Barron's Cover

The New AmEx

As AmEx expands its franchise, profits could rise at a double-digit rate, lifting the stock nearly 30%.

By
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American Express cards have traveled the world in style for generations, tucked snugly into the breast pockets of their well-heeled owners. In the past year, they've been showing up in less familiar territory, like the checkout counters at Family Dollar and 7-Eleven.

Customers historically have used American Express (ticker: AXP) cards more sparingly than the plastic from other lenders, in part because AmEx wasn't accepted at as many locations as Visa (V) and MasterCard (MA). But expanded merchant relationships are convincing customers to swipe their AmEx more often, and could lead to higher revenue in the years ahead. That, along with an improving economy, technological innovations, and a robust policy of returning cash to shareholders, could send AmEx shares higher in the coming year.

American Express, like other financial-services companies that bounced back from the recession, has seen its stock outpace the Standard & Poor's 500 index in the past five years, rising 160%. But its recent performance has been less stellar, with the shares down 3% this year. They trade for just 15 times projected earnings, well below the 20-plus multiples of Visa and MasterCard.

CEO Ken Chenault is broadening AmEx's reach with new cards and an expanded merchant base. Photo: Peter Murphy for Barron's

American Express is both a lender and a payment processor, earning money by charging merchants who accept the card and customers who use it. While lending directly to its customers -- something MasterCard and Visa don't do -- increases AmEx's risks, it also offers benefits. The "closed-loop" network means the company has much more detailed data on its customers' spending habits, and can use it to enhance its rewards program and corporate partnerships.

For more than five decades, American Express has operated like a club, where the costs of membership for both consumers and merchants were often a little higher, but the rewards were also greater. Now the company wants to lower the velvet rope. "American Express is very focused on becoming a more inclusive and welcoming brand," CEO

Kenneth Chenault told*Barron's* in an interview. "What that means is we're certainly going to continue to focus on being a leader in serving the premium segment. But we also have a broader reach."

AMERICAN EXPRESS WAS ESTABLISHED in 1850 in New York as an express delivery business. It branched out into banking and travel services after introducing traveler's cheques in 1891, and didn't issue its first charge cards until 1958. By then, it had begun to build its name as a high-end services company, and a trusted base for American travelers far from home.

AmEx still offers travel services, largely to business clients, but the credit-card business drives its results.

In the most recent quarter, charges paid by merchants accounted for 57% of AmEx's revenue. Interest fees paid primarily by cardholders who carry balances contributed 15%, and fees paid by cardholders made up 8%. The rest came from travel commissions and fees, royalties from lenders that issue cards processed by AmEx, and other fees.

AmEx has a large overseas business but makes most of its money in the U.S. While it issues about as many cards internationally as in the U.S., Americans spend about twice as much on their cards as international customers, who prefer debit to credit cards.

AmEx earned $5.3 billion in net income, or $4.88 per share, last year, on $33 billion in revenue. It is expected to earn $5.8 billion, or $5.50 per share, this year, on $33.8 billion.

Credit-card lenders have struggled since the recession as Americans have been paying down debt. Total revolving debt, including credit-card debt, stood at $857.6 billion at the end of 2013, down from $1 trillion at year-end 2008, according to the Federal Reserve.

Deleveraging doesn't affect AmEx as much as other card companies, however, because its business model is less dependent than other lenders on customers carrying balances on their cards. While top card issuers such as Citigroup (C) and JPMorgan Chase (JPM) depend on such interest payments, AmEx relies much more heavily on other fees to drive revenue. Its traditional charge cards don't even allow customers to carry balances. If cardholder spending rises, revenue generally does, too.

The result is that AmEx's peers have seen their card revenue fall by about 2% a year, on average, since 2010, while AmEx revenue has grown at a 6% annual rate in that period, the company says.

DON'T CARRY CASH

American Express is going after a younger and less-wealthy clientele who prefer plastic to cas
its Serve and Bluebird cards, while maintaining the exclusivity of its core brand.

Company/Ticker	Recent Price	12-Mo. Change	Mkt Val (bil)	Rev '14E (bil)	EPS '14E	EPS '15E	P/E '15E
American Express/AXP	$87.64	16%	$91.7	$33.8	$5.50	$6.05	14.5
Discover/DFS	62.43	23	28.8	8.7	5.31	5.63	11.1
MasterCard/MA	75.47	13	87.4	9.4	3.00	3.58	21.1
Visa/V*	214.04	16	133.4	12.7	8.99	10.35	20.7

*Fiscal year ends September. E=Estimate.

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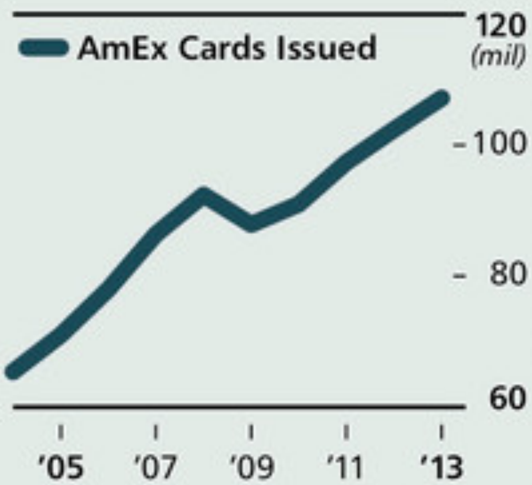

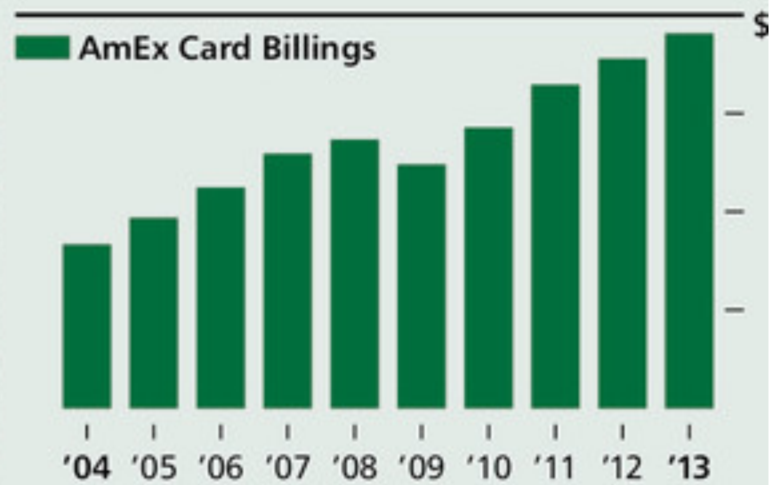

Source: Compan

There's reason to believe growth will accelerate. Americans have begun taking on credit-card debt again, with revolving debt rising 7.4% year over year in July. A lot of the bad credit that built up prior to the housing crash has been "weeded out," and loss rates have fallen to historic lows, says KBW analyst Sanjay Sakhrani.

"The consumer is in a good position to start carrying credit-card balances," adds Guggenheim Securities analyst David Darst.

The current economic climate of steady, if unexceptional, growth also bodes well. Morgan Stanley estimates that American Express cardholder spending grows about four and a half times as quickly as gross domestic product, or GDP. With the bank forecasting 2014 GDP

growth of 2.6% this year and next, Morgan Stanley analyst Betsy Graseck sees cardholder spending jumping 10% to 11% annually in the U.S., up from 8% in 2013.
For several investors and analysts, the promise of accelerated spending growth is reason enough to buy the stock. "If you think that things are improving from a macro standpoint and there's some acceleration in GDP growth, they benefit quite extensively," says Sakhrani.
If revenue growth can approach the company's targeted 8%, up from 4% last year, earnings per share could rise to the double-digits and perhaps to the mid-teens Sakhrani says. In that case, investors would value AmEx shares at a premium to the overall market instead of a discount, justifying a multiple of 17 instead of 15. He sees the stock rising to $113, a 29% premium to its recent price.

But investors don't have to wait for better GDP growth to boost AmEx shares. New initiatives could lift cardholder spending even with an uneven economy.
The average AmEx credit-card customer charges three times as much on his card every year as the average MasterCard holder, and two-and-a-half times as much as the Visa customer, according to The Nilson Report, an industry newsletter. But far more people have Visa and MasterCard than AmEx cards; Visa alone had nearly nine times as many credit cards in 2013, along with a dominant position in debit and prepaid cards. Consumers spent $3.1 trillion on Visa credit cards, $2.1 trillion on MasterCard, and $940 billion on AmEx cards, according to Nilson.

The discrepancy reflects the facts that AmEx cards historically came with annual fees; the company's credit requirements are more stringent; and the cards are accepted at about a third fewer merchants than industry leader Visa.

CHENAULT JOINED THE COMPANY in 1981 and has been chairman and CEO since 2001. He has been instrumental in expanding the company's reach. There were 107 million American Express Cards in circulation at the end of 2013, up from 55 million in 2001. And as the cardholder base has expanded, more AmEx customers have used their cards for daily purchases. While 64% of card purchases were for travel and entertainment in 1990, those areas now make up just 26% of spending on the cards.

Even as the card base has expanded, AmEx has retained its high level of customer service and basic value proposition. It remains the most attractive credit-card network, ranking first in customer satisfaction every year since J.D. Power started tracking the metric in 2007; it was tied this year with Discover Financial Services (DFS), which also lends to consumers and provides a card network.

Lately Chenault, 63, has been engineering another ambitious expansion. In March, the company launched its EveryDay card with commercials featuring Tina Fey buying humdrum products like zit cream and dryer sheets. That card gives customers access to AmEx's rewards program without requiring an annual fee, and it encourages use of the card almost everywhere. Customers earn double the usual rewards points if they use their cards at supermarkets, and receive 20% more points if they use the cards 20 or more times in a billing period.

Photo: Jenna Bascom for Barron's

AmEx, which converted to a bank holding company during the financial crisis, is also expanding its banking products. In 2013 the company worked with Wal-Mart Stores (WMT) to introduce a prepaid debit card called Bluebird, which acts as a mobile checking account, later adding Federal Deposit Insurance Corp. coverage and physical checkbooks.

Serve, another prepaid card introduced at retailers last year, also shows promise. Customers can reload the card at stores such as Family Dollar and 7-Eleven. The Serve card costs $1 a month, but there is no charge if it is connected to a direct-deposit banking account. The card allows free withdrawals at participating ATM machines. AmEx can offer such low rates because of its already existing merchant relationships and strong digital platform: None of these products would make sense financially "if we had to operate with bricks and mortar," says Chenault.

The results are still a drop in the bucket -- Serve and Bluebird are on track to bring in less than 1% of the company's billings this year -- but the company and the analyst community see a major opportunity. About half the cards' customers are under 35, and 90% are either new to AmEx or former cardholders.

AmEx freed up an estimated $300 million to spend on expanding these new initiatives by spinning its business travel division into a joint venture with an investor group led by Certares.

To spur spending, AmEx will have to convince more merchants to take its cards. Historically, merchants have shied away from AmEx's fees, which average an estimated 2.4% of each transaction, versus about 2.2% for competitors. The company's cards were accepted at about 67% as many merchants as Visa as of 2012, according to Morgan Stanley's Graseck. To narrow that gap, AmEx is partnering with third-party acquirers to sign up small merchants and simplify the billing process.

Discover embarked on a similar initiative in 2008, says Graseck. Within a year, it had increased its merchant acceptance to 90% from 75% of Visa's. If AmEx can find similar success, it could convince customers to spend an average of about $25 more per month on their cards, which could boost annual spending by about $16 billion by 2016, enough to raise the company's earnings per share by 2% a year,

Graseck estimates.
A FEW FACTORS COULD DISRUPT AmEx's plans to cozy up to more merchants. The Justice Department has sued the company, arguing that it forces merchants to accept high fees that ultimately hurt consumers. The government wants AmEx to change its agreements with merchants, potentially allowing them to charge customers more if customers purchase items with their American Express cards instead of cash or cards with lower fees. MasterCard and Visa, which were also sued by the government, have already settled, allowing merchants to add surcharges if people pay with their cards.
AmEx has argued that its market share is too small for it to bully merchants, and that allowing merchants to add surcharges could destroy its business model.
A decision is expected in the coming months, and a change in AmEx's relationship with merchants could hurt the stock price. But Sakhrani notes that merchants will likely be wary of steering customers away from using AmEx cards even if they win. "We haven't seen widespread surcharging with Visa and MasterCard even though merchants are allowed to surcharge," he says. "Merchants are reluctant to alienate consumers."
New technologies could also affect AmEx's relationship with customers, posing challenges as well as opportunities. Digital wallets have seen slow adoption so far, but that could change. Apple Pay, unveiled on Tuesday, will allow consumers to buy items by tapping their phones near a receiver at the checkout counter. AmEx, Visa, and MasterCard are all partnering withApple (AAPL) on the venture, and will continue to process the transactions and retain customer data. But Credit Suisse analyst Moshe Orenbuch has speculated that the deal will force AmEx to accept lower rates from merchants. The company would not comment on the deal's specifics.
Darst of Guggenheim Securities expects Apple Pay to be a net positive for all card providers because the system's security features should encourage consumers to spend more with their credit cards. "Anything that continues to accelerate electronic-payment adoption and mobile-payment growth is a key catalyst," he says.
AmEx has been returning cash to shareholders. It buys back about 4% of its shares a year and continually raises its dividend; shares now yield

1.2%. The big question is whether it can achieve targeted annual revenue growth of 8%, even though it has fallen short in the past two years. Chenault says 8% is "still an appropriate objective."

"What we've demonstrated is that we have different levers to pull that have helped us manage successfully through uneven economies relative to our earnings-per-share growth rate," Chenault says. "We are dependent in the moderate term on a better-performing economy, but what is critical is the initiatives we are putting in the market."

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