

## Discover Financial

## Few bright spots in 4Q results

Maintain Rating: BUY | PO: 130.00 USD | Price: 108.74 USD

## Disappointing 2024 guide drives sell off

We are not surprised to see Discover Financial (DFS) shares selling off in the after-market (down 10%) following its disappointing 4Q earnings and 2024 guidance. 4Q featured a larger-than-expected reserve build and a higher reserve rate. This was a negative surprise after DFS had indicated credit trends were improving in intra-quarter conference appearances. The 2024 guide also disappointed on both loan growth (500 bps below consensus) and credit outlook, both of which were weaker than expected.

We are maintaining our Buy rating. With shares down 10% much of the bad news is now reflected in valuation. Positively, the rate of new delinquency formation is slowing and credit losses should peak in 2024. The sharp slowdown in new card issuance and loan growth is also a credit positive. There is also potential for a positive catalyst path, over the next few months, as the student loan portfolio is sold, buybacks resume and the new CEO assumes his role.

## 2024 guide disappoints on both loan growth and credit

For 2024, DFS expects loan balances to be relatively flat, a sharp slowdown from 15% growth in 2023 and below BofAe/consensus 5.7%/5.2%. DFS is also guiding for a sharp slowdown in new card acquisitions – we estimate a 24% y/y decline. This likely drives the disappointing loan growth guide but should lead to better credit results, longer-term. For 2024, however, DFS expects company-wide net charge-off rates of 4.9%-5.3%, well above BofAe/consensus at 4.6%/4.4%. The outlook for net interest margin (10.5%-10.8%) and OpEx (up mid-single digits) were both in line with expectations. DFS also said it would update its capital plans post-CCAR. While there was some speculation that the weak loan growth guide could be due to the student loan portfolio sale, DFS clarified that the guide does not contemplate the potential sale of the student loan portfolio.

## 4Q misses on provisions and OpEx – variance table pg. 3

EPS (-): of \$1.54 was below BofAe/cons at \$2.56/\$2.58 on a higher reserve build.

PPNR: at \$2,421M was below BofAe/cons forecasts at \$2,475M/\$2,510M driven by higher marketing spend due to the cashback debit campaign and compliance costs.

Ending loan balance: of \$128.5B, up 2.7% y/y, was in between BofAe/cons estimates of \$129.1B/\$128.1B. Card balances of \$102.3B was below cons estimates at \$102.8B. NIM was 10.98% well above BofAe/cons at 10.72%/10.79%.

Card NCO rate: of 4.68% was in-line with cons at 4.68% and a touch better than our 4.70% estimate. Discover built \$618M of reserves well above BofAe/cons at \$344M/\$369M which resulted in a 7.23% reserve ratio, up 17bps q/q.

## Read-thru for other card issuers

There could be spillover to other card issuers (Capital One, Synchrony, Bread) given the credit guidance and slowdown in new card acquisitions.

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## Stock Data

Price	108.74 USD
Price Objective	130.00 USD
Date Established	10-Jan-2024
Investment Opinion	B-1-7
52-Week Range	79.04 USD - 122.50 USD
Mrkt Val / Shares Out (mn)	27,191 USD / 250.1
Free Float	99.2%
Average Daily Value	208.25 USD
BofA Ticker / Exchange	DFS / NYS
Bloomberg / Reuters	DFS US / DFS.N
ROE (2023E)	21.4%
ESGMeter™	High

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CCAR: Comprehensive Capital Analysis and Review

NCO: Net charge-off

NIM: Net interest margin

PPNR: Pre provision net revenue

**Exhibit 1: Higher provisions drives EPS miss, higher OpEx drives lower PPNR**

Variance table

(\$ in millions)	Actual	Estimate	Variance	Var per share	Consensus
	Dec-23-A	Dec-23-E	(Act - Est)	(net of tax)	
<b>Income Statement</b>					
Interest Income	\$4,868	\$4,743	\$125	\$0.38	\$4,773
YoY Growth	26.2%	23.0%			23.8%
Interest Expense	1,400	1,373	\$27	(\$0.08)	1,391
YoY Growth	77.4%	74.0%			76.3%
Net Interest Income	3,468	3,370	98	\$0.30	3,387
YoY Growth	13.1%	9.9%			10.4%
Discount/Interchange Revenue	1,158	1,175	(17)	(\$0.05)	1,171
YoY Growth	0.3%	1.8%			0.5%
Rewards Cost	788	824	(36)	\$0.11	808
YoY Growth	(1.1%)	3.4%			1.4%
Discount and Interchange Revenue, net	370	351	19	\$0.06	363
YoY Growth	3.6%	(1.6%)			(1.5%)
Total Other Income	728	707	21	\$0.06	707
YoY Growth	11.3%	8.2%			6.3%
Revenue Net of Interest Expense	4,196	4,077	119	\$0.36	4,093
YoY Growth	12.8%	9.6%			9.7%
Provision for Loan Losses	1,909	1,636	273	(\$0.83)	1,658
Total Other Expense	1,775	1,602	173	(\$0.52)	1,583
YoY Growth	18.7%	7.2%			5.9%
As a % of Revenue (Operating Efficiency)	42.3%	39.3%			38.7%
Income Before Income Taxes	512	839	(327)	(\$0.99)	852
Pre-Tax Margin	12.2%	20.6%			20.8%
Tax Expense	124	194	(70)	\$0.28	201
Net Income	\$388	\$645	(\$257)	(\$1.03)	\$651
After-Tax Margin	9.2%	15.8%			15.9%
Preferred Share dividends / Other	2	6	(4)		6
Net Income Allocated to Common Stockholders	\$386	\$639	(\$253)		\$645
YoY Growth	(62.1%)	(37.3%)			(37.2%)
<b>PER SHARE STATISTICS</b>					
Diluted EPS	\$1.54	\$2.56	(\$1.01)		\$2.58
YoY Growth	(58.7%)	(31.6%)			(31.4%)
Core EPS	\$1.54	\$2.56	(\$1.01)		\$2.58
YoY Growth	(58.7%)	(31.6%)			(31.4%)
Weighted Average Common Shares Outstanding (fully diluted)	250	250	-		250
<b>Other Key Metrics</b>					
Pre-Provision Net Revenue	\$2,421	\$2,475	(\$54)		\$2,510
Effective Tax Rate	24%	23%			24%
ROE	11%	18%			18%
Card Purchase Volume	\$57,145	\$57,333	-\$188		\$56,310
YoY Growth	2.7%	3.0%			1.2%
Rewards Rate	1.38%	1.44%			1.44%
Total Loans Receivable	128,409	129,077			128,080
Loan Growth (Company)	14.5%	15.1%	-0.6%		14.2%
Credit Card Loans Receivable	102,259	102,909			102,771
Credit Card Loan Growth	13.5%	14.2%	-0.7%		14.0%
Net Interest Margin	10.98%	10.72%	0.26%		10.79%
Net Charge-off rate - Company	4.11%	4.11%	0.00%		4.09%
Net Charge-off rate - Cards	4.68%	4.70%	-0.02%		4.68%
Reserve Ratio - Company	7.23%	6.98%			7.05%
Reserve Build / Release	618	344			369

Source: BofA Global Research estimates, company reports, Visible Alpha

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## Price objective basis & risk

### Discover Financial (DFS)

We calculate a \$130 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

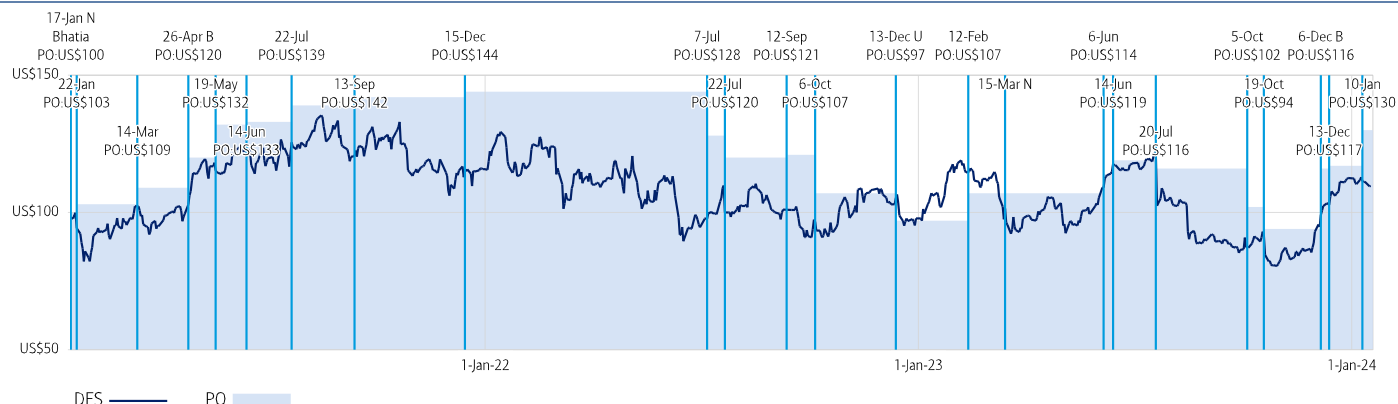
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### Discover Finl (DFS) Price Chart



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Coverage Universe	Count	Percent	Inv. Banking Relationships <sup>R1</sup>	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%

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Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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