

MARCH 2024

# Bank Watch

## ARTICLE

**Capital One Financial Corporation to Acquire Discover Financial Services**  
AND  
**NYCB Incurs Heavy Dilution in its \$1.0 Billion Capital Raise**

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# Capital One Financial Corporation to Acquire Discover Financial Services

The four major credit card networks are American Express, Discover, Mastercard, and Visa. In 2023, Discover had only 2.1% of the total market share in the U.S. based on the value of transactions, compared to Visa's 61.1% market share and Mastercard's 25.4% market share.<sup>1</sup> Prior to its acquisition of Discover, Capital One partnered with both Visa and Mastercard for issuing their credit cards. So, why would Capital One pay \$35.3 billion to acquire Discover's 2.1% market share?

Discover Financial Services operates as both a credit card issuer and credit card network. By owning its own credit card network, Discover is not partnered with any payment processors (Visa, Mastercard, etc.) and avoids "swipe fees" that payment processors collect. Therefore, one of Capital One's primary objectives in acquiring Discover is to move its credit and debit cards onto Discover's network over time and reduce its purchase volume on the Visa and Mastercard networks.

The two companies entered into a definitive agreement on February 19, 2024, in which Capital One Financial Corporation agreed to acquire Discover Financial Services in an all-stock transaction valued at \$35.3 billion. The deal represents a 26.6% premium to Discover's closing price of \$110.49 (2/26/24) as Discover shareholders will receive 1.0192 Capital One shares for each Discover share. More details on the transaction as well as the companies' financials as of fiscal 2023 are displayed on the right.

## Summary of Transaction Analysis

Transaction Details	Price / LTM Earnings	Price / LTM Core Earnings	Price / Book Value	Price / Tangible Book Value	Tangible Book Premium / Core Deposits	Price / Assets
Capital One Financial Corporation / Discover Financial Services	12.4x	12.0x	2.71x	2.77x	NA	23.3%

## Financial Comparison

Public Company	Total Assets (000s)	Common Equity / Assets	Tang Common Equity / Tang Assets	Gross Loans / Assets	NPAs / Loans & OREO	Reserve / Loans	Provision / Avg Loans	NCOs / Avg Loans
Capital One Financial Corporation	478,464,000	11.13%	8.18%	65.08%	0.49%	4.76%	3.36%	2.70%
Discover Financial Services	151,522,000	9.08%	8.93%	79.85%	0.21%	7.23%	5.09%	3.42%

Public Company	ROAA	Core ROATCE	Net Interest Margin	Fee Income / Avg Assets	Oper Expense / Avg Assets	Efficiency Ratio	PPOI / Avg Assets
Capital One Financial Corporation	1.04%	14.35%	6.63%	1.62%	4.28%	53.98%	3.59%
Discover Financial Services	2.12%	22.38%	9.38%	1.99%	4.34%	37.93%	7.10%

<sup>1</sup> Statista.com; Market share of Visa, Mastercard, American Express, Discover as general purpose card brands in the United States from 2007 to 2023, based on value of transactions

## Preparing for the Future

As technology continues to advance, both traditional, tech-heavy banks and Fintech companies have increased competition in the global payments industry. If the acquisition is approved, Capital One will surpass JPMorgan as the largest credit card company based on loan volume and become the third largest company based on purchase volume. With increased volume and market share, Capital One would be better prepared to compete against these other banks and Fintech companies. Richard Fairbank, the CEO of Capital One, strives to deal directly with merchants by owning his own payments network. This rare asset allows Capital One to create a closed loop between consumers and merchants, which better positions the company to deal with increasing threats from buy-now, pay-later companies (Affirm, Afterpay, Klarna, etc.).

Both Capital One and Discover customers may have a lot to look forward to in the future should the deal be approved. Capital One intends to move 25 million cardholders onto the Discover network by 2027 and offer more attractive rewards for both debit and credit cardholders. The proposed merger would expand both issuers' physical presence, and Discover customers would gain access to physical bank locations. Capital One will also leverage its international presence to increase accessibility and convenience for Discover cardholders on an international scale. In terms of credit and debit rewards, the increased competition in the industry is expected to drive companies to bolster their rewards program to seem more attractive to consumers.

## Regulatory Hurdles

The proposed deal between Capital One and Discover is expected to close by the end of 2024 or the beginning of 2025. However, the completion of the deal could depend on the results of the presidential election. Senators Elizabeth Warren and

Josh Hawley have both expressed interest in blocking the deal as they believe the deal will create a "juggernaut" in the industry and lead to the extortion of American consumers. The Biden administration is more likely to block the deal or implement limitations and requirements in order for it to be executed.

On the other hand, the proposed deal could stop legislation that threatens credit card rewards. Congress is considering new legislation known as the *Credit Card Competition Act (CCCA)*. The purpose of this legislation is to reduce the swipe fees paid by merchants by enabling access to a wider range of payment networks. If the legislation is approved, credit card networks and issuers would face reduced transaction fees causing issuers to potentially reduce the wide range of rewards offered. However, the primary objective of the CCCA could be accomplished through the proposed merger, as routing Capital One's purchase volume through Discover's payment network would create a more viable competitor to the Visa/Mastercard duopoly.

## Conclusion

Mercer Capital has roughly 40 years of experience in assessing mergers, the investment merits of the buyer's shares, and providing valuations of financial institutions. If you are considering acquisition opportunities or have questions regarding the valuation of your financial institution, please contact us.



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# NYCB Incurs Heavy Dilution in Its \$1.0 Billion Capital Raise

The other significant industry news from the first quarter was the \$1.05 billion equity investment in New York Community Bank (NYSE: NYCB) by an investor group led by former Secretary of the Treasury Steve Mnuchin. The investment was necessary to boost loss absorbing capital and to shore up confidence to stem a possible deposit run after its share price collapsed during February following a surprise fourth quarter loss that was later revised higher for a \$2.4 billion goodwill write-off.

The initially reported 4Q23 loss of \$252 million was not catastrophic, especially considering the company reported net income of \$2.4 billion excluding the goodwill write-off as a result of the bargain gain from the purchase of the failed Signature Bank; however, the fourth quarter loss that arose from a \$538 million provision for loan losses highlighted investor concerns about NYCB's sizable exposure to NYC rent-controlled apartments and offices.

The figure on the right presents our proforma analysis of the transaction and its impact on the consolidated company (NYCB), the parent company in which the group invested, and wholly owned Flagstar Bank, N.A. The adage that capital is exorbitantly expensive if available at all when it must be raised comes to mind here with NYCB.

## We note the following:

- » The investor group paid \$1.05 billion for 525 million common share equivalents consisting of 59.8 million common shares for \$2.00 per share and \$930 million of Series B and C preferred stock with a 13% dividend that is convertible into 465 million common shares at \$2.00 per share.
- » Tangible book value per share ("TBVPS") declined by about one-third from \$10.03 per share as of year-end 2023 to \$6.65 per share on a proforma basis.

	Reported @ 12/31/23			Investor Capital	Parent Adj <sup>1</sup>	Pro Forma @ 12/31/23		
	NYCB	Flagstar Bank	Parent Co			Flagstar Bank	Parent Co	NYCB
Cash	705	705	158	1,050	(950)	1,605	258	1,705
ST Investments	10,788	9,264	0	0	0	9,264	0	10,788
Securities	9,264	10,770	0	0	0	10,770	0	9,264
Loans - HFS	1,019	1,019	0	0	0	1,019	0	1,019
Loans - HFI	84,782	84,782	0	0	0	84,782	0	84,782
LL Reserve	(992)	(992)	0	0	0	(992)	0	(992)
Inv in Flagstar	0	0	9,160	0	900	0	10,060	0
Fixed Assets	1,078	1,078	0	0	0	1,078	0	1,078
MSRs	1,111	1,111	0	0	0	1,111	0	1,111
Goodwill & CDI	625	625	0	0	0	625	0	625
Other Assets	5,517	5,638	80	0	0	5,638	80	5,517
<b>Total Assets</b>	<b>\$113,896</b>	<b>\$113,998</b>	<b>\$9,398</b>	<b>\$1,050</b>	<b>(\$50)</b>	<b>\$114,898</b>	<b>\$10,398</b>	<b>\$114,896</b>
Deposits	81,365	81,684	0	0	0	81,684	0	81,365
Bank Borrowings	20,772	20,772	0	0	0	20,772	0	20,772
Parent Co Debt	997	0	997	0	0	0	997	997
Other Liabilities	2,395	2,382	34	0	0	2,382	34	2,395
<b>Total Liabilities</b>	<b>105,529</b>	<b>104,838</b>	<b>1,031</b>	<b>0</b>	<b>0</b>	<b>104,838</b>	<b>1,031</b>	<b>105,529</b>
Minority Interest	0	0	0	0	0	0	0	0
Preferred Equity	503	0	503	0	0	0	503	503
Common & Conv Pfd	7,864	9,160	7,864	1,050	(50)	10,060	8,864	8,864
<b>Total Equity</b>	<b>8,367</b>	<b>9,160</b>	<b>8,367</b>	<b>1,050</b>	<b>(50)</b>	<b>10,060</b>	<b>9,367</b>	<b>9,367</b>
<b>Liabilities &amp; Equity</b>	<b>\$113,896</b>	<b>\$113,998</b>	<b>\$9,398</b>	<b>\$1,050</b>	<b>(\$50)</b>	<b>\$114,898</b>	<b>\$10,398</b>	<b>\$114,896</b>
Common Shr Equiv	722.1		722.1	525.0			1,247.1 <sup>2</sup>	1,247.1
Tangible BVPS	\$10.03		\$10.03	\$2.00			\$6.65 <sup>2</sup>	\$6.65
CSEs w Warrants				840.0			1,562.1 <sup>2</sup>	1,562.1
Diluted TBVPS				\$2.19			\$5.82 <sup>2</sup>	\$5.82
Tier 1 Capital	8,538	9,305				10,205		9,538
Total Capital	10,441	10,271				11,171		11,441
Leverage Ratio	7.8%	8.5%				9.3%		8.6%
Total RBC Ratio	11.8%	11.6%				12.6%		13.0%
Double Leverage			109.5%				107.4%	

1) Assumes \$50M of parent expenses, \$900M contributed to Flagstar Bank as additional capital

2) Proforma diluted TBVPS ~\$5.80 inclusive of 315M seven-year warrants with \$2.50 p/s exercise price

Source: Mercer Capital, NYCB SEC filings, and S&P Global Market Intelligence

- » Inclusive of 315 million seven-year warrants with a \$2.50 per share strike price, diluted proforma TBVPS is ~\$5.80 per share.
- » The 525 million common shares represent ~40% of the 1.25 billion proforma shares while dilution to existing shareholders exceeds 50% inclusive of the warrants.
- » The capital injection boosted the Company's consolidated leverage ratio by ~80bps to 8.6% and total risk-based capital ratio by ~120bps to 13.0%.
- » NYCB will generate ~\$1.4 billion of pretax, pre-provision operating income in 2024 and 2025 based upon consensus analyst estimates that will supplement the new capital to absorb loan losses.
- » Given NYCB's shares are trading around 50% to 60% of proforma TBVPS, investors are questioning the magnitude of loan losses to be recognized; whether more capital will be required; and long-term earning power.

Our additional thoughts on the transaction can be found [HERE](#), and a link to NYCB's investor deck announcing the transaction can be found [HERE](#).

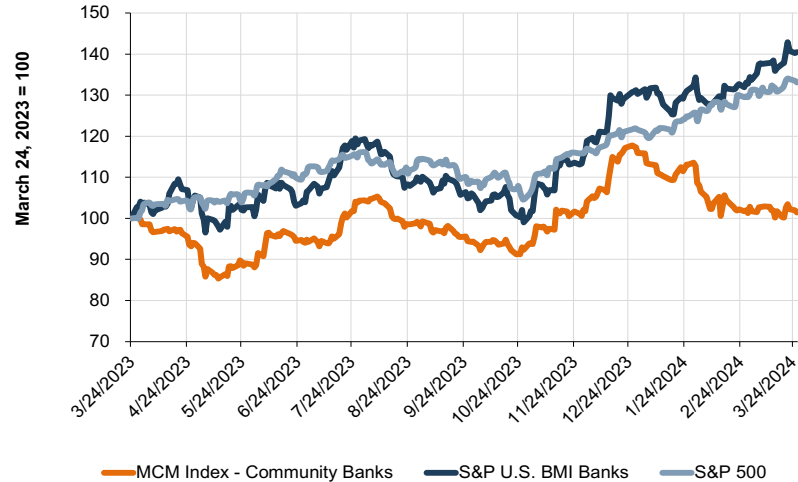
If we can assist your board with a capital raise or other significant transaction, please call us.

A handwritten signature in black ink that reads "Jeff K. Davis". The signature is fluid and cursive, with the first name "Jeff" being the most prominent.

**Jeff K. Davis, CFA**

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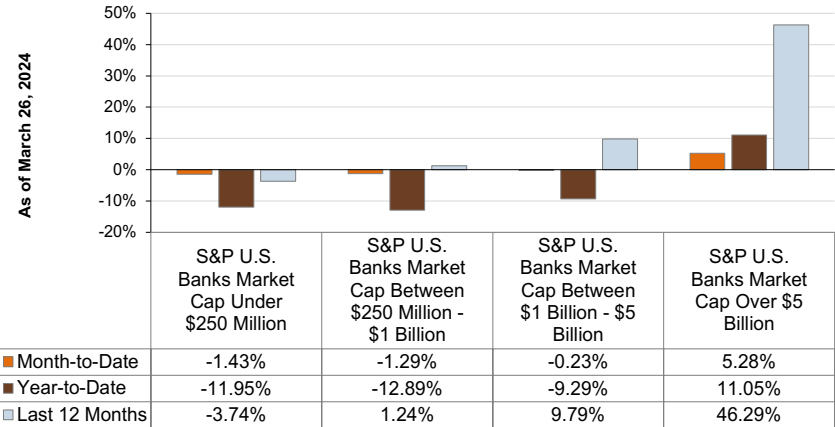
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



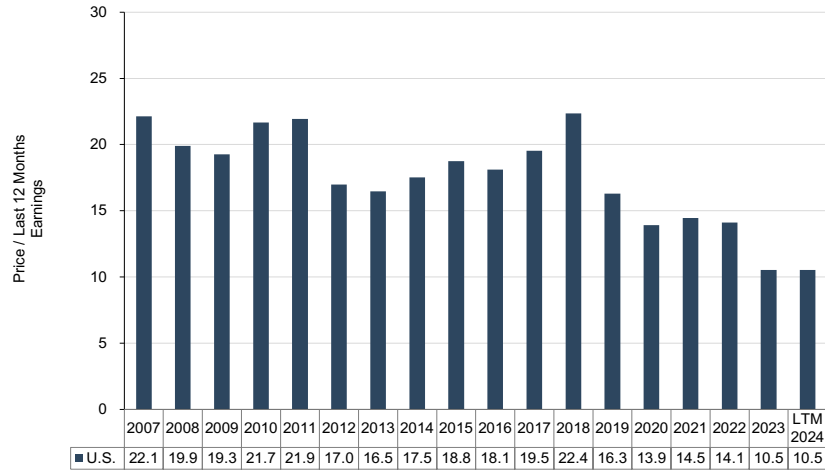
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of March 26, 2024					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2024 (E) EPS	Price / 2025 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-1.4%	-15.5%	-6.2%	10.7x	9.1x	9.0x	96%	102%	3.5%
Midwest Index	0.4%	-5.5%	2.8%	9.5x	9.7x	8.5x	83%	113%	3.8%
Northeast Index	-2.3%	-14.3%	2.2%	8.7x	9.0x	8.4x	88%	98%	4.1%
Southeast Index	-1.9%	-9.6%	5.6%	13.2x	8.3x	6.9x	88%	99%	3.3%
West Index	-0.8%	-12.7%	5.9%	8.7x	9.6x	8.4x	94%	98%	3.4%
Community Bank Index	-1.4%	-12.5%	1.4%	9.2x	9.4x	8.4x	89%	102%	3.7%
S&P U.S. BMI Banks	4.5%	7.8%	40.5%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

**Median Price/Earnings Multiples**

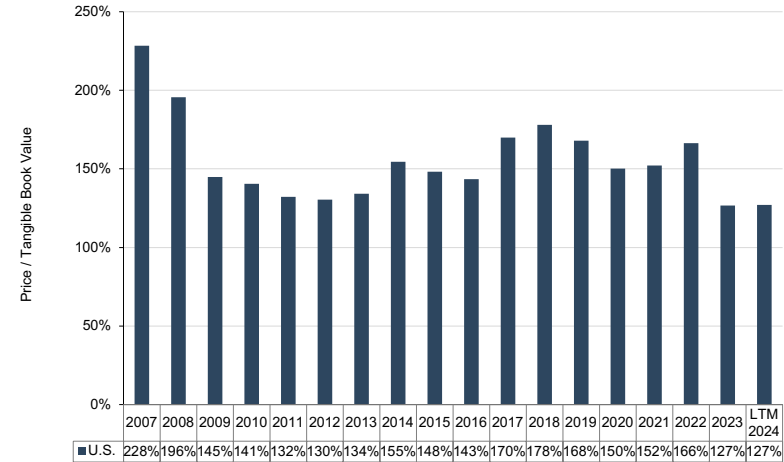
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

**Median Price/Tangible Book Value Multiples**

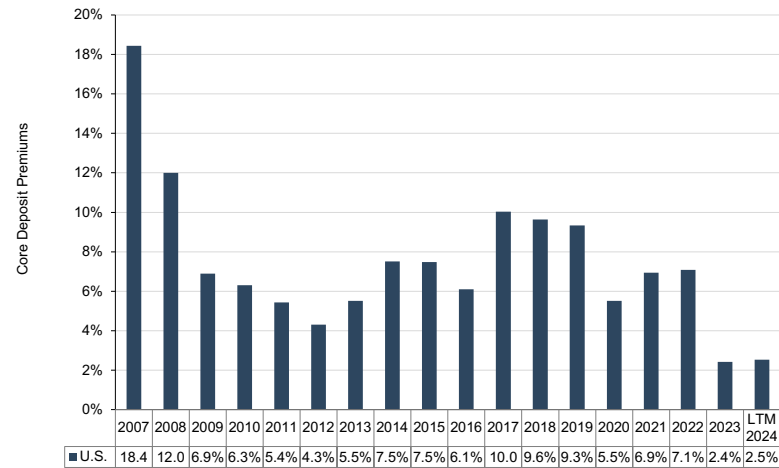
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

**Median Core Deposit Premiums**

Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

**Median Valuation Multiples for M&A Deals**

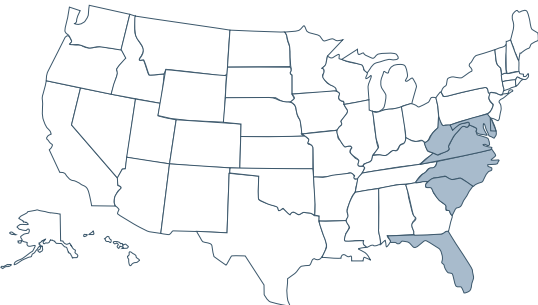
Target Banks' Assets <\$5B and LTM ROE >5%, 12 months ended March 27, 2024

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value (\$M)	Target's Median Assets (\$000)	Target's Median LTM ROAE
Atlantic Coast	11.9x	114%	1.6%	4	214.7	1,898,912	11.0%
Midwest	12.9x	152%	6.2%	1	42.3	473,109	18.3%
Northeast	9.2x	118%	1.7%	4	93.9	1,256,371	12.5%
Southeast	9.8x	128%	3.1%	5	44.3	405,681	9.6%
West	10.7x	154%	6.0%	9	32.6	383,276	10.2%
National Community Banks	10.5x	127%	2.5%	23	58.8	667,766	11.1%

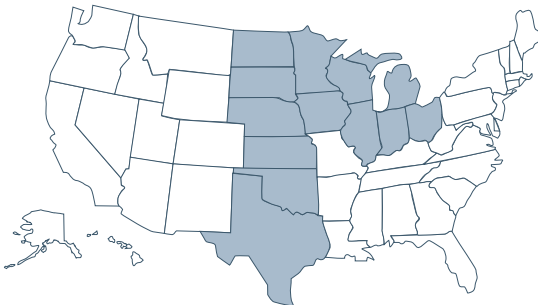
Source: S&P Capital IQ Pro.

# Mercer Capital's Regional Public Bank Peer Reports

Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



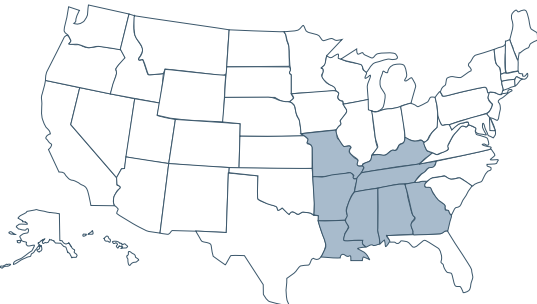
**Atlantic Coast**



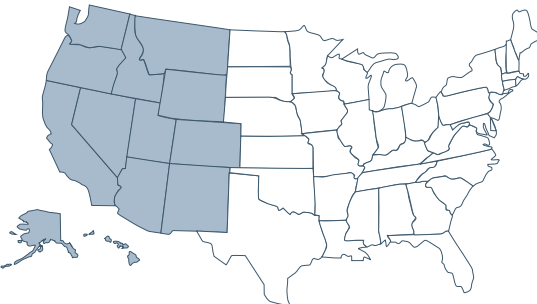
**Midwest**



**Northeast**



**Southeast**



**West**



MERCER CAPITAL

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Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction advisory services, and other strategic decisions.

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