

Discover Financial

Conservative 2024 guide disappoints, but core thesis intact; Maintain Buy

Reiterate Rating: BUY | PO: 118.00 USD | Price: 98.97 USD

Stock down on weak credit and loan growth outlook

We are maintaining a Buy rating on Discover (DFS) following its 4Q print which featured a lackluster 2024 outlook. Shares are trading lower today and we sense investor disappointment in both the loan growth and credit outlook for 2024. This likely keeps shares in the penalty box in the short-term. However, we remain constructive longer-term. DFS continues to expect losses to peak in mid-2024. The tightening actions DFS has taken and the slowdown in loan growth is also a credit positive and we expect losses to decline in 2025. The sale of the student loan portfolio and the resumption of DFS' buyback in 2024 (post-CCAR) also offer positive catalyst potential. Maintain Buy.

"Conservative" guide downplays baseline expectations

DFS referred to various aspects of its guidance as "conservative" seven times on the earnings call and we think 2024 is likely to be better than the mid-point of the guide. DFS explicitly noted that its baseline for credit losses is the low-end of the 4.9-5.3% range, and it hopes to tighten the range as the year progresses (similar to 2023). On loan growth DFS is assuming flat spending and payment rates and a conservative underwriting posture for the full-year which will keep new accounts at 2019 level. DFS also expects average loan balances to be up 5-6%. Continued payment rate normalization and better new account growth could be a modest tailwind to loan growth. On NIM, DFS' baseline expectation is to deliver full-year NIM at the upper end of the range (10.5-10.8%). The one area of the guide which is arguably not conservative is expenses (discussed below).

Other call takeaways (continued on page 3)

Discover continues to expect losses to peak at midyear and guided to a plateauing in 2H24. Positively, DFS does expect loss rates to improve in 2025. DFS also noted that the reserve rate will peak 1-2 quarters prior to peak losses. Given DFS expects credit losses to peak around mid-year, this suggests reserve rate could peak in 1Q and may even decline by year-end 2024. DFS has signed an agreement with Nelnet to become the servicer of DFS' student loan portfolio and reiterated it expects to sell the portfolio in 2H24. The sale will free up more than \$2B of capital. **See inside for more on credit, loan growth, compliance, and capital return.**

Lowering estimates and PO

We lower our 2024/2025 EPS estimates to \$11.26/\$14.68 from \$12.36/\$16.62 primarily due to a weaker credit outlook and slower loan growth. We lower our PO to \$118 based on an unchanged 10.5x multiple to 2024 EPS.

| Estimates (Dec) (US\$) | 2022A | 2023A | 2024E | 2025E | 2026E |
|---------------------------|-------|--------|-------|-------|-------|
| EPS | 15.46 | 11.26 | 11.26 | 14.68 | 18.11 |
| EPS Change (YoY) | -7.8% | -27.2% | 0% | 30.4% | 23.4% |
| Consensus EPS (Bloomberg) | | | 12.50 | 15.63 | NA |
| DPS | 2.30 | 2.70 | 2.95 | 3.00 | 3.00 |
| Valuation (Dec) | | | | | |
| P/E | 6.4x | 8.8x | 8.8x | 6.7x | 5.5x |
| Dividend Yield | 2.3% | 2.7% | 3.0% | 3.0% | 3.0% |

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12647867

Timestamp: 18 January 2024 03:30PM EST

18 January 2024

Equity

Key Changes

| (US\$) | Previous | Current |
|------------|----------|---------|
| Price Obj. | 130.00 | 118.00 |

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Stock Data

| | |
|----------------------------|------------------------|
| Price | 98.97 USD |
| Price Objective | 118.00 USD |
| Date Established | 18-Jan-2024 |
| Investment Opinion | B-1-7 |
| 52-Week Range | 79.04 USD - 122.50 USD |
| Mrkt Val / Shares Out (mn) | 24,748 USD / 250.1 |
| Free Float | 99.2% |
| Average Daily Value | 192.42 USD |
| BoFA Ticker / Exchange | DFS / NYS |
| Bloomberg / Reuters | DFS US / DFS.N |
| ROE (2024E) | 18.3% |
| ESGMeter™ | High |

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BoFA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BoFA ESGMeter Methodology".

CCAR: Comprehensive Capital Analysis and Review

NCO: Net charge-off

NIM: Net interest margin

iQprofileSM Discover Financial

Income Statement Data (Dec)

| (US\$ Millions) | 2022A | 2023A | 2024E | 2025E | 2026E |
|--------------------------------------|---------|---------|---------|---------|---------|
| Net Interest Income | 10,999 | 13,099 | 13,328 | 13,754 | 14,191 |
| % change | 15.6% | 19.1% | 1.8% | 3.2% | 3.2% |
| Net Fee Income | 632 | 763 | 830 | 768 | 796 |
| Securities Gains / (Losses) | NA | NA | NA | NA | NA |
| Total Operating Income | 13,304 | 15,860 | 16,181 | 16,559 | 17,046 |
| Operating Expenses | (5,216) | (6,016) | (6,291) | (6,458) | (6,648) |
| % change | 8.6% | 15.3% | 4.6% | 2.7% | 2.9% |
| Provisions Expense | (2,359) | (6,018) | (6,134) | (5,752) | (5,511) |
| % change | 982.1% | 155.1% | 1.9% | -6.2% | -4.2% |
| Operating Pre-Tax Income | 5,729 | 3,826 | 3,756 | 4,349 | 4,887 |
| Operating Net Income to Comm S/Hold. | 4,294 | 2,859 | 2,765 | 3,215 | 3,623 |
| GAAP Net Income | 4,382 | 2,940 | 2,846 | 3,296 | 3,704 |

Balance Sheet Data (Dec)

| (US\$ Millions) | 2022A | 2023A | 2024E | 2025E | 2026E |
|---------------------------------|---------|---------|---------|---------|---------|
| Total Assets | 131,628 | 151,522 | 151,211 | 156,171 | 161,998 |
| Average Interest Earning Assets | 116,395 | 139,642 | 148,303 | 151,837 | 157,235 |
| Total Gross Customer Loans | 112,120 | 128,409 | 130,107 | 134,435 | 139,571 |
| % change | 19.7% | 14.5% | 1.3% | 3.3% | 3.8% |
| Total Customer Deposits | 70,521 | 84,033 | 87,636 | 91,141 | 94,787 |
| % change | 13.9% | 19.2% | 4.3% | 4.0% | 4.0% |
| Tangible Equity | 13,279 | 13,517 | 13,381 | 14,012 | 15,109 |
| Common Shareholders' Equity | 14,590 | 14,828 | 14,692 | 15,323 | 16,420 |

Key Metrics (Dec)

| (US\$ Millions) | 2022A | 2023A | 2024E | 2025E | 2026E |
|--|--------|--------|--------|--------|--------|
| Net Interest Margin | 9.45% | 9.38% | 8.99% | 9.06% | 9.03% |
| Effective Tax Rate | 23.5% | 23.2% | 24.2% | 24.2% | 24.2% |
| Loan / Deposit Ratio | 159.0% | 152.8% | 148.5% | 147.5% | 147.2% |
| Tangible Common Equity / Assets | 10.1% | 8.9% | 8.8% | 9.0% | 9.3% |
| ROA | 5.1% | 2.0% | 1.8% | 2.1% | 2.3% |
| ROE | 30.6% | 19.6% | 18.3% | 21.2% | 22.5% |
| RoTE | 32.3% | 21.2% | 20.7% | 22.9% | 24.0% |
| Dividend Payout Ratio | 14.9% | 24.0% | 26.2% | 20.4% | 16.6% |
| Efficiency Ratio (Cost / Income Ratio) | 39.2% | 37.9% | 38.9% | 39.0% | 39.0% |
| Billings Growth | 9.2% | 7.1% | 2.7% | 4.5% | 5.0% |
| Share / Issue Repurchase | NA | NA | NA | NA | NA |
| Cost of Dividends Paid | (543) | (653) | (732) | (664) | (607) |
| Change in Debt | NA | NA | NA | NA | NA |

Quality of Earnings (Dec)

| (US\$ Millions) | 2022A | 2023A | 2024E | 2025E | 2026E |
|--|-------|-------|-------|-------|-------|
| Total Non-Interest Inc / Operating Inc | 17.3% | 17.4% | 17.6% | 16.9% | 16.7% |
| Loan Loss Reserves / Total Loans | 7.04% | 7.79% | 7.73% | 7.55% | 7.43% |

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 a Buy. We appreciate DFS' integrated issuer / network model that drives attractive economics (20%+ ROEs) and see the more optimistic macro outlook as supportive for future credit losses and provisioning. While the company has to overcome idiosyncratic risks related to compliance issues, we view current valuation as attractive.

Stock Data

Average Daily Volume 1,944,177

Quarterly Earnings Estimates

| | 2023 | 2024 |
|----|-------|-------|
| Q1 | 3.55A | 3.59E |
| Q2 | 3.54A | 2.63E |
| Q3 | 2.59A | 2.73E |
| Q4 | 1.54A | 2.29E |

Other takeaways continued

Loan growth: Discover expects the 2023 vintage to build balances throughout the year but is not expecting any additional growth from the 2022 cohort. The company has also reduced balance transfers and promotional balances which will be a headwind to 2024 growth. While DFS expects relatively flat ending loan balances, it sees average balances up 5-6% y/y for 2024.

Credit: Delinquency trends are improving across all stages, though the improvement is more pronounced in early-stage compared to late stage. DFS does expect credit loss rate to improve in 2025. We think longer-term credit losses likely end up in the 4.25-4.50% range. This is higher than the high-3% rate DFS was running at pre-COVID but reflects the normalized and slightly wider underwriting aperture DFS adapted in the late-2010s.

Expenses: DFS remains committed to long-term efficiency ratios below 40%. While the guide is for a mid-single digit increase, DFS did note that total expenses could increase if additional remediation or incremental compliance resources are needed. DFS does have an opportunity to lower costs post the student loan portfolio sale as a bulk of compliance resources are dedicated to the student loan product.

Compliance: The company continues to work through its compliance issues as exemplified by the \$80M customer remediation reserve, which is separate from the \$370M merchant tiering reserve. The customer remediation is primarily for refunding customer payments regarding the student loan business.

Capital return: The company is committed to returning excess capital to shareholders but will likely do so after the CCAR results. It noted that the sale of the student loan business will free an additional +\$2B of capital to return.

Economic outlook: Discover expects four rate cuts of 25bps in 2024 with each rate cut reducing NIM by ~5bps. DFS expects unemployment of 4.2% in 2024, GDP of 1.3%, and a slight decrease to the household savings rate, relatively in-line with most soft-landing forecasts.



Price objective basis & risk

Discover Financial (DFS)

We calculate a \$118 PO based on an 10.5x PE multiple to our 2024 EPS forecast. A 10.5x multiple is in the middle of DFS's recent historical range (7-12x) and reflects the more optimistic macro outlook, resilient consumer balance sheets, and strong business fundamentals.

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.

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 |
| | Block Inc | SQ | SQ US | Jason Kupferberg |
| | Capital One Financial | COF | COF US | Mihir Bhatia |
| | Discover Financial | DFS | DFS US | Mihir Bhatia |
| | Enact Holdings | ACT | ACT US | Mihir Bhatia |
| | 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 |
| | Jack Henry & Associates | JKHY | JKHY US | Jason Kupferberg |
| | Mastercard Inc | MA | MA US | Jason Kupferberg |
| | MGIC Investment Corp. | MTG | MTG US | Mihir Bhatia |
| | NMI Holdings | NMIH | NMIH US | Mihir Bhatia |
| | Nuvei | NVEI | NVEI US | Jason Kupferberg |
| | Nuvei | YNVEI | NVEI CN | Jason Kupferberg |
| | OneMain Holdings, Inc. | OMF | OMF US | Mihir Bhatia |
| | Shift4 Payments, Inc | FOUR | FOUR US | Jason Kupferberg |
| | Telus International | TIXT | TIXT US | Cassie Chan |
| | Telus International | YTIXT | TIXT CN | Cassie Chan |
| | Visa Inc. | V | V US | Jason Kupferberg |
| | WEX Inc. | WEX | WEX US | Mihir Bhatia |
| NEUTRAL | | | | |
| | ADP | ADP | ADP US | Jason Kupferberg |
| | Affirm Holdings | AFRM | AFRM US | Jason Kupferberg |
| | Bread Financial Holdings Inc | BFH | BFH US | Mihir Bhatia |
| | DLocal | DLO | DLO US | Jason Kupferberg |
| | Globant SA | GLOB | GLOB US | Jason Kupferberg |
| | Marqeta | MQ | MQ US | Jason Kupferberg |
| | PayPal Holdings Inc | PYPL | PYPL US | Jason Kupferberg |
| | SoFi Technologies Inc | SOFI | SOFI US | Mihir Bhatia |
| | Synchrony Financial | SYF | SYF US | Mihir Bhatia |
| | Thoughtworks | TWKS | TWKS US | Jason Kupferberg |
| | Toast | TOST | TOST US | Jason Kupferberg |
| | TTEC Holdings | TTEC | TTEC US | Cassie Chan |

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

| Investment rating | Company | BofA Ticker | Bloomberg symbol | Analyst |
|---------------------|--------------------------------|-------------|------------------|------------------|
| UNDERPERFORM | 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 |
| | 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 |
| RSTR | Western Union | WU | WU US | Jason Kupferberg |
| | EngageSmart | ESMT | ESMT 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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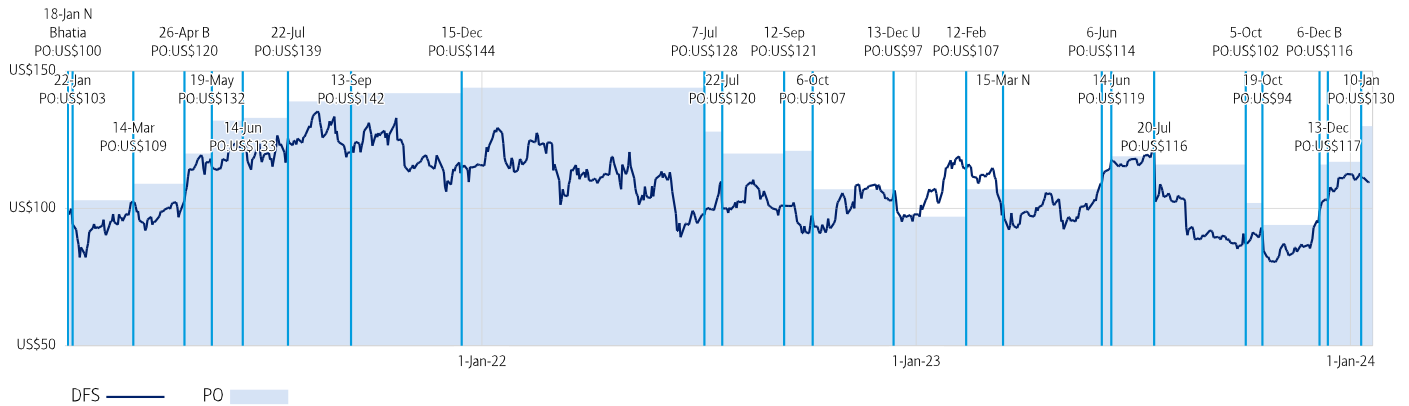
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Disclosures

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 Dec 2023)

| Coverage Universe | Count | Percent | Inv. Banking Relationships ^{R1} | Count | Percent |
|-------------------|-------|---------|--|-------|---------|
| Buy | 156 | 53.79% | Buy | 94 | 60.26% |
| Hold | 72 | 24.83% | Hold | 48 | 66.67% |
| Sell | 62 | 21.38% | Sell | 35 | 56.45% |

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

| Coverage Universe | Count | Percent | Inv. Banking Relationships ^{R1} | Count | Percent |
|-------------------|-------|---------|--|-------|---------|
| Buy | 1895 | 53.62% | Buy | 1083 | 57.15% |
| Hold | 832 | 23.54% | Hold | 454 | 54.57% |
| Sell | 807 | 22.84% | Sell | 383 | 47.46% |

^{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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