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The QVGs (Quality, Valuation and Growth) of American Express

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QUALITY

Competitive advantage

- Spent tens of billions of dollars on marketing. Has unparalleled brand. BusinessWeek ranks it 15th out of 100 global brands.
- Credit card network is very difficult to replicate, it has a first mover's advantage posing a massive barrier of entry for new entrants.
- 2004 antitrust ruling allowed banks to issue Amex credit card. Banks that account for half of the MasterCard/VISA volume in US are issuing Amex card. Issuance by banks grew almost 50% in 2007. Banks want to increase their fee business, Amex card with higher discount fee allows them to lure higher spend customer, offer higher rewards and generate higher fees.
- Merchants (i.e. retailers) still have limited bargaining power in this industry. This is unlikely to change. Amex processed close to $650 billion of payments in 2007 (Wal-Mart move over!)
- Controls all angles of the transaction. MasterCard and VISA (two largest competitors) don't issue cards and only see the processing angle. AXP developed deep relationship with merchants, beneficial for both parties. Costco relationship is probably the most noticeable one, it is a match made in heaven as Costco caters to affluent Amex's customer. Customers that pay with Amex spend more money than the ones that pay cash or pay with VISA or MasterCard (which Costco doesn't accept, though it accepts debit cards).

Now public competitors

- AXP will face tougher competition in the future as competing networks (MasterCard, VISA) used to be quasi bureaucratic, servants of many masters (banks), went or going public thus more focused and profit hungry. As market keeps growing at a very high rate focus is likely to be on growing with the market, not taking market share.
- In the future, as market growth slows down, competition will intensify. Focus is less likely to be on price i.e. discount fees, but on rewards offered.
- Competing networks developed products for higher end markets. Amex still grew market share in US even if you include debit cards into the mix, which is the fastest growing segment in the industry. Plastic market is growing 12% a year taking market share from paper (cash and check).

Recurrence of revenues

- Recurrence of revenues is high for two reasons: consumers and small businesses keep revolving their debt (credit card balances have risen every single year since… forever) and keep buying things (and earning points).
- Less economically sensitive, only 33% of discount revenues come from travel and entertainment spending (the first one to shut down when economy goes into recession), down from over 60% in 1991.
- Ben Bernanke is AXP's best friend. Money thrown from helicopter, i.e. inflation is a tail wind for AXP's sales and should help profitability – its costs should rise at a slower rate than inflation. Of course if the money thrown from helicopter policy sends us into stagflation, the opposite will take place.

Free cash flows

- AXP is a financial company, thus free cash flow is a very opaque metric.
- Global Network & Merchant Services (GNMS) and travel business must generate enormous cash flows, the network is already built, and incremental capex is low. Capex and depreciation are not broken out on a segment level, but overall depreciation matched capex. Total depreciation for 2007 was $650 million a relatively small number relative to revenues and other costs.
- One way to judge company's cash generating ability is to look at what it does with its cash flows. Since 1994, AXP returned 71% of its earnings to shareholders in the form of share buy backs and dividends. In 2006 and 2007, return of capital to shareholders amounted to 93% and 88% of earnings, respectively. This also speaks highly of management.

Management

- Excellent operating performance – above industry growth in number of cards and loan balances. ROE is 33-36%. EPS growth consistently in double digits. ROA a true, unleveraged, measure of company's operating performance, increased every single year since 2001. 30+ days delinquencies, a measure of lending practices, are far superior to competition.
- As the economy slows down the true colors of quality of Amex's portfolio will come to the surface. In conference calls and presentations management is arguing that it knew better than to sacrifice its lending standards. So far, data support that claim.

- CEO and managements' compensation is tied to company's operating performance. For instance, If AXP reaches the following targets: EPS and revenues must grow at least 15% and 10 a year on average, respectively. ROE must average at least 36% per year. Total return to shareholders must beat the S&P 500 average by at least 2.5% a year. CEO will receive $258 million worth of stock, if not he won't get much (of course, except millions of dollars in salary).

Return on capital

- ROA over 2% is respectable for a financial company and has been rising.
- Its ROE is only second to Goldman Sachs. I'd trust sustainability and quality of AXP's ROE a lot more than Goldman Sachs
- High return on capital is an indication of sustainable competitive advantage, business (especially processing) is not capital intensive, and growth doesn't cost the company much money.

Financial strength

- AXP is one of the cleanest financial stocks you can find.
- No sub-prime lending.
- Spend centric model which really sets AXP apart from other card issuers which (DFS is NOT an exception) heavily rely on interest spread.
- For AXP account balances are a secondary consideration – a much more stable business (more on it later). This is reason why you don't see as many 0% balance transfer offers from AXP. Its goal is not to grow account balances (though it did a good job doing it), but to grow its discount fee business.
- In my analysis, even if defaults spike to 11%, overall AXP will still have breakeven profitability on consolidated basis. This assumes that the fee revenues will not decline, which is an unlikely scenario as this kind of spike in defaults will be a sign of severe recession, thus fee business will decline. However, around 30-40% of AXP's revenues come from outside of the US, this will mitigate the problem. Bottom line, AXP is in great financial health.
- AXP caters to more affluent consumer who is more resistant (but not immune) to economic slowdown.
- Financial markets are not concerned about AXP's financial viability. Normal re-pricing of risk took place - commercial paper spreads widened by 3 basis points. Securitization costs raised by 25 basis points. Despite credit markets shutting many financial companies out of securitization markets, AXP was able to securitize its portfolio just fine.
- There is plenty of excess spread (about 8-9%) to cover a short-term rise in defaults. Also, a billion dollars arriving from VISA should further help to offset a short-term spike in

defaults. Though probability of MasterCard settling or losing lawsuit is high, I am not factoring it into the analysis (it will be a nice bonus though).

- Rated A+ by S&P, two or three notches higher than other mono-line card issuers like COF and DFS.
- Diversified sources of financing: un-securitized loans, ABS markets, and commercial paper. Reliance on commercial paper declined from 2000 by half.
- Traveler's Cheque portfolio is strong, 99% investment grade regardless of insurance. The fallout in mono-line insurers should have little impact.

GROWTH

- Payment (processing) industry growth is a function of US and global GDPs growth. It should grow at rate of at least several percentage points above GDP as plastic is taking market share from paper (cash and checks). This trend is unstoppable in the long-run, though economic slowdown/recession in the short run will taper the growth.
- Consumer and small business borrowing is a function of level of debt and economic health. Today household debt to GDP is at all time high. Though you could have said the same thing 5, 10, 15 years ago, at some point, and now it appears to be a lot sooner than later, consumer spending and their willingness to take on more debt will wind down and consumer will start deleveraging.
- Is AXP a credit card (lending centric) company or a processing (spend centric) company? Three quarters of AXP's revenues come from fee related activities that are not sensitive to the size of consumer balances. Management keeps emphasizing that it is targeting fees not interest spread. Financial numbers prove their point: AXP's fees as percent of revenues are twice of card issuing competitors (yes, even twice DFS's). This will only increase in the future as spend velocity (annual billed business divided by managed receivables) has gradually increased over the years from 5 times in 2000 to 6 times in 2007.
- Earnings growth visibility is high. AXP's high competitive advantage (see quality discussion) and industry's above average growth rate provide comfort to forecast above average revenue and earnings growth rates for 10-15 years. Of course, in the short-run growth rates may be slower due to macro developments.
- Travel business (which I did not address much as it only represents 8% of revenues) will grow at several points below GDP growth as it will be losing market share to online reservation systems such as Orbitz, Expedia, and Priceline.com etc…
- US and International cards and Global Services will grow at GDP plus 2-3%. No margin expansion expected as competition from MasterCard and Visa will force AXP to keep increasing rewards, offsetting any gains from operational leverage and economies of scale.
- GNMS's revenues will grow GDP plus 10% (if GDP grows 6%, then GNMS will grow at 16%) over next five years and then decline to GDP plus 2%. Recent growth rate, AXP

success of signing up new partners and abundant international opportunities support these estimates. As operational leverage kicks in (this is a fixed cost business, networks already built) margins will expand (it's already happening, I expect margins to increase by 8% over next 10 years, though this could happen faster) and earnings will outpace revenue growth by about 3%. Plastic only has 40% of market share in the US. Projected to grow 12% a year. AXP gained market share since 2002, even if you include debit cards (the fastest growing segment in 'plastic money' industry where AXP doesn't play).

- AXP's partners in GNMS business spent over $150 million to promote AXP's brand every year. As more traditional banks start issuing Amex credit cards acceptance of the card increase worldwide, benefiting cards already in existence and driving higher volume system.
- Discount rate slightly declined over time, about 1-3 basis point a year due to the change of mix of merchants. Costco, for instance - it likely pays a lower discount rate, and as its portion of transactions increases, the overall discount rate will decline.
- Company has a dividend yield of 1.7%, not a huge dividend, but AXP is buying back (net) about 3-4% of shares a year. Dividend is likely to grow in line with earnings.

<u>Normalizing financials</u>

Linear thinking is a very dangerous thing, when things are great, market is setting all time highs, and we draw a straight line into the sky and project prosperity to continue indefinitely. Of course when things go bad, we draw a straight line from bad to despair, stopping at hell on the way. We are great at those things. I offer an alternative way of thinking – analyze and normalize. I intend to do just this with the following analysis of American Express.

2007 earnings are full of one-time items.

- After adjusting earning for onetime items, excluding the impact of higher defaults and higher borrowing costs, earnings did not change much (see adjustments in notes).
- Ultra low level of defaults that seen since 2005 is not sustainable for a couple reasons:
    1. Bankruptcy law changed in 2005, many rushed to file bankruptcies under the old law in 2005 – defaults increased in 2005 and then dropped substantially. Defaults will normalize to a higher level. However, new bankruptcy law makes it more difficult to file for bankruptcy and discharge debts. Overall, this will help recoveries and lower defaults.
    2. Economic expansion, housing price appreciation and easy access to home equity loans lead to unsustainably low levels of defaults in credit cards as consumer paid off their higher interest credit cards with lower interest home equity loans. This is about to change.
- Default rates are likely to climb much higher. In the 2001 recession they were as high as 6%. The recession we are facing is a consumer driven recession; consumer leverage is a

lot higher than in previous recessions, in addition, in the recent past we had a much higher employment. Defaults at least in the short run are likely to be higher. Over the long run defaults have stayed about 4.5-5%.

- I'll use 5% defaults – consumers are more leveraged now.
- Increase in funding cost is not temporary. Increased securitization interest expense by 0.25%.
- **Earnings adjusted for onetime items and normalized for higher defaults and interest costs in 2007 are $2.52, not $3.38 as reported. This is our base.** (If default assumption of 4.5% is used then EPS for 2007 = $2.80)
- **The key to AXP analysis is to recognize the high growth, quality and thus value in GNMS business.** Also, resetting earnings to reflect normalized defaults and permanently higher funding costs is crucial.

  Earnings growth (in the long run) is likely to be higher going forward due to GNMS business. It is a faster growing business with earnings growth almost double AXP's card issuing business, plus it is a pure fee business not sensitive to default rates. Over time GNMS will become a larger portion of AXP's earnings (from 37% in 2007 to 52% in 2017).

VALUATION

<u>Sum of parts analysis</u>

- Based on DCF, using growth assumptions described above, GNMS is worth between $28-33 (difference comes from a choice of discount rate (9-10%) and degree of operational leverage).
- I expect GNMS to make $1.18 in 2008. If I apply the same valuation (P/E of 25) as the market places on its only publically traded competitor (MasterCard) I'd get a fair value closer to $30.
- Finally, using my Absolute P/E model (below average business and financial risk, and above average earnings visibility, and also assuming if it was a standalone company it would either pay a dividend or buy back stock) I'd arrive to a fair value P/E around 21 or stock price about $25.
- Instead of trying to figure out which value to use I'll average all three and get $27.
- Since the non-GNMS businesses generate $1.69 a share (AXP forward earning of $2.87 less GNMS EPS of $1.18). Now the question is what is the right P/E for the rest of AXP? Based on the quality and growth discussion, plugging in above average financial risk, it is a financial company after all, below average business risk, above average earnings visibility and 11% expected earnings growth rate (8% from net income and 3% from share buyback), and finally assuming its dividends remains where it is today, I get a

fair value P/E of 15. **Therefore the value of non-GNMS business is about $25, putting a fair value on the whole company of $52 (could be as high as $55 or as low as $50, if use high and low estimates for GNMS business).**

Valuing AXP based on DCF

- Since AXP is a financial company I'll approximate its net income and free cash flows to be the same (depreciation and capex were about the same historically, so this is not an outrageous assumption). I modeled GNSM cash flows separately as I expect its profit margins to expand. Then using the assumption that non-GNMS businesses will have no margin expansion and grow at the same pace as revenues (8%), I valued the rest of the company. Depending on required rate of return assumptions (10-11%) AXP is worth between $51-55.
- The precision of math of the above discussion is a bit deceiving, but the bottom line is this: if defaults stabilize at 5.0%, AXP is worth somewhere around low $50s.

Absolute P/E valuation

- Assuming earnings growth rate of 15% (12% from net income and 3% from stock buy backs, management seems to be committed to buying back stock and paying a dividend), I get a fair value P/E of about 18 or $51-52 a share.

Relative valuation

- In the early 1990s AXP traded at a 20-30% discount to the market – this was due to large losses from weak underwriting practices. In mid to late 90s stock traded at 20-40% premium to the market. Since 2000 it traded at about market multiple.
- Should AXP trade at premium or discount to the market? Spinning off Ameriprise (advisor, money management and insurance) simplified AXP and made it less complex. Management is focused on a core business.
- In the early 1990s AXP traded as low as 11 times earnings, and though you cannot rule anything out in this business, it is a much higher quality (less cyclical, more transparent) company now than it was then. Thus 13 times is a reasonable assumption for its downside risk.

Buy price

- If I am wrong and default rates are lower than 5.0% that stock is worth more (i.e. 50 basis points of net write offs add/subtract $5 based on DCF analysis) . I can always readjust the upside valuation as time goes by and I have more information on defaults. For now, I am

willing to error on the side of caution. The buy price will be really a function of your required rate of return. If you require a 40% total return from a stock (earnings growth, dividend yield and P/E expansion), then AXP is a buy at around $40.

Conclusion: AXP scores very high on Quality and Growth dimensions, making it a great company. AXP is one of the handful financial stocks I'd touch in today's environment, but at slightly lower price.

Risks

- Current recession will last longer and will be deeper than the ones in the past leading to much higher defaults than reasonably expected
- AXP will be cut off from accessing capital markets or risk premium increases to a much higher level
- Competition from VISA and MasterCard is greater than I expected

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Notes:

In 2007, AXP had a lot of onetime events; here are the adjustments I made to its income statement.

- A $1.1B ($700MM after-tax) initial payment in 4Q '07 as part of the Visa litigation settlement, and in light of the settlement: added to expenses, though AXP will get another $1.15 billion over next couple years and may get another balloon payment from MasterCard, this is not sustainable]
- $143MM ($89MM after-tax) of incremental business-building costs;
- $74MM ($46MM after-tax) of litigation-related costs; and [took out, logic is if AXP had not received money from VISA, then it would not have that expense]
- A $50MM ($31MM after-tax) contribution to the American Express Charitable Fund. [took out, though this one is a close call, logic is if AXP had not received money from VISA, then it would not have that expense]
- $140MM of total tax benefits from the IRS in 2Q '07 related to the treatment of prior years' card fee income and the resolution of prior years' tax items in 3Q '07; [not sustainable, used 30.5% tax rate, company stated that their tax rate is between 30-31%]
- An $80MM ($50MM after-tax) net benefit in 1Q '07 from the initial adoption of a new accounting standard, SFAS No. 155, that required the Company to record changes in the fair market value of its retained subordinated interest in securitized loans (or interest-only strip) in the income statement; [took out, one time]
- A $63MM ($39MM after-tax) gain in 1Q '07 relating to amendments to the Company's U.S. pension plans that reduced projected pension

obligations to participants; [took out, one time]

- A $685MM ($430MM after-tax) charge in 4Q '07 to increase the Membership Rewards liability; [this expense should have been allocated over several year period, added expense back, but allocated one fourth of it as an expense for the year]
- A $438MM ($274MM after-tax) credit-related charge in 4Q '07; [computed normalized losses if defaults were 5%, a 2001-2007 average]
- An $81MM ($41MM after-tax) charge in 3Q '07 related to mark-to-market adjustments and sales within the AEIDC investment portfolio; and [added it back, one time]
- $68MM ($42MM after-tax) of increased marketing and promotion expenditures in 2Q '07, above the level originally planned for that quarter. [left it as is, a cost of doing business]