

Consumer Finance

COF-DFS merger: Path to 2027 mid-teens EPS accretion appears feasible

Estimate Change

Double digit / mid-teens EPS accretion in '26/'27

We think double digit (2026) and mid-teens (2027) EPS accretion is very achievable if Capital One's (COF) acquisition of Discover Financial (DFS) is completed by early '25. Post-merger, we estimate COF could earn \$21+ in 2027 EPS, based on COF's synergy targets and commentary. In our view, the expense (26%) and marketing (10%) synergies appear reasonable given similarities in the core card business. We also see immediate benefit of the network acquisition as COF's captures more economics from vertical integration of certain transactions. We maintain a Buy rating for COF given solid core fundamentals and potential for the deal to provide long-term strategic benefits. Maintain No Rating on Discover.

Network advantage = merchant flywheel, not just pricing

In our conversations, a lot of investor focus has been on earning higher transaction economics and the path to move volumes onto Discover networks. While better economics are a nice outcome, we believe for Capital One the network acquisition is a more fundamental strategic asset that opens the door to direct merchant relationships and richer data that it can mine to drive capabilities and faster growth. For example, COF can utilize data analytics to drive additional sales to a merchant partner, and show the merchant the impact from its partnership. It can also share the enhanced economics with consumers creating a flywheel of higher sales, and better customer experiences.

Notably, COF has not planned any price increases for the Discover network. We also understand that on certain programs, COF earns a higher net interchange from Visa / Mastercard than Discover's merchant discount rate. As a result, economically it makes more sense to stay on Visa / Mastercard for those programs, at least in the near-term, which will be a factor influencing the pace of volume moving to Discover networks.

Moving Discover "Upmarket"

Capital One believes there is an opportunity to improve the Discover network's brand image. While Discover is by no means a down market brand (core customer is prime FICO), Capital One's focus has been on growing with super-prime, high spending customers. COF will want to make sure the Discover network isn't a deterrent to these customers. The crux of the strategy will revolve around bridging the gap between perception and reality on card acceptance, particularly among non-Discover customers. This will likely involve brand and marketing campaigns, and limits the expense synergies.

Ex-regulators more skeptical of deal closing than investors

Our conversations with ex-regulators suggest a healthy degree of skepticism that the deal will receive the regulatory approvals necessary to close in a timely manner. This is in stark contrast to most financial specialists who we have spoken with, who generally expect the deal to close. Ex-regulators noted that while front-line staff may be comfortable, the ultimate decision will lie with senior leadership and the deal is likely to be met with more skepticism there. This adds meaningful uncertainty to closing and likely helps explain the seemingly wide merger spread.

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See inside for Capital One and
Discover model changes

Underwriting knowledge and strategic fit

Capital One pioneered a barbell strategy in which it targets super-prime and the high end of sub-prime. Discover has a strong focus on prime revolvers. Neither has been able to replicate the other's underwriting strategy. Discover tried expanding the underwriting box in 2022 and that vintage is performing worse than expected. Capital One has publicly noted it tries to avoid high-balance prime revolvers. That said, both companies have deep histories and data with their targeted base which likely gives them premium insights in underwriting. The data gained from the acquisition can help Capital One become more full spectrum.

COF merger model available

We are not changing our COF estimates or incorporating the merger in our base model or forecast for COF at this time. However, we have included a separate worksheet incorporating the DFS acquisition in our model, given investor interest in a post-merger model. For the merger, we have layered in DFS' loan book and network business into COF. We also incorporate the share issuance for the transaction. Our synergy assumptions are in-line with COF's commentary as we view COF's assumptions as achievable. There could be some upside to estimates from higher capital returns post-merger as COF.

DFS model changes

We are lowering our DFS estimates for 2024/25 to \$10.81/\$11.90 from \$11.06/\$12.98 prior, to account for higher net charge-off rates and lower capital returns. DFS loss rates are expected to increase over the next couple of quarters, peaking in 2H24. We now expect DFS' loss rates will remain elevated into 2025 (vs. improving sharply prior). With the merger outstanding, we think DFS will be focused on keeping underwriting tight and less focused on delivering strong loan growth in the interim. This will help credit in the longer-term but adds denominator pressure to '24/'25 charge-off rates. COF also noted that its analysis of DFS' vintage curves and growth expectations suggests DFS charge-off rates will be elevated in '25 (and above consensus forecasts).

Exhibit 1: Stocks mentioned

Ratings and POs

Ticker	Company name	Stock price	Price Obj.	Rating
COF	Capital One Financial	\$139.43	\$152.00	B-1-7
DFS	Discover Financial	\$123.84	—	-6-

Source: BofA Global Research estimates, Bloomberg

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Price objective basis & risk

Capital One Financial (COF)

Our \$152 PO is based on a 9.5x PE multiple to our 2025 EPS forecast. A 9.5x PE multiple is in the middle of the historical range (7-12x) which we think is appropriate given the more optimistic macro outlook and strong loan growth, partially offset by rising credit costs.

Downside risks are: slower than expected revolving credit growth, faltering economic recovery and rising loan losses, which could drive earnings below our estimates, and result in valuation compression. Cybersecurity and regulations are also risks.

Discover Financial (DFS)

We have removed the investment opinion on the company's stock. Investors should no longer rely on our previous opinion or price objective.

Analyst Certification

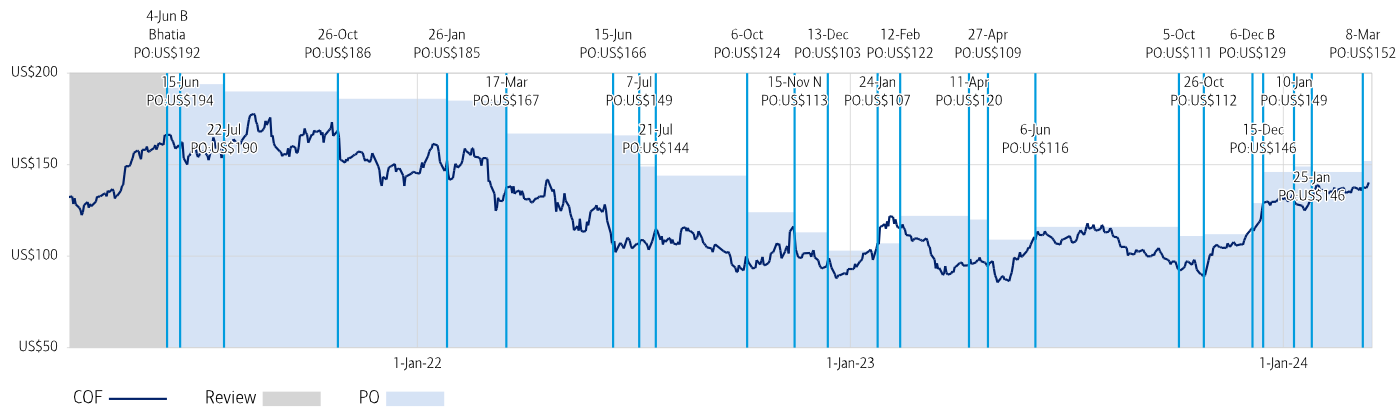
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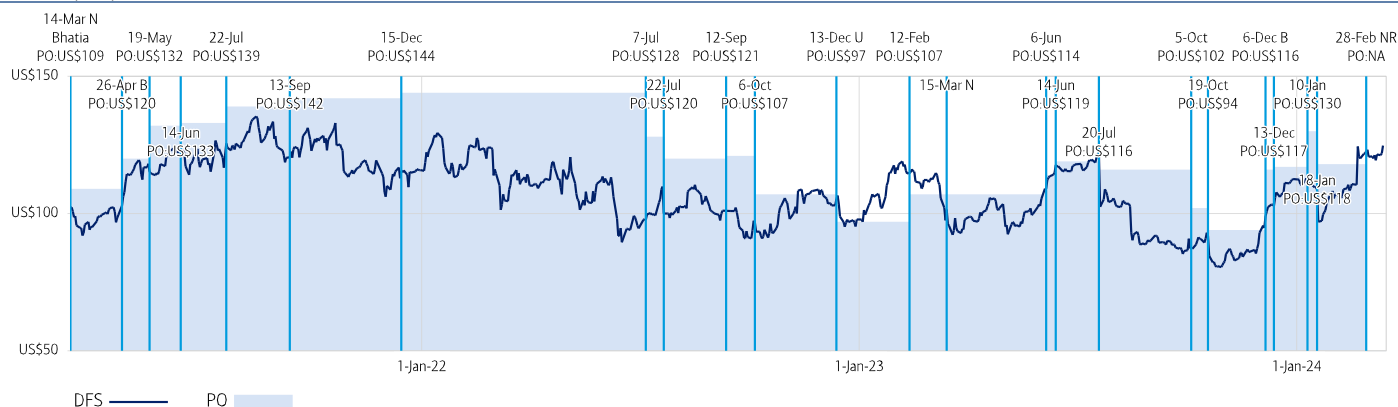
Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Accenture Plc	ACN	ACN US	Jason Kupferberg
	American Express Company	AXP	AXP US	Mihir Bhatia
	Block Inc	SQ	SQ US	Jason Kupferberg
	Capital One Financial	COF	COF US	Mihir Bhatia
	Enact Holdings	ACT	ACT US	Mihir Bhatia
	Essent Group	ESNT	ESNT US	Mihir Bhatia
	Fidelity National Information Services	FIS	FIS US	Jason Kupferberg
	Fiserv Inc	FI	FI US	Jason Kupferberg
	FleetCor Technologies Inc.	FLT	FLT US	Mihir Bhatia
	Flywire	FLYW	FLYW US	Jason Kupferberg
	Global Payments Inc	GPN	GPN US	Jason Kupferberg
	Jack Henry & Associates	JKHY	JKHY US	Jason Kupferberg
	Marqeta	MQ	MQ US	Cassie Chan
	Mastercard Inc	MA	MA US	Jason Kupferberg
	MGIC Investment Corp.	MTG	MTG US	Mihir Bhatia
	NMI Holdings	NMIH	NMIH US	Mihir Bhatia
	Nuvei	NVEI	NVEI US	Jason Kupferberg
	Nuvei	YNVEI	NVEI CN	Jason Kupferberg
	OneMain Holdings, Inc.	OMF	OMF US	Mihir Bhatia
	Shift4 Payments, Inc	FOUR	FOUR US	Jason Kupferberg
	Telus International	TIXT	TIXT US	Cassie Chan
	Telus International	YTIXT	TIXT CN	Cassie Chan
	Visa Inc.	V	V US	Jason Kupferberg
	WEX Inc.	WEX	WEX US	Mihir Bhatia
NEUTRAL				
	ADP	ADP	ADP US	Jason Kupferberg
	Affirm Holdings	AFRM	AFRM US	Jason Kupferberg
	Bread Financial Holdings Inc	BFH	BFH US	Mihir Bhatia
	DLocal	DLO	DLO US	Jason Kupferberg
	Globant SA	GLOB	GLOB US	Jason Kupferberg
	PayPal Holdings Inc	PYPL	PYPL US	Jason Kupferberg
	SoFi Technologies Inc	SOFI	SOFI US	Mihir Bhatia
	Synchrony Financial	SYF	SYF US	Mihir Bhatia
	Thoughtworks	TWKS	TWKS US	Jason Kupferberg
	Toast	TOST	TOST US	Jason Kupferberg
	TTEC Holdings	TTEC	TTEC US	Cassie Chan
UNDERPERFORM				
	CGI Inc.	GIB	GIB US	Jason Kupferberg
	CGI Inc.	YGIBA	GIB/A CN	Jason Kupferberg
	Cognizant Technology Solutions	CTSH	CTSH US	Jason Kupferberg
	Coinbase	COIN	COIN US	Jason Kupferberg
	DXC Technology	DXC	DXC US	Jason Kupferberg
	EPAM Systems	EPAM	EPAM US	Jason Kupferberg
	Paychex	PAYX	PAYX US	Jason Kupferberg
	Radian Group Inc	RDN	RDN US	Mihir Bhatia
	Rocket Companies, Inc.	RKT	RKT US	Mihir Bhatia
	TaskUs	TASK	TASK US	Cassie Chan
	Western Union	WU	WU US	Jason Kupferberg

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Capital One (COF) Price Chart

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Discover Finl (DFS) Price Chart

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Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

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Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

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