Business Description

Capital One (COF) is a domestic and international diversified bank. They have bank locations in Connecticut, Louisiana, New Jersey, New York and Texas, and offer a broad array of financial products and services to customers, small businesses and commercial clients. COF operates through two main subsidiaries, Capital One Bank (USA), National Association (“COBNA”) which offers credit and debit card products, other lending products and deposit products; and Capital One, National Association (“CONA”), which offers a spectrum of banking products and financial services to both consumers and businesses of various sizes. It is the eighth largest bank in the United States based on assets and the number four credit card issuer based on loan balances. The three main segments of Capital One are their credit card business, their consumer banking and their commercial banking businesses. The credit card business is their legacy business that they began with the inception of the company in 1994. They distribute credit cards to individuals, small businesses and corporates. This is the largest segment in terms of revenue and income. Their consumer banking offers a variety of mass-market and customized financial products for individuals, families and communities. Their commercial banking segment offers loans for corporations.

Industry Trends

The banking industry has been underperforming in 2016 due to the low interest rate environment. However, with consumer health improving there is a strong outlook in the financial services industry. The Census Bureau released data in 2015 indicating that the real median U.S. household income increased 5.2%. Additionally, consumer confidence has increased leading to more spending. With this increased income and confidence, disposable income is being put to work which is good news for the credit card and loan industries.

Investment Thesis

Capital One will deliver long run value due to its growing diversification in business, experience in managing quality of deposits and loans, and their competitive advantage in key areas such as online banking and their credit card business. The company has been able to withstand financial volatility (as seen during the financial crisis) and has taken on successful organic and inorganic growth opportunities throughout its life time. It is currently undervalued and has significant upside potential.

Valuation Assumptions

- WACC: 9.00%
- Growth Rate: 2.0%
- Dividends Paid 2016E based on Average since 1998
- Shares Outstanding Change: 0%
- Conservative given their share buyback plans

Key Financials

- DDM Stock Price: $82.32
- Stock Price Multiples: $102.06
- Weighted 50/50
- Intrinsic Value: $92.19

Corporate Social Responsibility

- Environmental Disclosure Score: 32.14 (Industry average: 16.88)
- % Of Women Employed: 57.00% (Industry average: 56.00%)
- Board Average Age: 63.60 (Industry average: 62.81)
- CEO Tenure: 18 (Industry average: 8.94)
- % NonExec Directors on Board: 90.00% (Industry average: 89.79)

5-Year Stock Performance

Competitive Analysis

Capital One competes with many different financial services firms across their various business lines. Their main competitors in terms of size and similarity, however, are JP Morgan Chase, Citigroup, Bank of America, American Express and Discover Financial. Capital One has shown bigger market-share gains than its leading competitors in the past six years ended June 30th, 2016.

Competitive Advantages

Capital One Corporation has three main competitive advantages. First, Capital One has a prominent international credit card business in the UK and Canada. Direct competitors Wells Fargo, U.S. Bank and PNC Bank don’t have a strong international card presence. Also, Capital One, since its acquisition of ING Direct in 2012, has been the pioneer in online banking and mobile banking. Capital One 360 was the first U.S. issuer app from contactless payments on Android. 360 and the Capital One wallet are two of the highest rated apps in financial services. Additionally, their cards with rewards are well-known and continuing to expand. Quicksilver and Venture cards are growing at a faster pace than competitors American Express and Discover Financial Services while also managing their overall costs well. Their credit card balances are up 12% in Q2 Year over Year.

Risks

The first risk that is most obvious is interest rate risk. Capital One is well-positioned for a rate increase, as they are not as rate-sensitive as a typical bank due to their higher net-margin and greater proportion of high-yield assets. Credit losses are also a risk but Capital One has proven itself to be a prudent underwriter of risk. Although the credit card business caters to low-prime and high-quality subprime borrowers, it did not have a loss during the financial crisis and all money borrowed from the government was returned the following year. There are also technology risks. As a prominent player in the online and mobile banking space, there is a risk of credit information being stolen through a security breach. There has not been an incident in the past however and Capital One has invested in cyber threat analytics, data encryption and tokenization technologies, anti-malware defenses and a vulnerability management program.

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Sources: Bloomberg, Yahoo! Finance, 2015 Capital One Annual Report