

Discover Financial (DFS)

\$75.80 (As of 01/29/20)

Price Target (6-12 Months): **\$64.00**

Long Term: 6-12 Months

Zacks Recommendation: Underperform

(Since: 01/28/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

5-Strong Sell

Zacks Style Scores:

VGM:C

Value: B

Growth: D

Momentum: D

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. Its Direct Banking business, dollar volume growth, card sales and capital management look promising. It 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 fourth-quarter 2019 earnings of \$2.25 beat the Zacks Consensus Estimate by 0.9% and improved 10.8% year over year on revenues and loan growth.

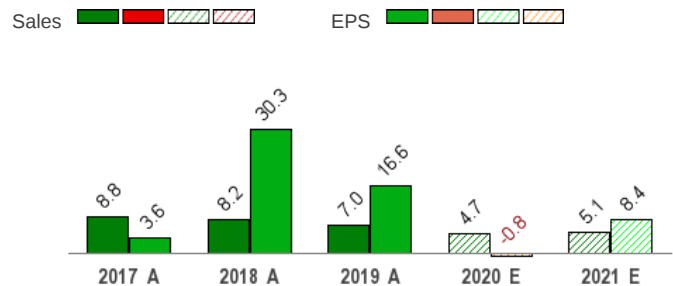
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$92.98 - \$66.54
20 Day Average Volume (sh)	2,542,033
Market Cap	\$23.8 B
YTD Price Change	-10.6%
Beta	1.61
Dividend / Div Yld	\$1.76 / 2.3%
Industry	Financial - Consumer Loans
Zacks Industry Rank	Bottom 24% (195 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	0.9%
Last Sales Surprise	-0.1%
EPS F1 Est- 4 week change	-4.8%
Expected Report Date	04/23/2020
Earnings ESP	0.0%
P/E TTM	8.4
P/E F1	8.4
PEG F1	1.1
P/S TTM	1.7

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	3,007 E	3,078 E	3,157 E	3,264 E	12,616 E
2020	2,896 E	2,951 E	3,024 E	3,115 E	11,999 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	\$2.56 E	\$2.49 E	\$2.43 E	\$2.30 E	\$9.77 E
2020	\$2.17 E	\$2.37 E	\$2.28 E	\$2.16 E	\$9.01 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 01/29/2020. The reports text is as of 01/30/2020.

Overview

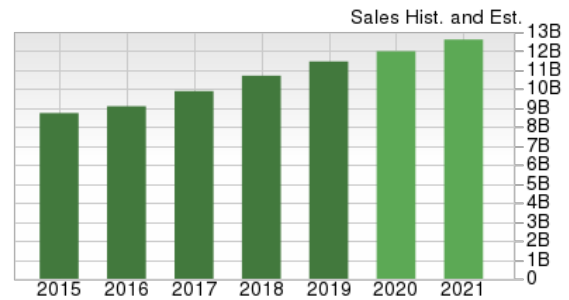
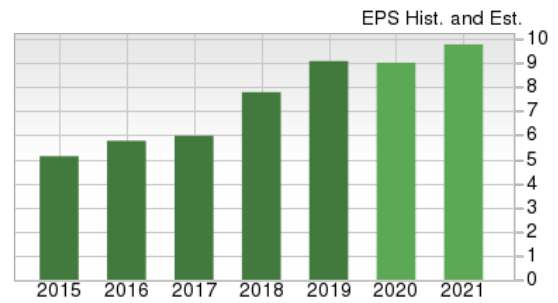
Founded in 1986 and based in Riverwoods, IL, Discover Financial Services is a direct banking and payment services company in the United States. The company offers credit cards, personal, student and home loans as well as deposit products. In March 2009, Discover Financial became a bank holding company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



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 209% (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.

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 2.1%, higher than its industry's average of 1.7%. 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 26.2% not only improved over the years but also compares favorably with the industry average of 13.1%.
-

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 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.

Discover Partners PayPal to Help Cardmembers Redeem Rewards — Nov 25, 2019

Discover Financial and PayPal sign a contract via which Discover cardmembers can use Cashback Bonus or Miles to pay for their purchases at millions of online stores through PayPal. This is another option for cardmembers to reward themselves.

Discover Global Network, Cabal Cooperativa De Provision De Servicios Limitada Collaborate — Nov 22, 2019

Discover Financial's payment brand Discover Global Network along with Cabal, a local payments network in Argentina, inked a deal to boost the international acceptance of cards issued by both companies.

Isbank Merchants Accepting Discover Global Network Cards — Nov 18, 2019

Discover Financial's payment brand Discover Global Network and Isbank entered into an agreement to boost the acceptance of Discover, Diners Club International and alliance partner cards in Turkey. The deal is through the relationship that both companies share with Interbank Card Center (BKM).

Valuation

Discover Financial's shares are up 12% over the trailing 12-month period. Over the past year, the Zacks sub-industry and sector are up 17.2% and 8.5%, respectively.

The S&P 500 index is up 21.4% in the past year.

The stock is currently trading at 8.02X trailing 12-month price to earnings ratio, which compares to 8.16X for the Zacks sub-industry, 14.45X for the Zacks sector and 18.81X for the S&P 500 index.

Over the past five years, the stock has traded as high as 13.18X and as low as 6.36X, with a 5-year median of 9.45X. Our Underperform recommendation indicates that the stock will perform worse than the market. Our \$64 price target reflects 6.77X earnings.

The table below shows summary valuation data for DFS

Valuation Multiples - DFS					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	8.02	8.16	14.45	18.81
	5-Year High	13.18	10.85	16.21	19.33
	5-Year Low	6.36	6.33	12	15.18
	5-Year Median	9.45	8.89	13.98	17.45
P/S F12M	Current	1.97	1.43	6.53	3.49
	5-Year High	4.01	2.05	6.61	3.49
	5-Year Low	1.63	1.1	5.2	2.54
	5-Year Median	3.02	1.52	6.03	3
P/B TTM	Current	2	0.89	2.79	4.48
	5-Year High	2.86	1.22	2.89	4.55
	5-Year Low	1.73	0.75	1.83	2.85
	5-Year Median	2.3	0.97	2.51	3.62

As of 01/29/2020

Industry Analysis Zacks Industry Rank: Bottom 24% (195 out of 255)



Top Peers

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

Industry Comparison Industry: Financial - Consumer Loans				Industry Peers		
	DFS Underperform	X Industry	S&P 500	ALLY Neutral	NAVI Neutral	SC Underperform
VGM Score	C	-	-	D	B	A
Market Cap	23.76 B	930.82 M	23.90 B	12.26 B	3.32 B	8.87 B
# of Analysts	9	3	13	7	5	7
Dividend Yield	2.32%	0.00%	1.8%	2.11%	4.27%	3.37%
Value Score	B	-	-	A	A	A
Cash/Price	0.73	0.29	0.04	0.30	0.37	0.29
EV/EBITDA	6.89	7.77	14.05	8.58	145.73	1.73
PEG Ratio	1.13	0.63	2.00	0.63	0.28	1.84
Price/Book (P/B)	2.00	1.18	3.28	0.87	0.99	1.21
Price/Cash Flow (P/CF)	8.97	6.10	13.57	4.33	5.20	3.87
P/E (F1)	8.41	7.69	18.76	7.61	5.07	9.20
Price/Sales (P/S)	1.70	1.36	2.63	1.92	0.60	1.13
Earnings Yield	11.89%	12.82%	5.33%	13.15%	19.73%	10.88%
Debt/Equity	2.06	1.62	0.72	2.47	24.40	0.00
Cash Flow (\$/share)	8.45	2.94	6.89	7.45	2.88	6.75
Growth Score	D	-	-	F	D	B
Hist. EPS Growth (3-5 yrs)	13.70%	11.52%	10.68%	17.52%	4.72%	-0.53%
Proj. EPS Growth (F1/F0)	-0.76%	5.27%	7.63%	13.86%	11.97%	-0.85%
Curr. Cash Flow Growth	20.79%	26.38%	13.04%	4.27%	12.54%	35.94%
Hist. Cash Flow Growth (3-5 yrs)	3.97%	4.84%	8.78%	5.70%	-5.09%	36.75%
Current Ratio	1.08	2.25	1.24	1.05	10.38	0.79
Debt/Capital	67.61%	61.80%	42.99%	71.20%	96.06%	0.00%
Net Margin	20.94%	12.28%	11.47%	26.82%	10.80%	12.66%
Return on Equity	26.25%	13.80%	17.21%	10.40%	18.15%	13.66%
Sales/Assets	0.13	0.24	0.54	0.04	0.06	0.17
Proj. Sales Growth (F1/F0)	4.71%	4.52%	4.10%	4.52%	-6.25%	7.04%
Momentum Score	D	-	-	F	B	D
Daily Price Chg	0.76%	0.00%	0.90%	1.57%	-0.13%	12.60%
1 Week Price Chg	-9.65%	0.00%	-1.09%	5.55%	8.98%	1.64%
4 Week Price Chg	-10.63%	0.00%	0.46%	5.53%	9.65%	11.68%
12 Week Price Chg	-8.87%	1.13%	4.15%	1.10%	5.86%	4.86%
52 Week Price Chg	11.93%	7.38%	18.27%	20.52%	31.00%	36.29%
20 Day Average Volume	2,542,033	195,654	1,730,811	4,031,293	1,892,952	1,067,957
(F1) EPS Est 1 week change	-4.92%	0.00%	0.00%	0.00%	0.16%	0.00%
(F1) EPS Est 4 week change	-4.85%	0.00%	0.00%	0.34%	6.14%	-2.07%
(F1) EPS Est 12 week change	-5.41%	-0.44%	-0.13%	-0.44%	6.14%	-3.79%
(Q1) EPS Est Mthly Chg	-4.56%	0.00%	0.00%	-1.47%	6.82%	-8.91%

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.

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
Growth Score	D
Momentum Score	D
VGM Score	C

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.

Disclosures

This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock. The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment. This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. ZIR is not a broker-dealer. ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients. Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.

No part of this report can be reprinted, republished or transmitted electronically without the prior written authorization of ZIR.