

Financials Discussion

By Eric Cote and David Huynh

The CUSP currently holds seven firms in the Financials sector: three are insurance companies and four deal with banking or capital markets. We, as analysts, investigated Western Alliance Bancorporation and recommended it as an addition to the CUSP. We also evaluated Visa, which is in the CUSP, by comparing it with Discover and Mastercard.

Western Alliance operates mainly as a business-to-business bank with more than 50% of its revenues coming from the Commercial bank segments. The bank operates primarily in Arizona, California and Nevada. They generate most of their revenues by providing loans for small and middle-market businesses. Recently, they have tried to create a more diversified loan portfolio with the acquisition of several consumer-focused businesses. Like all banks, its revenues are sensitive to the interest rates environment. An increase in interest rates could help to lift its net interest income by expanding the net interest margin.

Western Alliance has realized tremendous loan growth with the commercial lending rebound as the economy recovers from Covid-19. Over the past few quarters, the bank has experienced significant growth in its net interest income in spite of a decline in the net interest margin. This is mostly driven by the increase in loans. As the Fed begins to raise interest rates, Western Alliance expects to see growth in the net interest margin. Regarding valuation, Western Alliance (WAL) looks strong compared to its industry peers. WAL has a slightly above peer average Price to Tangible Common Equity, coupled with a Return on Tangible Common Equity that is higher than many peer banks. Based on its profitability and growth prospects, we believe Western Alliance would be a valuable addition to the CUSP. While the vote was close, the CUSP managers concluded the current bank-stock holdings are stronger, so we dropped the bank from further consideration.

Visa has been in the CUSP since before 2015. We undertook an analysis of Visa by comparing it with Discover Financial (DFS) and Mastercard (MA), its two closest peer competitors. The firms have important similarities and differences. Visa and Mastercard are both huge credit card companies that take up much market share in the industry. Both offer credit card and other financial services worldwide. Discover offers similar services, but its operations differ in ways that are important to consider.

Discover operates in two segments: Digital banking and payment services. The firm offers the well-known Discover card but also acts much like a traditional bank, offering loans and gathering deposits. The payment services segment is likely best known for its network of ATMs and funds transfer networks under the PULSE and the Diners Card names. While all three firms offer payment services, it's Discover's banking operations that provides the primary difference when compared to Visa and Mastercard. Discover's portfolio of loans makes it a much more capital-sensitive business relative to the other two firms.

Visa and Mastercard have very similar operating models. They are primarily payment processors but also offer card products, platforms and value-added services. The revenue segments that these two companies have in common are transaction/data processing and fees, services fees, international transaction fees and client incentives/rebates. Visa occupies about 60% of the market share, while Mastercard takes up 25% of the credit card industry. Both companies face some of the same economic challenges moving forward.

Based on our analysis, we eliminated Discover from consideration primarily because banking is already well-represented in the CUSP. We also preferred Visa over Mastercard. Visa

has maintained relatively steady growth with strong margins. When looking at valuation metrics, Mastercard gives the appearance of being valued like a growth company. Many of its traditional valuation metrics such as P/E, P/BV, etc. are higher than for Visa. In comparison, Visa appears to be valued much more like a value stock. Given the CUSP preference for value investing, we recommended holding Visa and dropping Mastercard. The class, via vote, agreed.