

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	2,670 E	2,686 E	2,735 E	2,816 E	11,023 E
2020	2,888 A	2,632 E	2,618 E	2,711 E	10,878 E
2019	2,763 A	2,852 A	2,900 A	2,944 A	11,459 A

## EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.37 E	\$1.29 E	\$1.71 E	\$2.12 E	\$5.77 E
2020	-\$0.25 A	\$0.38 E	\$0.88 E	\$0.75 E	\$1.69 E
2019	\$2.15 A	\$2.32 A	\$2.36 A	\$2.25 A	\$9.08 A

\*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/05/2020. The reports text is as of 06/08/2020.

## Overview

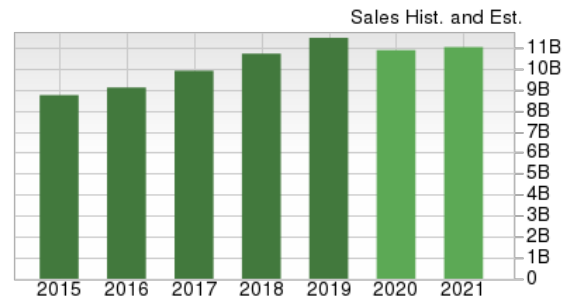
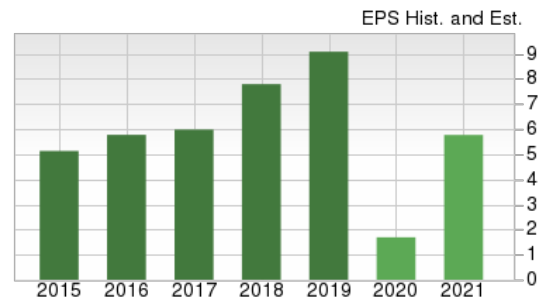
Founded in 1986 and based in Riverwoods, IL, Discover Financial Services is a direct banking and payment services company in the United States. The company offers credit cards, personal, student and home loans as well as deposit products. In March 2009, Discover Financial became a bank holding company under the Bank Holding Company Act of 1956 and a financial holding company under the Gramm-Leach-Bliley Act in connection with its participation in the U.S. Treasury's Capital Purchase Program.

Discover Financial offers its products and services with acceptance in more than 185 countries and territories. The company operates through three networks:

- The Discover Network – Discover Financial's credit card payment network.
- The PULSE network – Discover Financial's ATM, debit and electronic funds transfer network.
- Diners Club International – Discover Financial's global payment network.

Discover Financial manages its business activities in two segments:

- **The Direct Banking segment (accounted for 95% of pretax income in 2019):** This includes Discover card-branded credit cards issued to individuals and small businesses in the Discover Network. The segment also offers personal loans, student loans, home loans, prepaid cards and other consumer lending and deposit products.
- **The Payment Services segment (5%):** This includes PULSE, Diners Club and its network partners business (previously referred to as the third-party issuing business), which includes credit, debit and prepaid cards issued by the third parties on the Discover Network.



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## Reasons To Sell:

- ▼ **Escalating Expenses:** Discover Financial has been incurring considerable expenses, over the past many years, in order to compete with other credit card issuers, attract and retain customers and also increase the card usage. For 2018 and 2019, total other expenses increased 8% and 7% year over year, respectively. In the first quarter of 2020, expenses rose 13.2% year over year due to higher compensation expense, increased marketing cost and investments in technology. The planned marketing, technology and infrastructure investments and high legal, regulatory and compliance costs are also expected to increase operating expenses, going forward, which would limit its bottom-line growth.
  - ▼ **Withdrawal of Guidance:** The company scrapped its 2020 outlook due to the current market volatility. The company has witnessed its 2019 estimates move 7.6% south over the past seven days.
  - ▼ **Provision for Loan Losses:** The company's provision for loan losses has been increasing over the last few quarters due to higher net charge-offs, rise in reserve build, seasoning of newer vintages and constant supply-driven normalization in the consumer credit line. In 2018 and 2019, the metric grew 17% and 6% year over year, respectively. In the first quarter, provision for credit losses increased 123.3% year over year, reflecting weak economic outlook.
  - ▼ **Weak Sales Volumes:** The company has been witnessing pressure on its sales volumes since April. Increased spending on groceries was offset by a 60% decline in spending on petroleum. The company also saw softness in sales volume in travel category and retail and the trend is likely to continue until the pandemic persists. Although total card sales volume inched up 3.3% year over year in the first quarter, we expect the same to remain under pressure in the coming quarters.
  - ▼ **Price Movement:** In a year's time, shares of Discover Financial have underperformed its industry's growth. Moreover, the weakness in spending will pressurize the company earnings which is likely to keep the stock stressed going forward.
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Escalating expenses and increasing provision for loan losses are some of the headwinds facing the company.

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## Risks

- **Revenue Momentum:** Organic growth is a key strength at Discover Financial as reflected in its revenue growth story. The upside was mainly driven by higher net interest incomes and other total income of the company. Interest income of the company saw a CAGR of 8.1% from 2013 to 2019, which remains impressive to investors. In the first quarter of 2020, the company's revenues — net of interest expenses — increased 5% year over year to \$2.9 billion, driven by higher net interest income and total other income. We believe that the company should retain its revenue growth momentum in the coming quarters, given its solid market position, expansion in global payments business and attractive core business.
  - **Cost-Curbing Initiatives:** The company took certain cost-controlling initiatives in response to the current economic environment. For the remaining three quarters of 2020, the company targets \$400 of cost savings. The actions include reducing account acquisition expense, cutting down on brand awareness and consideration activities, and reducing vendor and technology spend.
  - **Strong Direct Banking Business:** Discover Financial's banking business provides significant diversification benefits. This business has been performing strongly from the past several years. Within this business, the private student loan portfolio grew significantly, evident from its eight-year (2010-2019) CAGR of 28.6%. In the first quarter, net interest income of this business inched up 1.5% year over year. We expect this segment to continue performing well going forward.
  - **Effective Capital Management:** Discover Financial has implemented several capital-boosting initiatives, including equity and debt offerings, which have helped the company to achieve a strong capital base. The healthy capital and cash position facilitate efficient deployment of excess capital through acquisitions, share repurchases and dividend payouts. Its current dividend yield stands at 2.9%, higher than its industry's metric of 2.5%. Although the company suspended its share buyback plan currently, we expect the same to resume once things get back to normalcy.
  - **Profitability:** Discover Financial's return-on-equity (ROE) reflects its growth potential. The company's trailing 12-month ROE of 20.4% not only improved over the years but also compares favorably with the industry average of 8.5%.
  - **Balance Sheet Strength:** The company's balance sheet position remains impressive. Net debt is 41.6% (almost in line sequentially) of its total capital, which is lower than the industry average of 48.8%. Its times interest earned now is 4.1x (in line sequentially), which is better than the industry average of 2.7x. As of Mar 31, 2020, it had cash and cash equivalents of \$1 billion and credit facilities through private providers of \$6 billion, higher than its long-term debt of \$2.6 billion. It also has \$35 billion in borrowing capacity at the Federal Reserve discount window. Thus, its solvency position looks strong.
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## Last Earnings Report

### Discover Financial's Q1 Earnings Miss, Tumble Y/Y

Discover Financial incurred first-quarter 2020 adjusted loss of 25 cents per share. The Zacks Consensus Estimate was of adjusted earnings of \$1.36. Moreover, the bottom line came in against the year-ago quarter's adjusted earnings of \$2.15 per share. This underperformance was due to the COVID-19 outbreak.

#### Operational Update

In the reported quarter, the company's revenues — net of interest expenses — increased 5% year over year to \$2.9 billion, driven by higher net interest income and total other income. Moreover, the top line beat the Zacks Consensus Estimate by 0.8%.

Total loans grew 5% year over year to \$93 billion.

Interest expenses of \$584 million decreased 7.6% year over year.

Total other expenses rose 13.2% to \$1.15 billion due to higher employee compensation and benefits, marketing and business development, information processing and communications, and professional fees and other expenses.

#### Segmental Update

##### Direct Banking Segment

This segment's pre-tax loss of \$161 million came in against the year-ago quarter's pre-tax income of \$879 million. This was due to higher provision of credit losses and higher operating expenses.

Total loans climbed 5% year over year to \$93 billion. Credit card loans augmented 4% to \$73.8 billion.

Personal loans ascended 3% while private student loans rose 4%, both on a year-over-year basis. Private student loans excluding purchased student loans also shot up 9% year over year.

Net interest income increased 4% year over year, backed by loan growth.

Net interest margin was 10.21%, down 25 basis points from the year-ago quarter.

##### Payment Services Segment

Payment Services pre-tax income was \$83 million in the quarter under review, up 62.7% from the year-earlier period owing to a one-time gain on the sale of an equity investment.

Payment Services volume was up 5% from the prior-year period.

PULSE dollar volume expanded 4% year over year, fueled by the impact of new issuers and acquiring relationships on the network as well as strong growth from existing issuers and acquirers.

Diners Club volume declined 6.5% from the year-earlier quarter.

Network Partners volume expanded 23%, backed by AribaPay.

#### Strong Financial Position

Discover Financial had total assets worth \$112.6 billion as of Mar 31, 2020, up 1.7% year over year.

Total liabilities as of Mar 31, 2020 were \$102.9 billion, up 3.6% year over year.

Total equity was \$9.6 billion on Mar 31, 2020, down 14.2% year over year.

#### Share Repurchase Update

During the quarter under review, the company bought back 4.7 million shares of common stock for \$343 million. It suspended the buyback program in March.

Shares of common stock outstanding dipped 1.2% from the previous quarter's level.

Quarter Ending 03/2020

Report Date	Apr 22, 2020
Sales Surprise	0.83%
EPS Surprise	-118.38%
Quarterly EPS	-0.25
Annual EPS (TTM)	6.68

## Recent News

### Discover Financial Postpones EMV Fraud Liability Shift – May 14, 2020

Discover Financial has deferred the EMV fraud liability shift, effective Oct 16, 2020 to Apr 16, 2021 for contact chip transactions at automated fuel dispensers. This is in response to the coronavirus outbreak, which will provide more flexibility to petroleum merchants.

### Discover Financial Declares Quarterly Dividend – Apr 22, 2020

The company's Board of Directors have declared a quarterly cash dividend of 44 cents per share, payable Jun 4, 2020 to shareholders as of May 21, 2020.

### Discover Financial Expands Existence in Oman – Feb 12, 2020

Discover's payment brand Discover Global Network recently entered a deal with the National Bank of Oman (NBO) to increase acceptance for Discover, Diners Club International and affiliate network cards.

## Valuation

Discover Financial's shares are down 27.3% and 20.3% in the year-to-date period and over the trailing 12-month period, respectively. Stocks in the Zacks sub-industry and the Zacks Finance sector are down 19.2% and 13.3% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 13.4% and 5%, respectively.

The S&P 500 index is down 0.2% in the year-to-date period and up 12.5% in the past year.

The stock is currently trading at 17.49x forward 12-month earnings, which compares to 16.2x for the Zacks sub-industry, 17.76x for the Zacks sector and 23.08x for the S&P 500 index.

Over the past five years, the stock has traded as high as 17.49x and as low as 2.8x, with a 5-year median of 9.34x. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$52 price target reflects 15x forward earnings.

The table below shows summary valuation data for DFS:

Valuation Multiples - DFS					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	17.49	16.2	17.76	23.08
	5-Year High	17.49	16.2	17.76	23.08
	5-Year Low	2.8	4.38	11.58	15.23
	5-Year Median	9.34	8.77	13.98	17.49
P/S F12M	Current	1.7	1.17	6	3.59
	5-Year High	4.01	2	6.65	3.59
	5-Year Low	0.64	0.72	5	2.54
	5-Year Median	2.84	1.5	6.05	3
P/B TTM	Current	2.04	0.72	2.49	4.36
	5-Year High	2.86	1.22	2.9	4.56
	5-Year Low	0.7	0.39	1.71	2.83
	5-Year Median	2.26	0.95	2.52	3.65

As of 06/05/2020

## Industry Analysis Zacks Industry Rank: Bottom 6% (239 out of 253)



## Top Peers

Company (Ticker)	Rec	Rank
Ally Financial Inc. (ALLY)	Neutral	4
MR. COOPER GROUP INC (COOP)	Neutral	4
First Cash, Inc. (FCFS)	Neutral	4
Santander Consumer USA Holdings Inc. (SC)	Neutral	4
Navient Corporation (NAVI)	Underperform	5
SLM Corporation (SLM)	Underperform	5
Nelnet, Inc. (NNI)	NA	NA
OneMain Holdings, Inc. (OMF)	NA	5

Industry Comparison Industry: Financial - Consumer Loans				Industry Peers		
	DFS	X Industry	S&P 500	ALLY	NAVI	SC
Zacks Recommendation (Long Term)	Underperform	-	-	Neutral	Underperform	Neutral
Zacks Rank (Short Term)	3	-	-	4	5	4
VGM Score	D	-	-	D	B	D
Market Cap	18.57 B	577.15 M	23.09 B	8.45 B	1.71 B	6.81 B
# of Analysts	8	2	14	3	3	6
Dividend Yield	2.90%	0.00%	1.82%	3.36%	7.26%	4.15%
Value Score	B	-	-	B	B	B
Cash/Price	0.77	0.77	0.06	0.95	2.61	0.47
EV/EBITDA	7.10	6.27	13.17	6.38	99.92	9.67
PEG Ratio	4.96	0.51	3.13	NA	NA	NA
Price/Book (P/B)	2.04	0.92	3.15	0.62	0.83	1.32
Price/Cash Flow (P/CF)	6.39	3.88	12.43	2.84	3.06	2.47
P/E (F1)	36.82	11.42	22.80	45.58	4.03	NA
Price/Sales (P/S)	1.32	0.98	2.52	1.36	0.34	0.85
Earnings Yield	2.79%	5.28%	4.19%	2.21%	24.86%	-0.61%
Debt/Equity	2.87	2.30	0.76	2.30	39.70	7.82
Cash Flow (\$/share)	9.48	4.49	7.01	7.96	2.88	8.57
Growth Score	D	-	-	F	C	D
Hist. EPS Growth (3-5 yrs)	12.65%	10.98%	10.87%	15.39%	6.79%	1.28%
Proj. EPS Growth (F1/F0)	-81.37%	-38.76%	-10.79%	-86.65%	-17.17%	-104.37%
Curr. Cash Flow Growth	7.14%	17.70%	5.48%	-1.59%	12.54%	20.07%
Hist. Cash Flow Growth (3-5 yrs)	4.70%	9.07%	8.55%	-4.75%	-5.09%	25.86%
Current Ratio	1.26	3.42	1.29	0.99	10.48	63.41
Debt/Capital	72.97%	68.95%	44.75%	69.68%	97.54%	88.66%
Net Margin	15.39%	8.29%	10.59%	16.46%	7.24%	9.32%
Return on Equity	20.38%	13.91%	16.26%	6.92%	18.83%	10.95%
Sales/Assets	0.13	0.24	0.55	0.03	0.05	0.17
Proj. Sales Growth (F1/F0)	-5.07%	0.00%	-2.61%	-6.62%	-5.28%	0.12%
Momentum Score	F	-	-	C	C	F
Daily Price Chg	4.05%	2.99%	2.89%	6.74%	7.24%	8.11%
1 Week Price Chg	17.40%	2.77%	4.60%	9.75%	6.74%	6.85%
4 Week Price Chg	49.75%	27.20%	15.60%	50.13%	16.91%	37.57%
12 Week Price Chg	35.07%	13.52%	29.34%	15.63%	9.10%	13.98%
52 Week Price Chg	-22.38%	-18.86%	2.76%	-24.10%	-33.02%	-8.46%
20 Day Average Volume	5,372,467	301,329	2,537,324	6,167,738	2,274,960	1,007,102
(F1) EPS Est 1 week change	-15.58%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-14.39%	-1.75%	-0.08%	24.17%	-12.06%	-259.57%
(F1) EPS Est 12 week change	-81.03%	-38.24%	-16.19%	-88.36%	-29.33%	-104.52%
(Q1) EPS Est Mthly Chg	-33.70%	0.00%	0.00%	12.65%	-8.57%	-54.55%

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## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

### Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

### Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

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### Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	<b>B</b>
Growth Score	<b>D</b>
Momentum Score	<b>F</b>
VGM Score	<b>D</b>

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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