# Superior Service and Exclusive Network Set This Company Apart

This company's best-in-class customer service and extensive payment network insulate it from incumbents and disruptors. Discover Financial Services (DFS: $123/share) remains a Long Idea after 3Q21 earnings.

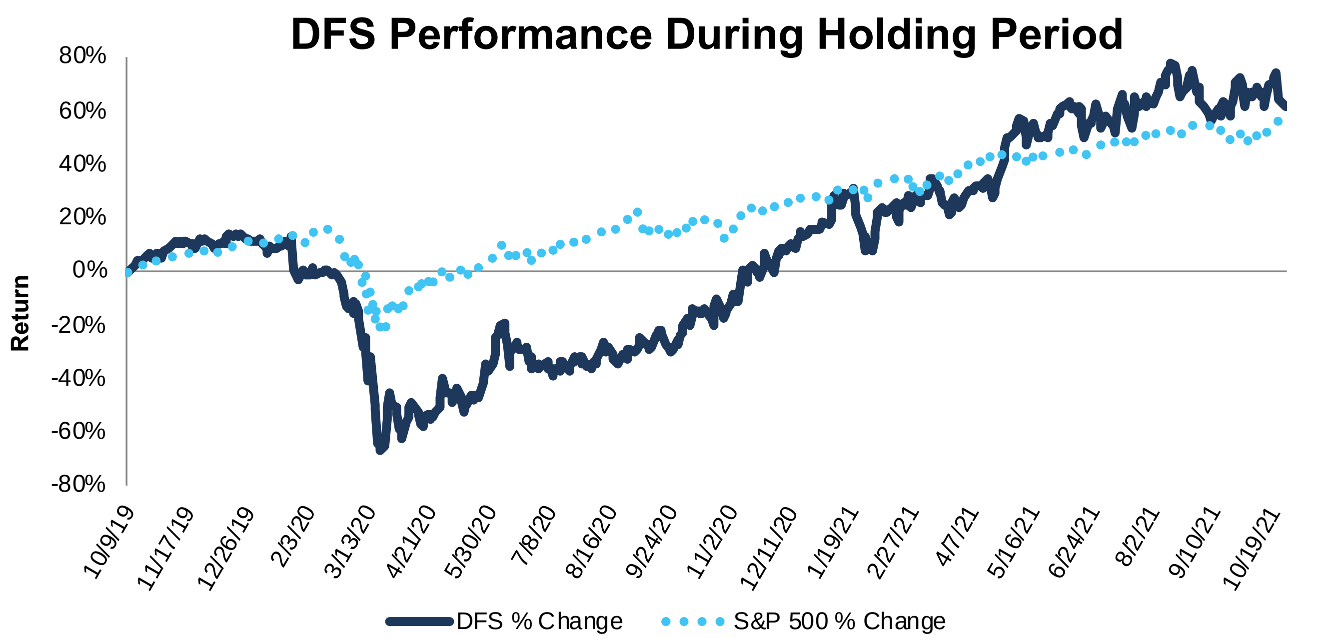
**Learn more about the best fundamental research**

We leverage more reliable fundamental data, as proven in The Journal of Financial Economics[1], and shown to provide a new source of alpha, with qualitative research to highlight this firm whose stock present excellent risk/reward.

**Discover Has More Room to Outperform**

We made Discover Financial Services a Long Idea in October 2019 and the stock has outperformed the S&P 500 by 5% since then. Despite its slight outperformance, we still see upside in the stock.

**Figure 1: Long Idea Performance: From Date of Publication Through 10/26/2021**




Sources: New Constructs, LLC and company filings

**What's Working:** While coming in below expectations, Discover's revenue grew 2% year-over-year (YoY) in 3Q21. Importantly, after five consecutive quarters of YoY decline, Discover returned to growing its loan portfolio and total loans in 3Q21 were 1% higher than 3Q20. Furthermore, the company continues to attract new customers and new accounts are up 17% over 2019 levels.

During the pandemic, consumers paid down outstanding credit balances with the help of government stimulus payments and fewer opportunities for discretionary spending, which improves the quality of Discover's loan portfolio. The company's net charge-off rate fell from 3% in 3Q20 to 1.5% in 3Q21. Discover's 30+ day delinquency rate fell 43 basis points YoY in 3Q21.

[1] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Discover operates an extensive payments network across 200+ countries that is rivaled only by other major credit card companies Visa (V), Mastercard (MA), and American Express (AXP).

Discover increased its share of outstanding balances from 7.6% in 2019 to 8.2% in 2020. The company's high-level customer service, as proven by its customer satisfaction rankings, fosters strong customer relationships that create a competitive advantage. When coupled with Discover's payment network, the company has a large moat that enables it to take market share from incumbents while protecting its business from new decentralized finance (DeFi) entrants.

Discover's established network and deep customer relationships have also prevented perceived threats from buy now, pay later (BPNL) companies from materializing. Our recent report on Affirm Holdings (AFRM) shows that BPNL companies don't replace credit cards, but rather just increase consumer debt.

Discover's integrated digital bank and payments model is more profitable than its direct peers as well. The company's trailing-twelve-months (TTM) return on invested capital (ROIC) of 19% is well above card issuing peers' Capital One Financial (COP) and American Express (AXP) ROIC's of 8% and 9%, respectively.

**What's Not Working:** While card and organic student loans grew in 3Q21, Discover saw personal loan balances fall 4% YoY in 3Q21 as customers quickly paid down outstanding balances during the period. However, personal loans accounted for just 8% of the company's total loan balance in 3Q21, and the company believes its return to pre-pandemic underwriting practices for this segment will lead to future growth.

Discover felt the pressure of the low-interest rate environment in 3Q21, which caused yields on personal loans to fall quarter-over-quarter. However, the company's large credit card portfolio positions the company for continued profitability even if the current low-interest rate environment persists.

Credit cards traditionally have provided a convenient transaction method, which the proliferation of digital payment platforms and DeFi now challenges. Grand View Research expects the digital payment market to grow 19% compounded annually from 2021 to 2028. However, Discover's extensive, secure network and credit facilities can be easily integrated within digital payment platforms. For example, Discover already leverages agreements with digital payment platforms such as PayPal, which contributed to the company's strong 3Q21 sales.

**DFS Priced for Uncharacteristically Low Profit Growth:** Discover's price-to-economic book value (PEBV) ratio of 1.0 means that the stock is priced for profits to never meaningfully grow beyond current levels. For reference, Discover has grown NOPAT by 35% compounded annually over the past decade.

Below, we use our reverse DCF model to analyze the expectations for future growth in cash flows baked into different stock price scenarios for Discover.

In the first scenario, we assume Discover's:

- net operating profit after tax (NOPAT) margin falls to 25% (three-year average vs. 28% TTM) from 2021 through 2030, and
- revenue grows by 2% compounded annually from 2021 to 2030 (vs. consensus CAGR of 6% for 2021-2023)

In this scenario, Discover's NOPAT grows by just 1% compounded annually over the next decade and the stock is worth $123/share today – equal to the current price. See the math behind this reverse DCF scenario. In this scenario, Discover's NOPAT in 2030 is just 3% above 2020 levels.

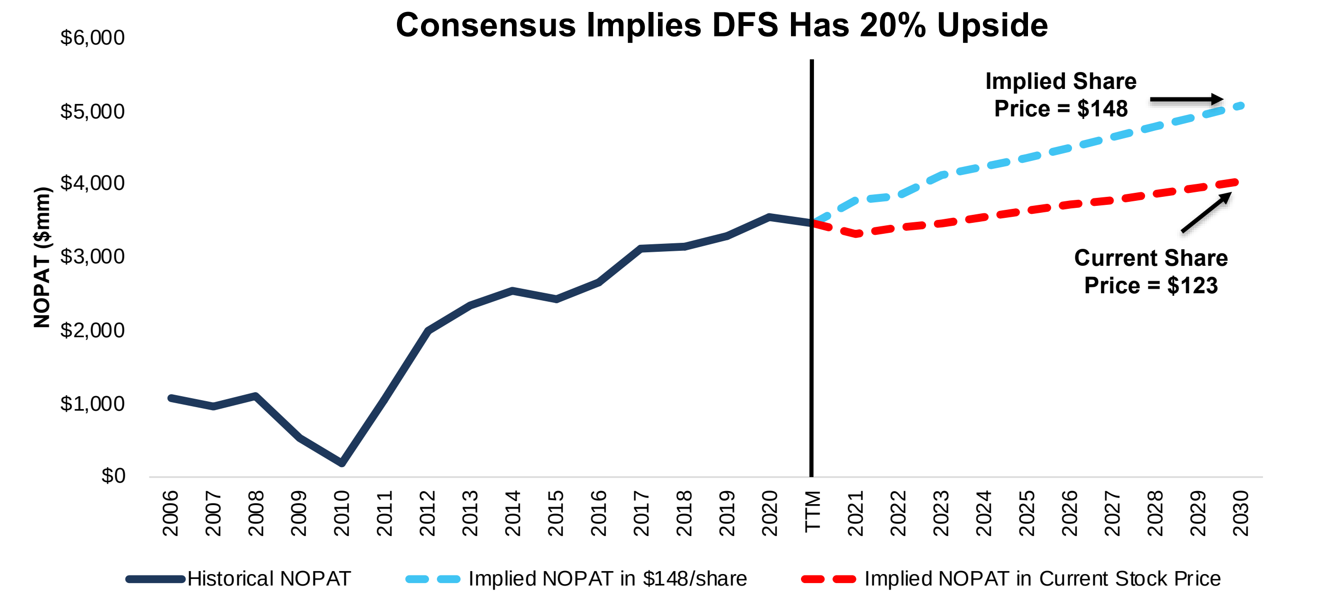
**Shares Could Reach $148 or Higher:** If we assume Discover's:

- NOPAT margin falls to 27%, (vs. 28% TTM) from 2021 through 2030, and
- revenue grows at a 6% CAGR through 2023 (same as consensus 2021-2023 CAGR), and
- revenue grows 3% a year from 2024 – 2030, then

the stock is worth $148/share today – 20% above the current price. See the math behind this reverse DCF scenario. In this scenario, Discover grows NOPAT by 4% compounded annually over the next decade. For reference, Discover grew NOPAT by 8% compounded annually over the past five years.

In the above scenarios, we assume a WACC of 9.7%, which is 100 basis points higher than Discover's current WACC, and functions to lower the terminal value in our DCF model in the event that Discover and/or credit card companies in general are disrupted by DeFi in the mid-to-long term. Should the company continue to fend off competition through its strong customer relationships and ease of use/availability of its network, this WACC assumption and lower terminal value could prove conservative, in which case DFS has even greater upside.

**Figure 2: Discover's Historical and Implied NOPAT: DCF Valuation Scenarios**




Sources: New Constructs, LLC and company filings

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*Disclosure: David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, sector, style, or theme.*

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Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

**Superior Models**

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [ as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

**Superior Stock Ratings**

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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