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American Express: Company update

Summary:

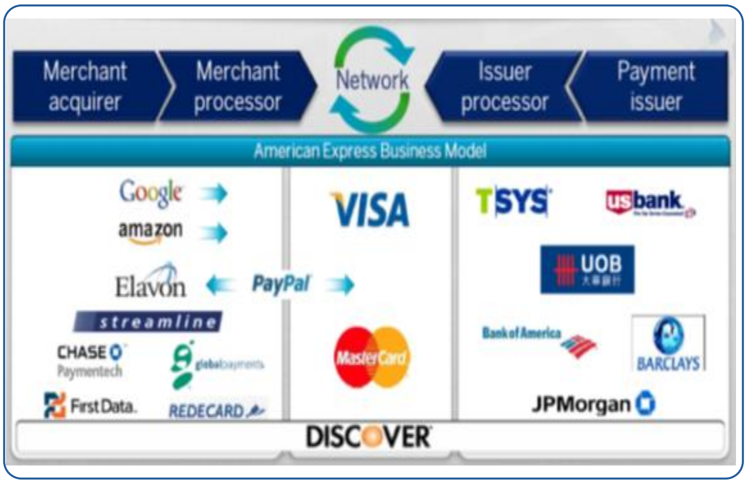
We believe that American Express (Amex) potentially represents an opportunity because, in our view, the company could be a +25% long-term ROE business that can currently be purchased at a 15.5x fwd P/E multiple. While it is significantly cheaper than other credit card companies (according to *Bloomberg* consensus data Visa's P/E is 33.8x trailing, 25.4x fwd; MasterCard's P/E is 27.6x, fwd 25.4x; while our data suggests Amex's P/E is 15.5x trailing and fwd). Therefore, we do not think the decision here is a sector call since Visa and MasterCard have such high P/Es that it is unlikely that we would ever buy those shares. Rather, in the case of Amex it is quite a stock-specific call. With the S&P likely to struggle to grow earnings (*Bloomberg* consensus forecasts 4.4% for FY15) and trading at a 20.29x P/E, and a generally low-return/ low-growth world, we see Amex as a potential quality holding within our overweight financials sector call.

Management seem extremely confident that they will recover from the Costco blow (Costco announced in February that it was ending its 16-year relationship with Amex, a move that pummelled the stock price but which now seems to be already well priced in) and return to EPS growth of 12%-15% p.a. by FY17. If this is achieved then the share could deliver a c. 15% p.a. return (EPS growth + 1.3% DY) as well as a potentially sizeable P/E rerating (here we also note that Amex is one of Berkshire Hathaway's major holdings). However, we do highlight that the risk is that, even if this longer-term growth story holds, the share price could still go nowhere for the next 18 months during the anticipated period of EPS stagnation.

Business description:

Amex is unique in that it owns an end-to-end payments platform. The Group sees this as its principal asset which can be leveraged into different opportunities. A recurring emphasis from Amex's side is that it is a payments platform company, not a credit card company. And, although it is smaller than Visa and MasterCard, Amex is still the biggest US credit card issuer by customer purchases. The illustration below shows the breadth of the Amex platform in relation to other financial services companies.

Amex business model:



Source: *Amex investor day presentation, March 2015*

Just briefly, by way of definition, we note that **merchant acquirers**/acquiring banks process card payments on behalf of a merchant; generally that means they receive funds from the **issuing banks** on behalf of merchants and charge them a fee (which gets split between acquirer, issuer and network); the network is the connection between these parties.

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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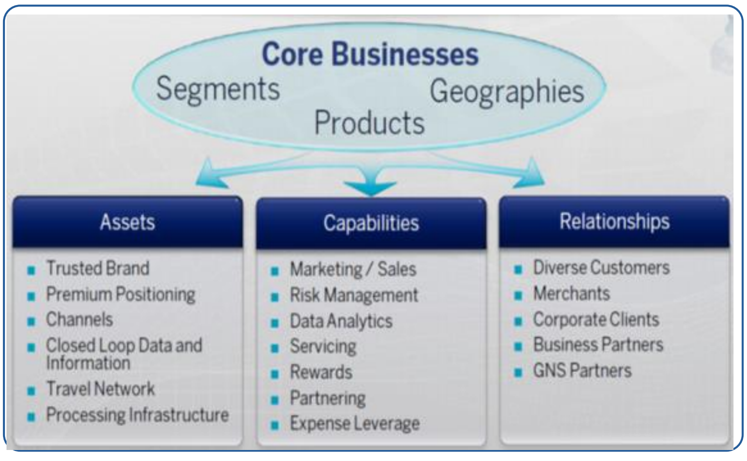
Amex owns the largest integrated payment platform in the world (Discover is similar but its scale and geographic footprint are smaller); Amex is simultaneously an issuer, network (Visa and MasterCard focus here), merchant acquirer and end-to-end provider. The Group processed over $1trn in terms of the volume of transactions in 2014. While Amex is also a lender (its net interest income [NII] is only c. 15% of earnings), the business principally operates a spend-centric model. For accounting purposes there are four reporting segments: US card services, international card services, global commercial services, global network and merchant services. The company's value proposition relates, variously, to the brand being seen as 'aspirational', lower fraud risk because Amex owns a closed/ end-to-end platform, and the many different reward points and benefits that can be accrued from Amex and its partners. We also highlight that Amex effectively has two types of customers: Amex cardholders and Amex merchants (who need to decide whether or not to accept the card with its higher fees). Thus, Amex also needs to make a convincing value proposition to merchants, which it does on the basis of its access to 'big data' (Amex seems to have richer consumer data because of the breadth of its platform) and the various rewards programmes in which merchants can participate.

As mentioned, AMEX charges higher fees to merchants (higher than Visa and MasterCard) and as a result many merchants don't accept the card. Thus, there is both the risk of price pressure (not only from markets, but also from regulators) and loss of market share here (witness the Costco split). We are quite concerned that Amex has to, in some cases, protect its premium fee with rules and that it isn't simply a matter of choice (this is what the US Department of Justice [DoJ] case against the company is all about - *see our comment on this below*).

Amex targets high-net-worth individuals (HNWIs) and hence should continue to see lower credit losses. However, having occupied a leading position in this market Amex is vulnerable to a loss of market share to competition, which is now coming through. It is also expanding beyond its affluent base (does this imply a lower quality earnings stream? We note perhaps it will also result in broader acceptability). The acquisition of new customers is the single biggest investment the Group makes and the company is also transforming its platforms to make it more global.

Amex core assets:



Source: *Amex investor day presentation, March 2015*

The figure above gives another perspective on what the fundamental/underlying assets of the Group actually are (as opposed to simply what shows up on the balance sheet):

Risks:

So, as we just mentioned, there is a concern that Amex is a premium-rate supplier competing against Visa and MasterCard whose 'product' is much cheaper. Although cardholders don't really pay this fee (technically they do, but not in any visible way; perhaps one should say the cardholders don't get penalised for Amex's premium merchant fees), the lower cost of processing non-Amex cards can lead to these cards being preferred. Therefore, Amex is in a position of having to justify its premium product price. However, it is also important to remember that these companies aren't directly comparable – Amex is unique in that it provides an end-to-end platform spanning the businesses of merchant acquirers, networks and issuers.

Furthermore, any kind of commoditisation through competition, or legal caps ("new regulations, including those designed to limit card fees paid by merchants, are challenging our business in many parts of the world", *2015 Annual Report, page 15*), we believe will hurt Amex in absolute terms; and relatively much more so than it would Visa and MasterCard. At the same time, competition for co-branded cards is increasing and financial services firms are more and more targeting the affluent segment – traditionally Amex's domain. Amex could also be exposed to lawsuits around the usage of its "big data" (an invasion of privacy?).

Possible opportunities:

Bearing the abovementioned risks in mind, we think the main business opportunities here are connected to the following:

- A more **secure network**. Amex has a much lower fraud rate (half of Visa and MasterCard), which makes sense given the end-to-end system. Thus, in a sense, Amex is a play on the cybersecurity theme.
- A b**etter understanding of the consumer** through 'big data'.
- Partnerships that have been formed with the likes of twitter, Uber, Facebook etc. We are of the opinion that this is potentially a really exciting growth area – the **high-tech new era** payments technology. It seems that MasterCard's payments platform is an ideal partner for these other players.
- An established and growing **rewards programme**. Rewards are "one of our most powerful tools for creating engagement with card members, and an engaged customer is a profitable customer".

Management forward guidance and targets:

Management have estimated FY15 EPS to be flat to moderately negative, while they see positive growth in FY16, and a return to targeted EPS growth (12%-15% p.a.) by FY17. This guidance assumes softer global GDP growth than has been forecast by major institutions, interest rates as indicated in forward markets, and a modest rise in write offs (the latter is conservative given that a stronger economy should see this going down).

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Bloomberg consensus' view is more bullish than Amex management (*see below*). Basically, in their view, the core/ underlying earnings performance is strong, but there are some short-term headwinds (in FY15 and FY16), which should drop away by FY17. Below we give some more information on these headwinds:

- **Loss of Costco**:
  - ◊ Costco accounted for c. 8% of FY14 billed business and the profit margins were slightly below the Amex average. The agreement terminates on 31 March 2016 and Amex's share price dropped 5.9% following the announcement on 12 February 2015. It is for this reason that we believe the loss of Costco has basically already been priced in, and the market doesn't seem to have given Amex much credit for its strategy to retain cardholders from the Costco co-branded cards.
  - ◊ "We believe that long term we will generate better returns for shareholders by pursuing other opportunities, but we do have a hole to fill." This has been management's constant 'spin' or 'take' on the situation: it's not, in their eyes, so much a blow or a loss as something they turned their backs on because they have better longer-term opportunities. We see the reality as being somewhere in the middle.
  - ◊ Amex has programmes to retain these customers for which the market does not seem to have given the company any credit,
  - ◊ Over 70% of spending on these cards occurred outside of Costco warehouses.
- **The strong US dollar.**
- **New EU legislation** (relating to fee caps).

Long-term targets are for >8% p.a. revenue growth; 12%-15% p.a. EPS growth (the "most important target", according to management); >25% ROE. While acknowledging the company won't achieve these in the short term, management still consider them appropriate for the longer term. Management are also targeting opex growth of <3% in 2015 including a growth in 'investment opex' (*note: this guidance doesn't include any restructuring charge they may incur with relation to Costco*).

<u>**Dividends and share buybacks**</u>:

Amex's 1Q15 dividend was $0.26/share. The US Federal Reserve (Fed) has approved a dividend of $0.29 from 2Q15. Historically, the Group has had an extremely high pay-out ratio of 98% (FY12), 81% (FY13) and 86% (2014). Long-term guidance/target suggests a 50% return of capital through dividends and share buybacks.

<u>**Sensitivities**</u>:

- Given that the company is a spend-centric model, **higher interest rates** are inclined to reduce earnings through increasing costs (a 100-bpt rise in rates tends to increase costs by $212mn over 12 months; which is 2.35% of profit before tax [PBT]). The company did however state that this can be academic because higher rates are usually associated with a stronger economy and thus higher revenues.
- A 10% **move in the US dollar** against other major currencies would generate a $182mn swing in its P&L (or 2% of PBT).

The recent presentation in which this guidance was given (*dated 25 March 2015, Investor Day*) gave us the impression of a company with excellent growth and return prospects in the longer term and a very confident and assertive management team. They seem to have a very sophisticated knowledge of their markets and to be really capitalising on "big data" and also appear to be well positioned to benefit from the tech revolution.

1Q15 guidance:

- Expect 1Q to be modestly better than FY15 outlook ("flat to modestly down").
- Reported revenues will be down slightly QoQ, in our view.

Below we highlight recent news reports pertaining to Amex:

- **DoJ lawsuit:** The company lost its lawsuit against the US DoJ (c. 19 Feb 2015). Amex has rules which prevent merchants from steering customers to lower-cost cards (merchants pay much lower fees on Visa and MasterCard credit cards than on Amex - a cost which is not visible to consumers and hence the apparently reasonable allegation that Amex is stifling competition). However, Amex is of the view that this year's decision was incorrect and the company will continue to fight the decision (we note that the share price didn't react much to this decision and was down less than 2% on the day). Nevertheless, this situation is quite a concern for us – that Amex needs to have a rule to prevent merchants from expressing their choice of card. Part of what Amex is fighting, in this legal battle, is (in their words) "the commoditization of payments cards". This theme would hurt Amex quite significantly, were it to become a reality.

- **The ending of its partnership with Costco**: The Group feels that it has better opportunities to deploy capital in other areas. Although the company won't replace Costco volumes in the short term, its priority is to replace profitability (this will likely hit earnings in FY16 as the deal still has an existing year to run, i.e. 2015).

- Less recently, the Group's EPS growth was challenged in 2010–2014 by the **loss of settlement payments** from Visa and MasterCard.

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Amex income statement summary ($mn):

FY to 31 Dec		2012A	2013A	2014A	2015E	2016E	2017E
Discount revenue		17 739	18 695	19 493			
net card fees		2 506	2 631	2 712			
travel commissions and fees		1 940	1 913	1 118			
other commissions and fees		2 317	2 414	2 508			
other		2 425	2 272	2 989			
total non-interest revenues		26 927	27 927	28 820			
total interest income		6 854	7 005	7 179			
total interest expense		2 226	1 958	1 707			
net interest income		4 628	5 047	5 472			
total revenues net of interest expens		**31 555**	**32 974**	**34 292**			
revenue growth			4%	4%			
net interest income as % of total revenue			15%	16%			
provision for losses		1 712	1 832	2 044			
expenses		23 392	23 254	23 257			
Income before tax	$mn	6 451	7 888	8 991			
tax	$mn	1 969	2 529	3 106			
net income after tax	$mn	4 482	5 359	5 885			
diluted EPS	Usc	3.89	4.88	5.56			
diluted eps growth			25%	14%			
adjusted EPS (forecasts per *Bloomberg*)		**4.2**	**4.9**	**5.3**	**5.5**	**5.8**	**6.6**
adjusted eps growth			18%	8%	3%	5%	14%
P/E at spot	78.8			14.8	14.4	13.6	12.0
R on Ave E	%	23.1%	27.8%	29.1%			
RoAve Tang Common Eq	%	29.2%	34.9%	35.9%			
Company EPS growth guidance					0 / moderately down	positive	12% - 15%
Long-term targets:							
Revenue Growth					> 8%		
EPS growth					12-15%		
ROE					>25%		

Source: Amex AFS 2014; Bloomberg; March 2015 Investor Day

From the table above, we note that *Bloomberg* consensus EPS is higher than the company has guided in FY15. Below is Amex's EPS forecasts (*Bloomberg*) in relation to Visa and MasterCard:

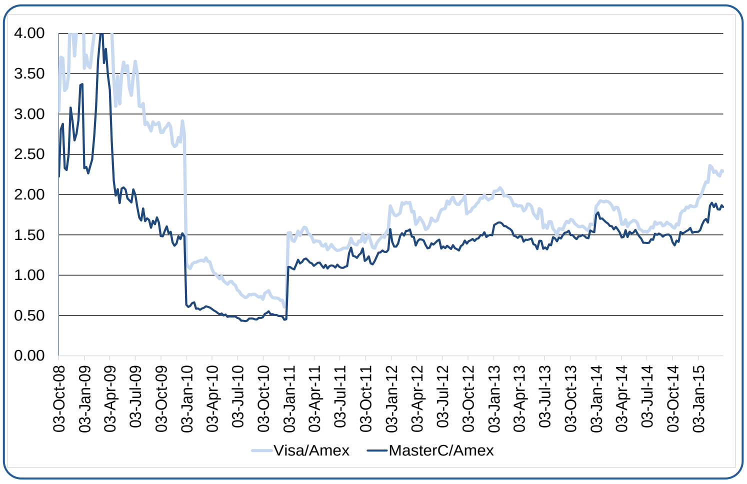
Amex forecasts:

		2014A	2015E	2016E	2017E	2018
EPS forecasts (USc, Bloomberg)						
MasterCard (FY Dec)		3.2	3.5	4.2	4.9	
Amex (FY Dec)		5.3	5.5	5.8	6.6	
Visa (FY Sept)		1.9	2.6	3.0	3.3	3.9
Visa (Adj to Dec YE)		2.1	2.7	3.1	3.5	
P/E Multiples:						
MasterCard	*88.09*	27.62	25.36	21.17	17.83	
Amex	*78.78*	14.79	14.36	13.64	11.97	
Visa	*66.05*	32.02	24.53	21.44	18.99	
EPS growth:						
MasterCard			9%	20%	19%	
Amex			3%	5%	14%	
Visa			31%	14%	13%	

Source: Bloomberg

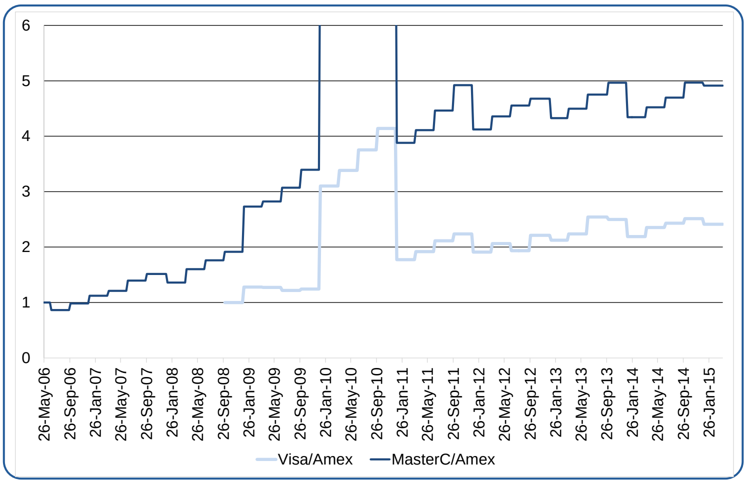
At P/E multiples of 28x and 32x, MasterCard and Visa are extremely unlikely to make it into a value investor's portfolio.

Relative P/E:



Source: Bloomberg, Anchor Capital

Relative EPS:



Source: Bloomberg, Anchor Capital

While Amex's EPS growth has lagged Visa and MasterCard extraordinarily, it is important to bear in mind the very high return *of* capital that Amex has made over the past few years. The share buybacks reflect in EPS growth (through lower shares outstanding), but capital returned through dividends does not and so can hamper the comparability between companies with materially different pay-out ratios. That is, however, not the case here (the DY for Visa and MasterCard is about half that of Amex but those companies also trade at roughly double the P/E multiple).

Blake Allen

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