

Consumer Finance

Capital One makes its move – plans to acquire Discover for \$35B

Industry Overview

COF plans to acquire DFS in an all-stock deal of \$35.3B

Credit card powerhouse Capital One (COF) announced plans to acquire Discover Financial (DFS) for \$35.3B in an all-stock transaction. The proposed deal would potentially create the largest US credit card issuer (~20% market share) by combining the current #4 and #6 largest issuers, by credit card loans outstanding. Capital One is scheduled to host a public call at 8am ET and also hold meetings at BofA's Financial Services conference today. We would also hear reactions from competitors at the conference this week. We think the potential transaction offers good strategic optionality for COF and maintain our Buy rating.

Key financial points: all-stock, 15% EPS accretive by '27

The proposed all-stock deal is at a 27% premium to DFS' Friday stock price. At close, COF shareholders would own 60% of the proposed combined entity, and DFS' shareholders 40%. COF expects to deliver 15% non-GAAP EPS accretion by 2027, including \$2.7B in synergies (details inside). COF also highlighted that the combined company's CET1 would be 14%, and 84% of year-end '23 deposits were fully insured. COF expects the deal to close in late '24/early 25, subject to closing conditions, regulatory approvals and approval by each company's shareholders.

All about network but also boosts prime segment

We believe COF would be most interested in DFS' network assets. Potentially owning a network would offer intriguing possibilities for a tech-savvy company like COF. Amex and DFS have long highlighted marketing, fraud, customization advantages from owning their own network and we suspect the prospect of adding more capabilities and customization could appeal to COF. In addition, our conversations with industry experts and the company itself suggest COF has historically specialized in near-prime & super-prime underwriting, so DFS' prime-heavy card holder base could be a nice strategic fit (see Exhibit 1 inside).

Regulatory, anti-trust issues appear largely manageable

Given the highly competitive credit card industry with many large banks having a strong presence, we think anti-trust concerns appear largely manageable. COF and DFS are also well capitalized and should potentially earn high ROEs to build capital if needed. Though we acknowledge the prospect of lower near-term capital returns and book value dilution could disappoint some investors.

COF plans to move debit and selected credit vols to DFS

While DFS cards run on its proprietary network, COF issues cards on both the V and MA networks. About 42% of COF's credit cards run on V and 58% on MA, as of 2022. COF's card volumes are split ~90% credit/~10% debit (DFS is virtually all credit). If the deal closes, COF probably would not want to make immediate major changes that could cause cardholder disruption. While flipping DFS cards to COF would enable more international acceptance, the transaction announcement indicated that COF's debit purchase volumes and selected credit card volumes would be moving to DFS in pursuit of COF's targeted network synergies of \$1.2B in 2027. In 2023, COF's US credit card volumes were \$606B, with DFS at \$218B. In 2022, we estimate COF's debit volumes were \$58.5B, most of, if not all, we believe is with MA. We estimate COF represents roughly ~25% of MA's US credit volume and 5% of US debit volume. COF represents ~9% of V's US credit volume.

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12661330

Timestamp: 20 February 2024 02:59AM EST

20 February 2024

Equity
United States
Consumer Finance

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CFPB: Consumer Financial Protection Bureau

COF: Capital One

DFS: Discover Financial

MA: Mastercard

V: Visa

Transaction details

Capital One and Discover announced that they have entered into a definitive agreement under which Capital One will acquire Discover for \$35.3B in an all-stock deal which represents a 27% premium to Discover's last closing price, the deal is expected to close in late 2024 or early 2025, subject to customary closing conditions, including regulatory approvals and approval by shareholders of each company. Current Capital One shareholders will own ~60% of the proposed combined company and Discover shareholders would own the remaining ~40%. We see strategic merit for Capital One to acquire DFS now due to DFS' recent underperformance and compliance issues, to potentially create a credit card issuer with a potent network advantage.

COF expects the deal to generate \$1.5B in expense and \$1.2B in network synergies. On the expense side, COF noted it can save 26% of DFS's operating expenses + 10% of marketing expenses via synergies from common functions. It also expects to generate \$1.2B in network synergies by adding COF debit purchase volume and selected credit card purchase volume to the Discover network. While COF did not clarify how it will achieve the synergies, we believe DFS' debit network, being a three-party network, is not subject to interchange cap rules and the combined company could earn higher interchange on transactions. In a scenario where we assume unregulated interchange of 150bps, and current regulated interchange of 50bps, on the \$58B in debit vols (2022 est.), COF could potentially earn an incremental \$580M in revenue and also save on network fees. This likely grows as deposits increase by 2027.

We also note that while the all-stock transaction appears to be dilutive in the near term, the combined entity plans to deliver +15% accretion to adj. EPS in 2027. Capital One also expects 16% ROIC in 2027 and an IRR of +20%. On a pro forma basis, Capital One would have a 14% CET1 ratio (12.9% as of 4Q23) and 84% of deposits would be insured.

Regulatory/anti-trust scrutiny likely, appear manageable

Combining two large card issuers may face some regulatory scrutiny and COF noted it could take 10-12 months to close (late '24 / early '25). In general, credit card lending is highly concentrated with the ten largest issuers currently accounting for over 80% of total credit card loans outstanding. The CFPB has also noted the highly concentrated nature of the industry in recent reports. We estimate the combined company would be the largest issuer by outstanding loans. That said, it would potentially have ~20% market share and would still be competing with many large banks and other providers of credit.

In addition, COF and DFS are highly regulated banking entities. We suspect regulators will want to ensure a smooth transition for cardholders and adequate capital. The combined company is expected to have a CET1 capital ratio of 14% at closing, which should alleviate capital concerns among regulators, in our view. We note that DFS has recently experienced some regulatory issues, though the proposed sale of the student loan portfolio may help address some of the concerns. Also, COF will become even more 'consumer dependent' as a result of the proposed merger, which will increase cyclicalities and also potentially reduces near-term capital return potential.

Discover's recent issues likely created an opportunity

Discover has recently struggled with compliance issues and underwriting decisions that have led to pressure on its stock price and also driven some management turnover. In 2022, student loan servicing hiccups led to the company suspending share repurchases briefly while it did an internal investigation. In late 2023, compliance issues returned due to a card product misclassification which resulted in another share buyback suspension, that has yet to be restarted, and another internal investigation. Additionally, there was consent order from the FDIC for an unrelated consumer compliance matter. This, in addition to a weak 2024 guide, has resulted in the stock down 1.7% YTD, but up 21% since the end of 3Q, and trailing COF which is up 4.7% YTD and 44% since the end of 3Q. With new leadership just coming in (new CEO started less than 1 month back), and

no entrenched management, COF likely saw an opportunity to acquire network assets, in our view.

Prime-revolver fills out Capital One's portfolio

Capital One targets a somewhat distinct blend of cardholders relative to its primary competitors. COF markets to the high end of subprime and superprime categories and this barbell approach is distinct to COF driven by its disciplined underwriting approach. In our conversations with the company, COF noted that it did not have specific insights in the prime revolver segment and as a result it was not a focus for the company initially. That said, prime revolver is Discover's focus within the sector and perfectly fills a gap within COF's portfolio, in terms of the cardholder base.

Exhibit 1: DFS's prime base fits nicely within COF's mini barbell strategy

Credit card industry competitive landscape by consumer segment

		Type of Consumer	
		Revolver (carries a balance)	Transactor (Pays off card in full each month)
FICO Band	Super-Prime (740+)	- Tend to be fewer consumers in this segment	- Tend to be reward focused which drives reward competition - American Express, Chase, Capital One - Other large banks have developed products to gain traction
	Prime (660-740)	- Discover's focus area - Most large banks active here given their large national deposit customer base (e.g. Wells Fargo)	
	Sub-prime (<660)	- Capital One targets the high-end of this category - Fintechs often operate in this space - Small, regional banks also compete here	- Tend to be fewer consumers in this segment

Source: BofA Global Research

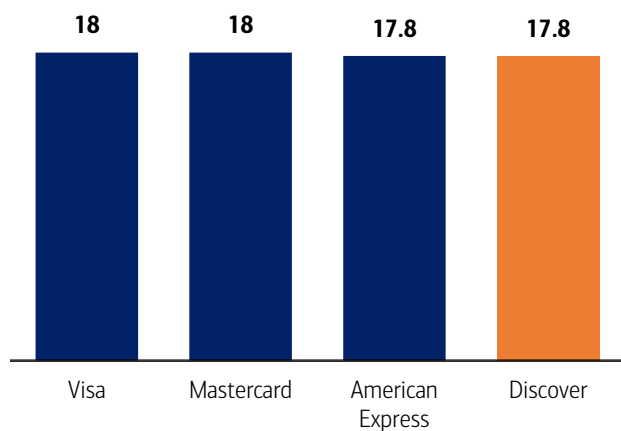
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DFS network is a scarce asset

We believe the DFS network is a key piece of the transaction. There are only four widely accepted credit card networks in the United States and while DFS is the smallest, it does still enjoy parity in acceptance with Visa and Mastercard. Internationally, through its partnerships, the Discover network is accepted more broadly than American Express.

Exhibit 2: Discover has virtual parity with Visa, Mastercard in US

US merchant acceptance locations (M)

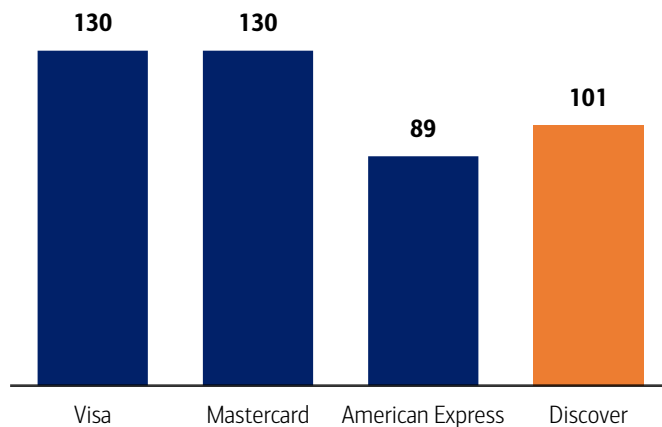


Source: Nilson Reports, BofA Global Research

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Exhibit 3: Discover has more acceptance locations than Amex globally

Global merchant acceptance locations (M)



Source: Nilson Reports, BofA Global Research

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Visa and Mastercard implications

Assuming the transaction closes as contemplated, we COF probably would not want to make immediate major changes that could cause cardholder disruption, such as flipping a significant number of DFS cards to V/MA or flipping many COF cards to the DFS network. While the former option would enable greater international acceptance, the latter would enable COF to capture more transaction economics, the transaction announcement indicated that COF's debit purchase volumes and selected credit card volumes will be moving to DFS in pursuit of COF's targeted network synergies of \$1.2B in 2027.

About 42% of COF's credit cards run on V and 58% on MA, as of 2022. In 2023, COF had credit card volumes of \$606B, representing ~14% of V and MA's combined US credit volumes (V had ~\$3T and MA had ~\$1.4T). If we assume COF's volumes are split between V and MA with same mix as the number of cards, that would imply V had \$255B of COF US credit card volume last year, and MA had \$351B. So, in a theoretical worst-case scenario where all COF credit cards flip to DFS, MA could lose approx. 25% of its US credit volume (and 5% of total global purchase volume), and V could lose approx. 9% of its US credit volume (and 2% of its global purchase volume). We also note that US credit volume generally carries yields above company average.

Per the Nilson report in 2022, COF had \$58.5B of US debit volumes, we believe most if not all of this runs on the MA network. COF represents about 5% of MA's total US debit.

Exhibit 4: Stocks mentioned

Rating and price summary

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
COF	COF US	Capital One	US\$ 137.23	B-1-7
DFS	DFS US	Discover Finl	US\$ 110.49	B-1-7

Source: BofA Global Research

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Price objective basis & risk

Capital One Financial (COF)

Our \$146 PO is based on a 10.5x PE multiple to our 2024 EPS forecast. A 10.5x 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 calculate a \$118 PO based on an 10.5x PE multiple to our 2024 EPS forecast. A 10.5x multiple is in the middle of DFS's recent historical range (7-12x) and reflects the more optimistic macro outlook, resilient consumer balance sheets, and strong business fundamentals.

Downside risks to our price objective are: if the economy falls into a recession, credit costs could rise rapidly and compress margins more than our current forecast.

Deteriorating economic conditions would likely hurt sentiment and drive DFS's valuation lower.

Analyst Certification

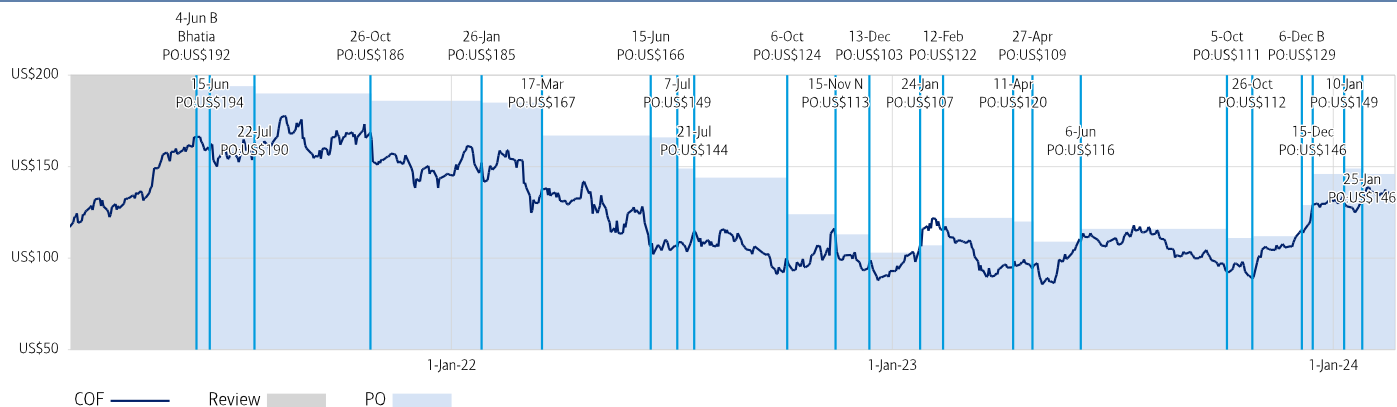
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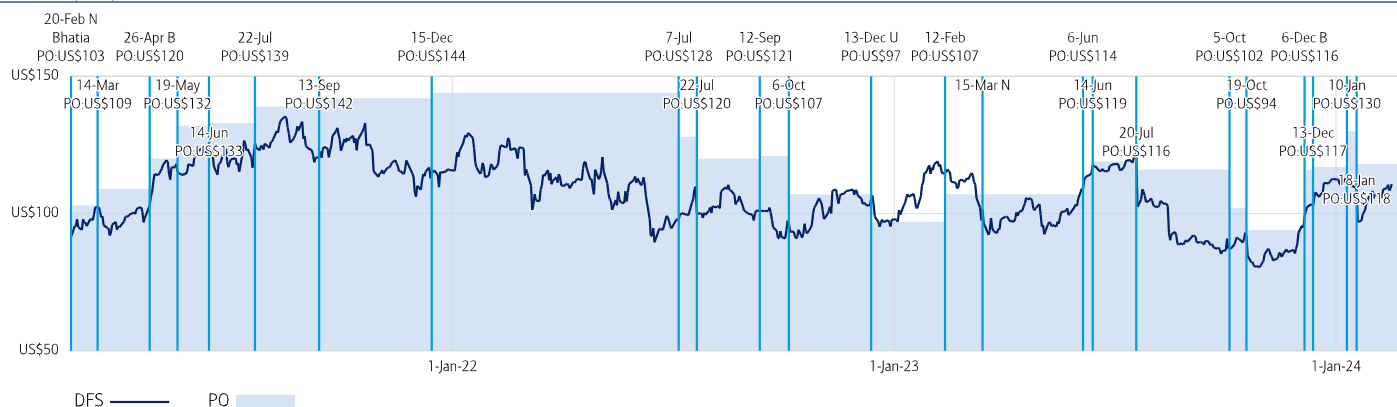
Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Accenture Plc	ACN	ACN US	Jason Kupferberg
	American Express Company	AXP	AXP US	Mihir Bhatia
	Block Inc	SQ	SQ US	Jason Kupferberg
	Capital One Financial	COF	COF US	Mihir Bhatia
	Discover Financial	DFS	DFS US	Mihir Bhatia
	Enact Holdings	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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Important Disclosures

Capital One (COF) Price Chart

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Discover Finl (DFS) Price Chart

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Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2023)

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%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships ^{R1}	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

^{R1} Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster ^{R2}
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

^{R2}Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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