August 06, 2016

How Discover Financial could boost income—and why it won't

By STEVE DANIELS

Discover Financial made a virtue of its conservatism in the aftermath of the economic meltdown, but a credit card industry hungry to lend more liberally is again pulling the company out of its comfort zone.

The company is responding by very modestly loosening credit standards to find pockets of borrowers with thin credit histories who are good bets to make good on their debts.

At the same time, Discover remains under intense cost pressure on its hallmark—the card that pays you back. The rest of the industry has aped Discover with a vengeance, offering richer rewards to consumers who spend a lot on their cards but pay their balance each month. On this front, the Riverwoods-based company is equally unwilling to give in to peer pressure, contending that others' rewards have grown too rich.

Ever since the Great Recession hammered card companies with loan losses, they've competed hard for American consumers whose credit scores survived the conflagration and ignored everyone else. Finally, the industry is looking beyond only the most creditworthy customers. For example, industry leader JPMorgan Chase is aggressively **courting "near-prime" consumers** in a bid to keep loan balances growing.

Discover's stock price, which soared following the recession as it suffered fewer losses than its rivals, has slowed its ascent. It is up 7.8 percent this year, compared with 6.8 percent for the Standard & Poor's 500, to $57.79 on Aug. 5. Over the past five years, Discover's stock has climbed 153 percent, nearly double the pace of the S&P.

Investors worry about deceleration in loan growth, which remains the main driver of Discover's earnings despite the company's efforts to **diversify beyond**

credit cards. “It's hard to keep growing at the pace that shareholders would like to see if (Discover) doesn't loosen up to some extent, especially when the rest of the industry is,” says Jim Sinegal, an analyst at Morningstar in Chicago.

Discover is trading at a little over nine times projected 2017 earnings, an indication that “people are either very worried about credit, which is hard to see, or they're (worried) the company doesn't grow much from here,” Sinegal says.

David Nelms

There are early signs of concern. While Discover's card loans increased 4 percent to $57.2 billion in the second quarter—the same rate Chase had—sales volume on Discover cards grew a disappointing 2 percent. Chase's sales volume, by contrast, grew 8 percent, a sign that Discover may be losing higher-spending consumers to card companies dangling richer rewards.

Citibank, for example, has been **offering 2 percent cash back** for more than a year. Other card companies are offering 1.5 percent. Discover has stuck with its base rate of 1 percent but over the past year has responded to the industry's rewards arms race by doubling its rewards for the first year to new customers. That sent its reward costs up substantially to 1.21 percent of sales volume from 1.05 percent a year earlier.

Discover is adamant that it won't follow Citi into permanent 2 percent territory, and it has yet to see what its new customers will do when their rewards drop to 1 percent. “We may have lost some (high-spending customers) to competitors, although our retention rates tend to be among the best in the industry,” Discover President Roger Hochschild says in an interview.

Discover is mostly sticking to its approach of lending overwhelmingly to those with sterling credit. “For us, we try to have a consistent value proposition built on rewards, **service** and value,” Hochschild says.

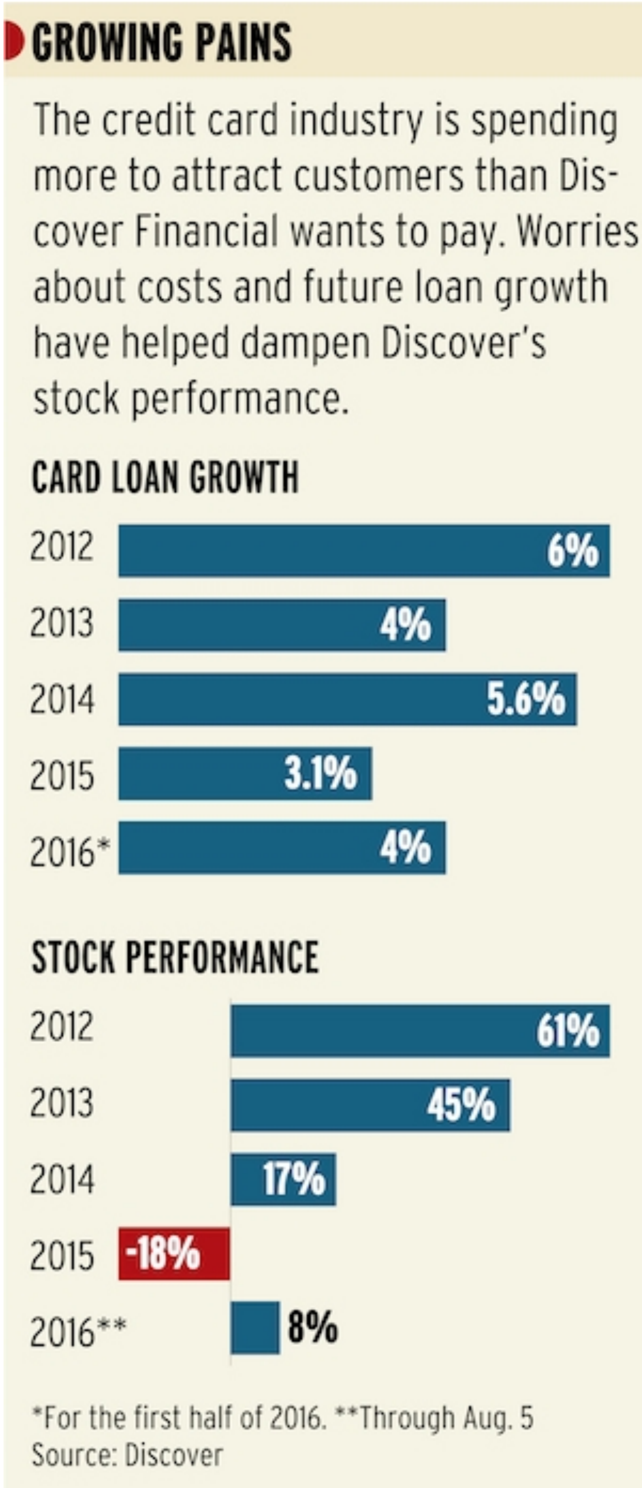
There also are concerns that card companies are loosening the purse strings just as more economists are **warning that recession** is possible within the next two years. Hochschild acknowledges that could happen, noting that the recovery is now in its eighth year.

Still, there are no signs yet that consumers are cracking. Loan-loss levels remain historically low.

“Discover is just playing an increasingly expensive game,” says David Robertson, publisher of the Nilson Report, which tracks the credit card industry. “So what do you do? You need to generate lending to produce more top-line growth. Where are you going to go? There's only one way to go, and that's down. The people who are at the margins always need credit.”

Hochschild says Discover won't do that. He points out that he has been in the card industry for more than two decades. CEO David Nelms has been with Discover for 18 years. “A lot of us at Discover, we've seen credit cycles well back before the downturn,” he says. “We'll continue our traditional approach while always looking to expand to people we can profitably lend to.”

Discover is excited about a year-old card aimed at consumers with lower credit scores that **requires them to provide a security deposit**. As they pay



back consistently, that security deposit can be refunded. Hochschild says the product is doing well but declines to provide numbers.

In the meantime, investors will watch loan growth at

Discover closely. If it flags, the company will come under more pressure to loosen up. As Hochschild allows, boosting loan balances is “the biggest driver of growth and profits.”

Discover Financial Services Inc.

J. P. Morgan Chase & Co. David Nelms

More +