INVESTMENT CASE STUDY

Capital One Financial Corp. (COF)

Thornburg

September 2021

Firm Overview - Capital One Financial Corp. is a diversified financial services holding company headquartered in McLean, VA. The company provides financial products and services through three segments: Credit Card, Consumer Banking and Commercial Banking.

Highlights:

- Trading at a pre-tax, pre-provision earnings (PTPP) multiple below five, lower than most national and regional banks.
- Low rate of charge-offs (provision for writing off bad/ delinquent accounts) could boost earnings going forward.
- Low relative valuation versus history.

The Bottom Line - Secular tailwinds are fueling the broad switch from cash to electronic payments. Capital One's foresight has enabled it to benefit from this trend by increasing overall efficiency and customer growth as consumers go digital. In short, we believe Capital One is a leading digital bank that continues to leverage fintech investments to further distance itself from the competition.

Potential Headwinds/Considerations:

- Near-term credit performance expectations
- Future sources of new account growth
- Cost of technology talent increasing significantly
- Competition from smaller fintech firms

Price	$154.69
52-Week Range	$58.35 – $166.29
Market Cap	$69.0 billion
Enterprise Value	$77.8 billion
TTM Revenue	$29.2 billion

As of 6/30/21.

Source: Bloomberg

The Company

Capital One Financial (COF) is a descendant of the Bank of Virginia, which was formed in 1945. Years of acquisitions and mergers that consolidated over two dozen banks and mortgage companies under the bank's umbrella led it to become Signet Banking in 1986. Under the leadership of Richard Fairbank and Nigel Morris, the bank began using sophisticated data-collection methods to gather massive amounts of information on existing and prospective customers, allowing them to design and mass-market customized products to the customer - the most notable being an innovative balance-transfer card. In 2005, the company expanded into banking with the acquisition of New Orleans-based Hibernia and adopted the Capital One moniker.

Today, Capital One Financial is one of the most recognizable credit card issuers in the U.S. In addition to credit cards, they offer debit cards, auto loans and other consumer lending products in markets primarily across the United States. Capital One maintains a strong online presence with its internet and mobile banking applications. The company's Credit Card business is its largest segment, representing over 60% of revenue while Consumer Banking generates roughly 30% of revenue. The Commercial Banking division serves the bank's commercial, multi-family real estate and industrial customers. This segment represents roughly 10% of revenue and 30% of the bank's loan portfolio.

The company focuses on the development and use of efficient and flexible computer and operational systems, such as cloud technology, to support complex marketing and account management strategies, the servicing of their customers and the development of new and diversified products. Management continuously explores opportunities to enter into strategic partnerships and acquire financial services and products as part of its growth initiatives.

(Source: Bloomberg - adapted from Hoover's Inc., a Dun & Bradstreet Co.)

Our Initial Thesis

The Thornburg Global Opportunities' team initiated a position in COF in early 2012 after several quarters of extensive analysis on the company and the financial services industry. At the time, we were broadly positive on the credit card segment for multiple reasons:

Market Share: We viewed the industry as a beneficiary of the retrenchment of debit card (due to the 2011 Durbin Amendment) and home equity lines of credit (due to lower mortgage equity)[1]. During the 2000s, debit cards and HELOCs took roughly 30 and 25 percentage points, respectively, of market share from credit cards. For the first time in a decade, this trend began to reverse in 2011. With its robust consumer credit card business, we believed COF would gain additional market share within the segment.

A Rebound in Consumption: With consumer balance sheets on the mend, U.S. spending volume growth turned positive in Q4 2009 and U.S. credit card loans outstanding turned positive in Q2 2011. Our analysis showed that credit card lending was poised to grow at a higher rate than total system lending. In addition, credit card receivables are a high-yielding asset, a trait that is particularly attractive in a low interest rate environment. With roughly 50% of COF's loan book consisting of credit card loans, we believed the company was uniquely positioned to take advantage of the opportunities created by a healthier U.S. consumer and strengthening credit card loan environment.

An additional component of our initial thesis was built around management's announcement in the second half of 2011 of the acquisitions of ING Direct and HSBC's U.S. credit card business, making Capital One the fifth largest depository institution and sixth largest discount broker in the United States at the time. Our team viewed the pending deals as being highly accretive to COF's earnings. With respect to the ING Direct deal, specifically, the acquisition would provide access to large, geographically diverse lower cost funding – The deposits and broader channel would give COF, a former monoline, more financing stability and more freedom from the bond market.

Our Current Thesis

Our thesis for Capital One remains intact, though it has evolved over time as we continue to sharpen our understanding of the business. Today, there are multiple components to our thesis. First, the consumer is relatively healthy, and the loan loss provisions taken by COF at the beginning of the COVID pandemic were potentially larger than required, providing a tailwind to earnings going forward.

More significantly, Capital One is a heavy investor in financial technology platforms and online delivery of products and services. As a best in class technological operator, it is our belief that Capital One will disproportionately benefit from the digital revolution in finance with consumers transitioning from in-person to online interactions and transactions. Capital One wants to be viewed as a technology company in the business of banking, not the other way around. This is key as fintech companies have been rewarded heavily by the market over the past five years, and Capital One currently trades more like a financial stock.

Applying Global Opportunities' Research Framework to Capital One

Identifying Sustainable Business Models -

- High credit quality of loans across multiple segments
- Strong management with track record of fintech investments to power growth
- Secular tailwinds fueling shift from cash to electronic payments
- *Potential headwind*: Increasing cost of technology talent.

Determining Intrinsic Value -

- Low rate of charge-offs should boost earnings going forward
- Low relative historical valuation
- Trading at low PTPP multiple vs most national and regional banks

Uncovering a Clear Path to Success -

- Higher consumer spending in CY21 & CY22 leading to positive inflection in receivables
- Continued digital transformation should increase engagement, efficiency and customer acquisition
- Excess capital driving future buybacks and dividends
- Better interest margins in a rising rate environment
- *Potential headwind*: Increased competition from smaller fintech firms

[1]The Durbin amendment also known as Regulation II is a provision of United States federal law that requires the Federal Reserve to limit fees charged to retailers for debit card processing. It was passed as part of the Dodd-Frank financial reform legislation in 2010, as a last-minute addition by Illinois Senator Richard Durbin.

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