

Discover Financial

Positive trends in May – solid loan growth and a slight uptick in credit

Reiterate Rating: NEUTRAL | PO: 119.00 USD | Price: 117.72 USD

Some credit stability and resilient loan growth

Yesterday, Discover Financial (DFS) reported May operating metrics highlighted by solid loan growth and a slight uptick in charge-offs. Overall, we view the print positively – loan balances grew sequentially and credit is trending better than expected. Delinquencies also stabilized in recent months, suggesting credit is normalizing not deteriorating. That said, the expected resumption of student loan payments and inflation pressure gives us some pause on future credit performance, and we reiterate our Neutral rating.

Loan balances up 20.3% y/y in May

May ending loan balances increased to \$92.9BB, up 20.3% y/y and 1.75% m/m. Loan growth slowed slightly from April which was up 21.7% y/y. Sequential growth was solid and the 1.75% m/m increase was a touch better than typical seasonality in May (5yr average ex-2020: 1.66%). Balances tend to increase in June and given seasonal outperformance, we are comfortable with our \$94.7B estimate and think consensus could be a touch low at \$93.3B.

NCO rates up 11bps m/m to 3.67%

The May net charge-off (NCO) rate was 3.67% and the delinquency rate came in at 2.77%. NCOs increased 11bps m/m which is a bit faster than typical seasonality (5yr average ex-2020: +4bps). However, the sequential increase was better than expected and charge-offs appear to be trending better than our prior consensus-like 3.80% 2Q forecast. 30+ day delinquencies only increased 2bps m/m and have been in the ~2.75% for the past four months, which could imply some stability in losses prospectively. This is a positive and could be an indicator that loan losses are normalizing, not deteriorating as many investors had feared.

Updating estimates and PO

We increase our 2023/2024 estimates to \$13.54/\$13.99 from \$13.00/\$13.36 to account for better than credit performance in 2023 and tweaks to reserve timing. We increase our PO to \$119 based on an unchanged 8.5x multiple to 2024 EPS.

Estimates (Dec) (US\$)	2021A	2022A	2023E	2024E	2025E
EPS	16.76	15.50	13.54	13.99	19.00
GAAP EPS	17.82	15.50	13.54	13.99	19.00
EPS Change (YoY)	368.3%	-7.5%	-12.6%	3.3%	35.8%
Consensus EPS (Bloomberg)			13.42	14.14	18.35
DPS	1.88	2.30	2.70	2.95	2.85
Valuation (Dec)					
P/E	7.0x	7.6x	8.7x	8.4x	6.2x
GAAP P/E	6.6x	7.6x	8.7x	8.4x	6.2x
Dividend Yield	1.6%	2.0%	2.3%	2.5%	2.4%

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Timestamp: 14 June 2023 08:27AM EDT

14 June 2023

Equity

Key Changes

(US\$)	Previous	Current
Price Obj.	114.00	119.00

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Stock Data

Price	117.72 USD
Price Objective	119.00 USD
Date Established	14-Jun-2023
Investment Opinion	B-2-7
52-Week Range	87.64 USD - 119.91 USD
Mrkt Val / Shares Out (mn)	29,895 USD / 253.9
Average Daily Value	243.08 USD
BofA Ticker / Exchange	DFS / NYS
Bloomberg / Reuters	DFS US / DFS.N
ROE (2023E)	23.9%
ESGMeter™	High

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iQprofileSM Discover Financial

Income Statement Data (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Net Interest Income	9,517	10,999	13,088	13,805	14,343
% change	3.1%	15.6%	19.0%	5.5%	3.9%
Net Fee Income	464	632	709	841	811
Securities Gains / (Losses)	NA	NA	NA	NA	NA
Total Operating Income	12,087	13,337	15,743	16,582	17,130
Operating Expenses	(4,805)	(5,236)	(5,759)	(6,384)	(6,732)
% change	6.3%	9.0%	10.0%	10.9%	5.5%
Provisions Expense	(218)	(2,359)	(5,502)	(6,010)	(5,221)
% change	-95.8%	982.1%	133.2%	9.2%	-13.1%
Operating Pre-Tax Income	7,064	5,742	4,481	4,188	5,177
Operating Net Income to Comm S/Hold.	5,351	4,304	3,361	3,135	3,896
GAAP Net Income	5,449	4,392	3,449	3,223	3,984

Balance Sheet Data (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Total Assets	110,242	131,628	145,910	155,554	164,467
Average Interest Earning Assets	112,266	116,395	138,170	149,175	158,138
Total Gross Customer Loans	93,684	112,120	128,091	136,822	144,975
% change	3.6%	19.7%	14.2%	6.8%	6.0%
Total Customer Deposits	61,939	70,521	78,904	82,849	86,163
% change	-2.5%	13.9%	11.9%	5.0%	4.0%
Tangible Equity	12,097	13,279	12,558	13,113	14,506
Common Shareholders' Equity	13,408	14,590	13,869	14,424	15,817

Key Metrics (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Net Interest Margin	8.48%	9.45%	9.47%	9.25%	9.07%
Effective Tax Rate	22.9%	23.5%	23.0%	23.0%	23.0%
Loan / Deposit Ratio	151.3%	159.0%	162.3%	165.1%	168.3%
Tangible Common Equity / Assets	11.0%	10.1%	8.6%	8.4%	8.8%
ROA	4.5%	5.1%	2.4%	2.1%	2.4%
ROE	39.4%	30.7%	23.9%	21.9%	25.3%
RoTE	41.6%	32.4%	26.8%	23.9%	26.9%
Dividend Payout Ratio	10.5%	14.8%	19.9%	21.1%	15.0%
Efficiency Ratio (Cost / Income Ratio)	39.8%	39.3%	36.6%	38.5%	39.3%
Billings Growth	20.8%	9.2%	6.6%	6.0%	6.0%

Quality of Earnings (Dec)

(US\$ Millions)	2021A	2022A	2023E	2024E	2025E
Total Non-Interest Inc / Operating Inc	21.3%	17.5%	16.9%	16.7%	16.3%
Loan Loss Reserves / Total Loans	7.85%	7.04%	7.31%	7.22%	7.20%

Company Sector

Financial Services-Consumer/Commercial

Company Description

Headquartered in Riverwoods (IL), Discover Financial Services (DFS) is a diversified financial services provider that is primarily in the business of issuing credit cards to US consumers. The company also operates one of the four major payment networks that process and clear point-of-sale transactions throughout North America. In addition, DFS is one of the largest private student loan providers in the country and also provides personal loans, home equity loans, and debit cards to its customers.

Investment Rationale

We rate DFS at Neutral. While we appreciate DFS' integrated issuer / network model that drives attractive economics (20%+ ROEs), the potential for credit losses to increase as the macro backdrop weakens make it challenging for the stock to outperform from current levels, in our view.

Stock Data

Average Daily Volume 2,064,863

Quarterly Earnings Estimates

	2022	2023
Q1	4.23A	3.58E
Q2	3.96A	3.69E
Q3	3.54A	3.50E
Q4	3.77A	2.72E



Price objective basis & risk

Discover Financial (DFS)

We calculate a \$119 PO based on an 8.5x PE multiple to our 2024 EPS forecast. A 8.5x multiple is in the middle of DFS's recent historical range (7-12x) and reflects concerns on rising unemployment and credit losses, offset by robust loan growth.

Downside risks to our price objective are: if the economy falls into a recession, credit costs could rise rapidly and compress margins more than our current forecast. Deteriorating economic conditions would likely hurt sentiment and drive DFS's valuation lower.

Upside risks are: Consumer balance sheets continue to hold strength and credit metrics remain strong. Increased visibility in peak loss rates shifts investor sentiment. Federal reserve achieves a soft landing. Outsized capital return.

Analyst Certification

I, Mihir Bhatia, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Payments, Processors, Specialty Finance and IT services Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Accenture Plc	ACN	ACN US	Jason Kupferberg
	American Express Company	AXP	AXP US	Mihir Bhatia
	Ares Capital Corporation	ARCC	ARCC US	Derek Hewett
	Ares Commercial Real Estate Corporation	ACRE	ACRE US	Derek Hewett
	Baring's BDC Inc	BBDC	BBDC US	Derek Hewett
	Blackrock TCP Capital Corp	TCPC	TCPC US	Derek Hewett
	Blackstone Mortgage Trust Inc	BXMT	BXMT US	Derek Hewett
	Block Inc	SQ	SQ US	Jason Kupferberg
	Bread Financial Holdings Inc	BFH	BFH US	Mihir Bhatia
	Carlyle Secured Lending Inc	CGBD	CGBD US	Derek Hewett
	CI&T	CINT	CINT US	Jason Kupferberg
	Compass Diversified Holdings	CODI	CODI US	Derek Hewett
	Crescent Capital BDC	CCAP	CCAP US	Derek Hewett
	DLocal	DLO	DLO US	Jason Kupferberg
	EngageSmart	ESMT	ESMT US	Jason Kupferberg
	Essent Group	ESNT	ESNT US	Mihir Bhatia
	Fidelity National Information Services	FIS	FIS US	Jason Kupferberg
	Fiserv Inc	FI	FI US	Jason Kupferberg
	FleetCor Technologies Inc.	FLT	FLT US	Mihir Bhatia
	Flywire	FLYW	FLYW US	Jason Kupferberg
	Global Payments Inc	GPN	GPN US	Jason Kupferberg
	Mastercard Inc	MA	MA US	Jason Kupferberg
	MGIC Investment Corp.	MTG	MTG US	Mihir Bhatia
	New Mountain Finance Corporation	NMFC	NMFC US	Derek Hewett
	Nuvei	NVEI	NVEI US	Jason Kupferberg
	Nuvei	YNVEI	NVEI CN	Jason Kupferberg
	Owl Rock Capital Corporation	ORCC	ORCC US	Derek Hewett
	PayPal Holdings Inc	PYPL	PYPL US	Jason Kupferberg
	Safehold, Inc	SAFE	SAFE US	Derek Hewett
	Shift4 Payments, Inc	FOUR	FOUR US	Jason Kupferberg
	Sixth Street Specialty Lending, Inc	TSLX	TSLX US	Derek Hewett
	SoFi Technologies Inc	SOFI	SOFI US	Mihir Bhatia
	Starwood Property Trust	STWD	STWD US	Derek Hewett
	Telus International	TIXT	TIXT US	Cassie Chan
	Telus International	YTXT	TIXT CN	Cassie Chan
	Toast	TOST	TOST US	Jason Kupferberg

US - Payments, Processors, Specialty Finance and IT services Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
	Visa Inc.	V	V US	Jason Kupferberg
	WEX Inc.	WEX	WEX US	Mihir Bhatia
NEUTRAL				
	Affirm Holdings	AFRM	AFRM US	Jason Kupferberg
	AGNC Investment Corp	AGNC	AGNC US	Derek Hewett
	Annaly Capital Management	NLY	NLY US	Derek Hewett
	Apollo Commercial Real Estate Finance	ARI	ARI US	Derek Hewett
	Bain Capital Specialty Finance, Inc.	BCSF	BCSF US	Derek Hewett
	Blackstone Secured Lending Fund	BXSL	BXSL US	Derek Hewett
	BrightSpire Capital Inc.	BRSP	BRSP US	Derek Hewett
	Capital One Financial	COF	COF US	Mihir Bhatia
	Discover Financial	DFS	DFS US	Mihir Bhatia
	Ellington Financial	EFC	EFC US	Derek Hewett
	Enact Holdings	ACT	ACT US	Mihir Bhatia
	Goldman Sachs BDC, Inc.	GSBD	GSBD US	Derek Hewett
	Golub Capital BDC, Inc.	GBDC	GBDC US	Derek Hewett
	Jack Henry & Associates	JKHY	JKHY US	Jason Kupferberg
	Ladder Capital Corp	LADR	LADR US	Derek Hewett
	Marqeta	MQ	MQ US	Jason Kupferberg
	Paymentus	PAY	PAY US	Jason Kupferberg
	PennyMac Mortgage Investment Trust	PMT	PMT US	Derek Hewett
	Synchrony Financial	SYF	SYF US	Mihir Bhatia
	Thoughtworks	TWKS	TWKS US	Jason Kupferberg
	TPG Real Estate Finance Trust	TRTX	TRTX US	Derek Hewett
	TTEC Holdings	TTEC	TTEC US	Cassie Chan
UNDERPERFORM				
	ADP	ADP	ADP US	Jason Kupferberg
	Angel Oak Mortgage Inc.	AOMR	AOMR US	Derek Hewett
	CGI Inc.	GIB	GIB US	Jason Kupferberg
	CGI Inc.	YGIBA	GIB/A CN	Jason Kupferberg
	Cognizant Technology Solutions	CTSH	CTSH US	Jason Kupferberg
	Coinbase	COIN	COIN US	Jason Kupferberg
	DXC Technology	DXC	DXC US	Jason Kupferberg
	EPAM Systems	EPAM	EPAM US	Jason Kupferberg
	Guild Holdings Company	GHLD	GHLD US	Derek Hewett
	Invesco Mortgage Capital, Inc.	IVR	IVR US	Derek Hewett
	loanDepot Inc	LDI	LDI US	Derek Hewett
	MidCap Financial Investment Co	MFIC	MFIC US	Derek Hewett
	New York Mortgage Trust	NYMT	NYMT US	Derek Hewett
	Paychex	PAYX	PAYX US	Jason Kupferberg
	Radian Group Inc	RDN	RDN US	Mihir Bhatia
	Rocket Companies, Inc.	RKT	RKT US	Mihir Bhatia
	TaskUs	TASK	TASK US	Cassie Chan
	Western Union	WU	WU US	Jason Kupferberg



IQmethodSM Measures Definitions

Business Performance

Return On Capital Employed

Return On Equity
Operating Margin
Earnings Growth
Free Cash Flow

Quality of Earnings

Cash Realization Ratio
Asset Replacement Ratio
Tax Rate
Net Debt-To-Equity Ratio
Interest Cover

Valuation Toolkit

Price / Earnings Ratio
Price / Book Value
Dividend Yield
Free Cash Flow Yield
Enterprise Value / Sales

EV / EBITDA

Numerator

NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization

Net Income
Operating Profit
Expected 5 Year CAGR From Latest Actual
Cash Flow From Operations – Total Capex

Numerator

Cash Flow From Operations
Capex
Tax Charge
Net Debt = Total Debt – Cash & Equivalents
EBIT

Numerator

Current Share Price
Current Share Price
Annualised Declared Cash Dividend
Cash Flow From Operations – Total Capex
EV = Current Share Price × Current Shares + Minority Equity + Net Debt +
Other LT Liabilities
Enterprise Value

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
Amortization
Shareholders' Equity
Sales
N/A
N/A

Denominator

Net Income
Depreciation
Pre-Tax Income
Total Equity
Interest Expense

Denominator

Diluted Earnings Per Share (Basis As Specified)
Shareholders' Equity / Current Basic Shares
Current Share Price
Market Cap = Current Share Price × Current Basic Shares
Sales

Basic EBIT + Depreciation + Amortization

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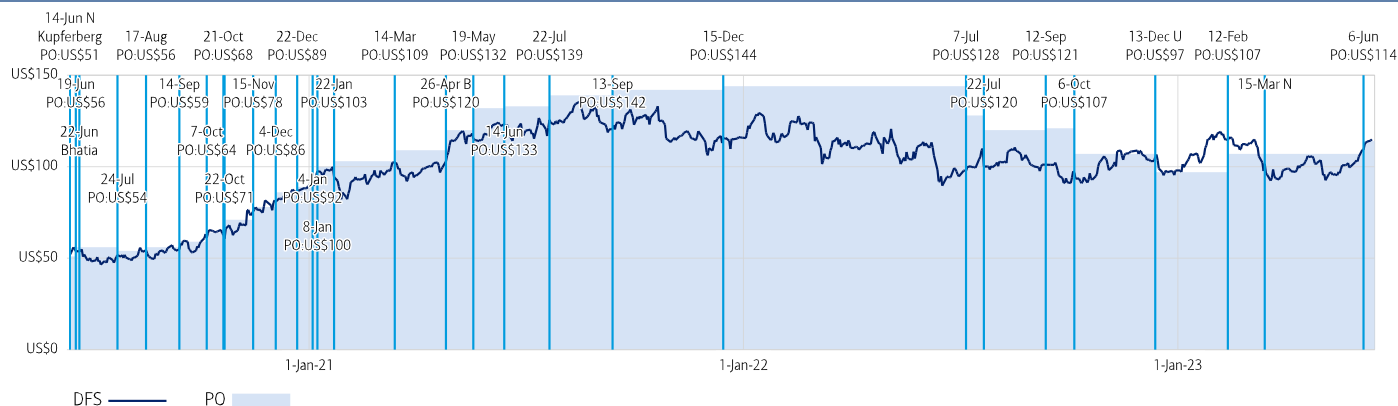
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Important Disclosures

Discover Finl (DFS) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Financial Services Group (as of 31 Mar 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	152	52.41%	Buy	92	60.53%
Hold	73	25.17%	Hold	44	60.27%
Sell	65	22.41%	Sell	41	63.08%

Equity Investment Rating Distribution: Global Group (as of 31 Mar 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1869	53.01%	Buy	1030	55.11%
Hold	827	23.45%	Hold	476	57.56%
Sell	830	23.54%	Sell	389	46.87%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2} Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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