Capital One to acquire Discover: antitrust takes center stage

Overview

Among companies in the credit card industry, three names always stand out – Visa [NYSE: V], Mastercard [NYSE: MA] and American Express [NYSE: AXP]. However, that may soon change if the deal between Capital One and Discover Financial Services goes through. It was announced on 20th February 2024 and quickly gained a lot of attention due to being proposed in a particularly sensitive industry. When it comes to big deals in banking, regulatory scrutiny is almost always sure to make its way into the discussion. Different opinions have been voiced, but two clashing views are noticeable. Some support this move, arguing that it will increase competition in the industry, as the combined entity would be able to compete with other credit card giants. On the other hand, politicians and regulators see it as a potential concern due to increased concentration and hence reduced competition. The decision of anti-trust will be crucial for banking, as the industry faced such regulations with increased frequency in the past and lately has been hesitant about consolidation.

Deal analysis

Capital One [NYSE: COF], headquartered in McLean, Virginia, and founded in 1994 by Chairman and Chief Executive Officer Richard Fairbank, is one of the largest retail banks in the US, serving more than 100m costumers. As of 31st December 2023, the Company had $348.4 billion in deposits and $478.5 billion in total assets. Capital One is engaged in the businesses of (i) credit cards, which includes lending to domestic consumers and small businesses, (ii) consumer banking, consisting of deposit gathering and lending activities for consumers and small business, and auto lending, and (iii) commercial banking, which includes lending, capital markets, and treasury management services to customers in the commercial real estate and industrial sectors. With more than 70 office locations and over 290 branch locations, Capital One mainly operates in US, UK, and Canada.

Discover Financial Services [NYSE: DFS], one of Capital One's main competitors, is another American financial services company, founded in 1985 and headquartered in Riverwoods, Illinois. The company is engaged in checking and saving account services, personal, home equity and student loans, and credit cards. It operates the Discover Global Network which includes (i) Discover Network, with many merchants and cash access locations; (ii) PULSE, one of the nation's leading ATM/debit networks; and (iii) Diners Club International, a worldwide payment network with global acceptance. The company actively operates in 3 different regions - North America, Europe, and Asia Pacific - where it has more than 50 offices.

Capital One announced the merger with Discover Financial Services in February 2024, with a valuation of $35.3 billion, 27% higher than the closing price the day before the announcement, making it the largest agreed-upon merger of 2024 so far. With this agreement, which is expected to finalize in late 2024 or early 2025, the two leading financial service firms would join in an all-stock tie-up, with Discover shareholders receiving 1.0192 Capital One shares for each share of Discover. If the transaction is completed, current Capital One shareholders will own 60% of the combined entity, with Discover stockholders owning the remaining 40%.

The transaction, one of the largest in the financial services industry since the 2008 financial crisis, will establish the largest US card issuer by loans, with around $250 billion in card balances and a 19% market share. This would allow Capital One to compete in the lucrative realm of payment networks, alongside industry titans such as Visa, Mastercard, and American Express. Mastercard and Visa currently have a combined equity value of $1 trillion and together account for 83% of the credit card processing business. Scale is important in this market, as seen by the valuations of other prominent competitors. Stripe, an Irish American global financial services and software as a service (SaaS) company that underwent a growth program, attained a private valuation of $95 billion, while Klarna, a Swedish fintech start-up that provides online financial services, hit $45 billion.

The combination is also expected to improve processes and generate synergies, which will be favored by the businesses' compatibility. Capital One and Discover are established credit card franchises with similar strategies and a common focus on the customer. The combination is estimated to yield $1.5 billion in expense savings and $1.2 billion in network synergies, totaling $2.7 billion in pre-tax benefits in 2027. This merger is predicted to result in a 16% return on invested capital this year, with an IRR of more than 20% and an increase in EPS of more than 15%. Finally, the purchase will help to bolster Capital One's balance sheet. On a pro forma basis, the combined business would have a CET1 ratio of around 14% at completion, with 84% of company deposits insured as of year-end 2023.

Following the announcement of the potential acquisition, which investors believe to have only a 50% chance of occurring due to regulatory concerns, the stock of both firms rose modestly and then remained volatile over the subsequent days. Despite this initial positive reaction, several aspects should be considered: according to Wall Street analysts, there is still a considerable level of uncertainty about the future, and Capital One stock may experience severe volatility in the next years. Even if Morningstar analyst Michael Miller believes that Capital One's initial cost savings estimates are credible, predicting the future is challenging due to the high level of uncertainty. Capital One stock, which ended at $137.39 on February 20, has a "hold" rating from Morningstar and a fair value estimate of $153. Bank of America has a "buy" recommendation with a price target of $146.

Because of its scale, this transaction has the potential to be a watershed moment in financial sector history, as it is the sixth largest bank merger. Other mergers have occurred in recent years, revolutionizing the financial services industry. For instance, in 2019, BB&T and SunTrust, two leading players of the US banking and financial services sector, merged in a $31.6bn agreement to form Truist Financial [NYSE: TFC], which was the seventh largest commercial bank by consolidated assets at the end of 2023. This merger is the seventh largest in its industry, slightly smaller than Capital One and Discover Financial Services. The record for the actual largest deal in the sector is presently held by JP Morgan, which in 2004 acquired Bank One, an American bank founded in 1968 and at its peak the sixth-largest bank in the US for $56.9bn. This transaction established JP Morgan as the largest US bank by consolidated assets.

Anti-trust concerns

One of the biggest concerns regarding this deal is its risk of approval considering the size of the deal and the political climate it is proposed in. This acquisition is likely to make Capital One the biggest card issuer in the US with a 19% share of revolving consumer loan market even over JP Morgan Chase's 16%. Considering that the deal will lead to a major financial network acquiring an issuer network, the deal is bound to attract even more scrutiny by anti-trust regulators.

Democratic senators are by far and large, eager to urge the Biden administration to pay closer attention to the deal. Elizabeth Warren commented, "The Wall Street deal is dangerous and will harm working people. Regulators must block it immediately." Moreover, her along with 12 Democratic lawmakers argued that this merger threatens the financial stability of consumers in a letter to Michael Barr, the vice chair for supervision of the Federal Reserve Board of Governors, and acting Comptroller Michael Hsu. This view however is not only reserved for the Democrats. Republican senators like Sen. Josh Hawley have also made their views clear that the merger would only hurt the consumers and make the consolidated firm more likely to exploit their customers. As the deal is raising concerns on both sides of Congress, the Biden administration - which has been more active on anti-trust regulations than any recent government, is likely to sue to block this deal as well.

The concerns over a large new firm entering the market seem valid when we observe the exploitative practices of American credit card-issuing financial institutions currently in the market. Lenders make a profit on customers who carry credit card debt from one month to the next. The average interest rates for credit card debt go upwards of 23%, with Capital One itself charging upwards of 30% for its credit cards. A survey by NerdWallet, a personal finance company, found that the average U.S. household carried $7,486 in credit card debt in 2023. Therefore, credit card providers gain a huge source of income from consumers who rack up credit card debt due to either spending on necessities or impulse buying and are likely to evade laws that curb their interest rates. Regulators have introduced bills for caps on these high interest rates, but they are unlikely to pass due to Republican lawmakers. Adding another massive institution to this group of large corporations that have become publicly notorious for putting users into crippling debt with high-interest rates, is sure to get backlash from the general public and their political representatives alike.

Competitive benefits

Despite the various anti-trust concerns raised, this deal could have its own benefits thanks to increased competition between the card issuer networks. Capital One is currently one of the largest card issuers in the US offering branded cards through Visa and Mastercard. However, after the deal goes through it is likely to switch to Discover's payment network and eliminate costs while better competing with Visa and Mastercard. Discover, which has previously struggled to compete in terms of payment volume, could help invade the long-standing duopoly in the industry. This outlook is represented by the fall in shares of Visa by 1.5% and Mastercard by 3% following the deal announcement. However, considering the massive size of the payment volume the immediate effect on their profits might be negligible.

JP Morgan Chase CEO Jamie Dimon does not express any concerns about Capital One eclipsing the firm after the acquisition. Dimon says, "My view is, let them compete, let them try, and if we think it's unfair, we'll complain about that". He is appreciative of the CEO of Capital One and acknowledges the firm has a good hold in the market of issuing credit cards but has his reservations about whether it would truly translate to an alternative to dominant card networks. This runs in line with big banks promoting less regulative actions on big deals to pave the way for similar deals in the future.

In addition to arguments supporting the deal, the Credit Card Competition Act of 2023, if passed, would allow merchants to have more choice in terms of payment networks used for processing transactions that involve certain banks' credit cards. According to previous practices by Visa and Mastercard, only their payment networks could be used if the payment terminal was offered by them. This law was created in lieu of breaking the duopoly in the market due to this. Open competition in payment networks is likely to lead to lower fees for the merchants and possible translation to lower price for customers. This could serve as a good argument in support of allowing Capital One to acquire Discover so that a new payment network with a competitive chance could emerge in the market. However, with the current democratic government and elections coming up soon, the government is sure to heavily scrutinize the deal.

Final thoughts

In the end, this deal is important for the credit card industry and its consumers. The implications of it going through, such as increased competition and lower fees for merchants, could shape the environment looking forward. However, politicians' and regulators' views are partly valid too, as the merger would create one of the biggest firms in the industry. Considering exploitative practices – even those of Capital One – in the recent past, there is more than one way the consumer could get hurt. What is known for sure though, is that Mastercard and Visa would not like to see its approval. Jefferies analysts revealed that Capital One represents 16% of Mastercard's US purchase volume and 4% of Visa's. If the combined entity entered the market, there would most definitely be a major shake-up, hence any updates on the deal should be monitored closely.

TAGS: Capital One, Discover, financial services, credit cards, Visa, Mastercard, JP Morgan, antitrust, merger, banking

