

## Discover Financial (DFS)

**\$27.00** (As of 03/18/20)

Price Target (6-12 Months): **\$23.00**

Long Term: 6-12 Months

**Zacks Recommendation:** Underperform

(Since: 01/28/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

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

**4-Sell**

Zacks Style Scores:

VGM:A

Value: A

Growth: B

Momentum: A

## Summary

Discover Financial's shares have underperformed its industry in a year's time. The company has been incurring costs to compete with other card issuers. Rising expenses is another concern. Increasing provision for loan losses due to higher net charge-offs, rise in reserve build, seasoning of newer vintages and constant supply-driven normalization in the consumer credit line bothers Discover Financial. Nevertheless, its Direct Banking business, dollar volume growth, card sales and capital management look promising. The company continues to launch new products tailored to suit customer needs in order to attract new customers. Revenues have been rising over the past few years driven by higher net interest incomes and other total income. Its return on equity also impresses.

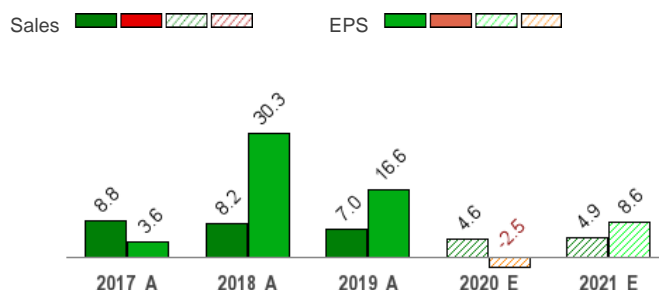
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	<b>\$92.98 - \$23.25</b>
20 Day Average Volume (sh)	<b>3,941,335</b>
Market Cap	<b>\$8.3 B</b>
YTD Price Change	<b>-68.2%</b>
Beta	<b>1.52</b>
Dividend / Div Yld	<b>\$1.76 / 6.5%</b>
Industry	<b>Financial - Consumer Loans</b>
Zacks Industry Rank	<b>Top 33% (83 out of 253)</b>

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



Last EPS Surprise	<b>0.9%</b>
Last Sales Surprise	<b>-0.1%</b>
EPS F1 Est- 4 week change	<b>-1.1%</b>
Expected Report Date	<b>04/23/2020</b>
Earnings ESP	<b>-1.4%</b>

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	2,987 E	3,060 E	3,138 E	3,244 E	12,575 E
2020	2,897 E	2,951 E	3,020 E	3,106 E	11,986 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	\$2.43 E	\$2.40 E	\$2.33 E	\$2.24 E	\$9.61 E
2020	\$2.17 E	\$2.34 E	\$2.23 E	\$2.11 E	\$8.85 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.

P/E TTM	<b>3.0</b>
P/E F1	<b>3.1</b>
PEG F1	<b>0.4</b>
P/S TTM	<b>0.6</b>

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 03/18/2020. The reports text is as of 03/19/2020.

## Overview

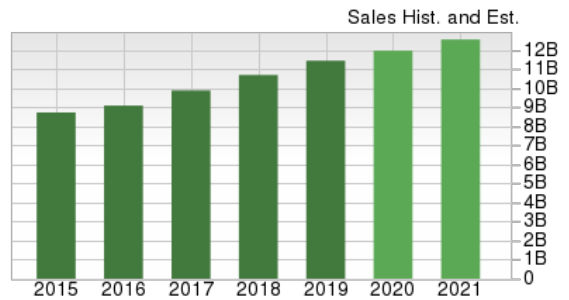
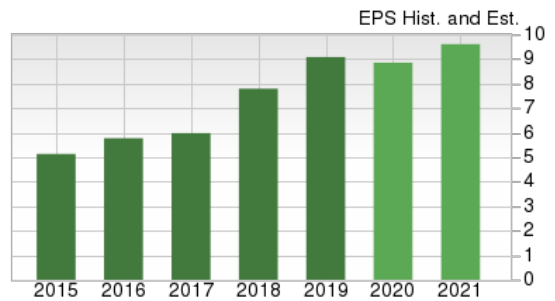
Founded in 1986 and based in Riverwoods, IL, Discover Financial Services is a direct banking and payment services company in the United States. The company offers credit cards, personal, student and home loans as well as deposit products. In March 2009, Discover Financial became a bank holding company 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:

- ▼ **Expense Pressure:** Discover Financial has been incurring considerable expenses in order to compete with other credit card issuers, attract and retain customers and also increase the card usage from the past many quarters. For 2018 and 2019, total other expenses increased 8% and 7% year over year, respectively. The anti-money laundering program enhancements, other 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. Discover Financial also anticipates its operating expenses between \$4.7 billion to \$4.9 billion in 2020, the mid-point being 9.3% more than the 2019 reported figures.
- ▼ **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.
- ▼ **Increase in Financial Leverage:** The company's over dependence on debt has resulted in a persistent increase in the leverage level. Its debt-to-equity ratio rose from 189.4% in 2013 to 244.6% in 2018 and currently stands at 217% (as of Dec 31, 2019). Moreover, times interest earned, a ratio that measures the company's ability to pay its interest expenses, declined to 5 at the end of 2019 from 9.8 in 2013. An increase in leverage thus might cause heightened financial risk for the company and burden on margins.
- ▼ **Share Price Performance:** Shares of the company have underperformed its industry in a year's time. Major concerns such as increase in leverage might put a pressure on the stocks going forward.

Escalating expenses and increasing provision for loan losses are some of the headwinds facing the company. Its elevated debt level also bothers.

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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. 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.
  - **2020 Guidance:** Following fourth-quarter results, the company provided its outlook for 2020. It expects loan growth in the range of 5-7%. On the back of a stable credit environment and the seasoning of its expanding portfolio, the company projects net charge-offs for 2020 between 3.3% and 3.5%.
  - **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 2019, net interest income of this business increased 8% year over year. We expect this segment to continue performing well going forward.
  - **Soaring Card Sales Volume:** Discover Financial is one of the major card issuers in the U.S. and a leading innovator in the credit card industry. The company continues to launch new products tailored to suit specific customer needs in order to attract new customers. It is also active in forging alliances and partnerships, on the back of which, card sales volume increased at an average rate of 4.6% in last five years (2013-2018) primarily due to a rise in the number of customers using Discover card. On the back of escalated consumer spending, the metric rose 5% year over year in 2019. We believe that the significant investments in marketing and business development will continue to benefit Discover Financial's card account growth and card sales volumes in the future.
  - **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. In June, the company declared its capital plan for the four quarters ending Jun 30, 2020, pertaining to which the company will buy back shares up to \$1.63 billion and there is also a 10% hike in its quarterly dividend. Its dividend yield stands at 6.5%, higher than its industry's average of 4%. Steady capital deployment should instill investors' confidence in the stock.
  - **Profitability:** Discover Financial's return-on-equity (ROE) reflects its growth potential. The company's trailing 12-month ROE of 26.6% not only improved over the years but also compares favorably with the industry average of 13%.
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## Last Earnings Report

### Discover Financial Q4 Earnings Top Estimates, Rise Y/Y

Discover Financial's fourth-quarter 2019 adjusted earnings of \$2.25 beat the Zacks Consensus Estimate by 0.9%. Moreover, the bottom line improved 10.8% year over year on higher revenues and loan growth. The Payments Services segment witnessed significant growth in the fourth quarter.

#### 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 discount and interchange revenues. However, the top line missed the Zacks Consensus Estimate by 0.1%.

Total loans grew 6% year over year to \$95.9 billion.

Interest expenses of \$615 million increased 1.7% year over year.

Total other expenses rose 6.7% to \$1.18 billion due to higher employee compensation and benefits, information processing and communications, and professional fees.

#### Segmental Update

##### Direct Banking Segment

This segment's pre-tax income inched up 1% to \$883 million owing to more net interest income. However, the same was largely offset by a rise in provision for loan losses and higher operating expenses.

Total loans climbed 6% year over year to \$95.9 billion. Credit card loans augmented 6% to \$77.2 billion.

Personal loans ascended 3% while private student loans rose 3%, 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 5% year over year, backed by loan growth. Net interest margin was 10.29%, down 6 basis points from the year-ago quarter.

##### Payment Services Segment

Payment Services pre-tax income was \$41 million in the quarter under review, up 78.3% from the year-earlier period owing to higher revenues, aided by transaction volume growth from PULSE and Network Partners businesses. Payment Services volume was up 9% from the prior-year period.

PULSE dollar volume expanded 6% year over year, fueled by the impact of new issuers and acquiring relationships on the network and strong growth from existing issuers and acquirers.

Diners Club volume grew 1.5% from the year-earlier quarter.

Network Partners volume expanded 52%, backed by AribaPay.

#### Strong Financial Position

Discover Financial had total assets worth \$113.9 billion as of Dec 31, 2019, up 4.1% year over year.

Total liabilities as of Dec 31, 2019 were \$102.1 billion, up 3.8% year over year.

Total equity was \$11.8 billion on Dec 31, 2019, up 6.5% year over year.

Discover Financial's return on equity for the fourth quarter was 24%.

#### Share Repurchase Update

During the quarter under review, the company repurchased approximately 4.9 million shares of common stock for \$401 million.

Shares of common stock outstanding dipped 1.5% from the previously reported quarter's tally.

Quarter Ending 12/2019

Report Date	Jan 23, 2020
Sales Surprise	-0.10%
EPS Surprise	0.90%
Quarterly EPS	2.25
Annual EPS (TTM)	9.08

## Recent News

### Discover 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.

### Discover Ties Up to Expand Its Presence in UK, Ireland – Dec 19, 2019

Discover Financial Services' payment brand Discover Global Network entered into an agreement with EVO Payments, which would allow EVO merchants in the UK and Ireland to process Discover, Diners Club International and associate card networks.

### Discover Cardmembers Can Now Use Their Accounts Via Amazon Alexa — Dec 9, 2019

Discover has announced that cardmembers can now access their credit card accounts through Amazon Alexa.

## Valuation

Discover Financial's shares are down 68.2% and 62.2% 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 54.9% and 35.5% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 48% and 30%, respectively.

The S&P 500 index is down 25.4% in the year-to-date period and down 15.8% in the past year.

The stock is currently trading at 3 trailing 12-month price to earnings ratio, which compares to 3.7 for the Zacks sub-industry, 9.9 for the Zacks sector and 14.1 for the S&P 500 index.

Over the past five years, the stock has traded as high as 13.2 and as low as 3, with a 5-year median of 9.4. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$23 price target reflects 2.6 earnings.

The table below shows summary valuation data for DFS

Valuation Multiples - DFS					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	3	3.71	9.85	14.12
	5-Year High	13.18	10.82	16.21	19.34
	5-Year Low	3	3.71	9.85	14.12
	5-Year Median	9.39	8.77	13.97	17.42
P/S F12M	Current	0.69	0.65	5.99	2.58
	5-Year High	4.01	2.07	6.64	3.43
	5-Year Low	0.69	0.65	5.39	2.54
	5-Year Median	2.98	1.51	6.04	3
P/B TTM	Current	0.75	0.35	1.83	3.23
	5-Year High	2.86	1.23	2.89	4.55
	5-Year Low	0.75	0.35	1.83	2.85
	5-Year Median	2.28	0.96	2.52	3.63

As of 03/18/2020

## Industry Analysis Zacks Industry Rank: Top 33% (83 out of 253)



## Top Peers

MR. COOPER GROUP INC (COOP)	Outperform
SLM Corporation (SLM)	Outperform
Ally Financial Inc. (ALLY)	Neutral
First Cash, Inc. (FCFS)	Neutral
Global Payments Inc. (GPN)	Neutral
Navient Corporation (NAVI)	Neutral
Santander Consumer USA Holdings Inc. (SC)	Neutral
Synchrony Financial (SYF)	Neutral

Industry Comparison Industry: Financial - Consumer Loans				Industry Peers		
	DFS Underperform	X Industry	S&P 500	ALLY Neutral	NAVI Neutral	SC Neutral
<b>VGM Score</b>	<b>A</b>	-	-	<b>B</b>	<b>B</b>	<b>A</b>
Market Cap	8.33 B	487.52 M	16.02 B	4.62 B	966.67 M	4.44 B
# of Analysts	9	2.5	13	4	5	7
Dividend Yield	6.52%	0.00%	2.66%	6.16%	12.80%	6.73%
<b>Value Score</b>	<b>A</b>	-	-	<b>A</b>	<b>A</b>	<b>A</b>
Cash/Price	0.44	0.42	0.06	0.46	2.26	0.32
EV/EBITDA	5.76	6.00	10.21	6.71	99.50	9.01
PEG Ratio	0.40	0.29	1.46	0.18	0.09	2.38
Price/Book (P/B)	0.75	0.59	2.18	0.33	0.33	0.61
Price/Cash Flow (P/CF)	2.85	2.23	8.79	1.55	1.74	1.53
P/E (F1)	3.00	3.72	12.92	2.91	1.62	4.77
Price/Sales (P/S)	0.60	0.60	1.74	0.72	0.17	0.56
Earnings Yield	32.78%	26.89%	7.70%	34.44%	61.80%	20.95%
Debt/Equity	2.28	1.87	0.70	2.36	24.40	5.36
Cash Flow (\$/share)	9.48	4.49	7.01	7.96	2.88	8.57
<b>Growth Score</b>	<b>B</b>	-	-	<b>D</b>	<b>D</b>	<b>A</b>
Hist. EPS Growth (3-5 yrs)	13.70%	12.44%	10.85%	17.52%	4.72%	0.79%
Proj. EPS Growth (F1/F0)	-2.55%	9.24%	5.12%	14.18%	17.20%	-4.09%
Curr. Cash Flow Growth	7.14%	18.19%	6.03%	-1.59%	12.54%	20.07%
Hist. Cash Flow Growth (3-5 yrs)	4.70%	7.35%	8.55%	-4.75%	-5.09%	25.86%
Current Ratio	1.30	3.20	1.23	1.03	10.68	62.53
Debt/Capital	68.43%	65.09%	42.57%	70.24%	96.06%	84.26%
Net Margin	20.94%	12.62%	11.57%	26.82%	10.80%	12.66%
Return on Equity	26.59%	16.68%	16.74%	10.35%	18.15%	13.64%
Sales/Assets	0.13	0.24	0.54	0.04	0.06	0.17
Proj. Sales Growth (F1/F0)	4.60%	4.21%	3.22%	5.17%	-6.25%	8.49%
<b>Momentum Score</b>	<b>A</b>	-	-	<b>A</b>	<b>B</b>	<b>C</b>
Daily Price Chg	-26.77%	-15.35%	-6.77%	-23.21%	-15.97%	-15.45%
1 Week Price Chg	-17.29%	-12.71%	-11.01%	-15.31%	-17.35%	-13.11%
4 Week Price Chg	-64.27%	-46.52%	-34.65%	-56.44%	-65.12%	-50.79%
12 Week Price Chg	-68.34%	-47.76%	-32.08%	-59.79%	-64.11%	-44.65%
52 Week Price Chg	-62.24%	-46.89%	-23.52%	-53.43%	-57.59%	-36.87%
20 Day Average Volume	3,941,335	339,872	3,834,688	6,877,191	3,651,777	2,548,652
(F1) EPS Est 1 week change	0.00%	0.00%	-0.06%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	-1.07%	0.00%	-0.74%	0.75%	0.00%	-0.93%
(F1) EPS Est 12 week change	-6.56%	0.44%	-1.38%	0.62%	6.97%	-5.28%
(Q1) EPS Est Mthly Chg	-0.12%	0.00%	-0.85%	0.19%	0.00%	-0.25%

## 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	A
Growth Score	B
Momentum Score	A
VGM Score	A

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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