Capital One & Discover Acquisition Report

Kathy, Lillian, Moyi, Joya

Research Report | 8/7/2024

NEW EIC

Table of Contents

1. Event overview

1.1 Company Overview

1.1.1 Capital One Introduction

Capital One Financial Corporation (NYSE:COF) is a diversified financial services company. The company's primary business is to provide a broad range of financial products and services to consumers, small businesses and commercial customers through branch offices, the Internet and other distribution channels. It operates primarily through three segments: Credit Card, Consumer Banking, and Commercial Banking. Financial services are provided to users through digital channels, outlets, ATMs and Capital One cafes. Through its two principal subsidiaries, Capital One Bank (USA), National Association ("COBNA") and Capital One, National Association ("CONA"), it operates in the United States, Canada and the United Kingdom.

In 2019, the company had assets of $390.4 billion, net operating income of $28.6 billion (compound annual growth rate of 17% from 1994-2019), Non-GAAP net income of $5.2 billion, and pre-provision profit of $13.1 billion. As of the third quarter of last year, Capital One is the 12th largest bank in the U.S., with 40 million clients, total assets of $471.4 billion, deposits of $346 billion and a market capitalization of $52.2 billion, according to S&P Global. The chart below shows Capital One's credit card net revenue and net income from 2010 to 2019. In recent years, the company's net revenue CAGR has been 6.3%, while net profit has **fluctuated throughout**.

1.1.2 Discover Introduction

Discover Financial Services (NYSE:DFS) was founded in 1960 as a credit card company under Morgan Stanley and is the largest independent credit card network in the United States. Discover Financial Services, through its subsidiaries, operates as a digital banking and payment services company in the United States. Discover Financial Services is divided into two segments, Digital Banking and Payment Services. According to S&P Global, as of the third quarter of last year, Discover is the 33rd largest bank, with 8 million customers, $143.4 billion in assets and $104 billion in deposits, and a market capitalization of $27.6 billion.

On July 21st, **RBC Capital maintained Discover's rating in line with the sector**, with a new price target of $148.00. Discover Financial announced on May 1 that for the quarter ended March 31, 2024, the company had revenue of $4.210 billion, 12.51% of the same period last year, net income of $308 million, and basic earnings per share of $1.10.

1.2 Industry Research Analysis

1.2.1 The past of credit cards

The first credit card for the general public appeared in the 1950s. In 1958, Bank of America launched BankAmericard in Fresno, California, which became the first successful modern credit card. In 1966, another group of banks formed Master Charge to compete with BankAmericard, and the forerunner of MasterCard was born. Early credit cards in the US were issued in bulk and actively mailed in large numbers to bank customers who were considered low risk. These mass-issued cards, which were not systematically risk assessed, were banned in 1970 because they were prone to financial disruption and the proliferation of defaulted debt. The modern credit card system was born in 1973 under the leadership of Visa's first CEO, Dee Hock, through computerisation, which reduced transaction times and increased efficiency. In 1976, all of BankAmericard's acquiring banks joined together under a single brand name, Visa, which is now one of the largest credit card organisations in the world. Today, in the world's major economies, credit cards are often closely linked to the social credit system; for example, in the United States, failure to make the minimum payment by the date specified by the bank and the subsequent grace period can result in a default on the credit record, which in turn affects the credit score.

1.2.2 The Present of Credit Cards

The main business of both Capital One and Discover is the credit card industry. Capital One is a credit card issuer, while Discover is a type of card. Credit card issuers supply credit cards to cardholders who can use them to make purchases from merchants and obtain a line of credit. Cardholders must pay their bills on time or be charged interest and fees. The US credit card industry is a mature and competitive industry, characterised by high profit margins and strong growth. The industry is dominated by a handful of large issuers, including Capital One, Chase, Bank of America, Discover, J.P. Morgan and others.

Of all the financial institutions in the country (Figure 1.2.2.1), Chase issues more credit cards than any other institution, with more than 149 million cards in circulation. This figure is significantly higher than the second largest issuer, Capital One, which has 106 million cards. Of the four main types of credit card (Visa, Mastercard, American Express and Discover), Visa is the most widely used, accounting for 58.3% of cards in circulation. In addition, Visa far outpaces the other payment networks in terms of purchase volume, processing more than twice as many transactions as Mastercard. American Express and Discover process only a fraction of the volume that Visa processes each year.

Forbes published its Credit Card Statistics And Trends 2024 report in March. The report's Credit Card Debt Statistics section shows that by the end of 2023, the average credit card debt per borrower will be a record $6,360, about 10% higher than the previous year due to possible inflation or other financial pressures. This shift, which could be due to inflation or other financial pressures, marks a move in the wrong direction, representing $50 billion in new debt in one quarter and $1.13 trillion in total credit card debt in the United States.

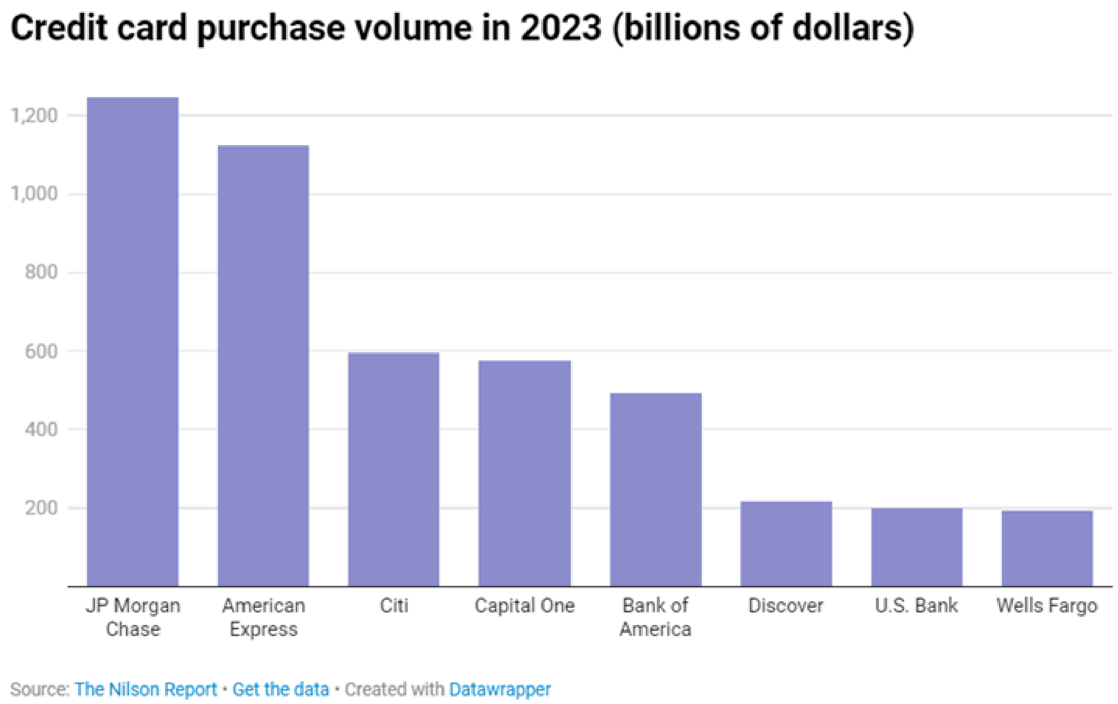

Figure 1.2.2.1 Credit Card Purchase Volume in 2023 (billions of dollars)

Data Source：The Nilson Report

There are a number of other notable points in the report:

According to TransUnion, the total number of credit card accounts in the world will exceed 542.6 million by the end of 2023, meaning that the credit card market has become a **major** means of spending globally. Within the US, the median credit card debt is highest among 55 to 64 year olds and the average debt is highest among 65 to 74 year olds at $3,500 and $7,720 respectively, and more than 90% of consumers choose to swipe a card over cash for everyday purchases. In terms of credit card ownership, the number of cards varies by generation, with older generations tending to have more credit cards. By 2022, members of Generation Z will have just 2.1 credit cards, compared to 4.6 for Baby Boomers. This is a logical progression as people are likely to apply for new accounts throughout their lives.

Looking at demographics, the number of credit cards used and held is positively correlated with annual income and related to ethnicity and educational attainment, and as shown in Figure 1.2.3. 1, with card prevalence reaching over 90 per cent of households with an income of $50,000 or more and 96% of those with a Bachelor's degree or higher. When it comes to race, Asians lead the way with 92% using credit cards, followed by Whites at 87%, Hispanics at 73% and finally Blacks at 71%.

1.2.3 The future of credit cards

Having looked at the present, the future of credit cards should also be given high priority. The credit card industry is strongly linked to **interest rates** - as the base rate fluctuates and rises, so does the APR on credit cards. As of February 2024, the average annual percentage rate (APR) on credit card accounts where cardholders carry a balance is 22.63%, up from 16.98% in 2019, so this rate is trending upwards. In the event of an unexpected job loss or other financial setback, this means it's more expensive to carry a balance and more difficult to pay off debt. **The industry has seen a wave of consolidation in recent years as smaller issuers struggle to compete with larger rivals.** This trend is likely to continue, as the merger of Capital One and Discover could lead to further deals.

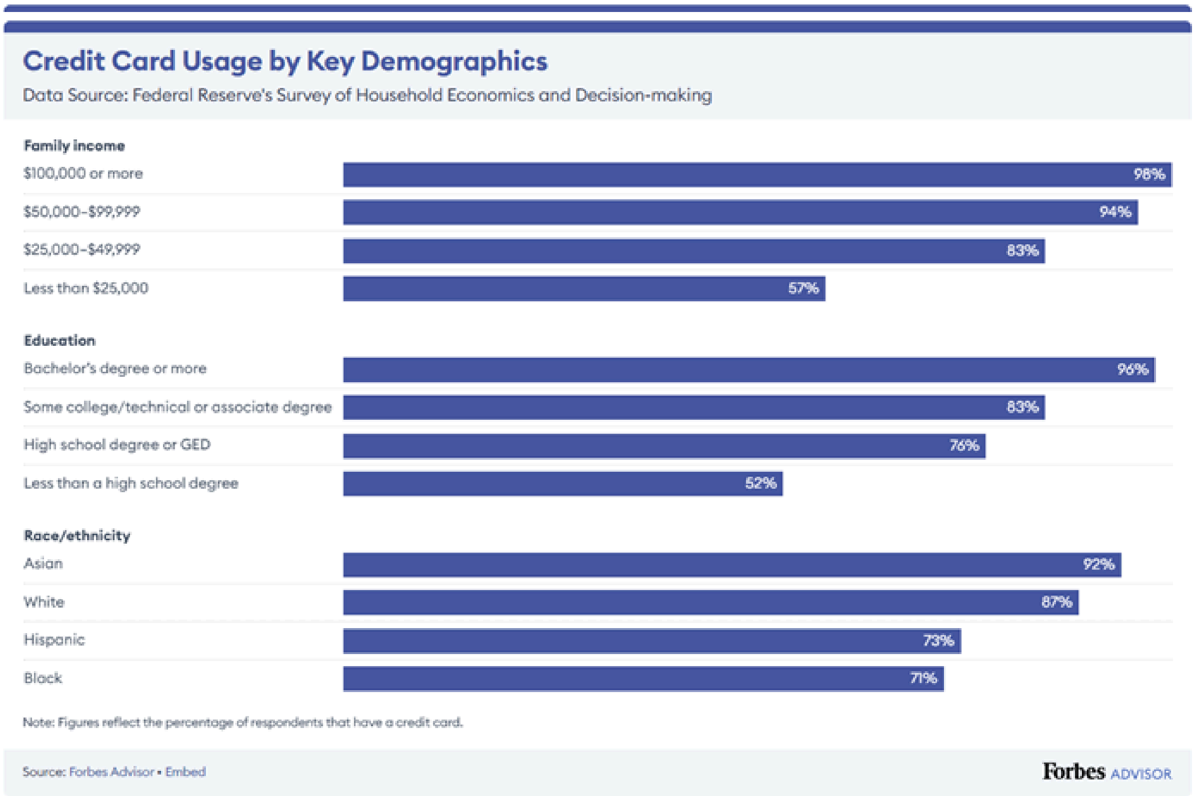

Figure 1.2.3.1 Credit Card Usage by Key Demographics

Data Souce：Forbes Advisor

2. The pre-acquisition stage and process

2.1 Process Overview

On February 19, 2024, major news reported that Capital One Financial Corporation was planning to acquire Discover Financial Services for $35.3 billion in the form of all-stock. If the proposed acquisition passes anti-monopoly supervision, the combined new bank would become the sixth-largest in the United States by assets. Under the terms of the acquisition, Capital One will pay Discover's existing shareholders in the form of an all-stock payment of 1:1.0192. This means that Discover shareholders will receive 1.0192 Capital One shares for each share. Based on the closing price of February 16th ($110.49), the proposed acquisition offers a premium of 26.6%.

From the perspective of payment, the acquisition of Capital One is the identity of a card issuer, and the acquisition of Discover, which advocates a tripartite payment model and has the role of both a card issuer and a card organization.

The transaction will be completed in late 2024 or early 2025, at which time three members of Discover's board of directors will join Capital One's board. Additionally, Capital One's original shareholders will own 60% of the new company, and Discover's original shareholders will own the remaining 40%. Upon completion of the transaction, Capital One will quadruple its credit card user base to 305 million, while taking a 19 percent share of the $1.3 trillion revolving consumer loan market. The combined deal would make it the largest U.S. credit card company by loan volume, surpassing longtime rivals JPMorgan Chase and Citigroup.

On March 4, Capital One and Discover said the transaction is expected to generate $1.5 billion in fee synergies by 2027. A 16% return on invested capital (ROIC) will be achieved in 2027, while the internal rate of return (IRR) will exceed 20%.

2.2 Reasons for the Acquisition

Next, we will analyze the possible reasons for this acquisition from four specific aspects.

Reason 1: Market Competition and Market Share

This merger will integrate two well-known consumer finance brands, and the combined U.S. credit card loan balance will surpass long-term competitors such as JPMorgan Chase and Citigroup. This merger is not only about expanding scale but more importantly, it involves a strategic layout in the global payment network, which will make it a strong competitor to credit card companies like Visa and Mastercard. The acquisition of Discover by Capital One not only strengthens its market share and financial market capital investment in the U.S. credit card market but also significantly enhances Capital One's competitiveness in payment networks. By integrating Discover's payment network, Capital One will be able to deal directly with merchants, reducing its dependence on Visa and Mastercard, thereby enhancing its overall competitiveness.

The market reaction on the day Capital One publicly announced the acquisition of Discover shows that the stock market is very optimistic about the future prospects of this acquisition. From the stock price chart of Capital One, it can be seen that on February 20th, the stock price reached a peak after continuous rises. In contrast, investors are clearly more optimistic about Discover's future development after the acquisition—on the same day, Discover's stock price rose by 12.61%, and the closing price was nearly $1 higher than the opening price, proving that the market is confident in this merger.

Figure 2.2.1 Capital One and Discover Stock Prices on February 20, 2024

Reason 2: Fee Reduction

Currently, Capital One's credit cards mainly use Visa and MasterCard, so they need to pay an interchange fee (about 1.5% per transaction) to Visa and Mastercard. After acquiring Discover, Capital One will gradually convert its credit cards to Discover cards, thus saving on the interchange fee.

Reason 3: Geographic Expansion

Discover has a larger business scale in international markets than Capital One, especially in the Asia-Pacific region. Through this acquisition, Capital One can quickly enter these emerging markets, expand its business to new markets, and increase its international revenue. Additionally, by integrating Discover's international business, Capital One can further optimize its global operational network, enhancing the synergy of transnational operations and overall competitiveness.

Reason 4: Customer Base

Discover has a high-quality customer base with high credit ratings, which is highly attractive to Capital One. According to Standard & Poor's global ratings, Discover has a long-term issuer rating of A+ with a stable outlook. A high credit rating means lower credit risk and higher profit potential, which is exactly what Capital One has been striving to enhance. Through this acquisition, Capital One can quickly improve the overall credit quality of its customer base and reduce risk exposure. Moreover, Discover also has a strong digital business, which will help Capital One expand its online products and services, enhance customer experience, and market competitiveness. By integrating Discover’s digital business, Capital One can further strengthen its leading position in the digital finance sector, attracting more high-quality customers.

Discover Bank			
	Standard & Poor's[1]	**Fitch**	**Moody's**
Senior Debt	BBB	BBB+	Baa1
Subordinated Debt	BBB-	BBB	Baa1
Outlook	Positive	Positive	Under Review[2]

Discover Financial Services			
	Standard & Poor's[1]	**Fitch**	**Moody's**
Senior Debt	BBB-	BBB+	Baa2
Preferred Stock	BB-	BB	Ba1(hyb)
Outlook	Positive	Positive	Under Review[2]
Credit Opinion Date / Last Rating Action	2/21/24	2/21/24	2/20/24

[1]For additional information related to Standard & Poor's credit ratings of Discover Financial Services and Discover Bank, please visit the following link (subscription required): https://www.globalcreditportal.com/ratingsdirect/Login.do

Figure 2.2.2 Relevant ratings for Discover at the end of 2023

Reason 5: Enhanced Technological and Innovative Capabilities

Discover has certain technological advantages in the financial technology field, especially in payment technology and risk management. By acquiring Discover, Capital One can gain advanced technology and innovative capabilities, thereby enhancing its own technological level and innovative capacity. This will help Capital One maintain competitiveness in the constantly evolving fintech environment and better meet future challenges.

2.3 Benefits of the Acquisition

2.3.1 Payment network expansion and synergies

Capital One's acquisition of Discover is not only a combination of two major credit card companies, but also a deep integration of the payment network, as Discover not only has a strong track record in rewards credit cards but also its '**cash back**' model is well received by consumers. Capital One has an advantage in **retail banking**, with a large customer base and a wide range of products. The combination will create a stronger payments network and provide customers with more comprehensive financial services.

- **Data support:** According to the Nilson Report, Capital One is valued at $52.2 billion by volume in 2022, ranking fourth in the US credit card market, while Discover is ranked sixth. Combining the two companies would significantly increase their market share and strengthen their competitive position against giants such as Visa and Mastercard.
- **Diversified product lines:** The combined company will be able to offer customers a more versatile portfolio of products, including credit cards, debit cards, personal loans, business loans and more. For example, Discover's rewards credit cards could be cross-sold with Capital One's retail banking products to attract more customers.
- **Expanded payment coverage:** By integrating the two companies' payment networks, the combined company will be able to reach a wider range of merchants and consumers and increase transaction volumes.
- **Cost savings:** The combined company is expected to realise significant cost savings and improve profitability by consolidating operations and sharing infrastructure.

The combined company will be able to offer consumers, small businesses and retailers financial solutions from one source. Consumers will enjoy a wider selection of products, more personalised services and more attractive rewards programmes. Small businesses will have access to a broader range of financial services, including loans, payment processing, business credit cards and more. Merchants will benefit from lower transaction fees and a broader customer base.

Capital One expects the transaction to generate $2.7 billion of synergies in 2027, including $1.5 billion of operational marketing expense synergies and $1.2 billion of payment network synergies. Upon completion of the merger, adjusted non-GAAP earnings per share growth in 2027 is expected to be **15%**, with a return on capital of **16%** and an internal rate of return (IRR) of **20%**. This suggests that the acquisition will not only enhance the company's competitiveness in the marketplace, but will also generate strong returns for shareholders.

In addition to creating value for shareholders, the ability to weather economic cycles can be enhanced by completing the merger and integrating the two companies. **With diversified products and services and a broader customer base, the combined company will be more resilient to risk and better able to cope with fluctuations in economic cycles.**

2.3.2 Significant increase in profitability

Even if the deal is approved and Capital One successfully completes the merger, it is unlikely that the combined company's business will pose a real threat to Visa and MasterCard, given their continued global dominance. But there’s no doubt that the deal will further strengthen Capital One's balance sheet. According to the publicly available balance sheet in Capital One's 2023 annual report (Table 2.3.2.1), non-interest income increased by $410 million to $7.5 billion in 2023 compared to 2022, primarily due to higher treasury income as a result of higher interest rates and higher net interchange fees as a result of higher purchases; net interest income (Table 2. 3.2.2) increases by $2.1 billion to $29.2 billion, primarily as a result of an increase in the average outstanding balance of the credit card loan portfolio and an increase in the yield on assets, partially offset by an increase in the cost of funds. From the data below, it can be concluded that **if the merger and acquisition had been successful in 2024, the growth in the relevant balance sheet items would have exceeded the performance in 2023.**

Table 3: Non-Interest Income

(Dollars in millions)	Year Ended December 31, 2023	2022	2021
Interchange fees, net	$ 4,793	$ 4,606	$ 3,860
Service charges and other customer-related fees	1,667	1,625	1,578
Net securities gains (losses)	(34)	(9)	2
Other(1)(2)	1,120	914	824
Total non-interest income	$ 7,546	$ 7,136	$ 6,264

Table 2.3.2.1 The Non-interest Income of Capital One in 2023

Data Source：Capital One Annual Report 2023

Table 2: Rate/Volume Analysis of Net Interest Income(1)

(Dollars in millions)	2023 vs. 2022 Total Variance	Volume	Rate	2022 vs. 2021 Total Variance	Volume	Rate
Interest income:						
Loans:						
Credit card	$ 6,641	$ 3,584	$ 3,057	$ 4,152	$ 2,324	$ 1,828
Consumer banking	259	(215)	474	(22)	477	(499)
Commercial banking(2)	2,661	29	2,632	1,583	454	1,129
Other(3)	(1,061)	—	(1,061)	(1,066)	—	(1,066)
Total loans, including loans held for sale	8,500	3,398	5,102	4,647	3,255	1,392
Investment securities	666	(31)	697	438	(115)	553
Cash equivalents and other interest-earning assets	1,535	476	1,059	383	(20)	403
Total interest income	10,701	3,843	6,858	5,468	3,120	2,348

Table 2.3.2.2 Capital One's rate/total net interest income in 2023

Data Source：Capital One Annual Report 2023

Based on public data from Yahoo! Finance, it is possible to compare the acquisition with the two giants of the credit card industry (Visa and Matercard). By analysing and comparing the data, it can be seen that the acquisition will increase the earnings and balance sheet profitability of both parties.

- **First**, through the linear comparison analysis, Table 2.3.2.3 shows that the market value of Capital One and Discover is relatively small, and the market size of Visa and Mastercard is much larger than the former two, reflecting the dominant position of Visa and Mastercard in the payment industry;
- **Second**, the P/E ratio of Capital One and Discover is relatively low, indicating that investors are relatively optimistic about the future earnings growth of these two companies; Discover has the highest dividend yield, indicating that it is more willing to pay dividends to shareholders, while Capital One's dividend yield is in the middle

range and Visa and Mastercard's lower dividend yields may be related to their greater focus on reinvesting in business expansion.

- **Third**, the share prices of both Capital One and Discover have outperformed Visa and Mastercard over the past year, which may be related to the market's favourable view of Capital One's acquisition of Discover; Capital One's and Discover's relatively low free cash flow suggests that they have a greater need for cash that can be used for investments, acquisitions or debt repayment.
- **Fourth**, Visa's and Mastercard's net profit margins are significantly higher than those of Capital One and Discover, suggesting that Visa and Mastercard are more profitable for investors; Discover has the highest operating margins, indicating that its core business is the most profitable, meanwhile Visa and Mastercard also have much higher operating margins than Capital One;
- **Fifth**, Visa's and Mastercard's price-to-book ratios are much higher than Capital One's and Discover's, indicating that investors value their assets more highly; Capital One's and Visa's earnings per share grew faster, while Discover's earnings per share declined significantly, which may be related to industry cycles or internal company factors.

Based on the above data, the combination of Capital One and Discover is expected to significantly strengthen their position in the payments industry and close the gap with Visa and Mastercard. By integrating their strengths in rewards programmes, payment networks, data analytics and other areas, the new company is expected to achieve significant synergies. For example, Discover's higher operating margin of 35.74% indicates strong profitability in its core business, while Capital One's larger market size and diversified product lines can provide more solid support for the new company. Following the merger, the new company's free cash flow will increase significantly, providing sufficient funds for future business expansion. For instance, Capital One's free cash flow of $1.962 billion and Discover's of $832 million would be nearly $3 billion after the merger.

Of course, the latest **trends in the payments industry** must also be taken into account. Rapidly evolving technologies such as contactless payments, digital wallets and blockchain are fundamentally changing the face of the payments industry. By integrating the technological capabilities of both parties, the new company will be able to accelerate its layout in these emerging areas and seize the first opportunities in the market. In addition, changes in **regulatory policies** will also have a significant impact on the payments industry. New companies will need to pay close attention to regulatory trends and adjust their strategies in a timely manner.

While Visa and Mastercard still have the advantage in terms of market share and brand influence, **the merger of Capital One and Discover will disrupt the existing market landscape and bring a new competitive landscape to the payments industry.** The P/E ratios of the new companies are relatively low, e.g. 14.02 for Capital One and 12.58 for Discover, suggesting that the market is **optimistic** about their future growth potential. As the merger progresses and synergies are gradually realised, the new company is expected to capture a larger share of the payments market and pose a greater challenge to Visa and

Mastercard. **The new entity would be worth over $90 billion, nearly half Visa's market value.**

In summary, the merger brings new variables to the payments industry. By leveraging each company's strengths, accelerating development in emerging areas and actively responding to changes in the industry, the new company is expected to differentiate itself in a highly competitive marketplace and create greater value for shareholders.

As of 2024/7/30	COF	DFS	V	MA
Market Value	57.88B	36.09B	513.84B	415.41B
Price to Earnings	14.02	12.58	28.01	35.08
Forward Dividend&Yield	2.40(1.61%)	2.80(1.96%)	2.08(0.80%)	2.64(0.60%)
Price Performance (1 year)	34.60%	41.38%	12.88%	14.39%
Free Cash Flow	19.62B	8.32B	18.96B	10.62B
Profit Margin	13.13%	13.49%	54.72%	46.09%
Operating Margin	20.16%	35.74%	66.95%	58.47%
Forward Price to Earnings Per Share	14.02	12.58	28.01	35.08
Price to Book Value Per Share	0.98	2.22	13.29	56.64
EPS 1Yr Growth	35.50%	-69.01%	20.00%	30.36%

Table 2.3.2.3 Side-by-side comparison of profitability performance of four companies - Capital One, Discover, Visa, Mastercard - in 2023

Data Source：Yahoo! Finance

2.4 Risks of the Acquisition

2.4.1 Supervisory review

The FDIC and the Department of Justice warned the banks that the deal would be subject to heightened and slower regulatory scrutiny because of the size of the two banks' assets. The merger was also heavily criticised in Congress, which argued that **the transaction would increase concentration in the banking industry.**

Capital One Bank wrote off $31 million in integration costs during the quarter related to the bank's expected acquisition of Discover. Capital One CEO Richard Fairbank said on a conference call with analysts on Tuesday (16 July, 2024) that he was confident the $35.3

billion deal would close by the end of this year or early next year, pending regulatory approval. The earnings announcement came a day after two Capital One customers filed a class-action lawsuit on behalf of the states of Vermont and New Jersey. The plaintiffs are seeking to block Capital One's acquisition of Discover on the grounds that the deal would raise prices, stifle competition and violate antitrust laws. The plaintiffs argue that the presence of Discover and American Express puts pressure on the leading credit card networks, Visa and Mastercard, to pay rewards to their customers in order to remain competitive. If the acquisition goes through, the plaintiffs say, "that competitiveness will be severely diminished". Capital One Bank portrayed the deal as pro-competitive, claiming that the merger with Discover would give it the scale needed to compete with Visa and Mastercard.

But lawyers say the deal is certain to face antitrust scrutiny because it would create the largest credit card issuer and the sixth-largest bank by assets in the United States. Massachusetts Senator Elizabeth Warren said in remarks on social media X that a merger that makes already powerful financial firms even bigger and more powerful will not benefit ordinary families. Democratic lawmakers including Warren, such as Representative Maxine Waters of California, have called on regulators to block the deal, using arguments similar to those in the lawsuit. Waters spoke on Friday at an all-day public hearing on the Capital One-Discover deal held by the Federal Reserve and the Office of the Comptroller of the Currency. Community groups, business owners and individual cardholders expressed both support and criticism of the potential merger in dozens of public comments on Friday.

2.4.2 Customer churn

Customer churn is a significant challenge that Capital One may face following the acquisition of Discover. The combined entity may lose customers for a number of reasons. In terms of brand loyalty, some Discover customers may be extremely loyal to the brand and may find it difficult to accept a change. In terms of product and service differences, there are differences between the two companies in terms of product lines, service quality and rewards programmes. Customers may choose to leave if the merger does not continue to meet their individual needs. At the same time, systems integration and business adjustments during the merger process can lead to service disruptions, inconvenience and customer dissatisfaction. Of course, mergers and acquisitions also have information security implications, and customers may be concerned about the security of their personal information, fearing an increased risk of information leakage after the merger.

Customer churn will negatively impact the combined company in a number of ways. Firstly, it will lead to a reduction in revenues and churn will have a direct impact on the profitability of the business. Second, the loss of market share. A large loss of customers will weaken the company's competitiveness in the market, resulting in a loss of market share. Finally, there is damage to the brand image, customer loss events may trigger negative public opinion, damaging to the company's brand image. According to current public data, as of 22 July 2024, since Capital One announced its acquisition of Discover on 20 February, neither company has yet released specific information about the impact of the deal on its customer base. However, industry analysts have offered varying predictions, with analysts at S&P Global Market Intelligence suggesting that Capital One could lose **up to 5 million** Discover credit card customers. Other analysts believe the loss will be smaller, around 1 to 2 million customers.

The actual customer loss after the merger will therefore depend on a number of factors. How the combined company manages its brand, products and services will have a direct impact on customer retention. The ability to communicate with customers in a timely and effective manner to address their concerns will have a significant impact on customer churn. At the same time, not only the company needing a structural business adjustments, but whether competitors seize the opportunity to aggressively pursue lost customers will also affect the level of customer churn.

2.4.3 Execution risk

There are execution risks associated with any M&A transaction, and the acquisition of Discover by Capital One is no exception. The successful integration of the two companies will be key to realising the expected benefits of the transaction. However, historical data suggests that the execution of large financial institution M&A transactions is often challenging. According to a McKinsey report, more than **70%** of M&A deals fail to deliver the expected synergies.

Execution risks to the integration of Capital One and Discover include, but are not limited to, culture clashes and the complexity of systems integration. As the two companies may have different corporate cultures, business philosophies and risk appetites, failure to effectively manage cultural conflicts could result in employee turnover and low morale, which could impact the integration process. In addition, financial institutions' IT systems are often highly complex and interconnected. Successful system consolidation requires a significant amount of time and resources, and any technical failures or compatibility issues can lead to business disruption and increased costs.

3. Impact of the Acquisition

3.1 Long-term Goals and Strategic Vision

Capital One's long-term goal is to create **a globally competitive payment network** by leveraging Discover's infrastructure and expanding its digital banking business coverage.

By owning a payment network, Capital One aims to negotiate better terms with merchants and possibly transfer some of its credit card volume to the Discover network, thereby increasing its scale and profitability. Capital One also commits to not closing any branches post-merger and will continue to open more branches in low-income communities. The bank promises that one-third of its branches will be located in low-to-moderate income census tracts and plans to open more Cafes in these communities—branches that serve as community centers, coffee shops, and meeting spaces. This merger will significantly expand global acceptance points, currently totaling 120 million. This growth is primarily attributed to Discover's existing 70 million global acceptance points. Capital One will leverage this extensive network to enhance its global influence and compete more effectively with major players like Visa, Mastercard, and American Express. The increased acceptance points will foster more partnerships with merchants and expand customer reach.

Over twenty years ago, Capital One proposed **a data-driven strategy** (Information-Based Strategy) utilizing data technology and scientific testing to offer differential pricing to users, meeting diverse and personalized customer needs.

A key factor in the success of this strategy is its ability to quickly integrate acquired businesses. In July 1998, Capital One acquired Summit Acceptance Corporation (Summit) to enter the auto loan sector. Additionally, in January 2005, Capital One acquired the auto loan company Onyx Acceptance Corp and swiftly integrated Onyx's operations into Capital One's auto finance business. The integration was completed by the end of October, with all Onyx's systems and business processes transferred to Capital One's auto finance platform. After deploying the PeopleSoft ERP platform, Capital One successfully reduced system migration costs and effectively saved resources. Currently, Capital One is one of the largest auto loan companies in the United States.

The merger of these two major consumer finance companies, beyond increasing Capital One's bank deposits and loan accounts, fundamentally provides Capital One with access to Discover's payment processing network. The announcement states that post-merger, the parties will create a global payment platform expected to generate $2.7 billion in synergies by 2027, including $1.5 billion in operational marketing expense synergies and $1.2 billion in payment network synergies. For both companies' current credit card brands, Discover CEO and President Michael Rohdes stated that both have specialized operations in the credit card business with complementary strategies. The merged credit card business will be in a better position to offer industry products and experiences to consumers, small businesses, and merchants, providing attractive returns for shareholders through economic cycles.

Simultaneously, Capital One is committed to building **a technology-driven bank** by recruiting tech talent, establishing digital labs, and focusing on AI and full cloud adoption. Based on the information strategy, IT managers can participate in the company's planning decisions. Capital One CIO stated, "Since everything we do is digital, technology becomes the company's core." By acquiring Discover, Capital One absorbs Discover's payment network framework, enhancing its position in the payment ecosystem and expanding its payment network coverage, making it a competitor to Visa and Mastercard.

3.2 Changes in Corporate Structure

3.2.1 Changes in Existing Products

Currently, both Capital One and Discover offer cashback, travel rewards, small business, student, and secured card products, along with some co-branded products. In the investor presentation following the announcement of the merger, Capital One indicated that Discover's credit card product line would "complement and enhance" its existing card collection. Although both companies offer similar types of cards, there are significant differences in product offerings. For example, Discover does not have a premium travel rewards card, whereas Capital One offers the Venture X Rewards Credit Card. Similarly, while Capital One offers a variety of cashback card options, it does not have a rotating category card like the Discover it® Cash Back. These cards with significant differences may continue to be part of the merged card portfolio. Even if some cards are eventually discontinued, existing cardholders can continue to use their cards or be transitioned to structurally similar new cards.

3.2.2 Changes in Underwriting Policies

Underwriting refers to the approval process used by issuing institutions to determine which applicants qualify for their credit cards. Credit card issuers typically do not provide detailed information about their underwriting processes, and Capital One and Discover are no exceptions. For example, Capital One is quite strict when approving individuals with a large number of recent credit inquiries, while Discover does not have a similar policy. Capital One also limits an individual to having no more than two personal Capital One cards at a time, and only approves one card every six months. It is unclear how Capital One will handle applications for Discover cards, assuming the merger goes through, but this is a factor to consider for future applications.

3.2.3 Impact on Company Personnel Structure

Discover particularly emphasizes the importance of retaining employees with many years of experience and expertise, referred to as “Dawners.” The departure of these long-serving employees would have a significant impact on the company's operations. Capital One has mentioned the possibility of layoffs and severance costs, indicating their concern about employee turnover during the integration process and anticipating additional expenses to retain these key employees. Capital One stresses that successfully integrating Discover’s corporate culture is crucial to the success of the transaction. However, the integration process could lead to the loss of key personnel, posing risks to the company's operations and cultural unity. The challenges of cultural integration may cause uncertainty about future roles for Discover employees, thus affecting employee morale and retention rates.

3.3 Impact of Capital One's Acquisition on Shareholders

3.3.1 Premium and Ownership Structure

Discover shareholders will receive **1.0192** shares of Capital One stock for each Discover share, a **26.6%** premium over Discover's closing price before the announcement. This all-stock transaction will result in Capital One shareholders owning approximately 60% of the merged company, while Discover shareholders will own about 40%.

3.3.2 Financial Synergies and Cost Control

Capital One expects the acquisition to generate **$2.7 billion** in pre-tax synergies. These synergies are expected to come from operational efficiencies and cost reductions, particularly in technology and compliance. By 2027, the transaction is expected to increase adjusted non-GAAP EPS by over 15%, with a return on invested capital (ROIC) of 16% and an internal rate of return (IRR) of over 20%.

3.3.3 Impact on Shareholders

Following the announcement of fourth-quarter profit declines, the company's stock price plummeted. Since the acquisition announcement, Discover's stock price has been rising, gaining **18%** in pre-market trading following the deal announcement, while Capital One's stock dropped by about **4%**. Discover's stock surged up to 18% in pre-market trading, indicating investor optimism about the merger's premium and strategic benefits. Conversely, Capital One's stock fell slightly, reflecting market caution regarding the execution risks and regulatory hurdles of such a large-scale transaction.

3.4 Market Feedback

Capital One CEO **Richard Fairbank** described the acquisition as a "great opportunity" to integrate two companies capable of competing with the largest payment networks. The deal will combine two renowned consumer finance brands with their U.S. credit card loan scale surpassing competitors JPMorgan Chase & Co. and Citigroup Inc. Capital One and other supporters argue that the deal could enhance competition in credit card payments.

Bloomberg Intelligence's **Ben Elliott** described the timing of the deal as "opportunistic," considering Discover's legal issues and bleak 2024 outlook. The acquisition also marks an opportunity to explore new avenues.

Critics worry that it will reduce services, increase costs for Americans, and threaten financial stability by creating another "too big to fail" bank. National Community Reinvestment

Coalition CEO **Jesse Van Tol** called the merger a "terrible, horrible, no good, very bad idea," fearing it will ultimately harm consumers and raise financial stability concerns.

The Federal Reserve and **the Office of the Comptroller of the Currency** are under political pressure to take a tough stance on mergers. Both agencies held meetings on this acquisition, a rare move reserved for the most contentious merger reviews. This provided opponents with an opportunity to increase public pressure on regulators. Congressional Democrat leader **Maxine Waters** urged regulators to block the deal, arguing it would "reduce national options for consumers."

Analysts, however, say it is unclear whether market criticism will impact regulators who must review the deal on relatively narrow grounds, including its effects on financial stability, affected communities, and competition. The Department of Justice is also considering antitrust implications, with regulatory experts indicating that the entire process will take several months.

Capital One promises to invest **$265 billion** in loans, philanthropy, and investments over five years if the acquisition succeeds. The company aims to appease critics and gain regulatory support. According to the NCRC, the scale of this community benefit plan is more than twice that of any previous plan, although Van Tol noted it primarily includes credit card and auto loans already offered by banks. Van Tol also mentioned that based on NCRC's analysis of data disclosed by the two banks in the merger application, the $44 billion commitment to community development financing would not increase Capital One and Discover's spending on a five-year average basis. In response, Capital One argued in an email to Reuters that NCRC's historical baseline includes anomalous market conditions in 2020-2021 due to the COVID-19 pandemic, including historically low-interest rates.

References

[1] Becky Pokora, B. (2024, March 28). *Credit card statistics and trends 2024*. Forbes. https://www.forbes.com/advisor/credit-cards/credit-card-statistics/#credit_card_debt_by_age_section

[2] Caitlin Mullen, C. (2024, July 19). Capital One-Discover deal critics, supporters sound off, Yahoo! Finance. https://finance.yahoo.com/news/capital-one-discover-deal-critics-115827783.html

[3] Capital One Financial Corporation. (2023). *2023 Annual Report*. Retrieved July 31, 2024, from chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://ir-capitalone.gcs-web.com/static-files/3381e479-cf44-4a85-a0f6-b7d8d30c2a31

[4] Discover Financial Services. (2023). 2023 Annual Report. Retrieved July 31, 2024, from chrome-extension://efaidnbmnnnibpcajpcglclefindmkaj/https://s23.q4cdn.com/669804705/files/doc_financials/2023/ar/Annual-Report-10K-Combined-PDF.pdf

[5] Matt Frankel, M. (2024, July 26). *Could this bank beat Visa at its own game?*, *Yahoo! Finance*. https://finance.yahoo.com/news/could-bank-beat-visa-own-095100826.html

[6]Crcm, Z. K. C. C. M. C. (2024, March 2). Capital One buys Discover - now what? (Finale).https://www.linkedin.com/pulse/capital-one-buys-discover-now-what-finale-zarik-hh5ne/

[7] Lowery, B. (2024, February 26). What Capital One's acquisition of Discover could mean for consumers. Bankrate. https://www.bankrate.com/credit-cards/news/capital-one-acquisition-of-discover/#existing

[8] The Associated Press. (2024, July 18). Capital One offers $265B benefit plan to appease regulators for its planned purchase of Discover. WTOP News. https://wtop.com/business-finance/2024/07/capital-one-offers-265b-benefit-plan-to-appease-regulators-for-its-planned-purchase-of-discover/

https://www.mg21.com/cof.html

https://www.mg21.com/dfs.html

https://www.investopedia.com/capital-one-to-acquire-discover-financial-for-usd35-3-billion-8584863

https://www.google.com/url?q=https://new.qq.com/rain/a/20240220A03PFW00&sa=D&source=docs&ust=1722461019587454&usg=AOvVaw3d18ocauGlgRmNQf45KOOZ

https://www.investopedia.com/capital-one-to-acquire-discover-financial-for-usd35-3-billion-8584863 https://www.10100.com/article/42016

https://www.uscreditcardguide.com/capital-one-to-acquire-discover-all-stock-deal-2024/

https://www.fortunechina.com/america500/300/2018

https://research.cicc.com/frontend/recommend/detail?id=1381