FEATURE

Synchrony: A Growing Credit-Card Powerhouse

As it outpaces its competitors, the private-label giant is poised to see its shares spike later this year.

By LAWRENCE C. STRAUSS
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Synchrony partners with 22 major retailers, including the names below, to issue private-label cards.

The credit-card industry is facing head winds as major players duke it out for customers. But one part of the market isn't getting enough credit: private-label cards, which typically are branded with one retailer and offer consumers perks that include discounts, loyalty rewards, and promotional financing.

Private cards are gaining market share, growing at a 7% annual clip, compared with 5% for traditional offerings, says Bill Carcache, an analyst at Nomura Securities.

The industry leader is Synchrony Financial (ticker: SYF), which was spun off from General Electric (GE) in 2014. The company has gained 12 points of market share since 2004, to an estimated 43%, according to the Nilson Report and Nomura, and its loan portfolio should grow by some 8% this year, thanks to continued market-share gains and a healthy U.S. consumer.

Synchrony's retail-card division partners with 22 merchants, including Amazon.com (AMZN) and Chevron (CVX). Synchrony "sits in the sweet spot of the [retail] payments ecosystem, where we expect it will continue to outperform," Carcache noted after it announced solid fourth-quarter results on Jan. 22. It earned 65 cents a share, two cents ahead of the consensus and a penny better than the prior year.

Still, the stock is down 17% in the past year, badly trailing the Standard & Poor's 500 index's 8.7% loss, amid concerns about deteriorating credit quality if the U.S. economy heads south. At a recent $26.62, the stock fetched 9.5 times the $2.81 analysts expect it to earn this year.

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THAT LOOKS OVERDONE. The stock could rise at least 40%, as strong, steady loan growth boosts the price/earnings multiple. It trades at 8.6 times 2017 earnings estimates; that could easily rise to more than 12.

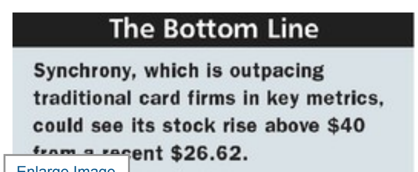
Unlike American Express (AXP) and Discover Financial Services (DFS), whose 2016 earnings estimates have declined, Synchrony's have moved up steadily, to $2.81 a share, versus $2.68 a year ago. "Where earnings go, these stocks typically follow," says Carcache, whose price target is $39.

Synchrony makes most of its money on the interest it charges on outstanding loan balances. Such income totaled $9.4 billion last year, up 7% from 2014.

Many card users pay off their balances every month, but many do not. Synchrony's average account balance last quarter was just over $1,000, up 4% from a year earlier. Even though its balances are often lower than traditional card companies, the annual percentage rates it charges are typically higher. The average yield on Synchrony's credit-card loans was 21.7% in the fourth quarter, versus 14.3% for Capital One Financial (COF), which does not have nearly as big a presence in private-label cards.

These higher APRs partly reflect a higher credit risk: 27% of Synchrony's loan receivables have FICO scores of 660 or below, compared with an industry average of 16%, says Arren Cyganovich, an analyst at D.A. Davidson. Yet Synchrony has been strengthening its overall loan book. Borrowers with scores of 660 or lower—generally considered to be subprime—accounted for nearly 40% of the portfolio in 2008, far above the current level.

Synchrony has several ways to entice retailers to use its cards and to drive growth. With private-label cards, retailers avoid the set fee of roughly 1.5% per transaction paid to the issuing bank on traditional card purchases. "They would rather reward customers directly for their own program," says Carcache.



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Private cards can also provide much more specific information about purchases, as they are integrated with retailer inventory systems. In addition, last year, Synchrony paid $2.7 billion to its partners in revenue-sharing agreements.

THOUGH PRIVATE-LABEL CARDS account for nearly 80% of Synchrony's loans, it also issues so-called dual cards, which are co-branded with a retail partner but also can be used wherever its network is accepted.

Synchrony is well capitalized and is expected to start returning some of its cash to shareholders as dividends and buybacks later this year. It has also been paying down debt and keeping expenses under control. The company should benefit from higher interest rates, as its deposit costs rise more slowly than its asset yields.

The economic backdrop remains reasonably stable, with the unemployment rate, a key indicator, at 4.9%. In a January note, Morgan Stanley said it expects "increased spending and lending growth in 2016, given strong consumer balance sheets and increasing wages." Patient investors should also get their rewards.

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