

#### DOW JONES REPRINTS



This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: [www.djreprints.com](http://www.djreprints.com).

• [See a sample reprint in PDF format](#) • [Order a reprint of this article now.](#)



Saturday, April 11, 2009

### BARRON'S COVER

## Charge!

By JONATHAN R. LAING

***American Express is in better shape than investors think. Under CEO Ken Chenault, it boasts a premier brand, lots of liquidity and a less risky business model than competitors. Getting a grip on defaults.***

**DESPITE A FABLED BRAND NAME AND AN AFFLUENT**, free-spending clientele that is the envy of the charge- and credit-card business, [American Express](#) has gotten caught in the same downward vortex as the rest of global financial industry.

Indeed, its once-highflying stock crashed to under 10 in early March from more than 50 last spring, before rebounding to 18.83 last week. Negatives seem to abound. A poor economy caused card usage, both business and personal, to slow, and in some categories, to drop. Amex credit-card delinquencies and charge-offs hurtled to higher levels both in the second half of 2008 and the first two months of this year. And an ill-fated company decision to push credit cards on folks with multiple mortgages (this had long been deemed a positive factor in creditworthiness) resulted in Amex dramatically increasing its exposure to customers in the epicenter of the home-price collapse in California and Florida.



Under CEO Kenneth Chenault, Amex is getting a grip on defaults.

Not even American Express (ticker: AXP) thinks things will improve much for at least the next three quarters, or so Amex Chairman and CEO Kenneth Chenault said in recent shareholder communications; company officials were unavailable to comment to *Barron's*, since Amex is in a "quiet period" before releasing first-quarter earnings.

Yet American Express' outlook isn't nearly as hopeless as is commonly thought on Wall Street. For one thing, unlike its peers, the company gets the bulk of its revenue and earnings from fee income generated by transaction volume, not the extension of credit. This is because charge cards, which are supposed to be paid off monthly, make up a substantial share of American Express' volume. AmEx therefore has substantially less credit risk.

Likewise, the company has addressed its credit-card mistakes with some vigor since the fall, and should be able to stem the surge in defaults in the next couple of quarters. Not least, with the help of various government bailout programs, AmEx seems to have ample liquidity to ride out the current economic downturn without having to dilute shareholders by selling stock.

To be sure, plenty of uncertainties remain for the New York-based company. The outlook for home prices and unemployment levels weighs heavily on any credit-card lender like AmEx, and remains a wild card in a weakening economy. As a result, analysts' estimates for AmEx are all over the place. Consensus forecasts for this year vary from a profit of \$1.65 a share to a loss of \$1.11, with the average of 19 estimates coming in at 55 cents. Next year has spawned even wilder inconsistencies in earnings forecasts. The average forecast of \$1.16 includes high and low estimates of \$2.79 and negative 27 cents.

Yet William Ryan of the financial-industry research boutique Portales Partners recently issued a Buy on the stock at 15, after rating AmEx a Hold since it traded above 60 in July 2007. He reasoned that even with higher credit-card charge-offs coming in the near term, the stock is a great buy in the longer term. "Look, we never know until after the fact when the inflection point comes, as low valuation finally trumps near-term fundamentals," Ryan says. "Most people are going to miss the party if they wait for the turn in credit losses."

Ryan and Portales refrain from giving out target prices. But an analyst at a large, low-profile hedge fund that has been loading up on American Express wasn't so constrained. "I think AmEx is at least a double over the next year or two," he avers.

**MUCH OF AMEX'S RESILIENCE** to tough times comes from a business model that emphasizes lower-risk transaction-fee volume rather than lending, according to Fox-Pitt Kelton analyst Bill Carcache. Last year, for example, AmEx cardholders used their charge and credit cards to buy \$683 billion worth of goods and services, a volume that dwarfed that of their competitors. Chief among the transaction fees generated by this prodigious volume is the industry-high 2.5% fee that AmEx typically charges merchants for access to AmEx's big-spending cardholder population.

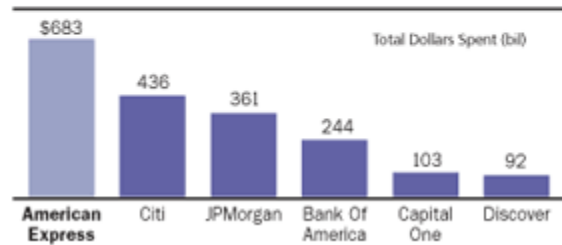
AmEx gets to keep the bulk of this fee income, since unlike most card sponsors, the company runs a closed-loop network in which it issues and markets cards, handles all transaction processing and even "acquires" and directly pays off all its merchants around the globe. Most bank issuers have to share their merchant fees with the likes of [Visa \(V\)](#), [MasterCard \(MA\)](#) and First Data.

Credit risk from customers stiffing credit-card companies looms smaller at AmEx. It had extended \$72 billion to cardholders as of year-end 2008, less than half the total in cardholder receivables carried by competitors [Citigroup \(C\)](#), [Bank of America \(BAC\)](#) and [JPMorgan Chase \(JPM\)](#).

## THE KING OF CARDS

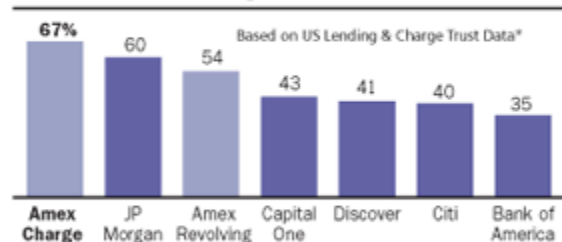
The volume of purchases made with American Express cards towers above that of rivals...

Total Sales on Cards, 2008



...And most American Express customers have excellent repayment histories.

Customers With Strong Credit Records\*



Much of the investor concern over AmEx arises from the sudden surge in delinquencies and, even more damaging, loan charge-offs in excess of the company's competitors. This wasn't supposed to happen at American Express, given the company's more affluent customer base. Yet after lagging behind industry averages for most of 2008, charge-offs at AmEx began to skyrocket in the fourth quarter, according to closely watched monthly performance data taken from the company's major credit-card-receivables securitization. By February of this year, charge-offs in the AmEx trust had vaulted to 9.31%, far above the industry's monthly average of 7.76%.

The jump in AmEx loan defaults, however, may not be as telling as it first appears. The rates of late have been pushed higher by a wicked denominator effect, as management began reducing outstanding credit to U.S. consumers in the second half of last year by cutting credit lines and raising interest rates and fees on accounts. The company even offered some account holders with outstanding balances a \$300 gift card in exchange for closing the accounts.

The efforts earned AmEx some bad press for its hard-nosed tactics but enabled the company to reduce its U.S. credit-card receivables total (the denominator of the charge-off data) to \$57.8 billion at the end of February from \$65.9 billion at year-end 2007. This also magnifies the default rate vis-à-vis peers who were less aggressive in paring back their credit exposures.

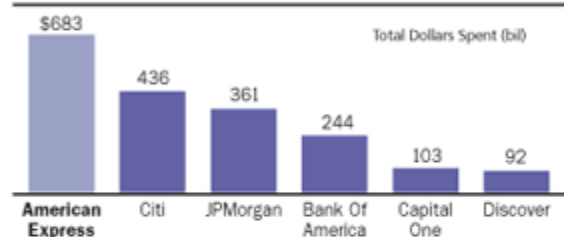
While the company's loan charge-off rate is high, that partly

**OTHER FACTORS ALSO MAY WORK** to blunt the recent

## THE KING OF CARDS

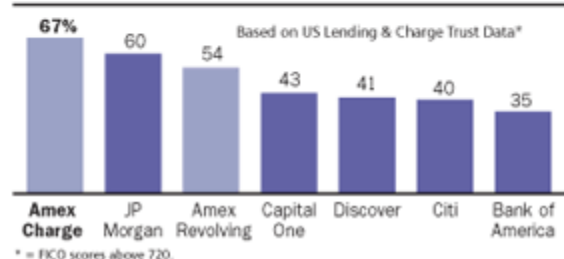
The volume of purchases made with American Express cards towers above that of rivals...

### Total Sales on Cards, 2008



...And most American Express customers have excellent repayment histories.

### Customers With Strong Credit Records\*



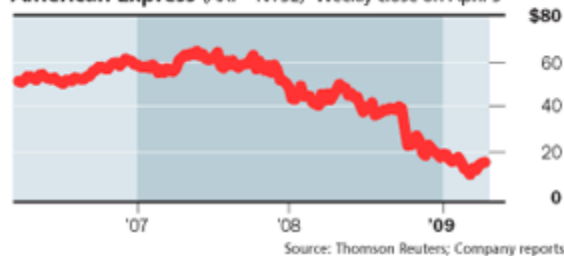
While the company's loan charge-off rate is high, that partly reflects a declining loan base as AmEx curbs shaky accounts...

### Net Chargeoffs by Issuer\*



...But Wall Street has wrung its hands, sending the stock down about 70% from its peak. Shares are now oversold.

### American Express (AXP - NYSE) Weekly close on April 9



vertiginous rise in AmEx's U.S. charge-offs. After closely examining the February trust data, Portales' Bill Ryan sees some favorable developments. While charge-offs surged in the month, loan delinquencies (the raw material for future charge-offs or defaults) were far better-behaved. Total delinquencies in the trust rose just 12 basis points (12 hundredths of a percentage point) to 5.40% of total U.S. credit-card receivables or borrowing, compared with a sequential monthly jump of 42 basis points in January. But even more telling, according to Ryan, was the fact that in February, early-stage (31-to-60-day) delinquencies actually dropped from the month before by nine basis points, to 1.38%, while mid-stage (61-to-90-day) delinquencies rose but five basis points, to 1.23%.

Early-stage delinquencies normally drop some in February, for the simple reason that many cardholders labor hard to pay down swollen balances quickly from the holiday season. But the drop this February was larger than usual.

As a student of the credit cycle, Ryan thinks that yet another factor may soon steady AmEx's fortunes. AmEx currently is paying the price for its promiscuous extension of credit and bad underwriting practices of recent years that saw its U.S. card-lending jump from \$39.9 billion at the end of 2004 to the aforementioned peak of \$65.9 billion at the end of 2007. AmEx was looking for love in all the wrong places, oblivious as were most Americans of the approaching financial and economic tsunami.

Yet, says Ryan, the losses AmEx is now suffering from bad underwriting decisions tend to be short-lived and violent, compared with losses that creditors suffer from economic weakness, with its attendant rise in unemployment and drop in consumer spending. "I'm not saying that credit losses at AmEx won't continue to rise some in the months ahead, but the deterioration in charge-offs compared to that of its peers will be tempered somewhat as the underwriting mistakes are quickly washed through AmEx's system," says Ryan.

Liquidity has been yet another concern of investors, about AmEx specifically and the financial industry in general. Beaten-up stock prices in the sector make stock offerings punishingly dilutive to current stockholders. Even more damaging has been the freezing-up of the all-important asset-backed securitization market, which allowed lenders like AmEx to bundle vast hunks of their credit-card receivables and sell them off to investors in the form of bonds. At the end of last year, such securitizations accounted for some \$29 billion of the \$72 billion in credit that AmEx had extended to cardholders in both the U.S. and abroad.

**AFTER THE COLLAPSE OF GLOBAL** credit markets following the Lehman bankruptcy last September, AmEx, like other U.S. financial institutions, has made ample use of the panoply of U.S. government liquidity and credit facilities to fill in the financing breach. It received an injection of \$3.4 billion under the now somewhat notorious Troubled Asset Relief Program.

AmEx also availed itself of \$5.9 billion in borrowings under the government-guaranteed Temporary Liquidity Guarantee Program. In addition, AmEx has plenty of unused credit capacity, including \$7.4 billion under the TLGP, \$8.7 billion under its bank facilities and a \$5 billion credit conduit that won't expire for several months, according to a recent report by JPMorgan analyst Andrew Wessel.

All of this has left AmEx with about \$25 billion in cash and readily marketable securities, which more than covers its liquidity needs for the next 12 months. They include some \$20 billion in long-term debt and asset-based-securitization maturities.

American Express seems to have ample capacity to weather the current financial storm and survive comfortably until charge-offs abate and the all-clear sign is posted for the economy. Among other things, the company recently exhibited its confidence by affirming its current dividend-payout level, which costs it some \$200 million a quarter. And as AmEx recently observed on its Website, its ratio of tangible common equity to risk-weighted assets was 8.5% at year end, "higher than that of most bank holding companies, and all our regulatory ratios are comfortably above the 'well-capitalized' thresholds."

**THE GOVERNMENT FACILITIES** eventually will expire. Yet AmEx is hard at work developing other funding sources should its access to traditional capital markets remain difficult. It is now availing itself of retail certificates of deposit pushed by traditional brokerage houses like Merrill Lynch as an investment alternative to high-net worth customers. This program has yielded some \$8.8 billion in funding since last fall.

The company also plans to roll out a new program this quarter designed to attract direct deposits to American Express using direct mail, the Internet and other forms of advertising. With the cachet of the American Express name, the company should have no trouble using these channels to replace the securitization market as a source of cheap funding.

Given the necessity of carrying a larger capital base even after the economy improves, AmEx said in its annual report that in the future it expects to deliver a return on equity of more than 20%, instead of meeting its old goal of better-than-33% ROE. Of course, 20% is a return that most companies would die for.

Investors could do a lot worse than shares of American Express, especially at current price levels, even if it no longer aspires to be the fastest car on the track.

**Copyright 2009 Dow Jones & Company, Inc. All Rights Reserved**

This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit [www.djreprints.com](http://www.djreprints.com).