

Discover Financial

Disappointing credit results in January operating metrics

Reiterate Rating: BUY | PO: 118.00 USD | Price: 109.11 USD

Loss rates higher than expected in January

Discover Financial (DFS) reported January operating results highlighted by a sequential increase in loss rates, above typical seasonality, but better than expected loan growth. While we expected credit performance to weaken sequentially, the pace was worse than expected in January and delinquencies have yet to turn the corner. As such, loss rates are likely to move higher in the near-term. DFS said during its 4Q earnings last month that it expects losses to rise through the mid-year and then plateau. We do expect that DFS will benefit from a soft landing, and the resumption of share buybacks and resolution of compliance issues could be positive catalysts for shares. Reiterate Buy.

Loan balances up 12.2%

End of period loan balances of \$101.0B increased 12.2% y/y compared to December in which balances were up 13.5% y/y. On a month-over-month basis, loans declined 1.27% less than the average 1.49% decrease observed in the last five years. If loan balances decline in-line with historical averages for the remainder of 1Q, card balances will be higher than BofAe/consensus forecasts at \$97.8B/\$97.6B.

Loss rates up 33bps m/m to 5.23%

The January net charge-off rate was 5.23% up 33bps from 4.90% in December. Over the past five years, January losses increased an average of 8bps m/m, so the 33bps increase this January suggests Discover is experiencing continued credit deterioration. Additionally, the 30+ day delinquency rate increased to 4.02% from 3.87% in December. The m/m increase in delinquencies of 15bps was also above the five-year average of +7bps. Delinquency trends imply further weakness in near-term losses (Exhibit 1) and current BofAe 1Q24 loss rates forecasts at 5.20% appear too low and as such we revise our loss forecast up to 5.40%.

Adjusting estimates

We adjust our 1Q/2024 EPS estimate to \$3.09/\$11.22 from \$3.59/\$11.26 previously as we account for January results, weaker 1Q credit and higher near-term reserves. Given increases in delinquencies/loss rates and faster loan growth, we now expect higher reserve builds in 1Q24 and less reserve building as loss rates peak in 2H24. We maintain our \$118 PO based on an unchanged 10.5x multiple to 2024 EPS.

Estimates (Dec) (US\$)	2022A	2023A	2024E	2025E	2026E
EPS	15.46	11.26	11.22	14.50	18.23
EPS Change (YoY)	-7.8%	-27.2%	-0.4%	29.2%	25.7%
Consensus EPS (Bloomberg)			11.05	13.91	16.76
DPS	2.30	2.70	2.95	3.00	3.00
Valuation (Dec)					
P/E	7.1x	9.7x	9.7x	7.5x	6.0x
Dividend Yield	2.1%	2.5%	2.7%	2.7%	2.7%

14 February 2024

Equity

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Stock Data

Price	109.11 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)	27,284 USD / 250.1
Free Float	99.2%
Average Daily Value	252.02 USD
BofA Ticker / Exchange	DFS / NYS
Bloomberg / Reuters	DFS US / DFS.N
ROE (2024E)	18.3%
ESGMeter™	High

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DQ: Delinquency

NCO: Net charge-off

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Timestamp: 14 February 2024 07:17PM EST

iQprofileSM Discover Financial

Income Statement Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Net Interest Income	10,999	13,099	13,434	13,861	14,307
% change	15.6%	19.1%	2.6%	3.2%	3.2%
Net Fee Income	632	763	836	774	802
Securities Gains / (Losses)	NA	NA	NA	NA	NA
Total Operating Income	13,304	15,860	16,293	16,672	17,168
Operating Expenses	(5,216)	(6,016)	(6,334)	(6,502)	(6,695)
% change	8.6%	15.3%	5.3%	2.6%	3.0%
Provisions Expense	(2,359)	(6,018)	(6,218)	(5,872)	(5,555)
% change	982.1%	155.1%	3.3%	-5.6%	-5.4%
Operating Pre-Tax Income	5,729	3,826	3,741	4,298	4,918
Operating Net Income to Comm S/Hold.	4,294	2,859	2,754	3,176	3,646
GAAP Net Income	4,382	2,940	2,835	3,257	3,727

Balance Sheet Data (Dec)

(US\$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Assets	131,628	151,522	151,308	156,202	162,035
Average Interest Earning Assets	116,395	139,642	149,442	153,046	158,502
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	13,370	13,963	15,083
Common Shareholders' Equity	14,590	14,828	14,681	15,274	16,394

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%	8.9%	9.3%
ROA	5.1%	2.0%	1.8%	2.1%	2.3%
ROE	30.6%	19.6%	18.3%	21.0%	22.7%
RoTE	32.3%	21.2%	20.6%	22.7%	24.2%
Dividend Payout Ratio	14.9%	24.0%	26.3%	20.7%	16.5%
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%	17.5%	16.9%	16.7%
Loan Loss Reserves / Total Loans	7.04%	7.79%	7.69%	7.57%	7.44%

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

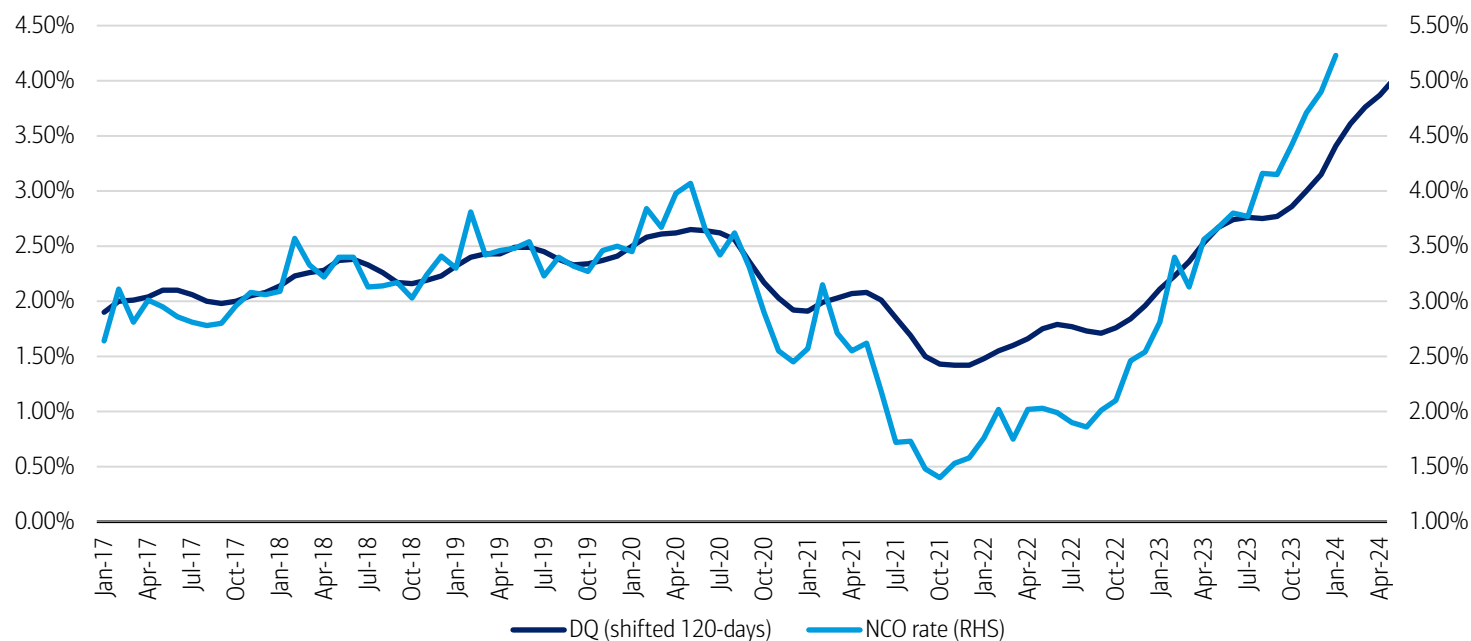
Average Daily Volume 2,309,812

Quarterly Earnings Estimates

	2023	2024
Q1	3.55A	3.09E
Q2	3.54A	2.77E
Q3	2.59A	2.87E
Q4	1.54A	2.47E

Exhibit 1: Delinquency trends imply losses should move higher in the near-term

NCOs vs DQs shifted by 120 days



Source: BofA Global Research estimates, company reports

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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
	Marqeta	MQ	MQ US	Cassie Chan
	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
	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
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	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
	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

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

Denominator

Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization

Shareholders' Equity

Sales

N/A

N/A

Quality of Earnings

Cash Realization Ratio

Asset Replacement Ratio

Tax Rate

Net Debt-To-Equity Ratio

Interest Cover

Numerator

Cash Flow From Operations

Capex

Tax Charge

Net Debt = Total Debt – Cash & Equivalents

EBIT

Denominator

Net Income

Depreciation

Pre-Tax Income

Total Equity

Interest Expense

Valuation Toolkit

Price / Earnings Ratio

Price / Book Value

Dividend Yield

Free Cash Flow Yield

Enterprise Value / Sales

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

Diluted Earnings Per Share (Basis As Specified)

Shareholders' Equity / Current Basic Shares

Current Share Price

Market Cap = Current Share Price × Current Basic Shares

Sales

EV / EBITDA

Basic EBIT + Depreciation + Amortization

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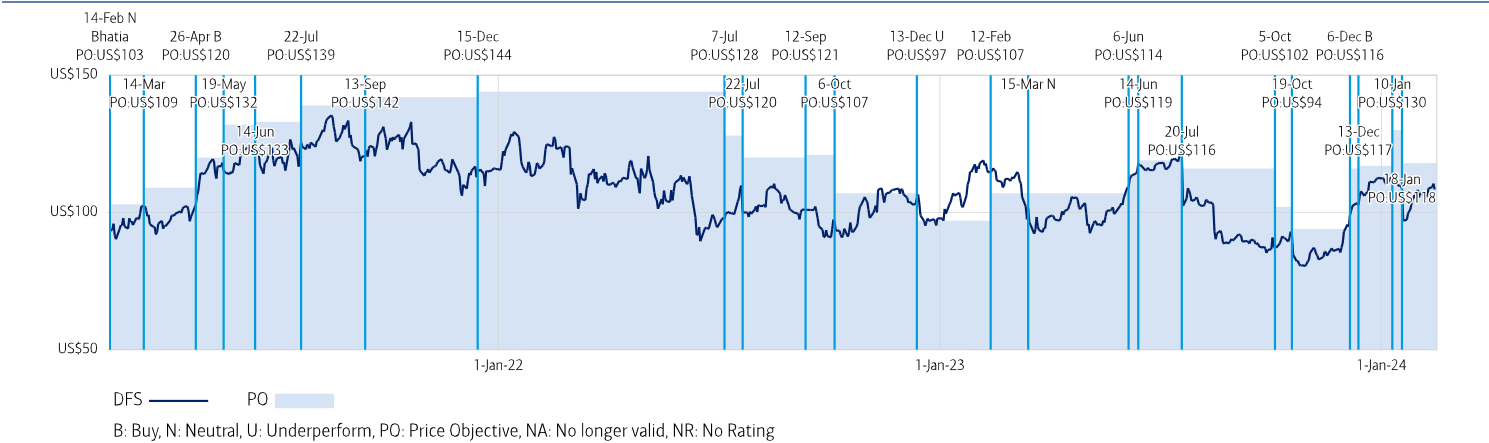
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Discover Finl (DFS) Price Chart



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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%

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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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