

## Discover Financial (DFS)

**\$50.81** (As of 08/19/20)

Price Target (6-12 Months): **\$53.00**

Long Term: 6-12 Months

**Zacks Recommendation:**
**Neutral**

(Since: 06/07/20)

Prior Recommendation: Underperform

Short Term: 1-3 Months

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

**4-Sell**

Zacks Style Scores:

VGM:B

Value: A

Growth: D

Momentum: B

## Summary

Discover Financial has undertaken several cost-cutting initiatives. Its strong balance sheet is another positive. Its sound capital position impresses. Its banking business provides significant diversification benefits. Its shares have underperformed its industry in a year's time. However, 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. Its weak card sales volume bothers. Its second-quarter 2020 adjusted loss came in at \$1.20 per share. The Zacks Consensus Estimate was for earnings of 5 cents per share. The bottom line came against the year-ago quarter's adjusted earnings of \$2.32 per share.

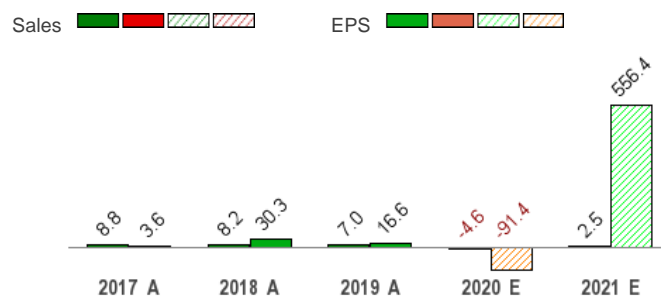
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	<b>\$87.43 - \$23.25</b>
20 Day Average Volume (sh)	<b>3,114,423</b>
Market Cap	<b>\$15.6 B</b>
YTD Price Change	<b>-40.1%</b>
Beta	<b>1.84</b>
Dividend / Div Yld	<b>\$1.76 / 3.5%</b>
Industry	<b><a href="#">Financial - Consumer Loans</a></b>
Zacks Industry Rank	<b>Bottom 28% (182 out of 252)</b>

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



Last EPS Surprise	<b>-2,500.0%</b>
Last Sales Surprise	<b>1.1%</b>
EPS F1 Est- 4 week change	<b>-35.9%</b>
Expected Report Date	<b>10/27/2020</b>
Earnings ESP	<b>0.0%</b>
P/E TTM	<b>16.1</b>
P/E F1	<b>65.1</b>
PEG F1	<b>8.8</b>
P/S TTM	<b>1.1</b>

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	2,722 E	2,745 E	2,808 E	2,888 E	11,205 E
2020	2,888 A	2,662 A	2,657 E	2,724 E	10,932 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	\$0.69 E	\$1.11 E	\$1.30 E	\$1.59 E	\$5.12 E
2020	-\$0.25 A	-\$1.20 A	\$1.09 E	\$1.16 E	\$0.78 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 08/19/2020. The reports text is as of 08/20/2020.

## Overview

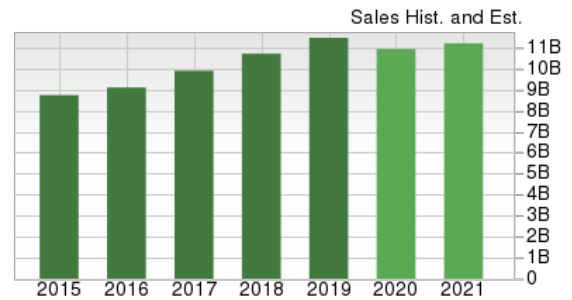
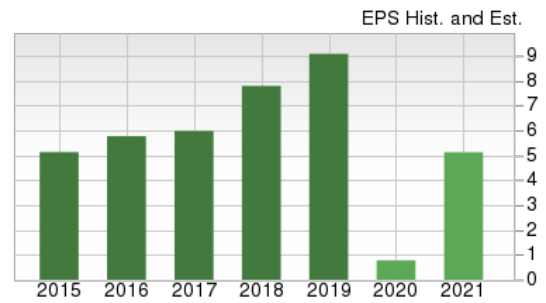
Founded in 1986 and based in Riverwoods, IL, Discover Financial Services is a direct banking and payment services company in the United States. The company offers credit cards, personal, student and home loans as well as deposit products. In March 2009, Discover Financial became a bank holding company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

- ▲ **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. Although in the first six months of 2020, the company's revenues — net of interest expenses — decreased 2% year over year to \$5.3 billion, we believe that its revenue growth will bounce back in the upcoming quarters on the back of 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. It is on track to achieve its previously announced \$400 million of cost savings over the second, third and fourth quarter of 2020. The actions include reducing account acquisition expense, cutting down on brand awareness and consideration activities, and reducing vendor and technology spend. Excluding a onetime impairment charge to Diners business, operating expenses in the second quarter were down 6% year over year. The major part of the expense reduction was on the back of brand marketing and card acquisition costs.
- ▲ **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 six months, net interest income of this business slipped 1% year over year. However, we expect this segment to continue performing well going forward.
- ▲ **Profitability:** Discover Financial's return-on-equity (ROE) reflects its growth potential. The company's trailing 12-month ROE of 10.5% not only improved over the years but also compares favorably with the industry average of 8%.
- ▲ **Balance Sheet Strength:** The company's balance sheet position remains impressive. Net debt is 25% (compared with sequential figure of 41.6%) of its total capital, which is lower than the industry average of 28.2%. As of Jun 30, 2020, it had cash and investment securities worth \$27 billion, higher than its long-term borrowings of \$11 billion. Thus, its solvency position looks strong.
- ▲ **Price Movement:** In a year's time, shares of Discover Financial have underperformed its industry's growth. However, its solid fundamentals are likely to help the stock bounce back going forward.

A strong direct banking business, global expansions, prudent capital management and increased card sales remain long-term growth drivers for the company.

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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 six months of 2020, the company's operating expenses rose 4% year over year. 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 six months of 2020, provision for credit losses surged 141% year over year, reflecting a weak macroeconomic outlook. The company followed the conservative reserving approach and added \$1.3 billion to its allowance for credit losses.
- ▼ **Weak Sales Volumes:** The company has been witnessing pressure on its sales volumes since April due to lower spend in travel, retail, etc. Total card volumes fell 16% in the second quarter. The highest weekly dip was during the middle of April with total sales plunging 33%. Sales slid 3% in the first six months of 2020. On the back of online spend, retail sales were up 7% year over year. However, its strong online spending growth was offset by other factors.

Escalating expenses and increasing provision for loan losses are some of the headwinds facing the company.

## Last Earnings Report

### Discover Financial's Q2 Earnings Miss, Tumble Y/Y

Discover Financial incurred second-quarter 2020 adjusted loss of \$1.20 cents per share. The Zacks Consensus Estimate was of earnings of 5 cents per share. Moreover, the bottom line came against the year-ago quarter's adjusted earnings of \$2.32 per share. The results include a \$1.3-billion addition to the allowance for credit losses. This underperformance was due to weak segmental performances.

Quarter Ending 06/2020

Report Date	Jul 22, 2020
Sales Surprise	1.13%
EPS Surprise	-2,500.00%
Quarterly EPS	-1.20
Annual EPS (TTM)	3.16

### Operational Update

In the reported quarter, the company's revenues — net of interest expenses — declined 7% year over year to \$2.6 billion due to lower discount and interchange revenues as well as loan fee income. However, the top line beat the Zacks Consensus Estimate by 1.1%.

Total loans dipped 1% year over year to \$88.9 billion.

Interest expenses of \$482 million decreased 25.3% year over year.

Total operating expenses slid 0.1% to \$1.08 billion on the back of lower marketing and business development costs.

### Segmental Update

#### Direct Banking Segment

This segment's pre-tax loss of \$484 million came against the year-ago quarter's pre-tax income of \$941 million. This was due to hike in provision for credit losses as well as weak net interest income.

Total loans slipped 1% year over year to \$88.9 billion. Credit card loans declined 3% to \$70.2 billion.

Personal loans decreased 1% 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 decreased 6% year over year, backed by net interest margin compression.

Net interest margin was 9.81%, down 66 basis points from the year-ago quarter.

#### Payment Services Segment

Payment Services pre-tax income was \$23 million in the quarter under review, down 50% from the year-earlier period.

Payment Services volume was up 4% from the prior-year period.

PULSE dollar volume expanded 12% year over year, aided by higher average expense per transaction in response to the prevalent COVID-19 pandemic, the impact of stimulus funds accessible to customers and a spurt in e-commerce transactions.

Diners Club volume contracted 48.8% from the year-earlier quarter.

Network Partners volume grew 22%, backed by AribaPay.

### Strong Financial Position

Discover Financial had total assets worth \$113.7 billion as of Jun 30, 2020, up 2.8% year over year.

Total liabilities as of Jun 30, 2020 were \$104.1 billion, up 5% year over year.

Total equity was \$9.6 billion on Jun 30, 2020, down 16.1% year over year.

### Share Repurchase Update

In response to the coronavirus outbreak, the company suspended its share buyback plan.

## Recent News

### Discover Financial Makes Changes to Travel Card — Jul 23, 2020

Discover Financial announced a change in its travel card that will provide more convenience to its card members along with wider options to redeem rewards.

### Discover Financial Announces Stress Capital Buffer Results – Jun 30, 2020

Discover Financial announced results for the Federal Reserve's 2020 supervisory stress testing and capital plan review exercise. The company's preliminary stress capital buffer (SCB) has been set at 3.5%.

The final SCB results for Discover Financial as well as other firms are subject to Federal Reserve's capital plan rule, which will be finalized in August and effective Oct 1, 2020.

## Valuation

Discover Financial's shares are down 39% and 34% 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 28.2% and 15% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are down 23.3% and 4.2%, respectively.

The S&P 500 index is up 6.4% in the year-to-date period and 19.3% in the past year.

The stock is currently trading at 14.45x forward 12-month earnings, which compares to 10.64x for the Zacks sub-industry, 16.58x for the Zacks sector and 22.9x for the S&P 500 index.

Over the past five years, the stock has traded as high as 17.68x and as low as 2.8x, with a 5-year median of 9.34x. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$53 price target reflects 15.09x 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	14.45	10.64	16.58	22.9
	5-Year High	17.68	13.16	16.58	22.9
	5-Year Low	2.8	4.4	11.6	15.25
	5-Year Median	9.34	8.77	14.26	17.58
P/S F12M	Current	1.4	0.94	6.22	3.72
	5-Year High	4.01	1.82	6.67	3.72
	5-Year Low	0.64	0.72	4.97	2.53
	5-Year Median	2.6	1.5	6.06	3.04
P/B TTM	Current	1.81	0.55	2.47	4.55
	5-Year High	2.86	1.2	2.91	4.56
	5-Year Low	0.7	0.4	1.72	2.83
	5-Year Median	2.24	0.95	2.53	3.75

As of 08/19/2020

## Industry Analysis Zacks Industry Rank: Bottom 28% (182 out of 252)



## Top Peers

Company (Ticker)	Rec	Rank
MR. COOPER GROUP INC (COOP)	Outperform	1
Ally Financial Inc. (ALLY)	Neutral	3
First Cash, Inc. (FCFS)	Neutral	4
Global Payments Inc. (GPN)	Neutral	3
Navient Corporation (NAVI)	Neutral	3
Santander Consumer USA Holdings Inc. (SC)	Neutral	3
Synchrony Financial (SYF)	Neutral	4
SLM Corporation (SLM)	Underperform	4

Industry Comparison Industry: Financial - Consumer Loans				Industry Peers		
	DFS	X Industry	S&P 500	ALLY	NAVI	SC
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	3	3	3
VGM Score	B	-	-	C	B	B
Market Cap	15.57 B	618.64 M	23.61 B	8.33 B	1.70 B	5.45 B
# of Analysts	8	2.5	14	6	4	6
Dividend Yield	3.46%	0.00%	1.65%	3.41%	7.31%	5.10%
Value Score	A	-	-	A	A	A
Cash/Price	0.91	0.77	0.07	2.26	2.30	0.40
EV/EBITDA	5.14	5.14	13.36	3.51	98.32	9.52
PEG Ratio	8.67	0.19	2.99	NA	NA	NA
Price/Book (P/B)	1.81	1.04	3.16	0.60	0.80	1.11
Price/Cash Flow (P/CF)	5.36	3.65	12.71	2.80	3.04	2.02
P/E (F1)	64.29	12.39	21.82	31.15	3.26	110.23
Price/Sales (P/S)	1.14	0.92	2.47	1.33	0.37	0.68
Earnings Yield	1.54%	6.65%	4.37%	3.19%	30.59%	0.93%
Debt/Equity	2.70	1.90	0.76	2.11	37.75	8.30
Cash Flow (\$/share)	9.48	4.49	6.94	7.96	2.88	8.57
Growth Score	D	-	-	F	D	F
Hist. EPS Growth (3-5 yrs)	6.74%	10.51%	10.44%	12.24%	8.66%	-3.50%
Proj. EPS Growth (F1/F0)	-91.41%	-39.21%	-5.97%	-80.78%	1.70%	-94.52%
Curr. Cash Flow Growth	7.14%	14.13%	5.22%	-1.59%	12.54%	20.07%
Hist. Cash Flow Growth (3-5 yrs)	4.70%	9.07%	8.52%	-4.75%	-5.09%	25.86%
Current Ratio	1.18	3.09	1.33	0.99	11.82	58.77
Debt/Capital	70.63%	65.56%	44.50%	67.85%	97.42%	89.25%
Net Margin	7.65%	7.74%	10.13%	10.87%	7.38%	3.47%
Return on Equity	10.45%	14.19%	14.67%	5.85%	21.05%	4.50%
Sales/Assets	0.12	0.24	0.51	0.03	0.05	0.17
Proj. Sales Growth (F1/F0)	-4.60%	0.00%	-1.54%	-5.35%	-0.76%	0.78%
Momentum Score	B	-	-	B	C	A
Daily Price Chg	-0.26%	0.12%	-0.38%	1.55%	0.92%	-0.17%
1 Week Price Chg	5.66%	1.62%	1.09%	5.45%	2.29%	-6.01%
4 Week Price Chg	0.22%	2.06%	2.23%	3.63%	9.77%	-6.34%
12 Week Price Chg	2.44%	4.34%	6.91%	19.73%	13.03%	-4.00%
52 Week Price Chg	-36.30%	-28.63%	2.28%	-28.46%	-33.03%	-33.98%
20 Day Average Volume	3,114,423	324,535	1,899,976	3,562,963	2,520,795	986,339
(F1) EPS Est 1 week change	1.63%	0.00%	0.00%	1.42%	0.00%	22.08%
(F1) EPS Est 4 week change	-35.87%	8.33%	1.70%	12.90%	22.79%	100.00%
(F1) EPS Est 12 week change	-61.07%	9.60%	3.08%	-13.33%	22.79%	225.33%
(Q1) EPS Est Mthly Chg	39.84%	12.09%	0.83%	12.75%	38.56%	39.01%

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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	A
Growth Score	D
Momentum Score	B
VGM Score	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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