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Synchrony Financial — making good money by the handful and avoiding the bucket

By Jeff K. Davis

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An old bank saw states that banking is one of the easiest ways to make money year after year by the handful and then lose it by the bucket. General Electric Capital Corp. has epitomized the consistent handful saw by contributing a large percentage to the consolidated company's earnings year after year. A highly rated company like GE can leverage capital in its financial subsidiary by borrowing cheaply to earn an attractive spread and thereby producing a high ROE. GE has done this so well that it could be described as a bank in an industrial company wrapper. In 2006, GE Capital produced net income of $10.4 billion, which was by far the largest business unit contributor to GE's $20.7 billion of net income that year. GE Capital's returns were outstanding. ROA of 2.06%, ROE of 19.3% and ROTCE of 36.0% qualified as very high performing banking metrics even by the higher profitability standards of the pre-crisis years.

To management's credit, GE Capital did not lose buckets of money in the financial crisis (a modest profit was posted in 2009); however, CEO Jeffrey Immelt probably got the gist of the saw because GE Capital's funding challenges were so great that it got government support through the FDIC's Temporary Liquidity Guaranty Program. As an aside, had TARP recipient and GE Capital competitor CIT Group Inc. received liquidity support from the FDIC, I suspect it probably would not have filed for bankruptcy in late 2009.

Big balance sheets like GE Capital's require lots of financings, and liquidity always has been fickle — abundant when not needed and scarce when a company is desperate. Management is now shrinking GE Capital's balance sheet and targeting an earnings contribution of 30% or less by 2016, from 45% in 2013 when net income totaled $6.3 billion. (see letter to shareholders: http://www.ge.com/ar2013/#/letter) Assets were $510 billion at March 31, 2014, down from a peak of $637 billion at year-end 2008. They will shrink by another $60 billion or so once the North American retail finance unit, which has been rechristened Synchrony Financial, is fully spun-out sometime next year. The separation will result in GE Capital's asset base aligning more closely with GE's core industrial and commercial businesses.

The first installment of the divestiture will be an IPO for about 20% of GE's interest in Synchrony later this year. It has been a great year for IPOs, though price performance has been uneven among three specialty lenders – Ally Financial Inc., Santander Consumer Finance SA and Ladder Capital Corp. Subprime auto lender Santander's shares are down 21% since its February 5th IPO through June 17, while prime auto lender Ally's shares are nearly unchanged since its IPO priced on April 9. CRE lender Ladder Capital's shares have risen about 14% since its IPO priced on February 5, perhaps reacting favorably to the easing of intermediate- and long-term rates. Santander shares presumably reflect pressure related to the Federal Reserve's objection to the company's capital plan in March. But pressure on the shares also may be a heads-up about the longer-term credit outlook for subprime borrowers following a period of loosening credit standards.

Assuming the markets do not weaken and consumer credit metrics remain steady, I think Synchrony's IPO will be well received even though it does not represent a high growth company or an opportunity to invest in a new concept. Unlike Ally Financial whose core business is originating very low yielding auto loans, or Santander whose business involves originating very high yielding auto loans to subprime borrowers, Synchrony is the largest issuer of private label credit cards. The average FICO for active consumer accounts was 710, which puts Synchrony in the prime space. About 69% of its $54 billion receivables portfolio as of March 31 consisted of private label cards that are issued on behalf of 24 companies. The balance of the portfolio consists of consumer loans for larger retail purchases such as home furnishings and health care-related purchases.

Synchrony appears to be a finance business that will be able to consistently make very good money by the handful if management does not push growth and key private label partners are retained as renewals occur. The company reported net income of $2.1 billion in 2013 and $1.8 billion on a pro forma basis after adjustments for higher funding costs after the separation from GE Capital occurs. Reported net income in 2011 and 2012 were comparable at $1.9 billion and $2.1 billion. Returns have been great. Reported ROA and ROE in 2013 were 3.50% and 38.6%, which compare well with Discover Financial Services's 2013 returns of 3.25% and 23.7%. The S-1 implies ROE will trend lower given management's intent to build capital. Equity excluding goodwill and other intangibles was $4.6 billion at March 31, or about 8% of tangible assets.

The core math for the business model is good, provided competition or technological advances in the payments industry does not alter the model too much. According to the S-1, the yield on $52 billion of average receivables in 2013 was 21.6%. The net yield was 12.4% after credit losses of 4.7% and 4.5% of retail promotion costs. Funding costs were modest too in 2013, totaling 1.6%. The S-1 notes the pro forma cost of funds would be higher if Synchrony had been independent; however, the growth of direct deposit funding following the acquisition of MetLife Bank in 2013 may reduce the cost of funds in time.

What could go wrong? A number of critical things — credit, the loss of a major retailer and/or regulatory issues are obvious candidates. A consumer-led recession would be bad news. That does not seem likely today, though I think one has to pause and consider the weak same-store sales growth metrics that have been reported by a broad swath of retailers the past several quarters. One bucket loss scenario for Synchrony would be a repeat of 2009 when losses spiked to 11.9% of average receivables. But even in that scenario the gross yield on the portfolio may provide enough revenue to avoid an

earnings disaster. By comparison, Discover Financial Service's loss rate was 7.5% in 2009 (and 2.0% in 2013).

Investors will also have to weigh (or discount) revenue concentration. According to the S-1, the ten largest retail partners accounted for nearly 60% of platform revenue in 2013, and the five largest accounted for about 48% (Gap, JCPenney, Lowe's, Sam's Club and Wal-Mart). Wal-Mart is struggling with flattish U.S. same store sales, while JCPenney may eventually seek bankruptcy protection according to some analysts. However, card payment usage continues to increase among consumers and portfolios such as Nordstrom's periodically become available. The downside to returns may be more subtle than a spike in credit losses or the loss of a major retail partner. Intense competition may force management to increase the retail share arrangement and thereby reduce the net yield. In 2011, the sharing expense equated to 3.1% of average receivables, or about 140 basis points less than the cost in 2013.

Regulatory risks are two-fold. Consumer finance is highly regulated and politically charged. The company entered into a consent order in December with the Consumer Financial Protection Bureau following a similar agreement with Attorney General for the State of New York related to one product. On June 19 the CFPB alleged ordered subsidiary Synchrony Bank to pay $225 million in restitution to customers for two set of actions that were labeled as discriminatory and deceptive. The CFPB is going to be a never ending battle for consumer bankers. Also, it is unclear how much latitude banking regulators will give the company to distribute excess capital that I think will accumulate given the high ROE and prospects for moderate balance sheet growth. Robust dividends and share repurchases may take several years to develop once the company is completely separated from GE Capital, provided the Federal Reserve approves.

For those of you who read my post, you have seen my repeated view that the most important variable for investors (and acquirers) is the one that they absolutely control – the purchase price. I do not know if the underwriters will be able to dictate pricing, but Synchrony appears to be an attractive, high ROE story for investors. With credit losses near a cycle low, earnings are not always what they seem to be in a finance company. A seemingly modest multiple of 10x to 12x earnings around $2 billion implies a market cap of $20 billion to $24 billion, which is not bad for a tangential business that is being spun-out of an industrial company.

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