



Holland Views – American Express – Price: \$105; MCap: \$91bn

Closed Loop, Open Minded

We have ruminated extensively on American Express' business prospects in the last few weeks. Long standing readers might remember the multiple research pieces we published over the years lauding its Franchise credentials. Three years on from our last piece, Amex is priced as a business that has fallen out of favour. And yet, two years on from the Costco debacle and after much reinvestment – not to mention a new CEO now in place – we still have a business with a 30% ROE, that has recently resumed growing its top line at 9-10% and whose shares trade on just 14.6x earnings! Hmmm – we do wonder whether investors have mistaken the heavy investment phase of the last two years with secular decline.

Bears and sceptics alike will be glad to hear we spend much time in this note on the difficult questions that the Costco contract loss etc. forces the 'old guard' to confront. In this note, we shine a light on the long list of worries. After all, that 9-10% growth we mentioned is a trend of just 2-3 quarters!

That said, we keep coming back to the fact that this once great Franchise does seem to have revived growth and, more crucially, still has the uniqueness of its 'closed-loop' business model. Unlike Visa or say JPM, Amex holds the relationship and the data for both the merchant and the consumer in every transaction. Let's not forget: Amex has had such a 'closed-loop' model for decades and that such models have become very sought-after in today's world of big data.

“First, businesses will increasingly be valued based on the completeness, not just the quantity, of data they create. Why are Tencent and Amazon able to succeed? Not only because of the breadth of their data—knowledge of who their customers are; where they went before, after and during their visit; everything they saw along the way—but also that the data is a “closed loop.” – Steven A. Cohen, WSJ op-ed – ‘Models will Run the World’, August 19, 2018 [an excellent article¹ that all investors should read in its entirety]

Indeed, Big Data is a good segue into discussing the primary uncertainty that weighs on sentiment towards American Express these days. As much as investors worry about the internal culture and the company's growth prospects in the face of heavy incumbent competition, it is really the disruptive threat to the card industry from technology companies/processes like Stripe, Paypal, Amazon, Blockchain et al that weighs most heavily on what many now see as a very old-fashioned business. Some point to Charlie Munger's admission last year:

Charlie: Well I'm going to give you an answer that will be very helpful to you because you're somewhat confused about what the exact future of American Express will be...and I want to tell you, I'm confused too. I think that if you understand exactly what's going to happen to payment systems ten years out, you're probably under some state of delusion, it's very hard to know. So if you're confused, all I can say is “welcome to the club”. They're doing the best they can, they've got some huge advantages that they're...it's a reasonable bet. But nobody knows. I don't know if IBM is going to sell that much of Watson. I always say I'm agnostic on the subject. You're talking about payment system 10 years out, I'm agnostic on that too. I think if you keep trying to do the right thing and you play the game hard, your chances are better. **But I don't think those things are knowable. Think about how fast they changed.**

Source: Charlie Munger – Daily Journal AGM, January 2017 (emphasis added)

¹ <https://www.wsj.com/articles/models-will-run-the-world-1534716720>

We don't have all the answers but we do know the Amex business very well and suggest that investors might be getting a lot of optionality for the 14.6x PE price on offer today.

[This note shines light on five questions on Amex](#)

1. Is Amex broken?
2. What really went wrong at Costco?
3. What's being done to fix the malaise?
4. What are the key assets today within Amex vs the Competition?
5. And the most pertinent question: *“Can the new Management reinvent Amex (again!)?”*

We write this note to place a marker in the sand that says “Amex's history, unique business model and assets – not to mention its relatively modest valuation – justify that it remains on investors' radars – for now”. We suspect that over the next year, the sustainability of Amex's Franchise credentials (and its growth) will become more apparent to those watching closely. This note aims to help us navigate that process.

Buying Amex's long track record of growth, innovation and capital return for 14.8x PE offers much optionality. That this note focuses on the negative uncertainties is our way of assessing the downside risk/margin of safety.

A once-formidable Franchise – now broken?

We wrote in 2015 of Amex's Franchise credentials² and earlier in 2011³, we wrote in some detail on what made Amex unique as a company. Let's not pull any punches: American Express has never had a true peer in the global credit card/charge card market due to its unique independent network and strong business model. This uniqueness remains reflected in Return on Equity (Fig.1). A 30% ROE reminds us that this is not a bank we are discussing here!

Amex's uniqueness was/is because, unlike Visa or Mastercard's card transactions, Amex is usually the sole issuer, acquirer *and* processor of its card transactions globally. Being connected to both sides of the transaction thus affords Amex a unique insight and hold on consumers due to it having a part in both sides of a given card transaction – i.e. the consumer and the merchant.

Amex simply knows more about its customers' spending and by always having a guaranteed relationship with the merchant that facilitates that spending – is able to derive terrific customer insight. By capturing all of the interchange fees, Amex can in turn reinvest heavily in customer rewards thereby targeting the best, highest spending customers.

Amex's double-agent position allowed it to reward spenders with incentives to increase spending thereby driving volume for merchants and its own discount revenues – a classic flywheel in action. All of those facts remain in place today.

[To recap on the nuances of Amex's business model in a little more detail:](#)

- Cards which use Visa or Mastercard's processing network tend to engage with separate merchant bank and issuing banks to complete the transaction (creating a so-called 'open loop system'). Amex is the only card company of scale (Discovery is much smaller) that does it all itself creating a so-called 'closed-loop system'.

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

² Holland Views – AMEX – A Model Franchise - \$80, June 2015

³ Holland Views – AMEX – Everything we look for - \$46, January 2011

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