Red-hot card sector cooled by Cap One concerns, SNL Financial (July 21, 2003)

Several credit card stocks charged forward into new territory during the week of July 14, but it didn't take much for the bulls to begin a rapid retreat amid fears about the competitive landscape. Fueled by improving credit-quality metrics, optimism for better second-quarter earnings and continued takeover talk, the SNL Monoline Card Index closed July 14 above 6,000 on a price basis for the first time since June 2002. After another close above 6,000 on July 16, the index ended the following day at 5,707.

Providian Financial Corp., Capital One Financial Corp. and MBNA Corp. led both the charge and the retreat. All three set new 52-week highs early in the week before losing ground. Providian, MBNA and Capital One lost 6.3%, 3.6% and 12.8%, respectively, on July 17, after the latter's second-quarter earnings report raised concerns about the ability of the monoline card issuers to produce profitable loan growth in the second half of the year.

Wachovia Securities analyst Joel Houck was a day early in forecasting Providian's fall. He downgraded the stock to "market perform" from "outperform" on July 15, just hours before the company's shares traded at their highest point since a monumental October 2001 collapse. "In addition to valuation concerns, we also believe the intense competitive landscape of the credit card industry is likely to make net receivables growth for Providian a challenge for the remainder of 2003," Houck said in a note. "While we applaud management for maintaining an underwriting discipline in a tough pricing environment, we do not believe Providian shares can meaningfully outperform from current levels with a lack of net receivables growth."

Providian is scheduled to release earnings on July 28, but its shares were caught up in the commotion surrounding Capital One's earnings report.

Though that company meaningfully outperformed the second-quarter Thomson First Call consensus estimate of $1.10, posting earnings of $1.23, management left its full-year earnings guidance intact, and said improved results from the relatively untested auto finance and international credit card units would drive profit growth. That led analysts to question the quality of Capital One's second-quarter results and ask whether the company's business model can weather the difficult economic environment.

But Capital One's results and modest second-half forecast were only part of the story behind the July 17 decline. Analysts expressed concern about the company's commentary regarding competition in the prime and super-prime markets — areas of focus these days for Providian and Capital One, in light of recent regulatory intervention in the subprime market, and always MBNA's sweet spot.

"Competition in the U.S. credit card industry continues to be intense, particularly in the prime and super-prime markets," said Capital One CEO Richard Fairbank on a July 16 conference call. "As you know, many of our competitors have been offering 0% introductory rates for extended periods of time, up to 18 months."

Some analysts paid particular attention to a low fixed-rate offer being marketed by Capital One, claiming that the company could not possibly achieve acceptable margins on such a consumer-friendly product. Capital One management and its supporters on Wall Street argued that the company's technology in targeting the most profitable customers, something it relied upon with great success in the subprime market, will produce favorable results in higher credit-quality categories.

Despite Fairbank's comments, not everyone in the business is resigned to a continuation of intense price competition in the high-credit-quality markets. Citigroup Inc., one of the most active promoters of "teaser rates" this year, said it cut back its marketing of those rates "a bit" during the second quarter.

"We felt things had gone a little bit too far," said CFO Todd Thomson on a July 14 conference call. "We didn't see the kinds of returns we would like to see in some of the teaser rates as the offers got a little bit too aggressive."

Citigroup agreed to purchase the credit card operations of Sears Roebuck & Co. last week, a business with more than $29 billion in receivables. And it will soon assume servicing responsibilities for the $7 billion private-label portfolio of retailer Home Depot. Successful integration, rather than aggressive price-cutting, will be the financial services giant's most immediate objective.

"We were comfortable not playing the teaser game when it got to be ... uneconomic, and count on the fact that we're going to have the $7 billion in Home Depot [receivables] coming on and focus on that for the time being," Thomson said during the call, which was held a day before the Sears transaction was announced. "When the teaser game gets more realistic, we'll go back into it."
In addition, Thomson said, "We're looking at other value propositions out there other than just cost" to increase organic growth of credit card receivables. "Offering special values in terms of airline miles or other benefits like that — doing co-branded deals. ... The economics have turned so those are more interesting ways to put on balances than teaser rates."

But the comments of Bank One Corp. CEO James Dimon on July 16 seemed to suggest mixed trends in credit card competition.

"We are doing less marketing for the new customer stuff at very aggressive rates," Dimon said on a conference call. "I think you see recently a lot of people making noises that it doesn't pay for itself."

But, he continued, "If the competitors don't stop, we're not going to stop, either. ... You have to be competitive. Otherwise, you will get adverse selection. ... We will do what it takes [to compete]. If it compresses margin a little bit, so be it."

As analysts assess the competitive landscape, some determined that the selling pressure on Capital One's shares became unwarrantedly intense on July 17. J.P. Morgan Securities analyst Michael Freudenstein and US Bancorp Piper Jaffray analyst Robert Napoli both upgraded the stock on July 18.

Freudenstein added Capital One to the J.P. Morgan Securities "focus list," citing the potential for improvements in credit costs through the second half of the year.

"We believe there is light at the end of the tunnel for the revenue riddle that has plagued earnings quality in the first half," he said in a note.

Napoli lifted his rating to "strong buy" from "outperform," arguing that any decline in revenue margin from Capital One's new up-market focus would likely be offset by improvements in credit losses and operating efficiencies.

Analysts' renewed optimism put the brakes on the decline in Capital One's shares, but investors might wait for additional data points from the second-quarter earnings reports of MBNA and Providian later this month before bidding the monoline companies' shares back into record territory.