THE STATE UNIVERSITY OF NEW JERSEY
RUTGERS

Equity Research

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Capital One Financial Corp.

NYSE: COF-$34.11

Rating: STRONG BUY

Target: $65.00

Financial Sector Equity Research

Industry: Consumer Finance

Key Data		2001	2002	2003E
52-week range: $66.5-24.05	EPS			
Market Cap (mil): $5,830	Q1	$0.80	$0.83	$1.03E
Shares Out. (mil): 221.9	Q2	$0.75	$0.92	$1.08E
Price/Earnings: 6.68x	Q3	$0.70	$1.13	$1.16E
Price/Book: 1.6x	Q4	$0.66	$1.05	$1.22E
Short Interest (mil): 38.0	FY	$2.91	$3.93	$4.49E
Percent of Float: 16.9%				
Return on Equity: 22.5%	P/E	11.7x	8.7x	7.6x
5 Yr EPS CAGR: 33.4%				

Executive Summary

- Capital One Financial is trading at a discount on both a relative and absolute basis, as it is currently priced at a 37% discount to the industry on a forward P/E basis, and a 61% discount below its historical P/E average.
- Over the past 5 years, COF ranks 22nd among the S&P 500 in terms of annual earnings growth and has the highest growth rate of any financial services company over the same time period.
- The Company is in the midst of a transition in its business toward prime and super prime customers.
- The successful utilization of its information based strategy and data mining capabilities have shielded Capital One from the portfolio losses experienced by peers.
- 12-month price objective of $65 allows for upside potential of 90% at current levels.
- Catalysts for higher price levels include: peaking net charge-offs, lifting of memorandum of understanding, stricter bankruptcy legislation, bulk mail discount and short squeeze.

Humble Beginnings

The Company's origin began in the late 1980's when two consultants devised a proprietary methodology by which to market and structure credit cards. Their core belief was that credit card issuers didn't fully realize the necessity of customized products for individual consumers and therefore there was an untapped segment of the market. Although they had initial difficulties in obtaining a bank to aid them in getting this endeavor underway, they eventually partnered and operated as the credit card division of Signet Bank in 1988. Capital One separated itself from being a wholly owned subsidiary of Signet Bank by completing its initial public offering in November 1994.

Capital One has since come a long way as it is currently ranked as the fourth largest issuer of Visa and Mastercard credit cards with 47.4 million accounts and $59.7 billion in managed consumer loans outstanding.[1]

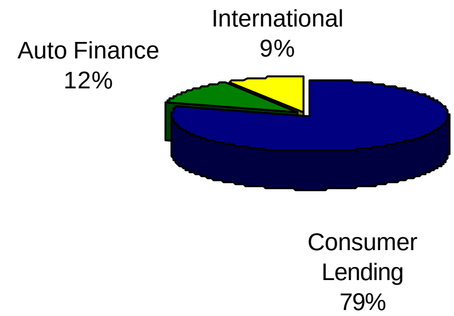
Business Model

Capital One Financial (COF) is a holding company that provides a portfolio of financial products and services through its subsidiaries which include the following:
(1) Capital One Bank (the Bank), a Virginia state chartered bank which offers both Mastercard and Visa credit card products (2) Capital One F.S.B (the Savings Bank), a federally chartered savings bank, through which consumer lending and deposit products are offered, as well as (3) Capital One Auto Finance. Of the two bank subsidiaries of Capital One, the Savings Bank is truly a bank in the traditional sense as it accepts deposits and originates loans while the Bank engages only in credit card operations. As a result, Capital One Financial is subject to periodic examination and regulation from the Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS) and the Federal Reserve Board.

The Company operates in three distinct operating segments: Consumer Lending, Auto Finance and International. The Consumer Lending segment is comprised of domestic credit card and installment lending activities while its Auto Finance segment is limited to automobile lending activities. Their international exposure is limited to originating loans in the United Kingdom and Canada. Capital One is cognizant of the importance of portfolio diversification in terms of their segments towards achieving solid risk-adjusted returns. At of the end of 2002, COF's loan portfolio as distinguished by segment is shown in Figure 1 on the subsequent page.

[1] 2002 Annual Report on Form 10-K

Figure 1



The essence of Capital One's competitive advantage lies in their information-based strategy (IBS) that the Company utilizes to differentiate customers based on credit risk, card usage and other characteristics. IBS is also used to match consumer traits with suitable product offerings thereby maximizing the probability of a successful product launch and facilitating the mass customization to a broad range of markets and industries. The primary goal of IBS is to establish credit limits and products relative to the associated risk thereby maximizing risk-adjusted returns.[2]

Profitability for the Company is a function of the net interest margin (net interest income/earning assets) and noninterest income, credit quality and operating efficiency. Revenues are a result of interest income generated by its loan and securities portfolio, along with fees assessed for a variety of transactions. Expenses can be mainly attributed to operating and marketing expenses, which in the 4Q02 accounted for $1.6 billion and $1.1 billion, respectively. Most of Capital One's accounts are solicited through telemarketing and direct mail efforts giving rise to associated expenses that have increased commensurate with managed loans, although alternate and more cost efficient modes of communication are being explored.

Capital One Financial strategically markets it products to specific consumer segments and actively manages the terms of its products so as to mitigate the level of risk and therefore obtain an expected return. Over the past couple of years, the Company has made a concerted effort to cater to the super-prime and prime consumer segments by aggressively marketing low non-introductory rate cards. Conversely, COF has gradually been shifting their focus away from subprime assets, which as defined in the Subprime Guidelines are those customers with a Fair, Isaac and Company (FICO) score of below 660 or declared bankruptcy within the past 5 years. Although

[2] Capital One 10-K (3/17/2003)

interest rates on loans to prime consumers are lower than those to subprime consumers, prime consumers are higher quality borrowers and offer less of a credit risk. The Company is currently managing the subprime portfolio to comprise less than 35% of total managed assets.

Financial Sector: Behind the Eight Ball

The financial sector has performed much like the broader market as of late, which is understandable given that returns within a sector are affected by future prospects of profitability within a sector as well as the overall market outlook. So, while in aggregate the sector has been lower over the 52-week period, there have been some differences in the details as evidenced by the various industry indices below.

Figure 2
(as of April 4, 2003)

Index	YTD	52 weeks
DJIA	-4.2%	-13.8%
S&P 500	-3.6%	-15.4%
Nasdaq Bank Index	-3.3%	-5.6%
DJ Securities Brokers Index	-1.9%	-26.9%
DJ Insurance Index	-7.2%	-21.5%
DJ Diversified Financial Index	1.9%	-20.6%
SNL Mortgage Index	11.2%	21.4%

Mortgage companies have displayed relative strength vis-à-vis the rest of the sector as mortgage loan applications have hit peak levels due to the fact that rates, both fixed and variable, are hovering at or near all time lows. Refinancing continues to drive overall activity, representing 73.8% of total applications[3], however, the refinancing boom should slow down as rates have little downside. Going forward, the mortgage industry will face its challenges as originations begin to slow and these companies find difficulty in overcoming exaggerated expenses associated with the increased workforce built up over the past couple of years.

Banks have represented a safe harbor for investors in that bricks and mortar businesses have once again regained respectability in the post dotcom bubble. The declining interest rate environment has served to compress net interest margins (net interest income/earnings assets) while the growth in loan portfolios have been enough to boost earnings per share. However, the ailing

[3] Mortgage Bankers Association

economic environment has forced some banks to pursue more risky tactics to compensate for diminished commercial lending which has left them vulnerable. This trend coupled with a rising tide of bad commercial loans to ailing telecommunications and energy companies leave doubt as to whether EPS growth can continue for this industry.

The insurance industry has seen minimal investment income growth over the last several years, reflecting both reduced cash flows from the payment of losses and the lower interest rates available on both new money and cash from maturing investments. For the first time, industry investment income showed a decline in 2001 and as a consequence, net earnings have since been depressed while returns on equity have not seen double-digit levels since the late 1990's. Various insurers and reinsurers such as AIG, Chubb and St. Paul have reported increased charges to reserves as a result of asbestos settlements and other adverse developments. Estimates depict that the industry may be under-reserved by as much as $40-60 billion for asbestos and environmental losses.[4] Therefore, the industry is raising rates to compensate, however, given the inherent lag the earnings outlook remains bleak over the near term.

The investment banks and brokerage firms faced perhaps the most inauspicious performance over the past year as economic concerns hampered organic growth while regulatory investigations caused skepticism into their standards and practices. The bleak economic environment has resulted in a dearth of merger and acquisition activity as well as reduced commissions and fees, normally the bread and butter of Wall Street. Therefore, brokerage firms have greatly reduced their work force in order to curb expenses and attempt to somewhat salvage earnings. Concurrently, state regulators exposed inherent conflicts of interest and received large settlements from these firms along with an agreement to cease such practices. In today's skeptical climate, the future of the financial services industry rests as much in the hands of political change as economic recovery.

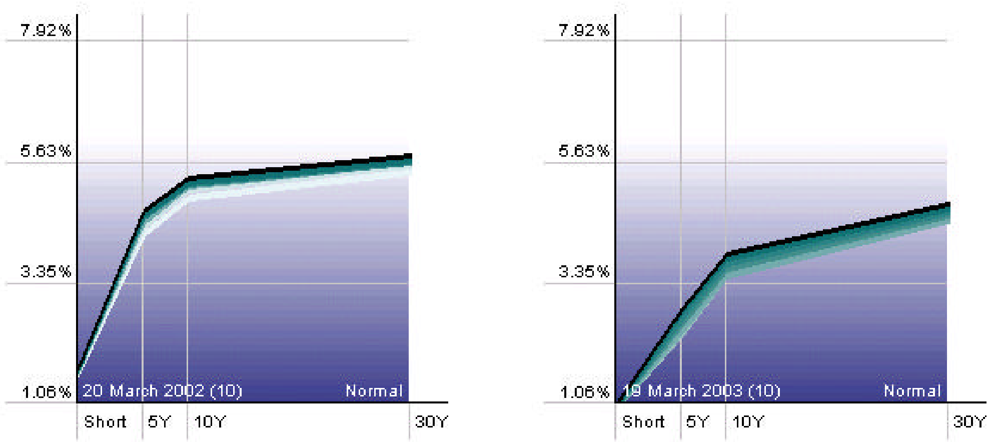
Valuations throughout the entire sector have been depressed as of late, except for perhaps banks and mortgage companies. In essence, the outlook on the sector is reliant on interest rates, the economy, as well as the geopolitical and regulatory environment. However, as will be discussed, there are certain sub-industries that will be able to withstand further economic deterioration rather well, while remaining fully poised to take advantage of an economic recovery and rising interest rates.

[4] A.M. Best

Industry/Sub-Industry Overview

The Consumer Finance industry, and more specifically, the credit card segment underwent a dynamic year in 2002 both from an economic and regulatory perspective. Although the yield curve flattened over the course of the year (see Figure 3), the industry as a whole experienced healthy net interest margins due to the lower interest rate environment and the fact that credit card issuers did not pass on the reduction in the cost of funds to the consumer. In fact, even though the prime rate has been cut in half over the past two years, the average credit card rate still stands at 14.87%, a decrease of only 147 basis points over the same time period.[5]

Figure 3[6]



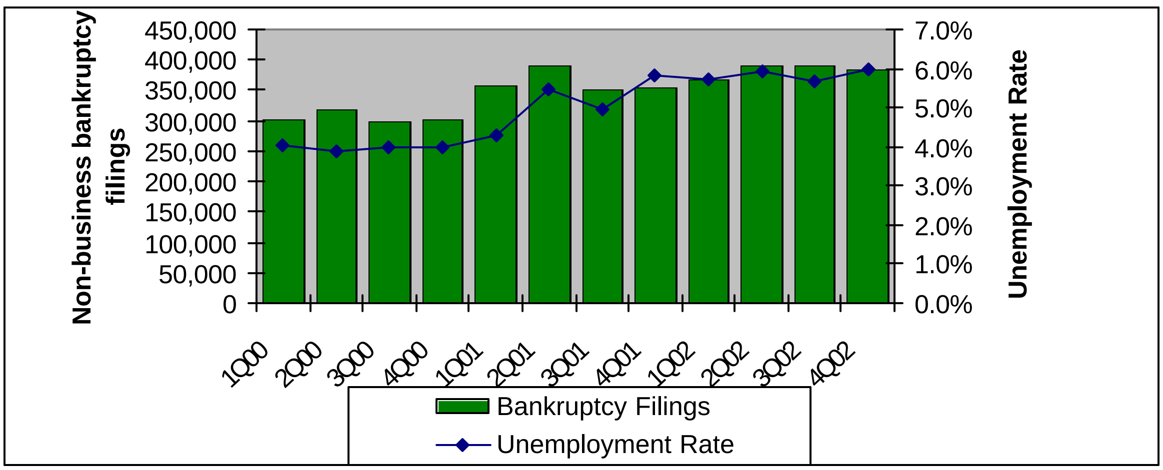
An integral means by which many companies in the consumer finance industry maintain diversified funding sources is through securitization, or off balance sheet financing, as it is referred to in SFAS 140. Securitization involves the transfer to a trust of loans receivable generated by a designated pool of accounts, whereupon they are sold to investors as asset backed securities. Similar to the sale/securitization of mortgages in the secondary mortgage markets, these transactions provide the originating institution with reduced liquidity risk, interest rate risk and credit risk. Moreover, securitization generates fee income and alleviates the effects of regulatory constraints. For those sales that comply with FASB standards, the principle amount of the loan receivables is removed from the company's balance sheet. As a core operational component for much of the industry, any adverse shift in

[5] Cardweb.com, Inc.
[6] www.stockcharts.com

interest rates, lowered debt rating or inability of the capital markets to absorb such securities could increase funding costs and negatively affect profitability.

As evidenced in Figure 4 below, the overall economic environment was a major source of concern as non-business bankruptcy filings expanded to 385,629 in the 4th quarter of 2002, an 8.6% year over year increase[7] lending to the renewed industry focus on super-prime and prime consumers. Concurrently, the unemployment rate has been at relatively high levels ranging from 5.6 to 6.0 percent over the past 36 months creating difficulties since nearly one-half of credit losses are a direct result of personal bankruptcies. As a result, most of the credit card lenders saw rather prodigious increases in charge-offs and delinquencies.

Figure 4



The regulatory authorities proved to be a thorn in the side of the credit card issuers throughout the year as the Federal Financial Institution Examination Council (FFIEC), an inter-agency body which is comprised of various bank regulators such as the Federal Reserve and FDIC, drafted proposed rule changes in July serving as a harbinger of future scrutiny. The guidance focused primarily on the practices of subprime lenders with most of the attention centered on the allowance for loan loss requirements and negative amortization. Negative amortization occurs when the required minimum payment is not sufficient to cover fees and finance charges assessed in the current billing cycle.[8] In essence, more stringent requirements in either of these two areas would directly affect the bottom line since a mandated

[7] www.abiworld.gov
[8] Draft 7/22/2002: Credit Card Lending. (www.ffiec.gov)

increase in allowance for loan losses would be an expense and reduce net income, while curbing negative amortization would reduce fees and therefore impact revenue. Fortunately in January the official guidance was less restrictive than originally anticipated, and the only issue on which it took an explicit stance was current recovery practices.

The risk still remains, however, that regulatory scrutiny will continue to intensify especially into the aggressive marketing and fees still commonplace within the industry. The ultimate danger would be another instance of what occurred to Providian in 2000, when they were imposed a $400 million fine by the District Attorney of San Francisco and the Office of the Comptroller of the Currency (OCC).

Figure 5[9]

As can be seen in Figure 5 above, the month of July proved to be precarious for the stocks of credit card issuers. On average, these stocks saw a 24% decline in their value over the month as investors and lenders alike were unsure of the implications of the initial draft by the FFIEC. However, even after final guidance provided by the regulatory authorities in January proved to be rather benign, most of the stocks affected did not recoup their earlier losses. News of a Fitch downgrade on MBNA Corporation's debt and the fact that Metris Companies was unable to pay its most recent quarterly dividend certainly has not helped matters any.

In spite of the foregoing, certain companies within the credit card peer group have had their asset and earnings growth uninterrupted although its valuation

[9] www.bigcharts.com

has been dampened as investors fear that it will meet the same fate as its weaker competitors. Moreover, the credit card group as a whole has avidly been pursuing the migration towards higher quality consumers; a trend that has been overshadowed in the midst of the regulatory cloud. This presents an attractive opportunity to obtain a company with a solid business model that has been depressed more out of near term uncertainties and disenchantment of the group rather than for fundamental flaws.

Capital One: Timeline

COF, along with some of its peers, has been in the spotlight recently but unfortunately for all the wrong reasons. The following timeline displays the underlying reasons behind the negative perception placed on the Company by the investing public:

7/16/2002- At Capital One's 2Q conference call, it was voluntarily announced that the Company entered into an informal memorandum of understanding (MOU) with the bank regulatory authorities. By definition, an MOU is an informal action (milder than a formal supervisory action) that is not published or otherwise available to the public. Some of the issues addressed were finance and fee policies, allowance for loan losses, procedures and controls.[10]

7/22/2002- FFIEC released draft guidelines concerning industry wide practices aimed towards people with impaired credit.

8/22/2002- Capital One received a formal order from the Securities and Exchange Commission (SEC) partially based upon the 40% drop in their stock price following the 2Q conference call.

1/8/2003- FFIEC released its final version of its "Account Management and Loss Allowance Guidance" for credit card lending. The final guidance was less stringent than initially implied in the earlier draft, especially with respect to the charging of over-limit fees. As a result, Capital One and other companies characterized as being subprime lenders were seen as beneficiaries in that fee income would go unimpeded.

2/9/2003- Capital One's CFO, David Willey, received a Wells notice from the Securities and Exchange Commission (SEC) accusing him of insider trading activity.

3/3/2003- Announcement of CFO's resignation.

[10] Capital One Financial. Report 8-K (www.sec.gov)

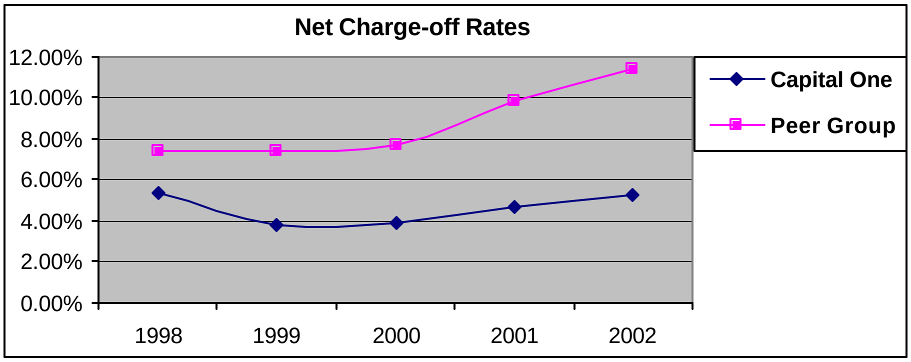
Outpacing Their Peers

The timeline in the prior section displays many of the exogenous events that have affected Capital One and served to shift investors' focus off of their core business model. Rather than remain apprehensive of what will transpire with some of the Company's unresolved regulatory issues, it is essential to focus on the fundamentals and earnings as a harbinger of future profitability. In doing so, it is evident that Capital One is a well run company performing at a level deserving a substantial premium to their current valuation, or at the very least a return to fair valuation. Initial evidence of this is the fact that the Company has met their goal of at least 20% EPS growth consistently over the past eight years. As well, over the past five years, Capital One ranks 22nd among the S&P 500 in terms of annual earnings growth and has the highest growth rate of any financial services company over the same time period.

As stated previously, a central issue for Capital One and its peer group is the ability to manage charge-offs and delinquencies regardless of the prevailing economic environment. COF's data mining capabilities allow it to detect erratic consumer behavior and get out ahead of those customers that look like they will overextend themselves, thereby allowing them to better predict potential default. According to the Company's recent 10-K, any credit card account that is 180 days past the due date or any auto finance/consumer loan that is 120 days past due is charged off. This has been the main focus of Company management as they have established a strategic plan to intentionally slow down the pace of annual asset growth, from historic levels of 40% to 20-25%. Concurrently, Capital One is also concentrating their efforts away from subprime asset and focusing new originations on prime assets. Current marketing efforts that support this initiative include 'No Hassle' credit cards, Lifestyle credit cards, mortgage loans and refinancings. To date, subprime assets declined to 29.2% of on-balance sheet assets, a substantial decrease from 40% in 2001.

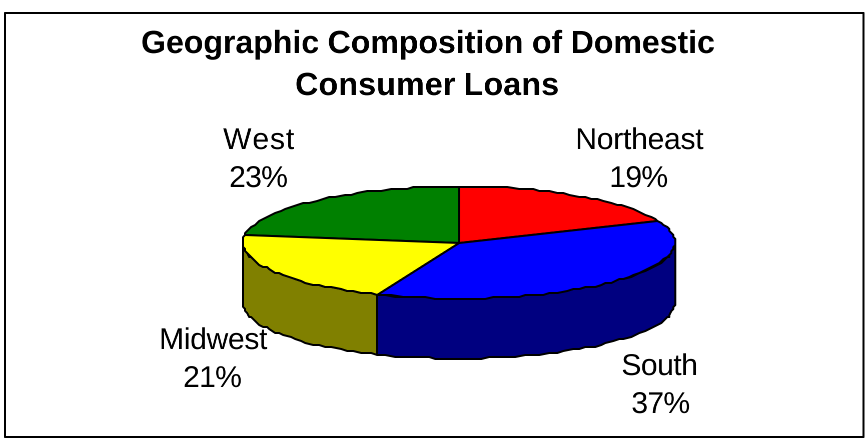
The past year saw a rise in net charge-offs for Capital One, with the trend accelerating over the past two quarters rising from 4.96% in the third quarter to 6.21% in the fourth quarter of 2002. This was primarily attributed to the seasoning of the portfolio from subprime accounts booked in the 4Q of 2001 and early 2002. However, as the transition to prime continues and the subprime accounts charge off and constitute less of the portfolio, future charge-offs will diminish. Although net charge-offs have risen over the past year for Capital One, they are still well below the average rate of net charge offs booked by their peer group.

Figure 6



Much of Capital One Financial's proficiency in managing net charge-offs is a result of its successful use of proprietary IBS across all segments to achieve superior risk adjusted returns through strategic diversification. In analyzing the Company's domestic geographic composition of consumer loans (see Figure 7) and the applicable unemployment rates for those regions, it follows that while the national unemployment rate in January 2003 was 5.7%, the weighted average unemployment rate in COF's universe was eight basis points lower at 5.62%. Furthermore, the Company is seeking to bolster their international presence outside of Canada and the United Kingdom to France and South Africa. Depending on the success of this campaign, this would further enhance the diversification of their loan portfolio as unemployment rates overseas have declined over the past three years while domestic unemployment rates, and consequently bankruptcy filings, have been on the rise.

Figure 7



In an environment of increasing net charge-offs, it is important to analyze the provision, or allowance, for loan losses. When a credit lender charges off a loan, the resulting loss does not affect profitability since the charge-off is against the allowance for loan losses (ALL). Capital One increased its ALL for 2002 by $880 million, to $2.1 billion which was an increase of 92% over the prior year, thereby increasing the ratio of allowance for loan losses to reported loans to 6.18% from 4.02% in 2001. The underlying impetus for this was not only a change in the methodology for recoveries of charged-off loans in response to final guidelines published by the FFIEC, but also due to conservative estimates of future portfolio risk. Regardless of the motivation behind this action, it should serve as an enhanced buffer against charge-offs going forward.

Comparison with Other Monoline Credit Card Issuers

Figure 8

Company	**Symbo**	**Price 4/11/03)**	**52 week range**	**Margin (Net Income/Sales)**	**X Productivity (Sales/Total Assets)**	**X Leverage (Assets/ Equity)**	**= Return On Equity**
Providian Financial	PVN	$6.91	$8.49-2.50	8.9%	10.1%	7.8	7.01%
Metris Companies	MXT	$2.18	$23.76-1.25	-2.6%	38.4%	2.95	-3%
MBNA Corporation	KRB	$15.69	$26.25-11.96	20%	18.3%	5.8	21.2%
Compucredit Corporation	CCRT	$7.43	$8.70-4.00	3.1%	36.1%	1.16	1.16%
Capital One Financial	COF	$34.11	$66.50-24.05	13%	20.25%	8.25	21.7%

If the adage that the ultimate measure of a company is the value that it generates for shareholders has any merit, then Capital One has set the standard among credit card issuers. COF's return on equity is 5 basis points above its closest competitor, MBNA Corporation, and well above any other member of its peer group. The primary impetus behind Capital One's high ROE has been their ability to cut costs and focus on the bottom line as well as successfully employ favorable leverage.

Figure 9

Company	Symbol	EPS 2001	EPS 2002	1-Year EPS Growth	EPS 2003E (consensus)[11]	5-Year EPS CAGR	Debt/ Equity
Providian Financial	PVN	$0.49	$0.30	-38.8%	$0.61	-9%	6.8x
Metris Companies	MXT	$2.62	-$1.2	-146%	-$1.29	*N/A*	1.6x
MBNA Corporation	KRB	$1.92	$1.47	-23.4%	$1.62	17.9%	4.9x
Compucredit Corporation	CCRT	$0.06	$0.04	-33.3%	$0.88	*N/A*	0.2x
Capital One Financial	COF	$2.91	$3.93	35.1%	$4.49	33%	7.1x

In looking at Figure 9 above, it is blatantly obvious that not only has COF had the highest earnings growth over the past year, but it was the only member of its peer group to have positive earnings growth. What makes this feat even more impressive is that Capital One's 35% growth occurred in an environment in which the S&P 500 as a whole only managed earnings growth of 5%. This is by no means an anomaly as the Company has consistently generated at least 20% annual earnings growth since 1995, and is projected to once again outperform its peers in terms of EPS growth in 2003. It should be noted that even though the consensus estimate for 2003 is $4.49, Capital One exceeded the 2002 consensus estimate of $3.70 by 6.2%, therefore Company guidance of $4.55 for this year may be closer to reality.

Figure 10

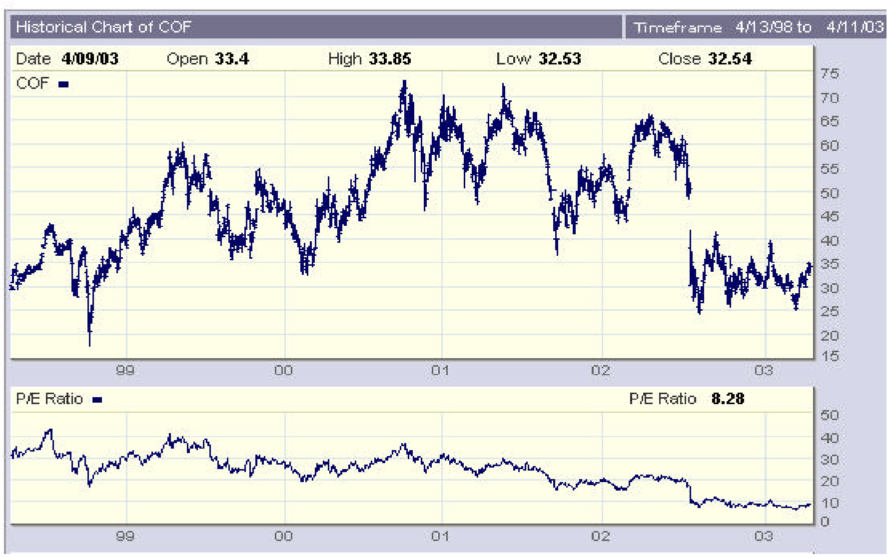
Company	Symbol	P/E	2003E P/E	5-Year Avg. P/E	PEG	P/B	5-Year Avg. P/B
Providian Financial	PVN	12.85x	10.7x	16.4x	0.13x	0.88x	5.3x
Metris Companies	MXT	*N/A*	*N/A*	*N/A*	*N/A*	0.21x	1.9x
MBNA Corporation	KRB	11.45x	9.5x	20.1x	1.1x	2.3x	6.4x
Compucredit Corporation	CCRT	*N/A*	8.0x	*N/A*	*N/A*	0.81x	2.9x
Capital One Financial	COF	8.7x	7.6x	22.5x	0.6x	1.6x	5.0x
Consumer Finance Industry		14.4x	12.0x		0.8x	3.1x	
S&P 500 Index		21.2x	17.0x		1.6x	3.1x	

[11] www.thompsonfn.com.

Valuation

Capital One Financial offers a compelling valuation given its low price to book multiple of 1.6x versus an over 20% ROE, and a 7.6x earnings multiple for expected growth of 15-20%. COF is trading at a discount on both a relative and absolute basis, as it is currently priced at a 37% discount to the industry on a 2003 P/E basis and 61% below its historical P/E average of 22.5x (see Figure 11 below). Given COF's enviable record of earnings growth, a conservative valuation would be an average of its respective industry and benchmark forward P/E of 14.5x, which when using consensus estimates for 2003 yields a 12-month price target of $65. Alternatively, Capital One is trading at 160% of book value vis-à-vis 310% for both the industry and the S&P 500, further confirming the price target as it represents a multiple of 3.1x COF's book value of $20.84.

Figure 11



Catalysts

The primary catalyst would be the peaking of net charge-offs in the 3Q of 2003. Capital One is currently undergoing a transition whereby they have decreased subprime assets from 40% to 29% over the past year. This shift towards superprime and prime consumers has not benefited earnings due to the inherent lag in net charge-offs. The Company's current model will yield results in 2003, as net charge-offs should peak dramatically thereby providing a boost to earnings and validating in the minds of investors that COF's current strategy is on track.

Should the bankruptcy reform legislation (H.R. 975) that was recently passed on by the House of Representatives also be affirmed by the Senate and eventually be enacted, then credit card lenders would see an immediate boost in valuations. On March 19, 2003, the House approved bankruptcy reform legislation by an overwhelming vote of 315-113. This legislation would make it more difficult for debtors to discharge debt and subject them to a means test that would require a repayment plan. As stated by Rep. William Delahunt (D-Mass.) who is opposed to reform, "The big winner here is the credit card industry because passage is going to mean billions of dollars to their bottom line."[12]
Although similar legislation in prior years was unable to make it through Congress, these bills contained a controversial protestor provision that has been excluded in the current legislation. Therefore, given that the Bush Administration supports the bankruptcy reform provisions in H.R 975 and certain members of Congress are determined to see this come to fruition, 2003 may see the inception of more stringent bankruptcy laws.

Another event that would serve as a catalyst would be the lifting of the memorandum of understanding by the regulators. Capital One has been proactive in adjusting the aspects of their business model that have been brought into question and have been in open dialogue with the authorities. As well, the Company has taken the requisite measures and increased levels of capital, reserves and allowances to where it believes that it will satisfy all the condition of the memorandum. Further proof that Capital One is in compliance could occur depending on whether its existing subprime receivables mature according to management's expectations. If credit quality falls in line with expectations, it will solidify in the minds of regulators that the Company has this segment under control and it should only be a matter of time before the memorandum of understanding is terminated.

[12] www.cch.com. "House Approves Bankruptcy Reform of 2003".

If the volume-based bulk mail discount proposed by the U.S. Postal Service specifically for Capital One would be implemented, it would mean an immediate reduction in expenses that would flow directly to the bottom line. The U.S.P.S. filed an unprecedented proposal with the Postal Rate Commission in September 2002 to reduce first class mail by as much as 6 cents per piece of mail for its largest first class mail customer, Capital One.[13] Given that the Company mails over 1 billion letters annually consisting of both solicitation letters and monthly account statements, a rate reduction of this magnitude could reduce cost savings in the range of $55-70 million, or $0.17-$0.20 per share. The Postal Commission is currently in the process of holding evidentiary hearings and is expected to make a decision by the end of May.

The high short interest on shares of COF could result in a short squeeze. The market has been exceedingly bearish on shares of Capital One as well as on credit card lenders as a whole, evidenced by the fact that short sellers represent 16.9% of COF's float. While this phenomenon has enhanced the demise of the stock price over the past year, it bodes well for future price action as all the short positions must eventually be covered. Currently, it would take 8.6 days for all the short sellers to cover their positions, given average trading volume. So as the economy turns and the sentiment for Capital One shifts gears, short sellers will have to exit their positions so as to not incur a loss and thereby boost the stock price.

A final catalyst would be the gain in market share that Capital One could see over the next year due to impending internal difficulties of competitors. Recently, CompuCredit Corporation disclosed that it portends being cash flow negative for 2003 and as a result of this lack of liquidity does not anticipate growing receivables. As well, Metris Companies had substantial workforce reductions in January leaving them in a position where they will be constrained in the number of additional customer relationships that they will be able to service.

[13] www.prc.gov. Docket No. MC2002-2

Risks

A sustained economic downturn or recession with associated high unemployment and bankruptcy rates would have implications on borrowers not being able to repay their credit card and other unsecured loans. This would increase charge offs and delinquencies and negatively affect the Company's core capital and earnings.

Capital One's future success is reliant on securitization of their credit card receivables in order to fund asset growth and raise capital. Therefore, should this funding source become relatively unstable and either become more expensive or more difficult it could increase the cost of funds and adversely affect margins. As of the end of fiscal year 2002, 61%, or $36.7 billion of total loans was subject to securitization transactions.

As a holding company for a state chartered bank and a federally chartered savings bank, Capital One is subject to comprehensive regulation and periodic examination from numerous regulatory bodies including the Federal Reserve Board, the FDIC, OTS and the Bureau of Financial Institutions. As such, any guidance or new regulations issued by any of the above named institutions could impinge upon the way that they do business and cause material losses.

Capital One's net interest income is dependent on the spread between their receivables and their cost of funds. If interest rates were to rise rapidly, it may not be feasible to immediately reprice all accounts in order to match the increase in borrowing costs, thereby compressing their net interest margin and ultimately, earnings.

Conclusion

Capital One Financial presents an uncommon value in the financial sector and the opportunity to obtain a solid growth stock currently selling at a steep discount to both historical and industry valuations. While the Company's stock price has been excessively depressed as a result of near term uncertainties, these are concerns and nothing more. Granted, investors have seen competitors fall on hard times which has plagued Capital One with guilt by association; however, continued earnings growth and peaking net charge-offs will alter sentiment and validate COF's business model in the minds of investors. Accordingly, Capital One is an excellent Long opportunity as its price target of $65 would provide for 90% upside potential at current levels.

APPENDIX

CAPITAL ONE FINANCIAL CORP
Income Statement

Year Ended December 31 (In Thousands)	2000	2001	2002	2003E
INTEREST INCOME:				
Consumer loans, including past-due fees	2,350,771	2,729,519	3,868,664	4,338,764
Securities available for sale	96,554	138,188	184,407	214,439
Other	6,574	53,442	127,695	148,491
Total interest income	2,453,899	2,921,149	4,180,766	4,701,694
INTEREST EXPENSE:				
Deposits	324,008	640,470	811,889	944,109
Senior notes	274,975	357,495	422,529	491,340
Other borrowings	202,034	173,042	227,236	264,242
Total interest expense	801,017	1,171,007	1,461,654	1,699,691
Net interest income	1,652,882	1,750,142	2,719,112	3,002,002
Provision for loan losses	812,861	1,120,457	2,149,328	2,499,356
Net interest income after provision for lo	840,021	629,685	569,784	502,646
NON-INTEREST INCOME:				
Servicing and securitizations	1,152,375	2,441,144	2,805,501	3,157,861
Service charges	1,646,588	1,536,338	1,937,735	2,253,304
Interchange	237,777	379,797	447,747	520,665
Other	28,370	106,483	275,853	320,777
Total non-interest income	3,065,110	4,463,762	5,466,836	6,252,607
NON-INTEREST EXPENSE:				
Salaries and associate benefits	1,023,367	1,392,072	1,557,887	1,724,837
Marketing	906,147	1,082,979	1,070,624	1,140,451
Communications and data processing	296,255	327,743	406,071	472,202
Supplies and equipment	252,937	310,310	357,953	416,247
Occupancy	112,667	136,974	205,531	239,003
Other	556,284	807,949	987,515	1,075,166
Total non-interest expense	3,147,657	4,058,027	4,585,581	5,067,906
Income before income taxes	757,474	1,035,420	1,451,039	1,687,347
Income taxes	287,840	393,455	551,395	641,192
Net income	469,634	641,965	899,644	1,046,155
Basic earnings per share	2.39	3.06	4.09	4.55
Diluted earnings per share	2.24	2.91	3.93	4.37