Don’t leave home without Amex?

by Christopher Demasi

The iconic American Express Centurion Card, made from anodized titanium, etched by laser, with limitless spending capability and dedicated concierge service commands a premium annual fee that runs in the thousands and has remained elusive for all but the privileged few individuals. So it is with great irony that American Express shares are currently trading at a discount, available to any investor who is looking for a bargain.

Founded in 1850 as an express mail business, today “Amex” is a global credit and charge card issuer and payments network. Last year over US$1 trillion was spent on more than 100 million American Express-badged cards around the world. In the US, where around two thirds of Amex billings take place, the company operates the third largest card network behind giants Visa and Mastercard, capturing a quarter of the market for spending on plastic.

Such enormous scale belies Amex’s unique asset: its closed loop network. Lured by a superior rewards program and strong brand Amex’ card member base is both large and valuable. On average, an Amex customer spends more than triple a Visa or Mastercard cardholder each year and knows they can use their card with almost every merchant they want to. At the same time, merchants are willing to accept Amex cards and pay more for the privilege in order to access such important potential customers. This creates a self-reinforcing spend-centric cycle, a “chicken-and-egg” scenario that is almost impossible to replicate and becomes even more impenetrable as it expands.

Amex’s uniqueness also extends to its revenue model. Like Visa and Mastercard, Amex earns fees from merchants every time a customer swipes their card to make a purchase. Like a bank, Amex also lends to certain cardholders and earns interest on these balances. Yet the combination of high fees and interest income, along with an affluent customer base that rarely defaults, means that American Express is able to earn very high returns on the capital it must retain to support its lending operations. When most card issuers struggle to make double-digit returns on equity, Amex has easily exceeded the company target of 25%.

As the world transitions from “paper to plastic”, Amex is positioned well to capture the growing volume of spend on cards and electronic forms. Today payment forms other than cash account for just 20% of global payment volumes, despite the apparent ubiquity of credit cards in wallets and online accounts. This structural shift in the way the world pays is likely to support Amex billings growth of up to 10% annually for many years to come.

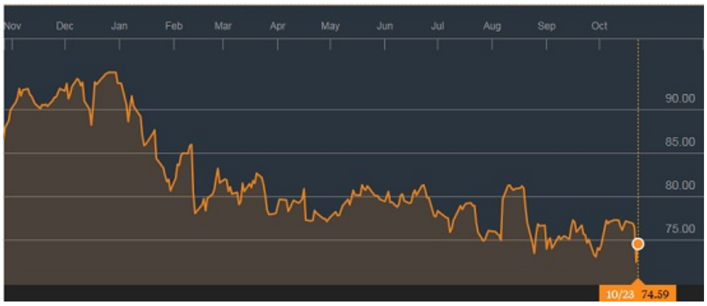
And yet a privileged business model, with high returns and lofty growth prospects has not been rewarded with a premium market rating. Following announcement of quarterly earnings this week, the price of Amex’ shares fell 5% to $72.50 representing a forward PE multiple of 14x. Indeed, a meaningful discount to the PE multiple rating of the broader US equity market, which sits at 17x.

It is likely that the market has become overly concerned by a raft of recent issues, which have been something of a perfect storm for the company this year. In February, Costco decided not to renew its exclusive relationship with Amex in the US following a similar decision in Canada. The large retailer accounted for 8% of spend on Amex cards and 20% of its global loan balance, but margins were low and management intend to deploy resources in higher returning pursuits.

At around the same time, the US Department of Justice ruled that Amex should allow merchants to steer their customers to other payment forms and away from the higher charging Amex card, even if the ability to pay with Amex brought the customers to the store in the first place. So far this has had no impact on customer behaviour. And while the long-term outlook for spending looks robust, the near term is susceptible to an uneven global economic outlook. All the while, management continues to invest in the brand and expanding Amex's technological capabilities to serve its card members and merchants in the network.

Investors who are willing to see through a transition period for Amex in the next 12 months are likely to reap rewards of their own. Not through premium rewards points, rather the return of a premium rating for an exceptional business that has lost the market's favour for now.

American Express Co (AXP: NYSE)



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