M&A DEAL ANALYSIS
Shake-up on Wall Street: Inside the Biggest Merger of 2024

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M&A DEAL ANALYSIS

Acquirer: Capital One
Target: Discover
Deal value: $35.3billion
Sector: Finance
Type of M&A: Strategic
Exit multiple: 9.14x
Announced date: 16/02/2024
Completed date: 31/01/2025 (expected)

Acquirer details
Capital One
Founding year: 1994
Headquarters: McLean, Virginia, USA
CEO: Richar Fairbank (1994 - Present)
Number of employees: 56,000
Market Cap: $52.02bn
EV: $67.05bn

- LTM Revenues: $26.361m
- LTM EBITDA: $6.127m
- LTM EBITDA margin: 23.24%
- LTM EV/EBITDA: 10.94x
- LTM EV/Sales: 1.97x

(All financial data as of 2/03/2024)

Company industry:
American bank holding company specializing in credit cards, auto loans, banking, and savings accounts.

Target details
Discover
Founding year: 1984
Headquarters: Riverwoods, Illinois, USA
CEO: Michael G. Rhodes (2024 - Present)
Number of employees: 21,000
Market Cap: $30.27bn
EV: $35bn

- LTM Revenues: $12.921m
- LTM EBITDA: $3.826m
- LTM EBITDA margin: 29.61%
- LTM EV/EBITDA: 9.14x
- LTM EV/Sales: 2.71x

(All financial data as of 2/03/2024)

Company industry:
Online bank that offers checking and savings accounts, personal loans, home equity loans, student loans and credit cards. Direct banking and payment services company that focuses on credit card issuing.

Deal Overview

On February 20th, 2024, the US banking sector experienced one of the largest M&A deals in years. The Virginian Capital One agreed to acquire the Illinois Discover Financial for $35.3billion.

Capital One (based in Virginia) agrees to acquire Discover Financial (based in Illinois) for $35.3 billion. Notwithstanding the agreement in place, the transaction is expected to be closed only by the end of 2024 or, latest, the beginning of 2025. The deal comprises all stocks of the target company, namely Discover Financial, and is expected to generate expense synergies of $1.5billion in 2027, yielding a return on invested capital of around 16% in 2027 (Financial Times, 2024).

The deal is set to combine two of the largest American credit card lenders. Capital One is currently the 9th largest US banks by assets (Forbes, 2024), managing around $468 billion (Capital One, 2024). On the other side, Discover Financial was the 33rd largest US bank at the end of 2023, with an asset side valued at $143.4 billion (S&P Global, 2023).

Capital One agreed on paying a premium of 27% on Discover Financial's stock price at the end of February 16th, 2024. The exchange ratio was set at 1.0192. In other words, Discover Financial's stockholders will receive 1.0192 shares of Capital One for every share they currently possess.

The acquisition of Discover Financial by Capital One is yet to be scrutinized by the US antitrust regulators. Fears are growing that concerns may be raised by the authorities due to the large size of the parties involved. This holds even more true considering the high insolvency risk faced by the credit card sector. Consumers have gradually spent much of their excess savings, resulting in relatively high risk of insolvency for lenders.

This transaction represents a big move by Capital One. After being under pressure following the collapse of Silicon Valley Bank in March 2023, the management managed to rebound the stock price, partly helped by the $1billion investment from Warren Buffett's Berkshire Hathaway.

Industry Overview

The US banking sector is extremely fragmented, with many players operating in a highly competitive environment. Capital One and Discover are two of the largest companies in the industry, behind the giants JP Morgan and Citigroup. The high fragmentation of the market suggests the absence of major deals, at least in recent times. The analyzed deal represents one of the biggest deals in the industry since the 2008 financial crisis. The last big merger between two banks occurred almost five years ago, when the regional lender BB&T bought SunTrust for around $28bn in a $66bn deal, giving life to Truist.

The banking sector was not the only one affected by lower M&A activity in 2023. Higher-than-the-average interest rates and stricter enforcement of antitrust regulation brought about a sharp decrease in the number of mergers and acquisitions around the world (Financial Times, 2024). However, few mega-deals were still signed. In this regard, it is worth mentioning the acquisitions of Pioneer Natural Resources by ExxonMobil for $60billion and of Ansys by Synopsys for $35billion.

Financial analysts have been expecting some consolidation dynamics in the banking industry, yet few large players managed to carry out acquisitions after the 2008 financial crisis. The difficulty of capturing synergies in this specific sector is considered one of the main reasons behind this lack of M&A activity. However, with expense synergies expected to be at around $1.5bn in 2027, the acquisition of Discover by Capital One may mark the beginning of a new consolidation era in the US banking industry.

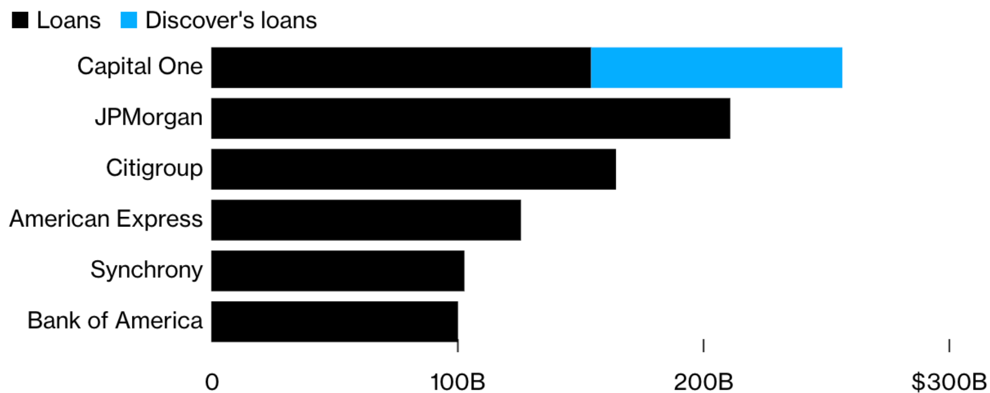
Deal rationale

The recent merger between Capital One and Discover is strategically driven by the aspiration to construct a globally competitive payments network. Despite boasting a strong global payments network spanning over 200 countries and territories and comprising 70 million merchant acceptance points, Discover remains the smallest among the four US-based global payments networks. Capital One's acquisition of Discover brings about a significant increase in scale and investment, strengthening Discover's competitiveness against the largest payments networks and companies in the industry. For Capital One, this merger represents a pivotal step in its endeavor to establish a global payments enterprise. By synergizing with Discover's extensive network, Capital One aims to expedite its longstanding pursuit of collaborating directly with merchants. This collaboration enables Capital One to leverage its expansive customer base, cutting-edge technology, and reliable data ecosystem to drive increased sales for merchants while concurrently offering enhanced value propositions to consumers and small businesses. Thus, the merger aligns with both companies' strategic objectives, propelling them towards the realization of their targets in a dynamic financial landscape.

The acquisition between Capital One and Discover is anticipated to yield significant synergies, with expected expense synergies of $1.5 billion in 2027, driven by common business functions and targeted investments in the Discover network. Additionally, network synergies of $1.2 billion in 2027 are forecasted due to the integration of Capital One's debit and selected credit card purchase volumes into the Discover network. The deal is projected to be over 15% accretive to adjusted non-GAAP EPS in 2027 and deliver a return on invested capital of 16%, with an internal rate of return exceeding 20%. Furthermore, the transaction will bolster Capital One's balance sheet, with a pro forma CET1 ratio of around 14% at closing and 84% of company deposits insured as of year-end 2023.

Revenue synergies

In integrating Capital One and Discover's complementary card businesses, the merger capitalizes on their established credit card franchises, each renowned for effective strategies and customer-centric approaches. With shared commitments to innovation and customer satisfaction, both entities have cultivated flagship products and brands, fostering resilient growth and returns. The merger enhances their collective capacity to deliver unparalleled products and experiences across consumer, small business, and merchant segments, solidifying their position as leaders in the credit card marketplace.



Moreover, the merger strengthens Capital One's "Digital First" national banking model by integrating Discover's thriving national direct savings bank. Capital One Bank, renowned for its fee-free and digital-centric approach, offers customers unparalleled accessibility through its branch network, ATMs, cash deposit locations, and Capital One Cafes. By expanding its reach through Discover's assets, including the Discover Global Network, the combined entity is positioned to rival the nation's largest banks and accelerate its national banking growth trajectory, offering customers an enhanced portfolio of digital banking solutions and services.

Cost synergies

Capital One aims to capitalize on its extensive eleven-year technology transformation by scaling and leveraging its benefits across all of Discover's operations and network. This transformation drives innovation, accelerates speed to market, and facilitates the development of breakthrough products and customer experiences. Additionally, it enables real-time customized marketing, faster growth, improved underwriting, enhanced efficiency, and superior risk management and compliance measures across the combined entity, thereby generating significant cost synergies.

Other synergies

Both Capital One and Discover demonstrate strong commitments to their communities, with Capital One displaying a notable track record of Community Reinvestment Act performance and community development lending, including a substantial investment in its Impact Initiative supporting various causes such as Affordable Housing and Workforce Development. Capital One also emphasizes its commitment to maintaining a strong presence in key markets like Chicagoland while upholding service excellence nationwide. Moreover, both Capital One and Discover have consistently earned recognition as exemplary workplaces, appearing on the Fortune 100 Best Companies to Work For® list multiple times, underscoring their dedication to fostering positive work environments and employee satisfaction.

Deal Structure

Acquirer (Capital One):

- Business Overview: Headquartered in McLean, Virginia, the Capital One Financial Corporation stands as a prominent American bank holding company. Its focus extends across a spectrum of financial services, encompassing credit cards, auto loans, banking, and savings accounts. While its operational footprint is primarily centered in the United States, Capital One has established itself as a key player in the financial industry.
- Financial Overview: total net revenue increased 7 percent to $36.8 billion.

Target (Discover):

- Business Overview: The Discover credit card is widely used in the United States. Its history dates back to 1985 when it was initially introduced by Sears. Subsequently, it was part of Dean Witter and Morgan Stanley until 2007. In that year, Discover Financial Services gained independence, becoming a separate company.
- Financial Overview: In 2022 the company made a revenue of $13.31. With a growing turnover since the onset of the pandemic, Discover has captured the attention of potential investors and buyers.

Deal Value: "The transaction, valued at $35.3 billion, underscores its substantial scale and strategic significance. Diverse elements, such as the competitive environment, financial positions of the involved parties, and projected synergies, play a role in shaping this evaluation."

Deal Type: Classified as a strategic amalgamation, the deal accentuates the expected creation of long-term value and operational advantages arising from the acquisition of Discover from Capital One. Operational gains are extended through a distinct arrangement in the shape of a divestiture.

Stock Structure: According to the agreement, Discover shareholders will receive 1.0192 Capital One shares for each Discover share, a premium of 26.6% compared to Discover's closing price on Friday. The acquisition of Discover will help "build a payment network capable of competing with the largest payment networks and companies," said Capital One's founder and CEO, Richard Fairbank, in a statement. Once the deal is completed, Capital One shareholders will hold approximately 60% of the combined company, while Discover shareholders will hold about 40%.

Risks and Implications

Short Term

In the short term, the merger of Capital One and Discover may encounter immediate customer attrition risks. There could be an increase in account closures or a decline in credit card usage as a result of clients' concerns about changes to fees, rewards programmes, or other terms following the merger. Additionally, the efficiency of customer assistance may suffer from higher call volumes and longer wait times brought on by the consolidation of customer service activities. Short-term financial concerns are also involved. The merging organizations may incur higher transaction and integration costs, including as severance payments for redundant employment, legal fees, and consultant expenditures. These up-front expenses may put pressure on the newly established entity's finances and have a short-term negative effect on its profitability. Furthermore, because billing and accounting systems are interconnected, revenue recognition issues could cause short-term problems with financial reporting. Another short-term effect is an increase in market rivalry. While the merging companies concentrate on internal integration, rivals can take advantage of the chance to draw in disgruntled

clients or increase their market share. The combined company may be less able to react quickly to innovations and developments in the market as a result of the management's temporary distraction from regular tasks. Finally, there is an increased risk of cybersecurity during the first stage of integration. Cybercriminals have an easier time targeting a larger and more appealing target when data from both businesses is combined. During the merger process, it is essential to guarantee the smooth integration of cybersecurity processes in order to safeguard confidential customer data and uphold client confidence. Essentially, the merger's short-term dangers go beyond financial and operational issues and include issues with client retention, competitive dynamics, and cybersecurity vulnerabilities.

Long Term

The merger of credit card companies can pose various long-term risks. One potential challenge lies in the intricacies of integrating systems and technological platforms, which may lead to service disruptions or data loss, consequently affecting the overall customer experience. Customer dissatisfaction during the merger process may prompt clients to switch credit card providers, resulting in a lasting negative impact on revenue streams. Additionally, inheriting a risky credit portfolio from one of the merging entities may expose the new company to heightened credit risks. Cultural disparities between the involved companies could give rise to internal tensions, impacting employee productivity and morale. Strict regulatory requirements governing the credit card industry may necessitate the adaptation to new regulations during a merger, with failure to do so potentially resulting in sanctions or fines. Furthermore, the anticipated synergies and cost savings from the merger may not materialize, diminishing the expected economic benefits. The dynamic nature of the financial sector, characterized by rapid changes and innovations, poses another risk. Mergers may fail to adequately account for these shifts, leaving the new entity vulnerable to unforeseen developments. Finally, economic fluctuations, interest rate changes, and other market risk factors can exert a negative influence on the long-term financial outcomes of the merged company.

Market reaction

The planned merger of Capital One and Discover has the potential to drastically alter the credit card issuer market if it can successfully negotiate the difficult approval procedure by regulators and shareholders. As these two enormous financial companies come together, their rivals—Visa, Mastercard, and American Express in particular—will unavoidably have to figure out how to compete with a stronger opponent. There could have a significant impact on market dynamics; industry analysts predict a change in the competitive landscape. Capital One would have a stronger market position as a result of the merger, enabling it to offer customers more alluring bonuses and benefits.

This newfound power may cause a domino effect in the market, forcing other credit card companies to review and improve their own products in order to remain competitive.

Being titans of the business, Visa, Mastercard and American Express, may be most affected by this combination. They might be forced to reconsider existing tactics and even introduce new ones in order to preserve their hegemony due to the heightened competition. In an attempt to fend off Capital One and Discover's combined power, these industry titans may roll out fresh, cutting-edge features, incentive schemes, or technological improvements in an effort to hold onto their clientele. As businesses compete to offer better value than their rivals, customers could gain from this competitive response across the board.

In conclusion, the credit card sector would probably see a dynamic and competitive environment following the approval of the merger between Capital One and Discover. To remain competitive and relevant, the competitors would have to reevaluate existing approaches and encourage innovation and new products. Consumers would emerge as the ultimate winners in this scenario, and they may anticipate a plethora of enhanced bonuses, perks, and innovations as credit card issuers compete for their business in this altered environment.

Deal Advisors

Discover
Financial advisors: PJT Partners, Morgan Stanley & Co
Legal advisor: Sullivan & Cromwell

Capital One
Financial advisor: Centerview Partners
Legal advisor: Wachtell, Lipton, Rosen & Katz

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