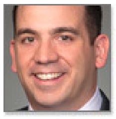
American Express Co AXP

Analyst Research Analyst Report Archive Top Rated Stocks in Sector

American Express' unique position in the payment industry should benefit the firm for years to come.



by
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Morningstar's Editorial Policies

Analyst Note

Apple Cooperating With Networks as It Dives Headlong Into Payments
by Jim Sinegal, 09/09/2014

Discuss

See what other investors are saying about AXP

Analyst Note 09/09/2014

Apple has announced that its new iPhones will incorporate a mobile payment system called *Apple Pay*, which will initially allow users to pay with their phones using cards issued by major U.S. banks. We don't think the technology--which essentially functions as a secure storage mechanism for payment data--is disruptive to the moats of networks or issuers, since it will allow customers to use a variety of payment options. We expect network volumes to expand even as the form of electronic transactions transitions from cash to card to digital, and are maintaining our fair value estimates.

It is, however, an interesting technological change. Rather than storing a single card number, Apple Pay stores its own account number and generates unique data for individual transactions after validating the card with the issuer. Instead of a magnetic stripe and reader, Apple Pay will use a secure element to store the data and near-field communication to transfer it to merchants at the point of sale. Its fingerprint sensor adds a layer of security. We see better security as a major selling point for consumers and retailers. Furthermore, Apple has reportedly negotiated lower interchange fees in exchange for the security improvements, which could offset the impact of lower fees on issuers.

Apple is also dipping its toes into the merchant acquirer space, working with a variety of large merchants to enable immediate acceptance of Apple Pay and overcoming another significant hurdle. We have long believed that marketing and rewards will be the focus of competition in the payment sector, and these partnerships--as well as Apple Pay's likely dominance of the digital wallet--position the company well for a variety of opportunities in this much massive market. Aggregator firms like OpenTable and Groupon were specifically mentioned in the announcement, and Apple has already developed the iBeacon, which could enable numerous retail applications.

Investment Thesis 10/23/2013

American Express relies on powerful network effects and the valuable intangible asset associated with its brand in order to generate excess economic profits. Over the years, American Express has assembled a base of big-spending cardholders by offering exceptional rewards and services. These affluent customers are attractive to merchants, who willingly pay higher discount fees to American Express. In turn, high discount fees fund the company's rewards programs, making the company's offerings more appealing to cardholders and completing a virtuous circle.

American Express, in contrast to competitors like Visa and MasterCard, is a closed-loop network--it both issues cards to consumers and acquires transactions from merchants. As such, American Express possesses a vast amount of valuable data about the spending habits of its prosperous cardholders. The company is still in the early stages of monetizing this data but American Express' unique knowledge of spending patterns is a clear source of opportunity.

Investors have been waiting for disruptive payment technology for some time, but

Morningstar's Take AXP

Analyst

Price 09-16-2014 88.36 USD	**Fair Value Estimate** 82 USD	**Uncertainty** Medium
Consider Buy 57.4 USD	**Consider Sell** 110.7 USD	**Economic Moat** Wide
Morningstar Credit Rating A-		**Stewardship Rating** Standard

Bulls Say

- The combination of American Express' affluent cardholder base and its proprietary merchant and customer data provides opportunities to expand into additional wide-moat lines of business.
- American Express is allowing third parties to issue cards and acquire transactions, expanding the reach of its network.
- American Express accounts for a significant percentage of an electronic spending pie that is certain to expand for years to come.

Bears Say

- Mobile technology will alter the payment landscape in the biggest way since the advent of the credit card.
- Competitors are making inroads into the premium space with ever more lucrative rewards offerings.
- An increasing emphasis on low-end offerings will damage the American Express brand.

Competitors AXP

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Name	Price	% Chg	TTM Sales $ mil
American Express Co	**$88.36**	**1.12**	**33,704**
Capital One Financial Corp	$82.18	0.83	22,033
Visa Inc Class A	$217.30	1.24	12,446
Synchrony Financial	$24.31	0.66	11,486
MasterCard Inc Class A	$76.59	1.79	8,898
Discover Financial Services	$63.42	1.02	8,441

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3 Banking Takeaways From the Quarter

despite the proliferation of mobile devices, it remains to be seen how a new paradigm will benefit both merchants and consumers--a necessity, in our view, if traditional players are to be displaced. At present, we still believe American Express will maintain a significant share of payment volume for years to come. Furthermore, American Express' closed-loop network is somewhat resistant to regulatory change in comparison to networks that set interchange fees for participants.

In the short run, we're somewhat skeptical of American Express' attempts to go downmarket. Previous efforts to expand the company's lending activities ended badly, as charge-offs skyrocketed during the financial crisis. American Express is now focusing its efforts on fee-based initiatives, including prepaid cards and online banking. We understand the company's desire to obtain additional revenue, but it remains to be seen how these products complement American Express' traditional product offerings, and we're somewhat concerned about dilution of the company's premium brand image.

Economic Moat 10/23/2013

American Express' closed-loop network and spend-centric model is the source of its wide economic moat. The network effect created by a large base of cardholders and merchants is strengthened even further by American Express' focus on the affluent--average annual spending on an American Express card is much larger than the amounts spent on competitors' cards. This makes the card more attractive to merchants, strengthening the American Express brand--a powerful intangible asset--as well as its pricing power and its ability to offer rewards to cardholders. Furthermore, as both issuer and merchant acquisitor, American Express possesses vast amounts of data on spending patterns that few competitors can match. This data can only benefit the company as commerce becomes increasingly digitized and merchants seek to offer personalized shopping experiences.

Valuation 05/09/2014

We are raising our fair value estimate to $82 per share from $77 based primarily on the time value of money since our last update and a slight increase in our net interest margin expectations. Over the next five years, we expect discount revenue to fall to 1.85% of billed business as competitive pressures continue. We think rewards expenses will consume 36% of discount revenue over the next five years, up significantly from the average over the last five years due to increased competition. However, we expect billed business/cards in force to increase both inside and outside of the U.S. as the move toward electronic payments continues. As a result, we forecast noninterest revenue growth averaging 6% annually over the next five years. We believe marketing expense will eventually average 9% of revenue over the long run, in line with the company's goals. We expect the efficiency ratio to fall to 66% by the end of our forecast period. We forecast net interest margin averaging 4.3% (as we calculate) over the next five years, with net charge-offs averaging 4% of loans over the same time frame.

Risk 10/23/2013

The biggest risk for American Express is the possibility that new types of technology will eventually bypass the traditional payment networks. It's also possible that digital wallets will shift some of the value now captured by the major network brands to cardholders, merchants, and wallet providers. American Express also faces competition in the rewards space and a consequent erosion of its pricing power. The company also faces regulatory risk--restrictions on interchange fees could lead to reductions in the discount fees it earns. Finally, American Express faces credit risk in its lending business.

Management 10/23/2013

We think management's stewardship of shareholder capital is standard. Unlike many financial firms, American Express managed to post a profit in each of the last 10 years. The firm is currently returning a vast majority of capital generated to shareholders via dividends and buybacks. However, these factors are offset by a few questionable decisions--American Express made dubious underwriting decisions in pursuit of growth prior to the financial crisis, and was arguably too dependent on short-term funding in those years as well. We're also not yet sold on some of the company's recent acquisitions, or the price management paid for these firms.

CEO Kenneth Chenault has been with the company for more than 30 years, serving in a variety of capacities. Overall, we think he guided the company relatively well through a difficult period over the past five years, and we believe he is well-qualified to continue leading the firm.

Overview

Profile:

American Express was founded as an express mail business in 1850. By the turn of the century, the company expanded into financial services and introduced its famous Travelers Cheques, before issuing the first American Express card in 1958. Today, the company provides charge and credit card products, travel services, network services, stored value products, loans, and other products and services to businesses and individuals. American Express issues cards to consumers and engages in merchant acquiring and processing globally.