HollAnd Advisors

Holland Views – American Express (Price: $80, MCap: $81bn)

A Model Franchise

The combination of our desire to find new investment franchises to highlight to clients and an ever-rising stock market has meant we are rarely able to revisit quality companies that we studied (and favoured) in the past, which are again offered at reasonable prices.

American Express (AMEX) has been a decent investment since our work on it in 2011(+74% to $80). Arguably however, relative to the quality of its business model and considering todays c. 13.8x headline PE multiple, it could be considered a laggard (the 50% relative outperformance vs the S&P up to last June has been almost entirely unwound since). Equally, as the bulk of our analysis to fully understand the business was conducted in 2011, a number of clients may have never seen it. Below, we repeat in simple terms our conclusions on this great franchise and provide what we hope is a simple guide to its investment case. We do not revisit every original observation in detail so please do look at our original pieces (attached).

Clients will likely be aware of the recent upset caused by the high profile co-branding contract lost by AMEX with Costco. Other fears for the AMEX business centre on the potential threat from disruptive payment technologies. We dismiss neither but rather point to AMEX's lengthy history as an innovator in terms of both business practices and technology adoption over numerous decades. More pertinently for us, we have spent more time thinking about provisioning levels which, frankly, do look low by historical standards. The reasons for such are plausible but a normalisation of earnings might still be prudent. Such an adjustment would result in the stock being on a 16.6x adjusted PE today – still reasonable for the quality of the franchise we suggest.

In this note, we review the longstanding attributes of the AMEX business that we like so much and the cyclical headwinds that the business is currently facing. Those investors who might be sceptical of the company's medium term guidance given (8% revenue growth, 12-15% EPS growth and 25% ROE) might think twice when they see the incredible track record that this business has built and sustained in recent decades.

The AMEX model –has everything we look for…still

We have observed many times that in order for an outsized level of compounding to be achieved a company needs to do five things well:

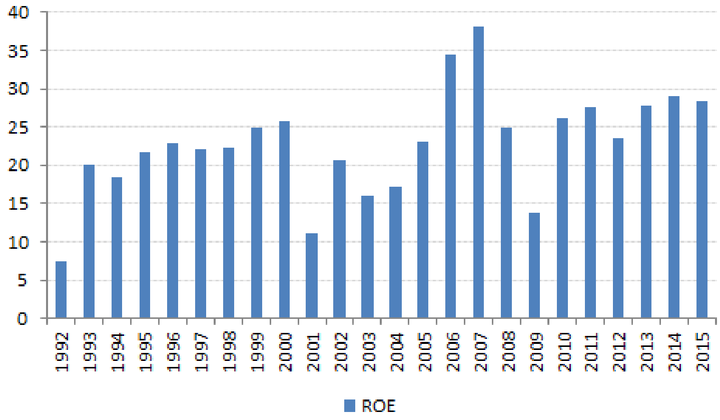
1. Make very high returns on capital
2. Excel in their chosen field
3. Be well managed
4. Allocate capital well
5. Grow

So how does Amex stack up against these five pillars? We suggest that AMEX is a business with…

1. Inherently high returns

AMEX has had extremely resilient returns over the last two decades (see Fig.1a). This has been largely due to the protection of the business' franchise-like characteristics. A great example of this and the aforementioned innovation prowess of the company has been the expansion of the Global Network Services (or GNS) business over the last decade which is a very high return on capital business as shown in Fig.1b below. In essence it transacts card transactions for 3rd-party banks under the AMEX brand without using group capital.

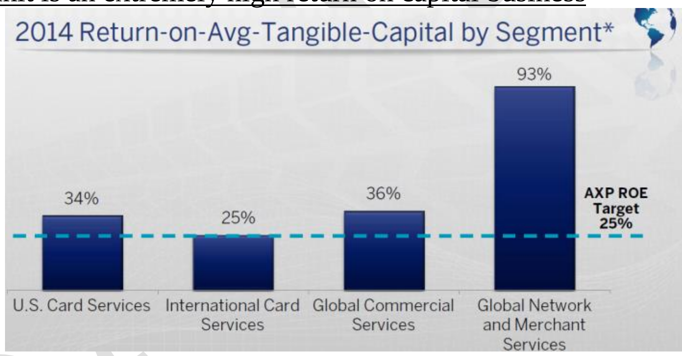
Fig.1a: Amex ROE – reassuringly consistent



Source: Capital IQ

The group's returns have some volatility due to the necessary higher provisioning during cyclical downturns (2001 and 2009). Allowing for these infrequent years, the group's ROE are high and very stable.

Fig.1b: The GNS unit is an extremely high return on capital business



Source: AMEX February 2015

2. With demonstrable operational excellence

AMEX's competitive moat is in essence derived from its brand, its 'closed-loop' knowledge of both consumers and merchants and shrewd management of customer service and business innovation. This moat is, we suggest, very much in display from the consistency of ROE in Fig.1a above. Further evidence of the moat can be found in the following:

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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