Introduction:

Over the last year or so, the Fed increased interest rates eleven times. While there is much debate about whether rates will decrease (or even increase) this year, one thing is abundantly clear. M&A has suffered and has been non-existent for two years. Maybe the $35 billion Capital One acquisition of Discover will kick start additional deals? Let's spend a few pages breaking down this card deal and "read the tea leaves" for any interesting payment implications.

On the surface, both Capital One and Discover have similar businesses. For example, both are in the card business, with Capital One issuing both credit and debit cards, and Discover issuing credit cards on its 4th ranked payment network. In addition, both firms offer various types of loans, with Capital One doing auto, CRE (commercial real estate) and C&I (commercial and industrial) loans and Discover with a sizeable student loan portfolio of over $10 billion. Both sets of financials are "bank like", showing critical metrics like NIM (net interest margin), delinquencies, charge-offs, ROE, book value, etc.

Market Share:

The best place to start our analysis is by examining market positioning and market share. In our opinion, the bible for payment statistics, data, and metrics is the Nilson Report. According to the Nilson Report, a combined Capital One and Discover will have over 100 million cardholders and nearly $250 billion of outstanding card loans. In terms of purchase volumes, Capital One was the #3 credit card company with $606 billion of spend in 2023, equating to roughly 10% of the market. In front of them is American Express at 18.7% and JP Morgan Chase at 19.3%. Once Discover is added to Capital One, with their 3.6% market share and $218 billion of spend, the combined entity moves to nearly 14%. On the surface, #3 and #6 combining should be "fine" and get through regulatory scrutiny since together they still sit at #3. In fact, some regulatory bodies might view the combined entity as providing a stronger competitor to existing participants and think the deal is a positive. However, we believe that this transaction will need to get multiple regulatory bodies to bless the deal, ranging from the Department of Justice, the OCC, the CFPB and even the FTC.

Besides purchase volumes, we believe looking at credit card loans outstanding will paint a very different picture. Examining the credit card loans outstanding marketplace could lead to a very different regulatory result. Capital One is currently the #2 player with 14.6% of the overall market. If it adds Discover's receivables, currently #5 with 10.1% market share, it vaults the combined entity into 1st place. Not only does it become the market leader, but it would be over 20% larger than the second-place player – JP Morgan Chase.

Regulatory Issues:

Would regulatory scrutiny intensify if two entities combine to equal market share leadership? What if this new entity is significantly larger than the next largest competitor? Would this equate to an unfair advantage and allow it to disadvantage its existing customers? Would this new company possibly be "too big to fail"? Over the last couple of years, the administration seems to have pushed back on many transactions. There is a perception that DC is anti-M&A and is ensuring that no company has an unfair position in the market. Do these two entities combining, where the new company has clear market share leadership (in credit card loans), equate to an unfair advantage? We actually do NOT believe it does.

However, Capital One has a long road ahead of it. On the deal announcement call, Capital One stated that it was comfortable with the regulatory environment and expected this transaction to close in late 2024 or early 2025. On the same day, Senator Elizabeth Warren (Democrat from Massachusetts) stated that this acquisition "threatens our financial stability, reduces competition, and would increase fees and credit costs for American families. This Wall Street deal is dangerous" and "regulators must block it immediately."

The Crown Jewel:

The reason Capital One is buying Discover isn't for its existing cardholders, loans outstanding or even its student loan portfolio. In our opinion (and the opinion of Capital One's Chairman and CEO Richard Fairbank), the real asset of Discover is its credit and debit payment networks. It's exactly what he said in his prepared remarks upon announcing this deal.

This transaction centers on synergies created when Capital One migrates transactions over to Discover's platform. On the deal call, Capital One indicated that it plans to create $1.2 billion of revenue synergies (by 2027) once it begins to switch onto Discover's payment network. In our opinion, the easy part will be switching the debit network to Discover's Pulse platform. The harder piece will be changing from the Visa and Mastercard bug/logo on credit to Discover. Let's review the details and explain these issues in more depth.

Debit:

As of now, 98% of Discover's debit business occurs at un-regulated interchange rates. That means, debit transactions occur at 1.41%. Our loyal readers know that we aren't big fans of Senator Durbin (Democrat from Illinois) and his amendment inside of Dodd-Frank legislation in 2010. Click here and here for our research notes on this subject, but understand that his legislation forced the Fed into setting unfair price caps on a well-functioning market. Dodd-Frank was a response to the Financial Crisis in 2008 and 2009, but nobody in their right mind would say that debit pricing had an impact on the near collapse of our economy. Either way, Senator Durbin's amendment forced the Fed to lower debit interchange to $0.21 plus 0.05% per transactions (for banks over $10 billion). This created a bifurcated industry and penalized the largest debit network (Visa) and larger US banks. As a response, banks removed loyalty programs on their growing debit business and began to institute account fees to pay for services associated with "free" checking and savings accounts. Continuing this assault on big banks, we believe the Fed will lower debit interchange again, this time by another 25% to 30%.

In our opinion, the "low hanging fruit" on this deal rests on the proposition of migrating $65 billion of Capital One's debit business from Mastercard over to Discover's Pulse network. As of now, Visa dominates the debit industry with roughly 65% share purchase volume. Mastercard is #2, with 20% market share. These two companies fiercely compete for business, even though Senator Durbin believes that they covertly work together to dominate the industry. From Visa's last earnings call, we calculate the average debit transaction to be roughly $36.50 per transaction. If we grow Capital One's $65 billion of debit business by 5% per year and apply Discover's advantageous debit pricing (1.41%), it will increase the debit revenue by over $500 million per year, an increase of 125% versus their Mastercard pricing. This simple math does not factor in the opaque rebates and incentives that Capital One (and any card issuer) receives from Mastercard and Visa. Maybe we aren't fully capturing the exact economics, but we think we're directionally accurate.

Senator Durbin's amendment specifically calls for a second debit brand to exist on each card (look on the back of your ATM card), outside of the leading two networks (Visa and Mastercard). In theory, the Capital One and Discover deals abides by Senator Durbin's wishes and creates additional competition in the debit industry. There are numerous debit networks: STAR (owned by Fiserv), Pulse (owned by Discover), Cirrus / Maestro (owned by Mastercard), Interlink (owned by Visa). Fiserv, when it acquired First Data in early 2019, got the STAR and Accel debit network and it has been talking about gaining debit market share as an alternative to Visa and Mastercard. Now, with this deal, Capital One can switch its debit business over to the Discover Pulse network and abide by Senator Durbin's arbitrary rules.

Capital One is based in Virginia but it has a long history of working in Illinois. Discover has its headquarters in Riverwoods, Illinois. How ironic is it that this combined company based its $35 billion deal by "skirting the rules" that Senator Durbin (from Illinois) wrote? In all of Senator Durbin's speeches (click here), he claims that he is trying to help merchants and small business owners by forcing competition onto Visa and Mastercard. We will now see if Senator Durbin stands behind his prior comments. Will he voice any concern about this transaction, or will he allow Capital One to charge merchants debit rates that are significantly higher than his intended price caps? As someone that has closely followed his political commentary and biased rhetoric for 15 years, we find this beautifully ironic.

Credit:

Looking at the debit angle of this deal provides an easy path to revenue and expense synergies. However, one needs to analyze what Capital One intends to do on its large credit card portfolio. This deal isn't immediately accretive to Capital One. For this to become a successful deal, Capital One will need to drive beneficial credit economics by migrating some percentage of its credit card portfolio to Discover's network.

Senator Durbin is also attempting to pass additional legislation called the CCCA or credit card competition act (click here to see our recent note on this subject). He is actively trying to force the Fed to institute credit interchange rates similar to what he forced onto the market in 2010 for debit. Despite this Discover acquisition running squarely counter to everything Senator Durbin proclaims, we imagine that it will successfully clear regulatory scrutiny. The bigger question is whether or not Capital One can switch from issuing Visa or Mastercard credit cards over to Discover. Unlike the debit migration, which will happen seamlessly and without the consumer even knowing, a credit switch will be a much harder migration. We believe cardholders will push back on getting a new plastic card, with the Discover logo and not their existing Mastercard or Visa brand.

According to the Nilson Report, Capital One issues both Visa and Mastercard credit cards. Of their over 100 million credit cards, it is estimated that 58% are Mastercard branded and 42% have the Visa logo. In terms of credit card purchase volumes (looking at 2023 figures), Visa and Mastercard handle 54x and 32x the volume of the fourth player – Discover. In terms of average annual spend, Visa cardholders conduct 3x the amount of business than the typical Discover card. We believe the credit migration will be more challenging for Capital One to switch than the debit business discussed earlier.

In terms of card acceptance, we know that Visa and Mastercard are accepted in over 200 countries and at well over 100 million merchants. In fact, we just saw that Visa has nearly 130 million global merchant acceptance points. This is significantly higher than Discover's acceptance at just 70 million merchants. One sell-side report just mentioned that if Capital One switched off of Mastercard and Visa over to Discover, its cardholders would immediately have merchant acceptance fall by 45% (mostly outside of the US). Capital One has to realize that the two big payment networks offer a better option, in terms of merchant acceptance, fraud prevention, scale, value added services, etc. We do NOT believe that Capital One will look to migrate all of its credit business off of Visa or Mastercard. Instead, we believe that Capital One will begin to differentiate its cardholders into different buckets.

For example, for those cardholders that have a Capital One checking account or have a have FICO score or want access to their airport lounges can keep their Mastercard or Visa credit cards. We expect Capital One to try and create a strong loyalty program and get certain cardholders to begin to pay annual fees for its value-added services. These higher-end customers will remain on Visa and Mastercard and Capital One won't want to make any unnecessary changes to their relationship.

However, for lower income or lower FICO scoring cardholders, we expect Capital One to try to migrate them over to the Discover network. No cardholders would prefer to be on Discover versus the clearly superior Visa or Mastercard. Who is the typical new Discover cardholder? We believe it is college-aged students and those without a strong credit profile. Maybe Discover attracts certain individuals that have had a few troubled credit experiences in the past? According to the Nilson Report, 31% of Capital One cardholders have a FICO under 660 and 19% of Discover cardholders fall under this FICO level. A combined Capital One and Discover would have nearly a quarter of its cardholders with FICO scores under 660. Maybe these individuals don't have any other options for credit, considering their current FICO score? We expect Capital One to leverage its best customers towards Visa and Mastercard branded credit cards and try to push its lower-end consumers towards the inferior Discover brand.

Conclusion:

By combining forces, Capital One and Discover will attempt to leverage their existing businesses in cards and loans. With normal deals, we would worry about integration issues, but we believe that the combined entity will simply utilize the best of breed of each company. Capital One will use Discover's payment network, while it will remain in charge of the business (i.e., management), marketing, loyalty programs, infrastructure, etc. While this deal was only announced two days ago, this is our early read on the implications and opportunities in our largest area of exposure – the payment sector. This deal will impact Visa, Mastercard, American Express, Stripe, Global Payments, Fiserv, Adyen, Paypal, and numerous others.

The least path of resistance and highest probability of capturing synergies is the opportunity to migrate off of Mastercard's debit platform and onto Discover's Pulse network. The favorable economics are simply too good to ignore. The credit issue will be much more of a challenge, but lower FICO scoring individuals don't really have a ton of alternative credit options. We imagine that some are "stuck" at Capital One or Discover because other card issuers probably denied them credit. We believe that the thesis behind this entire deal rests on Discover's payment (both debit and credit) network. The economics of this transaction rest on taking advantage of Discover's higher debit interchange and migrating a percentage of lower FICO cardholders away from Visa and Mastercard and towards the weaker Discover brand. The increased scale of this combined entity will lead to cost efficiencies and ultimately shareholder returns, but cardholders probably will not receive any tangible benefit (in our opinion). The existing cards, as well as the existing loans, are simply a bonus that can easily be valued on future cash flows, balances, and the interest rates.

Another fascinating aspect of this transaction will be regulatory. Will Democratic Senator Warren have enough sway to block this transaction? Will Democratic Senator Durbin make noise on an issue he has spearheaded for over a decade? Will he prevent a local Illinois company from skirting his pricing scheme?

Only time will tell, but we hope this transaction kick starts a wave of M&A (especially in our payment names) like we experienced in 2019. Nothing would please us more…

Warren Fisher, CFA

Founder & CEO

Manole Capital Management