AP CAPITAL RESEARCH

M&A Deal of The Week

CAPITAL ONE X DISCOVER

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Executive Summary

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Deal Summary

- On Tuesday, the 20th of February, Capital One (NYSE - COF) announced that it had entered into a definitive agreement to buy banking rival Discover Financial (NYSE - DFS) for $35.3 billion in an all-stock consideration, making this the biggest acquisition in 2024. Shares in Discover Financial rose 12.5% in response to this news.
- Under the terms of the agreement, Discover shareholders will receive 1.0192 Capital One shares for each Discover share. This represents a premium of 26.6% based on Discover's closing price of $110.49 on the 16th.
- This deal comes at a time when U.S. regulators are considering reforming bank merger rules in an attempt to boost transparency and increase scrutiny of deals, which means this acquisition will be under heavy scrutiny from regulatory bodies.
- The reason behind this deal is to add Discover to Capital One's portfolio, creating a payment merchant that can compete with American Express and Visa.
- This deal is expected to generate expense and revenue synergies of $1.5 and $1.2 billion in 2027 and increase non-GAAP EPS by 15% in 2027.

Deal Advisors

Capital One:
Financial Advisor: Centerview Partners

Discover:
Financial Advisors: PJT Partners and JP Morgan

Key Figures

- **Offer Premium**: 26%
- **Capital One Market Cap**: $52.5 billion
- **Capital One P/E**: 11.45
- **Discover Market Cap**: $30.5 Billion
- **Discover P/E**: 10.74
- **Discover EV/EBITDA**: 12.3x

Company Information

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Capital One - NYSE: COF

- Founded in 1994, Capital One is a banking giant offering worldwide financial services. Their business can be segmented into Consumer banking, Commercial banking and their Credit card section, accounting for 60% of their 2023 revenue. In 2023, Capital One was ranked the 12th best place to work in the U.S., offering low-interest loans to non-profit companies and highlighting their strong ESG commitments.
- Regarding finances, the fourth quarter earnings generated a revenue of $9.5 billion, a 4% increase from last year's Q4 revenue. This resulted in a Last Twelve-Month revenue of $36.7 billion, showing a 7% year-over-year growth. However, the net income for the year 2023 was $4.9 billion, which is a decrease of 34%. This decline is due to a significant rise in operating costs, which increased from $6.04 billion to $9.24 billion.
- Capital One's current P/E ratio comes in at 11.3X, and the latest earnings yielded an Earnings Per Share of $1.67, down 45% from 2022's Q4.

Discover Financial - NYSE: DFF

- Founded in 1985, Discover Financial is a financial services company that operates Discover Bank, a retail bank. Their business can be broken down into Payment services and Digital banking, with the latter making up 96% of revenue in 2023. Over the last three years, Discover's earnings have been falling despite rising revenues, and this is due to a massive jump in their provision for credit losses (from $218 million in 2021 to $6.028 billion in 2023).
- Regarding financials, earnings brought in a fourth-quarter revenue of $4.2 billion, a 13% increase from the previous year. This led to a net income of $388 million, down 62% year over year.
- Their P/E ratio is 10.7x, with the latest earnings yielding a Diluted EPS of $1.54.

Deal Rationale

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Competitiveness and Financial Benefits

Increasing Competitiveness

- Discover has a global network of 70 million merchant payment terminals (card machines) across over 200 countries. However, this is currently the smallest compared to the other three major US-based global payment networks. This acquisition increases Capital One's scale and reduces its dependency on Mastercard and Visa, enabling the combined entity to compete more effectively with big names such as Visa, American Express and Mastercard.
- Capital One is currently the third largest credit card lender, behind JP Morgan and Citibank, with concerns about credit card lending during 2023. Adding Discovery Financial to their portfolio would increase their loan asset base to $250 billion, making them the biggest credit card lender globally, overtaking JP Morgan and Citi.

Financial Benefits

- The acquisition is expected to produce $1.5 billion in expense synergy savings and $1.2 billion in revenue synergies. In turn, this is expected to lead to a 15% accretion in non-GAAP EPS during 2027, as well as strengthening Capital One's balance sheet.
- The transaction is expected to deliver a return on invested capital of 16 per cent in 2027.

Risks

Debt

- Concerning risk, Capital One has a long-term debt of $53.6 billion, putting their debt-to-equity ratio at 89%, which is not an issue as they have had good debt management over the past decade, with D/E spiking at a maximum of 129%.
- Discover Financial has a long-term debt of $23.3 billion, placing its D/E at 144%. This doesn't present an issue to Capital One due to their size. However, Discover's debt management since mid-2020 has been more active, with their D/E spiking at 317% in 2020 and falling back to 195% a quarter later.

Regulatory Concerns

- Capital One holds a large market share, so adding Discover to its portfolio raises some regulatory scrutiny by the FTC. Senator Elizabeth Warren stated that this deal "threatens our financial stability, reduces competition" and that "regulators must block it immediately".

Industry Analysis

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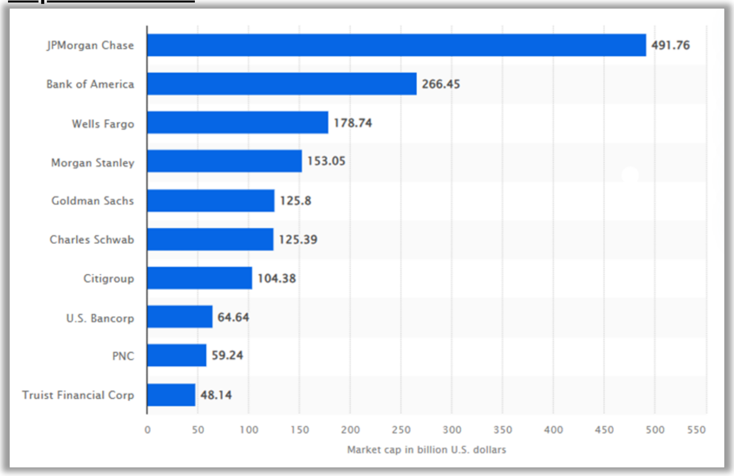
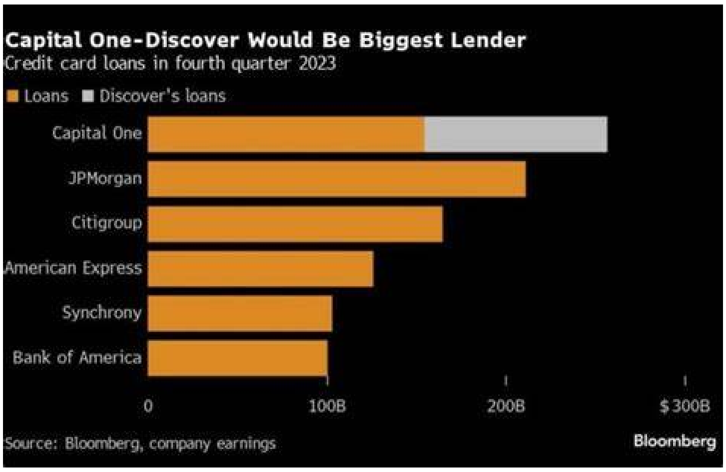
The Banking Industry

- The banking industry is one of the biggest industries in the U.S. and is expected to grow at a Compound Annual Growth Rate of 4% until 2029. This low CAGR rate is due to the high consolidation of the industry.
- The industry is heavily dominated by JP Morgan, as shown on the graph below, with Capital One placing 11th compared to its competitors.

Largest banks in the United States by market capitalization.



Credit Card Loan Size



- The graph on the right shows the impact of the Discover Financial acquisition on Capital One's position when comparing credit card loans against competitors. This shows that Capital One would become the biggest credit card lender globally, surpassing JP Morgan by an estimated $35 billion.

Threat

Stricter Regulation

- After the financial crisis of 2008/9, the government put stricter rules and regulations in place to prevent another event of this scale. An example of this is the Volcker rule, a part of the Dodd-Frank Act that restricted the way banks were allowed to act and conduct business.

Interest Rates

- High interest rates threaten so-called "zombie businesses" that are reliant on low-interest rates that were common during the mid-2010s. This has been seen in the collapse of Silicon Valley Bank due to heavy bond losses and the potential scare of bankruptcy regarding the New York Community Bank earlier this February, where their stock fell more than 50% in a week in response to news of solvency issues due to commercial real estate loan losses.

Final Thoughts

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This acquisition is good for Capital One as it provides an expansive network of merchant payment terminals for them to capitalize on and improve their competitiveness against their rival peers.

The only issue I can see with this acquisition is Discover's provision for credit losses, which has risen from $218 million in 2021 to $2.35 billion in 2022 and finally up to $6.02 billion throughout 2023. This shows a drastic increase in bad debts, and if this trend continues, it can be a cause for concern for Capital One.

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