

Capital One Financial Corporation

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Strong Buy/Aggressive

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Symbol: **COF**
 Exchange: **NYSE**
 Recent Price: **47.52**

		Year Ends December 31		
		2001	2002E	2003E
52-Week Price Range	72.58—46.50			
Dividend	\$0.11	EPS \$2.91	\$3.50	\$4.20
Yield	0%	P/E —	13.6X	11.3X
		ROE 23.1%	21.6%	21.5%

Fundamental Data

1997-2001 EPS CAGR	25.6%
Est. 2001-2003 EPS CAGR	20.0%
Book Value Per Share—12/01	\$15.40
Price/Book Value	3.1X
Market Value (mil.)	\$10,255
Equity to Managed Asset Ratio	6.33%
Managed Net Charge-Off Ratio	4.42%
Net Interest Margin	8.68%
Return on Equity	22.05%
Relative P/E, 2003E, S&P Composite	64%

CAGR—Compound Annual Growth Rate

Trading Data

Shares Outstanding (mil.)—12/01	215.8
Estimated Float (mil.)	213.6
Insider Holdings—12/01	1%
Institutional Holdings—12/01	72%
Average Daily Volume (mil.)	2.7

Concept List: Growth, Focus

COF—Upgraded to Strong Buy Due to Valuation Considerations And Strong Fundamentals

- Capital One (COF) is our top pick in the credit card sector, exhibiting exceptional growth with industry-leading credit quality.
- Capital One's information-based strategy leads to rapid innovation and superior risk-adjusted returns.
- We project 20% EPS growth through 2003.
- Our \$63 price objective implies COF shares trade at 18X our 2002 estimate of \$3.50 and represents 33% upside from current levels.

Company Description: Capital One is an information-based marketing company that specializes in the financial services sector by providing lending and deposit products to consumers in the United States and the United Kingdom. At December 31, 2001, Capital One had \$45 billion in managed loans and more than 43 million customer accounts. Capital One ranked as the fifth-largest U.S. bankcard issuer (Visa/MasterCard) as of December 31, 2001.

Investment Appraisal

Capital One Financial (COF) shares are currently rated Strong Buy and the company remains our top pick in the credit card sector. Despite near-term industry challenges, we continue to favor COF shares for long-term oriented investors. In the fourth quarter of 2001, Capital One's charge-off rate increased 50 basis points from the linked quarter, but Capital One maintains its top position with the lowest net charge-off rate of any major credit card issuer. We continue to believe that Capital One is better positioned for a prolonged recession than any other major credit card issuer. We find COF's valuation compelling and reiterate our Buy rating. COF's shares, at 13.6X our 2002 estimate of \$5.50 and 11.5X our 2003 estimate of \$4.20, trade at a meaningful discount to our long-term EPS growth estimate of 20%. In times of economic uncertainty, P/E multiples of growth stocks tend to compress. We view this as an opportunity for patient investors.

The shares of Capital One have been weak lately, which we attribute to false rumors being circulated in the market. First, rumors were circulated that a senior executive at Capital One was close to resigning. Then an additional rumor began to make the rounds that the company was under investigation by the Securities and Exchange Commission (SEC) for accounting-related issue. Both rumors were false. Nevertheless, many investors continue to believe something is not quite right at Capital One. The two major areas of concern surrounding the shares include accounting and disclosure issues, in our opinion. Below, we offer our thoughts on each area of concern.

Accounting—Simply put, we believe Capital One has one the most conservative orientations with respect to accounting assumptions in the financial services industry. Capital One has never had any restatements, write-offs, or one-time charges in its history. In an annual survey performed by its auditors, Capital One consistently ranked as one of the most conservative with respect to accounting assumptions. This includes aging policies, charge-off and collection recognition, revenue recognition, expense accruals, and loss reserve assumptions. For example, in 1997 Capital One modified its methodology for charging off credit card loans to 180 days past-due from the prior practice of charging off credit card receivables during the next billing cycle after becoming 180 days past-due.

MBNA, on the other hand, did not adopt the FFIEC (Federal Financial Institutions Examination Council) policy until it was mandated in the fourth quarter of 2000. COF management has an inordinate disdain for gain-on-sale accounting. In auto finance, Capital One has kept its loans on balance sheet in order to avoid gain-on-sale revenues. With respect to credit card securitizations, gain-on-sale revenues are not material for issuers because of the extremely short life of the asset securitized. Moreover, Capital One takes a most conservative approach with respect to its assumptions in credit card securitizations (e.g. COF does not present value any non-interest income like most other issuers do. Late fees, however, are included in interest income and a present value is used).

Disclosure—Admittedly, Capital One is not an easy company to understand. Management's reluctance to provide statistics on the composition of its portfolio is troubling for many investors. From our perspective, we take comfort in the fact that Capital One's top two executives, Rich Fairbank and Nigel Morris, have consistently forfeited their entire compensation in lieu of performance-based stock options. In our opinion, their willingness to make long-term bets on the strength of Capital One's business model and franchise is a huge positive and mitigates disclosure issues. Risk management is the essence of Capital One. If nothing else, the demise of Provident (PVN), CompuCredit (CCRT) and NextCard (NXCD), indicate to us that an information-based strategy is extremely difficult to execute. Why would Capital One want to give its competitors key insights into its business model? That said, we believe Capital One will likely provide more disclosure on a business line basis (i.e. installment, auto, international). However, we would be surprised to see Capital One disclose proprietary information regarding composition of its portfolio (i.e. super-prime, prime, and sub-prime).

In our opinion, these issues will be overcome, and investors will begin to focus on what makes Capital One the premier company in the credit card sector, exceptional growth driven by the company's information-based strategy.

Capital One's information-based strategy (IBS) has been instrumental in its ability to extract "excess profitability" from the credit card industry in a wide variety of adverse environments, including sluggish industry growth, intense competition,

rising interest rates, and rising credit losses. With each quarter that passes, our confidence in Capital One's ability to manage through the economic cycle improves. Of the four major credit card issuers that we follow, Capital One generated the greatest growth in the fourth quarter of 2001 with the best credit performance. From the fourth quarter of 2000 through the fourth quarter of 2001, credit loss rates rose 44 basis points for Capital One, far less than the increases of 99 basis points and 150 basis points for MBNA and American Express, respectively. Provident Financial's release of fourth quarter data revealed that the credit loss rate had increased to 12.7%. PVN had an increase of 427 basis points in the loss rate during 2001. PVN's loss rate increased over 225 basis points in the fourth quarter. We anticipate the loss rate for PVN will continue to rise throughout 2002. With respect to top-line growth, Capital One's 37% revenue growth in 2001 exceeded both MBNA, at 34%, and American Express, -30%. American Express took several charges throughout 2001, related to high yield investments and restructuring charges that have negatively affected results. PVN's full-year 2001 revenues increased 9% over 2000.

For the foreseeable future, we remain confident that Capital One can continue to execute its strategy and deliver above 20% EPS growth and 20% return on equity (ROE) in just about any environment. Indeed, our 2002 and 2003 EPS estimates of \$3.50 and \$4.20, respectively, represent 20% compound annual growth through the year 2003. Our five-year forecast for EPS growth is also 20%. Since its initial public offering in November 1994, Capital One has delivered a 20%-plus increase in earnings per share and a 20%-plus return on equity for seven consecutive years. Looking forward, we believe that Capital One, by virtue of its IBS, remains well positioned to continue to deliver 20%-plus earnings per share growth and return on equity. We can come up with at least five reasons to support our premise:

1. Capital One started as a U.S. credit card company. Today, Capital One has a growing international business. Capital One also markets and underwrites auto loans, installment loans, deposit accounts and other miscellaneous businesses. As of December 31, 2001, almost 15% of Capital One's managed receivables were generated from non-domestic credit card businesses.
2. In 1994, Capital One had 5 million customers. Today, with almost 44 million customers,

Capital One has one of the largest billable franchises in the United States to which the company can cross-market other financial and non-financial products. Capital One has grown its customer base every quarter since the company's initial public offering (IPO) in November 1994.

3. Capital One is one of the fastest growing financial services companies on the Internet. In 2000, Capital One exceeded its targets of 1 million net accounts originated via the Internet and more than 2 million accounts serviced on line. In 2001, Capital One serviced 4 million accounts online. Capital One recently ranked No. 2 with respect to credit cards on the Internet by Brittain Associates with an 18% Internet market share (NextCard 26%).
4. With IBS, Capital One can innovate constantly. Rapid, substantive innovation is the key to sustaining superior returns, in our view. In 2000, Capital One tested more than 45,000 new ideas, 27% more than 1999. In 2001, Capital One tested more than 63,000 ideas, 40% more than in 2000.
5. Recruiting is a top priority at Capital One. Senior managers at Capital One believe that recruiting the right people is the single most important job they perform. Many other financial services companies struggle with respect to eliminating employees in a down economic environment, or worse, they do nothing at all. Capital One's philosophy is to consistently reward high performers. Nearly 80% of associates own COF stock options. The top two executives, Richard Fairbank and Nigel Morris, have given up all remaining compensation through the year 2003, in exchange for performance-based option grants. The performance-based options vest if Capital One's stock price reaches \$100 by June 2002, \$120 by June 2003 or \$144 by June 2004.

Valuation—In the long run, we believe Capital One's valuation will be driven higher by its strong fundamentals. For 2002, we forecast 20.2% EPS growth and an ROE of 21.6%. We also believe Capital One has a substantial degree of earnings flexibility given its high level of marketing expenses, and healthy loan loss reserve and capital ratios. Ultimately, Capital One's valuation should be driven by its fundamentals and earnings

growth. We expect both to be stellar. We remain confident that Capital One will meet or exceed our EPS estimates through at least 2002. Our \$63 price objective assumes COF shares trade at an 18 P/E multiple to our 2002 EPS estimate of \$5.50, in line with our estimate of COF's long-term growth rate. Our \$63 price objective is fully supported by a multistage discounted cash flow valuation model. Figure 1 provides a relative valuation comparison for Capital One versus its peers.

The Power of IBS

Information-Based Strategy (IBS)—COF's IBS is designed to differentiate among customers based on credit risk, usage and other characteristics and then matches these characteristics with appropriate product offerings. COF management refers to this as mass customization—delivering the right product to the right customer at the right time at the right price. Mass customization enables COF to profitably meet the credit needs of virtually all consumers because it allows COF to balance risk and reward in every single account.

The IBS strategy begins with the collection of information from Capital One's extensive databases. Using large amounts of data, the company builds predictive models, tests hypotheses and tracks the results to build marketing programs targeted at specific profitable customer segments. The essence of COF's IBS is scientific testing on a massive scale. COF uses testing to learn how to customize products and services to the consumer. Equally as important, COF uses testing to build a steady stream of new

ideas to stay ahead of the competition. Finally, testing allows COF to cost-effectively explore numerous possibilities, and to know the likely results of its products and programs prior to rolling them out. In 1999, Capital One conducted approximately 36,000 separate tests; in 2000 COF conducted more than 45,000 separate tests, 25% more than in 1999. (See Figure 2.) In 2001, COF conducted over 63,000 tests, 60% more than in 2000. Continuous testing at COF is important to future success as scientific testing spawns continuous, breakthrough innovations at Capital One.

Capital One uses sophisticated analytical models to segment potential customers by integrating credit scores, demographics, and customer behavioral characteristics. By actively testing a wide range of product and service features, marketing channels and other aspects of its offerings, COF enhances customer response levels and maximizes its return on investment. COF's testing is integrated as analytical models are constantly being refined to build on information gained from earlier phases. In our opinion, COF's strong performance is a testament to the success of its information-based strategy. At the most basic level, we think account growth is the key indicator of COF's success since customers are the lifeblood of any consumer-oriented company. COF recently announced that it surpassed the 43 million customer mark, meaning its customer base has increased 27 fold since its initial public offering in November 1994. More impressive, account growth has actually accelerated at COF over the last five years. In 1995, COF added 3,000 net new accounts per day. This

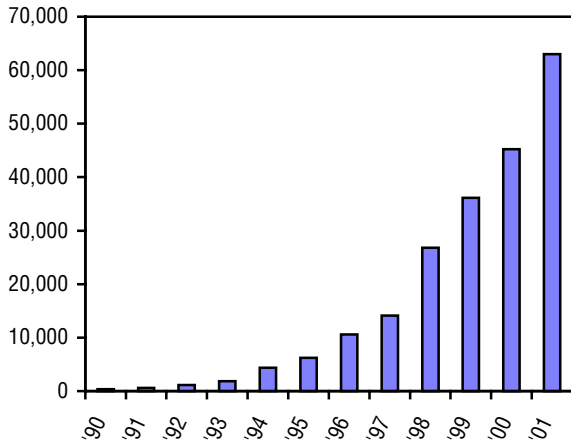
FIGURE 1 Comparative Valuation

Sym	Company	2/8/02 Price	Market Cap (\$MM)	Diluted Earnings Per Share			CAGR '01-'03	Price to			'02 P/E		Price/ Book	Yield
				2001A	2002E	2003E		2001A EPS	2002E EPS	2003E EPS	Relative to CAGR	S&P500		
AXP	American Express	33.85	45,163	0.98	1.75	1.96	41.4%	34.5	19.3	17.3	47%	77%	3.7	0.9%
KRB	MBNA	33.30	28,364	1.92	2.25	2.60	16.4%	17.3	14.8	12.8	90%	59%	4.1	1.2%
HI	Household	52.00	23,801	4.08	4.65	5.20	12.9%	12.7	11.2	10.0	87%	44%	3.0	1.7%
ACF	AmeriCredit	21.98	1,854	2.60	3.76	4.50	31.6%	8.5	5.8	4.9	19%	23%	1.4	0.0%
PVN	Providian	4.16	1,182	0.49	-0.30	0.35	-15.5%	8.5	-13.9	11.9	90%	-55%	0.5	2.9%
MXT	Metris	14.96	954	2.62	2.79	3.05	7.9%	5.7	5.4	4.9	68%	21%	1.4	0.3%
CCRT	CompuCredit	5.60	261	0.90	0.53	0.57	-20.4%	6.2	10.6	9.8	-52%	42%	0.6	0.0%
COF	Capital One	47.52	10,211	2.91	3.50	4.20	20.1%	16.3	13.6	11.3	67%	54%	3.4	0.2%
	Median Group						15%	10.6	10.9	10.7		43%	2.2	0.6%
SPX	S&P Comp.	1096.2	99,496	43.62	49.35	62.50	19.7%	25.1	25.1	17.5	128%	100%	3.2	1.5%

*2002 and 2003 earnings estimates are A.G. Edwards' estimates, except MXT and CCRT which are consensus.
A.G. Edwards has participated in an offering for HI in the past three years.*

compares with 7,000 net new accounts per day in 1996, 8,500 in 1997, 14,000 in 1998, 19,000 in 1999, and 27,000 in both 2000 and 2001. Figure 3 details account growth at COF since 1992, which we calculate has grown at a compound annual rate of 44% since the fourth quarter 1992.

FIGURE 2 Product Testing at COF



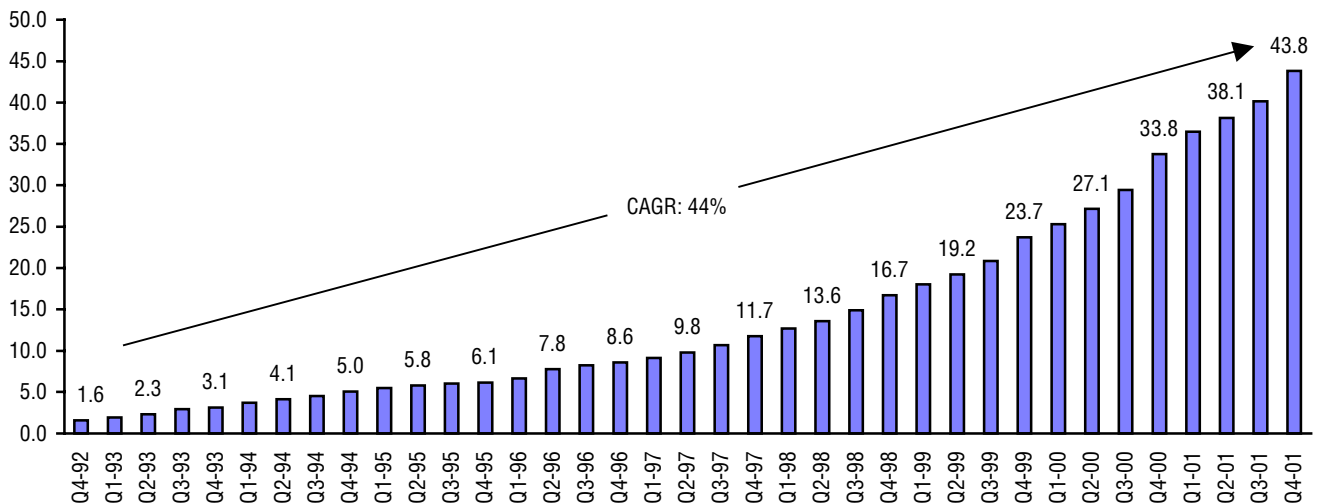
Source: Company reports

Although the IBS process itself is not proprietary, the predictive models, the test results, and subsequent solicitations are. Equally as important, Capital One applies IBS to everything it does, not just its solicitation efforts. Account and credit line management, pricing strategies, customer retention efforts and bad debt collection efforts are all driven by IBS. In a recent company visit, we witnessed COF's IBS in action. Perhaps the most

comprehensive and illustrative example of COF's IBS in action is intelligent call routing. Before an incoming call is routed within COF, a computer predicts who is calling (based on the caller's phone number) and what the person is calling about (i.e., balance inquiry, late payment, change account). The computer reviews multiple options and then selects the best place to route the call. In addition to receiving the call, a COF representative receives critical information about the person calling, including what the consumer might be interested in buying (e.g. insurance, long-distance service, buying club memberships).

On the retention side, if the computer determines a customer is not profitable, the computer can elect to route the caller to a voice response unit thereby eliminating the need for human contact and saving money in the process. If the customer is profitable, the computer will route the caller to a COF retention specialist. The instant the caller is connected, the specialist's computer screen displays three competing offers in order of profitability to COF. The retention specialist is incented to counter with the most profitable offer that satisfies the customer needs. After a brief conversation with the customer to determine the validity of a competitor's offer, the retention specialist is then ready to counter with one of the three alternative offers. This might include a lower annual percentage rate, waiving an annual fee, or increasing a credit limit for the borrower. All counteroffers are designed so that the account remains profitable to COF. In cases where COF cannot beat a competitor's offer and still have the

FIGURE 3 Mass Customization Powers Strong Account Growth
(Millions of Accounts)



Sources: Company reports and A.G. Edwards' estimates.

account remain profitable, COF allows the account to close.

COF's IBS has led to strong revenue growth, expanding margins, and consistent EPS growth and ROE. Figure 4 shows a composition of quarterly revenue growth for COF while Figure 5 details illustrates the margin expansion.

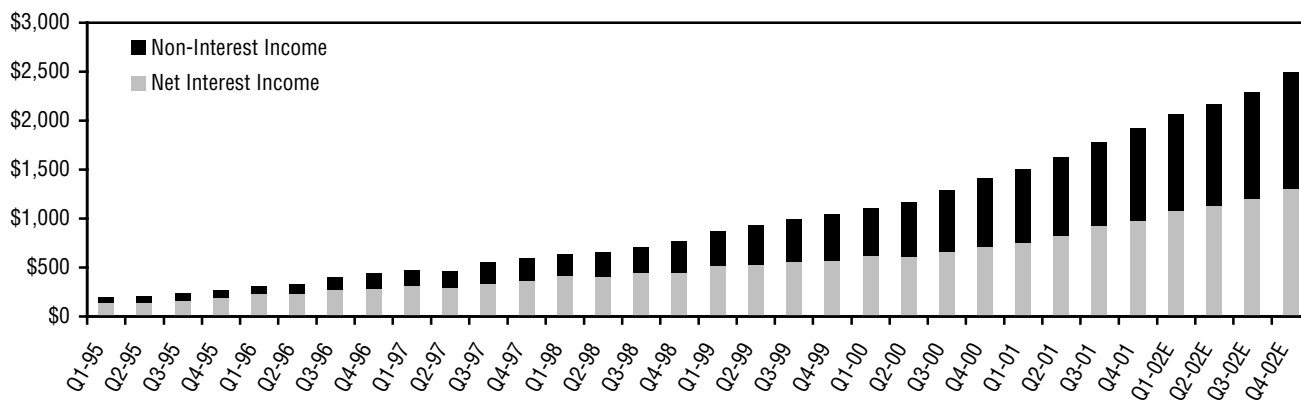
Capital One's IBS is not easy to duplicate. Capital One's application of IBS to the credit card business has been an evolutionary process that has taken the better part of a decade to perfect. With the notable exception of Provident Financial (PVN), essentially all other competitors in the credit card business have chosen different strategies or exited the business altogether. Most other major credit card issuers favor mass marketing over the mass customization approach of COF to acquire customers. We believe competitors that now try to duplicate COF's IBS approach to consumer lending face the formidable challenge of building proprietary databases and developing/testing analytical models to assimilate in the lending process. We think COF's IBS is a competitive advantage that serves as a barrier protecting excess profits. Figure 6 illustrates the power of COF's IBS in terms of financial performance. COF has consistently delivered at least 20% EPS growth and above 20% ROE to its shareholders since becoming a public company, in November 1994.

COF's IBS versus the Affinity Model—We believe COF's information-based strategy is a superior approach to the credit card business relative to the traditional approach of mass marketing used by the

affinity players MBNA and First USA (now part of Bank One). COF's risk-adjusted margin (total revenues less credit losses) of 14.20% is significantly higher than that of MBNA, at 8.81%. Based on Bank One's disclosures, we estimate that First USA's risk-adjusted margin is lower than that of MBNA, at 6.45%. This is even more compelling to us considering that First USA and MBNA's managed loan portfolios are each significantly larger than that of COF. So much for the notion that scale leads to superior profitability. In our opinion, skill is much more important than scale in the credit card business. The key to COF's success has been its ability to use technology and employ segmentation analysis to target less competitive sectors of the consumer market (super-prime and sub-prime).

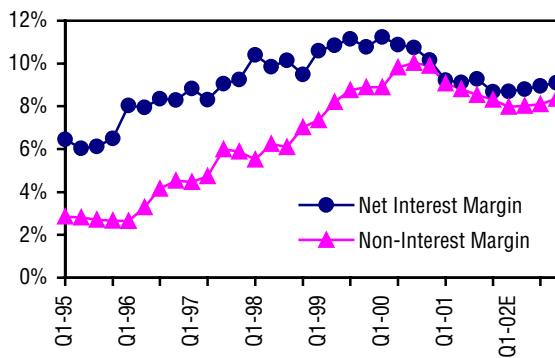
COF is one of the best examples of a company where information technology (IT) has been completely integrated. This includes account acquisition (marketing) and underwriting on the front-end as well as retention and collection efforts on the back-end. Information technology even drives the recruiting and hiring process at COF. Many companies think technology alone can give them a competitive advantage. However, the mere use of technology is not a sustainable competitive advantage, in our opinion. In the credit card industry, for example, competitors can very quickly duplicate product offerings such as the "teaser rate" credit card and marketing programs such as the "balance transfer" option, both pioneered by COF earlier this decade. It is, however, difficult to duplicate COF's proprietary customer databases and analytical models that are the crux of its IBS.

FIGURE 4 Solid Revenue Growth
(Dollars in Millions)



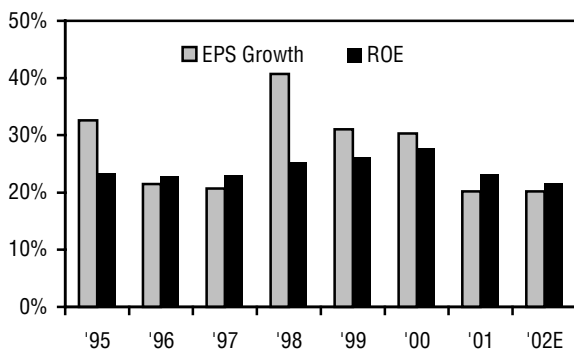
Sources: Company reports and A.G. Edwards' estimates.

FIGURE 5 Margin Expansion



Sources: Company reports and A.G. Edwards' estimates.

FIGURE 6 Power of IBS



Sources: Company reports and A.G. Edwards' estimates.

We believe that COF's databases contain background information on at least one in seven U.S. households as well as extensive data about how these customers behave. Credit cards contain incredible amounts of information that allow COF to use scientific methodology to make decisions. In essence, COF uses information technology to provide mass customization. This enables COF to deliver the right product to the right customer at the right time at the right price and via the right channel. In our opinion, COF represents a great opportunity for investors to participate in the information/technology revolution. Rapid technological advances require that COF continuously innovate in order to remain ahead of its competitors. As product life cycles continue to get shorter and shorter, this places a premium on effective marketing. COF is specifically designed to thrive in this environment.

Risk Management, Buffers and High Quality of Earnings

COF's track record is not built on aggressive accounting assumptions. Quite the opposite is true. COF's accounting policies tend to be pro-

active, and we consider its assumptions to be among the most conservative in the industry. In 1997, COF was one of the first card companies to adopt a "hard" 180-day contractual charge-off policy, long before it became mandatory. Compare this decision to that of Metris Companies, which just adopted the charge-off policy in the fourth quarter of 2001. COF fully reserves for uncollectible fees and finance charges and all marketing dollars are expensed at origination. COF defers all refundable cross-selling commissions. Finally, COF limits Financial Accounting Standard (FAS) 125 gain recognition to the extent that FAS 125 gains are negligible to earnings.

We believe COF is better positioned than most companies for a prolonged economic downturn. COF has several built in buffers that are likely to kick in if the economy slows. First, COF has the highest revenue margin among credit card issuers. Second, COF is substantially below the industry in late and over-limit charges. COF currently has approximately a \$29 late and over limit charge, where as the industry average is moving upward toward \$35 per incidence. Third, COF, which has the lowest price in each consumer segment, could reprice APR's. COF's IBS allows the company to accurately measure attrition for price increases. Finally, COF's huge marketing expense budget should act as a natural operating hedge. In the event of a slowdown, we would expect COF to pare back marketing expenses, which would help offset rising credit losses. The bottom line is that COF's 20% earnings target for 2002 takes into consideration a slower economic environment and higher losses and delinquencies.

Last year management indicated that it expected COF's losses, as well as industry losses, to move higher in 2001. This materialized and COF has successfully managed through the increase. Management cited a growth in consumer bankruptcies and higher mail volume in the second quarter as contributing factors to higher credit losses. Also, the consumer debt service burden (U.S.) continues to rise and remains near 14%. Perhaps more concerning from a macro perspective is that the percentage of families with debt service requirements greater than 40% of income continues to increase. In 1995, 11% of households fit into this classification, while in 1998, 15% were over 40%. Although the data is not available after 1998, we suspect this figure is now over 15% given continued growth in consumer credit in the U.S. With respect to COF's portfolio, seasoning in its under-served portfolio figures to be the main driver of higher loss rates, offset by continued growth in the super-prime category.

COF assumes a mild recession when evaluating potential targets for new loans. Using extensive modeling techniques, all proposed accounts must have a positive net present value (NPV) based on a recession-based scenario. For example, the company will collect data on a sample of the proposed population, including actual response rates, delinquency loss rates, attrition, success of cross selling initiatives, etc. Second, COF applies losses to the proposed population equal to that of the actual sample for a period of six months. Then, COF assumes that a mild recession begins and applies losses equal to 1.5 times the expected loss rates and maintains these losses for a period of twelve months. Finally, loss rates are scaled back to 1.25X the original estimate for the population for the remaining expected life of the loans. If the net cash flows (discounted with the appropriate hurdle rate) still have a positive NPV, then the product manager will receive the capital necessary to fund the solicitations for the entire population.

Another important factor is that COF's average credit line is among the lowest in the industry while its utilization rate is among the highest. COF's average credit line at the end of the third quarter of 2001 was \$2,671 versus an average of \$7,318 for the industry. These are important figures because consumers tend to charge-off for the maximum credit line and industry response rates are directly related to the size of the credit line. In our 2002 forecast, we have modeled a gradual increase in COF's managed loss rate to 5.50% by the fourth quarter. This compares with COF's loss rate of 4.42% for the fourth quarter 2001.

It's no longer a secret that COF is one of the credit quality leaders in the credit card industry. What might be surprising to some investors is that COF has achieved these results despite almost one-third of the portfolio being in the underserved segment. Only three other issuers have any meaningful exposure to the under-served segment (Household, Metris, Providian) and they all have substantially higher loss rates relative to Capital One. Figure 7 illustrates COF's leadership position, which we think is a testament to its IBS, but also the fact that more than one-third of Capital One's managed loans are in the superprime segment. We also find that COF also has a substantial buffer against risk as measured by its revenue margin divided by charge-offs. (See Figure 8.) The net result of COF's low charge-off rate and high revenue margin is that COF easily has the highest risk-adjusted margin of any major issuer in the industry. (See Figure 9.)

FIGURE 7 Charge-Off Rate by Issuer, Fourth Quarter 2001

Capital One	4.42%
MBNA	4.86%
BankAmerica	4.90%
Fleet	5.38%
Chase	5.48%
American Express	5.59%
Bank One	5.59%
Discover	5.85%
Citigroup	5.91%
Household	6.11%
Metris	11.80%
Providian	12.23%

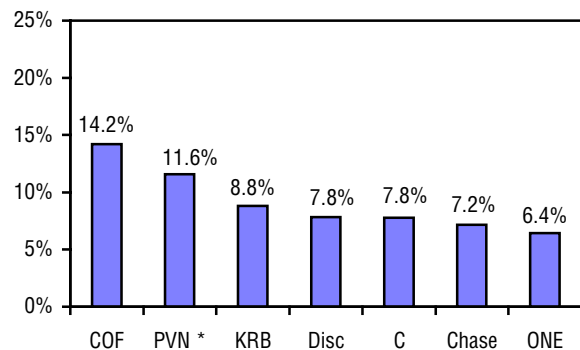
Sources: Company reports and Visa/MasterCard

FIGURE 8 Revenue Margin, Fourth Quarter 2001

	Risk-Adj. Margin	Charge-Offs	Revenue Margin	RevMar/Chg.Offs
Capital One	14.20	4.42	18.62	4.21
MBNA	8.81	4.86	13.67	2.81
Discover	7.83	5.85	13.68	2.34
Citigroup	7.78	5.91	13.69	2.32
Chase	7.18	5.48	12.66	2.31
Bank One	6.43	5.59	12.02	2.15
Providian *	11.58	10.33	21.91	2.12

Source: Company reports
Note: PVN Q3 2001

FIGURE 9 Risk-Adjusted Margin, Fourth Quarter 2001



Source: Company reports
Note: PVN Q3 2001

Next, we examine COF's hedges and buffers in greater detail.

- (1) Re-pricing of Accounts, (2) Late and Over-Limit Fee Revenues, (3) Marketing Hedge and (4) Strong Capital and Reserve Levels.

Re-pricing Accounts—COF can re-price existing accounts by providing customers with 30 days notice. Affinity issuers are typically restricted from doing this because their partners do not want their customers to be differentiated by price. COF, by virtue of its IBS, has a pretty good read on shifts in risk in its portfolio so its can re-price (up or down) dynamically. COF also better understands the elasticity at the customer level. This strategy leads to COF retaining more “good” customers and pricing out more “bad” customers. Furthermore, COF employs much lower lines than its competitors so it has far less off-balance sheet risk. Because most other issuers find it difficult to mass customize their marketing efforts, they typically offer high lines of credit as a marketing tool. This is very risky practice because consumers typically max out their credit lines just before charging-off.

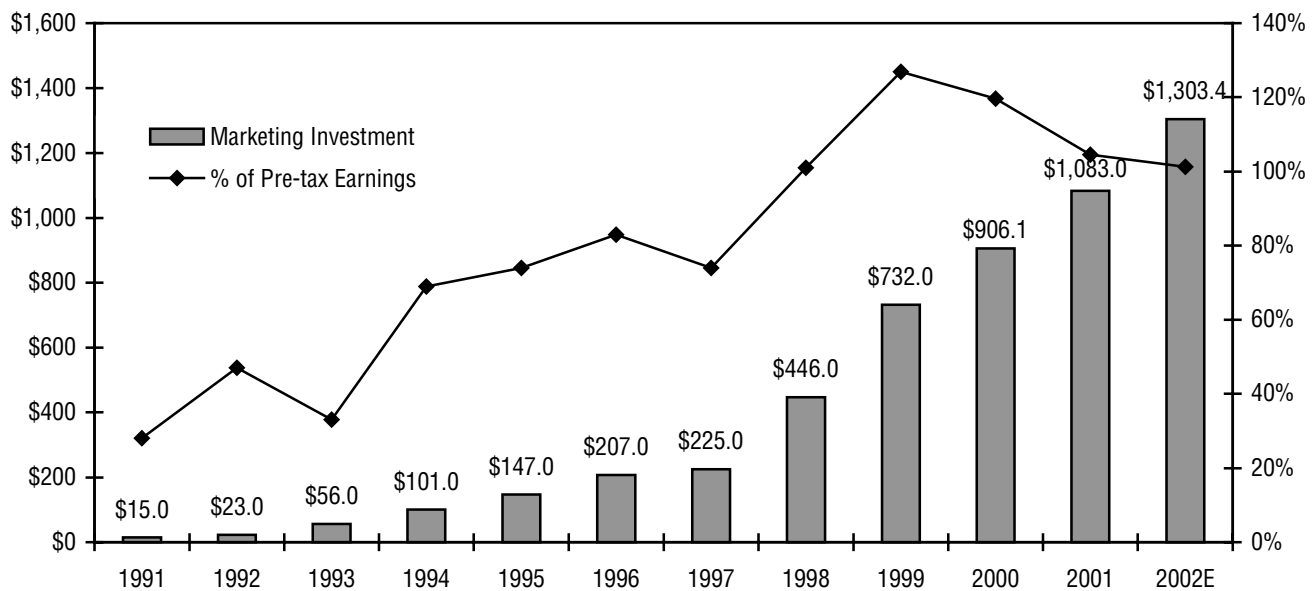
Late and Over-Limit Fees—Late and over-limit fees provide a very natural hedge against a risk shift. For the credit card industry, we estimate that rising late and over-limit fee revenues can offset about 20% to 50% of an increase in charge-offs. When delinquencies rise, late and over limit fees increase significantly because they are charged earlier. By increasing late and over-limit fees, and by automatic risk-based repricing of its portfolio, COF believes that the company can offset an increase in charge-offs of \$175 million per year.

The differentiation from the industry is due to COF’s relatively higher percentage of under-served accounts. These figures take into consideration uncollectible late and over limit fees.

Marketing Hedge—COF can pare back marketing expenses to protect its earnings growth. This is exactly what COF did in 1996 and 1997 when industry loss rate doubled each year. COF held the line on marketing investment and still generated over 20% EPS growth each year. COF’s marketing hedge is even greater today. Currently, COF is spending more in marketing than it is earning on a pre-tax basis. In an environment where risk moves against COF, we believe the company would deliberately reduce its marketing spend to protect earnings. Figure 10 shows that COF’s marketing investment has been increasing on an absolute basis and is still significantly higher than pre-tax earnings. As Figure 10 highlights, in our model we assume that marketing expense will gravitate back toward pre-tax earnings. If the economy stabilizes our marketing expense could prove conservative.

We think COF would actually gain market share in a tougher credit environment because its marketing investment would likely be disproportionately higher than its competitors. For

FIGURE 10 Reinvesting in the Franchise

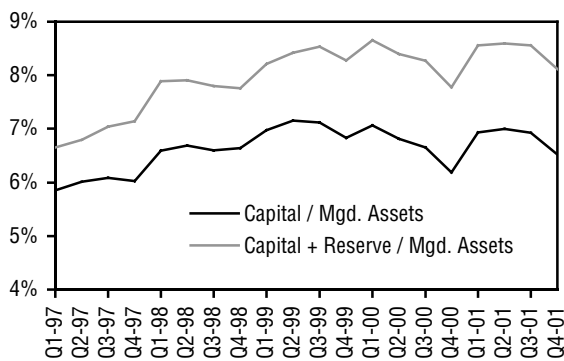


Source: Company reports

example, a 50% reduction in marketing expenditures from 2001 levels would provide a \$541.5 million hedge against rising losses at COF. This is enough to offset a 37.65% increase in charge-offs at COF. Net charge-offs were \$1,438.3 million in 2001; hence, a 38% increase would equate to \$541.5 million in incremental losses at COF. Even if COF reduced its marketing investment by 50% (unlikely, in our opinion), it would still be higher than its nearest competitor assuming no change from that competitor. Most likely, in a tougher credit environment, most (if not all) of COF's competitors would significantly reduce their marketing spending, thereby allowing COF to continue to gain market share.

Strong Capital and Reserve Levels—COF has strong capital and reserve levels. Figure 11 shows an upward trend in COF's capital and reserve levels.

FIGURE 11 Strong Capital and Reserve Levels



Source: Company reports

Building on IBS

Refining the Credit Card Market—An interesting dynamic in the U.S. credit card market is that the approximately \$500 billion market is essentially divided into thirds—one-third super-prime, one-third prime, and one-third non-prime. However, in terms of the number of households in the U.S., approximately 32% are super-prime (33 million), 27% prime (28 million), and 41% non-prime (42 million). Approximately 50% more households fall into the non-prime sector relative to the prime sector, and approximately 27% more households fall into the non-prime sector relative to the super-prime sector. Capital One, with credit card customers in all three sectors, is the only credit card company that is truly a full spectrum lender. Perhaps more

important, Capital One has been increasingly emphasizing the super-prime segment partly because the economics of that segment have improved due to less competitive pressure and lower funding costs.

Capital One defines the super-prime segment as individuals or households with blue chip demographics and having deep and virtually perfect credit histories with limited debt. The super-prime segment is Capital One's largest segment and revenues are more weighted toward net interest income due to the customer's tendency to carry higher loan balances. The prime segment is defined as individuals or households with middle-income demographics, moderate debt levels, and possibly a rare delinquency on the credit bureau. The prime segment is Capital One's second largest segment. Capital One calls the non-prime segment "underserved" rather than sub-prime because it does not necessarily equate to low-income demographics. Instead, these are individuals or households with limited access to credit. In some cases, it could be a new entrant (i.e. immigrant, college student), or someone with a limited credit history (i.e. recently divorced), or someone with tarnished credit (sub-prime). The "underserved" segment is Capital One's smallest segment but is the fastest growing. The "underserved" segment's revenues are more weighted toward non-interest income due to the customer's lower aversion to annual fees as well as higher incidence of over-limit transactions.

Different Approach for Each Segment—Capital One uses a distinctly different approach to each segment. In the super-prime segment, Capital One can combine a low fixed rate product with its Miles One program or a Lifestyle card. The Miles One program offers consumers unlimited mileage on any airline without restrictions usually associated with competitors' offers. Although MBNA's affinity cards rank high in terms of customer loyalty, Capital One's Lifestyle cards offer several advantages over MBNA's affinity cards. First, Capital One is able to target very small segments whereas MBNA's affinity card is marketed to a large customer base. Second, there is no need for a sales partner to help manage the infrastructure, enabling Capital One to completely control the customer experience. Third, there is no payment to an affinity partner. Finally, with Lifestyle cards, it is easier for Capital One to mass customize offers, which plays into the company's strength. The key for Capital One in the super-prime segment is accurately discerning credit risk.

Because of the relatively low net interest margin in super-prime, a company has little or no margin for error on the credit risk side. This is where Capital One's IBS is a huge competitive advantage. Capital One, by virtue of its IBS, is better able to dissect credit risk within the super-prime segment and actually distinguish between super-prime and prime borrowers. Many of Capital One's competitors do not even distinguish between super-prime and prime customers.

After having effectively bailed out of the prime segment in 1996 (COF kept testing in this segment) due to an irrational competitive environment, Capital One has re-entered this segment. The "play" in this segment is to find unidentified super-prime customers. These customers are what management refers to as "new" prime customers. COF management believes these "new" prime customers will have lower charge-off and attrition rates versus the "old" prime customers. Again, the key for Capital One relative to its competitors is being able to better segment customers within the prime segment. For example, within the prime segment (710-770 FICO score range), COF has multiple risk deciles. The charge-off rate increases about 20 basis points for each incremental decile up until the eighth decile. Then, for the eighth, ninth and tenth deciles, the charge-off rate increases dramatically, in some cases more than 300 basis points. Effectively segmenting within each FICO segment (subprime, prime, super-prime) allows COF to underwrite the highest quality customers at favorable pricing. We believe this example provides a good illustration of why Capital One's charge-off rates remain among the lowest in the industry even though it is the only full spectrum credit card lender.

Capital One's tries to find "prime" customers that are overlooked in the underserved segment. Capital One's strategy/approach in this segment is to give borrowers a relatively low secured or unsecured credit line and let them demonstrate credit worthiness over time. Capital One can then enhance the credit line if credit worthiness is demonstrated through an excellent payment pattern. In the underserved segment, the stakes are relatively low, from both Capital One's perspective and the individual's. Credit lines are typically less than \$1,000 and many are fully or partially secured with customer deposits. Indeed, we estimate that the average payback period for COF's expense is between six and 12 months in the underserved segment. The shorter payback period

relative to the prime and super-prime segments is due to higher annual fees and APR relative to the credit line. We believe that the underserved segment could perform better than the prime segment in a recession. The risk-adjusted outperformance of underserved segment in an economic downturn could come as a surprise to many credit card issuers, particularly companies focused exclusively on the prime segment.

Branding Capital One—As of September 30, 2001 Capital One is the 16th largest company in the U.S. in terms of billed customers, with approximately 38.1 million different billed customers. The top 10 companies in this survey are all household names, which in order of billed customers include: Citigroup, AOL/Time Warner, AT&T, Verizon, State Farm, Sears, SBC, Bell South, Bank One and MBNA. Capital One is the only company in the top 16 that has not yet had a separate branding strategy.

Management indicated that based on various surveys, it was somewhat disappointed with the relatively low customer recognition level of Capital One. About 50% of Capital One's customers confused the company with MasterCard and Visa. When asked what Capital One was most known for, the answer most often given was "we get a lot of mail from them". The good news is that Capital One's brand awareness has improved from 61% at July 1999 to 90% at August 2001. We believe Capital One's brand awareness will continue to improve as the company proceeds with its national branding campaign.

For Capital One, branding is not about a warm and fuzzy image. Rather, consistent with everything else it does, management intends to use a highly scientific approach to branding, particularly in product design and service fulfillment. We believe it makes sense for Capital One to increase its marketing spending incrementally to accomplish brand identity given its national ranking in terms of billed customers (No. 16), leading position in terms of mailed pieces within the credit card industry, and its top 10 position in terms of total mail sent in the United States. Our conclusion on branding is that is a generally a good idea, and should facilitate incremental account growth with higher response rates and lower attrition rates, and increased cross-sell revenue from existing accounts. In essence, Capital One intends to level out the playing field in an area where it has traditionally been at a disadvantage.

Leveraging its Infrastructure—This is another area where Capital One has just started to focus its efforts. Since its initial public offering in 1994 up until the second quarter of 1999, COF's operating expense per account exhibited an upward trend. The reason is that COF's IBS is very complex to operate and required the company to internalize virtually every single function in the credit card business. A true information-based strategy is impossible to perfect if functions are outsourced. Most of Capital One's competitors outsource some function or aspect of the credit card business. Even worse, some companies outsource many critical functions, which is likely a contributing factor to why these competitors often deliver mediocre results but tell investors they use an information-based approach. From our perspective, it appears difficult, if not impossible, to duplicate COF's IBS when outsourcing key functions.

Capital One has successfully internalized all critical functions and its operating cost per account is starting to improve. Since the fourth quarter of 2000, COF's operating cost per account has declined from \$78.09 to less than \$73.69. Chief Operating Officer Nigel Morris was quick to point out that there is no magic bullet, just raw focus and execution. He indicated that COF is not done yet with respect to efficiency improvements. What do these improvements mean for investors? If \$4.40 savings (\$78.09-\$73.69) is applied to 45.8 million existing accounts, this equates to about \$195 million in savings on an annual run rate basis, or about \$0.55 per share on an after-tax basis. Another benefit is that, all else equal, lower operating cost per account increases the NPV per account on the margin. This potentially could result in millions of additional accounts booked by COF that otherwise would not meet internal hurdle rates of return.

Despite the complexity of IBS, COF has the lowest operating cost per account of the major monoline credit card companies. COF gave its estimate of its monoline competitors operating cost per account. In 2000, COF estimates that MBNA, Providian, and Metris all had operating cost per account exceeding \$100, with all exhibiting increasing trends in operating cost per account since 1998. MBNA exhibited a \$2 increase in operating cost per account in 1999, and a \$22 increase in 2000. Providian had a \$7 increase in cost per account in 1999 and a \$7 increase in 2000. Metris exhibited a \$26 increase per account in 1999 and a \$13 increase in 2000.

Our research supports Capital One's claims. For 2001, we estimate that Providian, Metris and MBNA continued to have operating costs per account exceeding \$100.

Collections—COF uses a customer-centric approach to collections, which basically means that it tries to determine what the customer's situation is and why the customer has not paid. This is a highly targeted approach to collections, unlike many competitors who use a time-driven model (i.e. number of days past due). Using a customer centric approach to collections, COF has increased its dollars recovered. COF also plans to leverage its core competency in collections in the fresh charged-off market. The charge-off debt market is large (\$200 billion for credit cards, \$500 billion total) and growing.

Cross Selling—Capital One is one of a few companies that is simultaneously large and growing. Although Capital One has historically lacked brand recognition, that is changing—Capital One is building brand awareness. We figure the branding strategy will provide a big boost to incremental revenues from cross-selling products. The remarkable thing is that Capital One has been one of the most successful financial companies in terms of cross selling without a branding strategy.

Partnership Finance—This is a newer area of focus for Capital One. Capital One's co-branded deal with Kmart was its watershed deal in partnership finance. Since its launch in September 2000, the Kmart co-branded card has already generated 2.5 million new customer accounts. Although Kmart might be struggling fundamentally, it generated \$57 billion in revenue in 2001 and 87% of Americans live within six miles of a Kmart. Retailers continue to recognize that private label credit cards have been losing market share to general purpose credit cards (MasterCard, Visa) since at least 1990. Private label receivables' market share has declined to 16% in 2000 from 21% in 1995 and 29% in 1990. Private label accounts' market share has declined to 47% in 2000 from 52% in 1995 and 62% in 1990. The bottom line is that private label cards continue to get hammered by Visa and MasterCard. The limited use feature of the private label credit card is perhaps the biggest problem the product has. The limited use hurdle can be overcome for retailers by partnering with a general purpose issuer like Capital One. COF also has the expertise to underwrite accounts across the quality spectrum, which alleviates the conflict

between the sponsor and the issuer to underwrite all of the sponsor's customers. The retailer does not have to worry about residual credit risk, which stays with the credit card issuer.

International—Capital One's international loan portfolio has exhibited a compound annual growth rate of 78% since 1997, which compares favorably with 33% compound annual growth in total loans for COF. Meanwhile, the charge-off rate for the international loan portfolio is approximately 3%, significantly lower than that of the total portfolio. By far, Capital One's largest international segment is the United Kingdom (UK). Unfortunately, the UK prime market is currently under siege and management has backed away somewhat. Increased media spend and lower response rates have resulted in the economics in the UK prime market being sub-optimal at the moment. Fortunately, Capital One does not have to close up shop in the UK because it can focus on the underserved segment until the economics in the prime segment improve. Although the credit bureau data in the U.K. is less developed than in the U.S., the demographic and lifestyle data is richer.

The market dynamics in Canada are very favorable and the competitive environment appears rationale. Consumers' response is healthy to Capital One's marketing efforts and COF has been able to lower risk with each successive tranche. In the prime segment, cross-sell penetration (constant channel) is about 2X the U.S. prime market. Continental Europe is much different from either the U.K. or Canada in that consumer's there is less revolving borrowing and a different attitude toward unsecured debt. With respect to the credit card product, COF management believes that Continental Europe has supply issues such as limited product diversity, non-differentiated pricing, inconvenient delivery, and limited access. By addressing some, or all of these supply issues, COF might be able to have a meaningful impact in Continental Europe.

Internet—The Internet offers both promise and peril for credit card issuers. Fortunately for investors, COF management is keenly aware of the opportunity but understands the risks. The opportunity comes in the form of growth in online

spending as the credit card medium already represents about 90% of all online transactions compared with 18% overall. The risk lies with two structural problems in originating accounts over the Internet. First, because of adverse selection, Internet applicants' credit quality performance is worse across all segments. Second, there is limited targeting over the Internet relative to the physical world. Hence, it is more difficult to get lots of data points in a timely manner, which is needed for COF's IBS to work.

The Internet is a step backward for a direct marketing company in the sense that the consumer seeks out the issuer more often than not. This is where adverse selection comes into play. When credit card issuers put banner ads on the Internet, the consumer is more likely to respond to the offer when a life event has occurred (i.e. divorce, job loss, health issue) causing a need for credit. In the physical world, credit card issuers, like Capital One, target the consumer and the risk of adverse selection is much lower.

Capital One now services more than 4 million customer accounts online. In 2001, Nielsen/NetRatings ranked Capital One as the third most heavily visited financial site on the Internet, with 117,317,000 total visitors, and the highest ranking credit card site. In first and second place were Wells Fargo and Bank of America with 183,266,000 and 156,196,000 total visitors, respectively. Fourth and fifth place were held by Fidelity with 111,067,000 total visits and Next Card (NXCD) with 97,907,000. Since announcing capital issues on October 31, NXCD has significantly reduced its online business activity and web traffic has plummeted 73%. Given the situation with NXCD, we estimate that Capital One will continue to rank as the most visited credit card site on the Internet in 2002.

Auto Finance—Capital One acquired an auto finance company, Summit Acceptance, in July 1998 and an online auto finance company, PeopleFirst, in September 2001. As of December 31, 2001, Capital One Auto Finance had approximately \$4.0 billion in auto receivables in its managed portfolio, compared with \$300 million in 1998. The PeopleFirst acquisition added receivables of \$710 million to COF's managed loan portfolio when the deal was completed in October 2001.

The industry dynamics and economics in non-prime auto finance are much more favorable today than in the mid-1990's. Irrational competitors are either out of business, or lack access to capital and are non-factor. Because risk is the biggest driver of economics in auto finance, COF has deliberately taken its time in ramping up its business. Now that management has seen that IBS can be applied in the auto finance business, we look for higher growth out of COF. Unfortunately, because the dealer still has a lock on the customers in non-prime auto finance, it could take some time (years) for COF to revolutionize the auto finance industry like it did the credit card industry. Management pledged to use the most conservative accounting—no gain-on-sale and full loan loss reserve accounting.

Other Acquisitions—In May 2001, Capital One announced that it had agreed to acquire AmeriFee Corporation, the nation's leading provider of patient financing solutions for the elective dental, orthodontic, vision and cosmetic procedures. The price was \$81.5 million, with \$65 million to be paid in cash and the remainder in common stock. Current management of AmeriFee will continue to manage its operations as a subsidiary of Capital One. AmeriFee markets through medical providers who refer patients seeking elective orthodontic, dental, vision and cosmetic procedures. 12,000 health care providers located throughout the 50 states offer its programs. Capital One will leverage its knowledge of consumer behavior and credit scoring to help AmeriFee select and appropriately underwrite financial terms for elective medical procedures. At the present time, COF is not assuming a financial position in the underwriting of the loans.

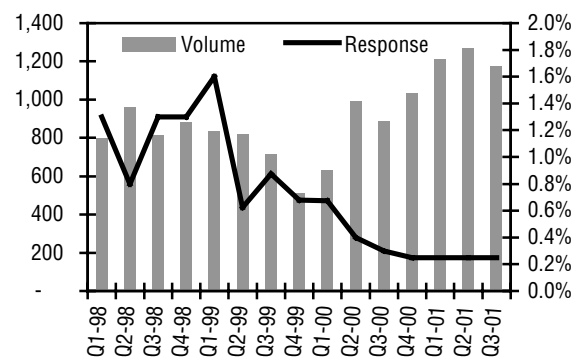
Management indicated that it will consummate more acquisitions going forward. We do not look for any major acquisitions anytime soon from COF given its inherent financial discipline. Instead of product, management is looking for growth platforms – small companies with threshold scale that are compatible with IBS. This includes indirect lending, other secured lenders, as well as other domestic financial service companies. Joint Ventures will likely be with international concerns, or companies in large, vertically integrated industries. We do not believe investors should be overly concerned about potential acquisitions from COF. We continue to believe the overwhelming proportion of growth will be organic and that management will adhere to its very rigorous

internal hurdle rate of return on prospective deals. The track record for COF's management team in terms of acquisitions is limited but good.

Industry Outlook

We remain cautious in our outlook for the credit card sector. Although the continued slowing in the U.S. economy has the potential to undermine credit quality and stifle consumer spending, we have been guardedly optimistic with the credit performance thus far. We view Capital One as the leader, with the most well developed information-based model that will enable the company to quickly adapt to changing market conditions and customer risk profiles to effectively reprice their portfolio. This is what is commonly referred to as dynamic risk-based pricing. In a slowing economy, an information-based model is critical in determining the changing risk profile of credit card borrowers. MBNA, which does not utilize an information-based model, figures to have a more difficult time correctly assessing consumer risk and being adequately compensated, in our view. Meanwhile, the competitive environment remains intense. As evidenced in Figure 12, industry mail volume was a 1,174 million pieces in the third quarter of 2001. In 2000, industry mail volume increased 25% from 1999 to 3.5 billion pieces. As industry response rates continue to decline, issuers have to send more and more solicitations just to retain market share. We believe only a handful of issuers, led by the monoline card issuers, will demonstrate organic growth in 2001.

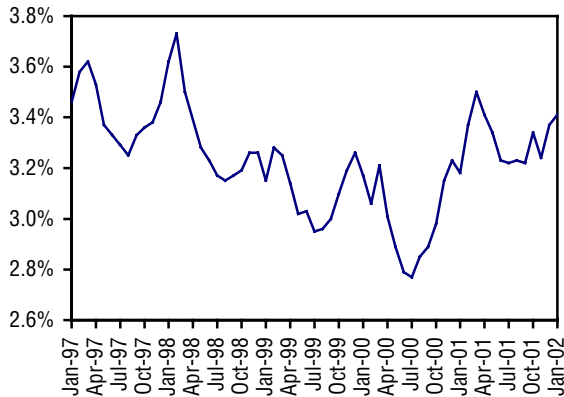
FIGURE 12 Mail Volume, Response Rates
(In Millions)



Source: BAI Mail Monitor

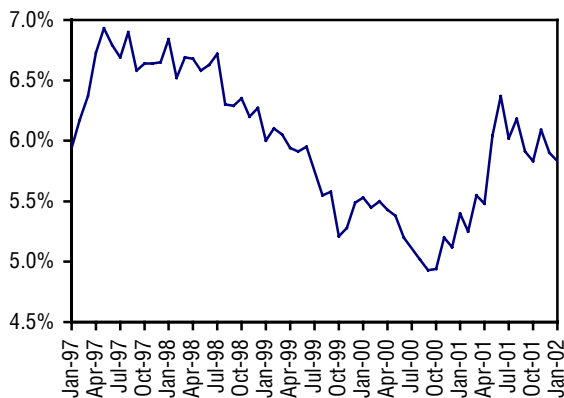
The current slowing economy has, as expected, created an environment where charge-offs and delinquencies are increasing in credit card portfolios. Figures 13 and 14 show a clear reversal

FIGURE 13 Delinquency Index,
January 1997-January 2002



Source: Fitch IBCA

FIGURE 14 Charge-Off Index,
January 1997-January 2002

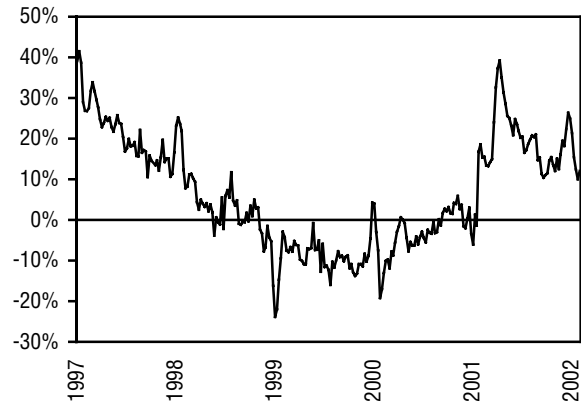


Source: Fitch IBCA

in credit quality trends in our sector late in 2000 with respect to both delinquencies and credit losses. Although the delinquency index in Figure 13 has shown some stabilization, we anticipate delinquencies will continue to move higher in first half of 2002. Credit card charge-offs are highly correlated to personal bankruptcies. We estimate that more than 40% of charge-offs are directly related to bankruptcy. We believe one of the more important indicators of consumer credit quality is the growth rate in personal bankruptcy filings. We monitor weekly personal bankruptcy filings collected by the Administration Office of the U.S. Courts via Lunquist Consulting. The growth rate in personal bankruptcy filings was negative for most of 1999 and 2000. However, in the third quarter of 2000, we reached an inflection point and the growth rate in personal bankruptcy filings accelerated throughout 2001. Figure 15 shows a year-over-year, four-week moving average of quarterly bankruptcy filings. We use a four-week

moving average because it helps smooth calendar changes. As Figure 15 shows, the year-over-year growth in bankruptcy filings peaked in May at nearly 40% following successful legislation in the House and Senate for bankruptcy reform. Since then the growth has stabilized near 20%, however, we anticipate that filings will remain well above last years level with annual growth of 15% in 2002.

FIGURE 15 Weekly Personal Bankruptcy Filings
(Year-Over-Year Growth of a 4-Week Moving Average)



Source: Administrative Office of the U.S. Courts

Macroeconomic Perspective

In the following section we identify a few of the important macroeconomic events that are directly affecting the credit card industry. Pending bankruptcy legislation, consumer credit quality, Federal Reserve action and the financial state of the consumer are all topics that we monitor closely in our coverage of Specialty Finance.

Update on Bankruptcy Legislation

Bankruptcy legislation was passed in both the House and the Senate in 2001, and the two bills moved into conference to reach a compromise on their differences. When Trent Lott was the Majority Leader, the appointment of conferees was delayed due to negotiations between Lott and Tom Daschle over the composition of the conference members. The Senate organizational resolution that was agreed to at the beginning of the year, which implemented the 50/50 committee split with Republicans as the chairmen, did not address how conference committee's would be made up. Now, with the unexpected change in leadership of the Senate that occurred in the summer of 2001, new Majority Leader Tom Daschle is expected to name the conference members after the updated "organizing resolution" passes the Senate. That should clear the way for the conference to begin its work.

We have attempted to follow this legislation through the political process, and initially believed it would be signed into law sometime in the fall of 2001. Due to partisan politics, the unforeseen power shift in the Senate and the shift in the nation's attention due to the events of September 11, the legislation never went to a vote.

It is our understanding that the value of the home exemption, which allows the bankruptcy filer to retain their primary residence, is the main sticking point between the House and Senate bills. If the differences in the bills are settled, President Bush has indicated he will likely sign the legislation into law. The legislation will essentially make individuals that have the ability to repay a portion of their debt file Chapter 13 to set a repayment plan instead of Chapter 7, which would erase all past debts. The bill requires most debtors with an income above the state median, (which should be a high percentage because the lowest earning citizens do not file bankruptcy as they have no assets to protect) and an ability to repay 25% of the debt over five years to file under Chapter 13. Currently, nearly two-thirds of filers file under Chapter 7, which allows them to absolve all credit card and other unsecured debt. The bill would also require debtors to go to credit counseling before they file for bankruptcy, and it will also increase the time period before filing a second bankruptcy to eight years. We view the bankruptcy legislation favorable for the credit card and consumer names in our coverage. Currently, over 40% of credit card charge-offs are directly related to a bankruptcy filing. However, the new legislation still only requires the debtor to repay 25% of his debts over time, so bankruptcy will still be a material issue in credit card charge-offs. In reality the legislation is not the "magic key" to unlock the relationship of credit card charge-offs to personal bankruptcy. The bill's recovery mechanism of 25% over five years is not substantially material to the bottom line, but instead the major positive affect the bill could have is the intangible amount of individuals that choose not to file due to the responsibilities they will still have to creditors in the revised bankruptcy process. Although we view the adoption of the new legislation as a positive, the near-term affect could be negative. When the final version of the bill is complete and sent to the President for approval, the bill will not officially be law until six months after the Presidents signs it. Our concern is that this will cause a rush to file for some individuals who wish to file under the current bankruptcy guidelines. It is difficult to

predict the magnitude of the increase, but we are hopeful it will be somewhat muted, as we believe the increased filings in early 2001 were partly caused by the same situation.

Our model and valuation of the credit card companies do not assume any changes to credit quality based on the proposed legislation, and our assumptions for personal bankruptcy filings in 2002 will not materially change based on the eventual outcome of the legislation. In 2001, bankruptcy filings increased 20.0% from 2000 to 1,454,297, a new record. Our estimate for 2002 is 15% year-over-year growth and is based on unemployment stabilizing by the end of the year at about 5.0%. For the first four weeks in 2001, personal bankruptcy filings have increased 10% over the first four weeks in 2001.

Federal Reserve—Lower Short-term Rates

From a macro perspective, the economic slowdown and deteriorating credit quality that has continued into 2002 should be cause for alarm to credit card investors. In 2001, however, the Federal Reserve cut interest rates 11 times, lowering the federal funds rate by 475 basis points to 1.75% from 6.00%. These rate cuts provided credit card companies with expanded margins despite lower credit quality in 2001. Although we fully expect credit loss rates for most finance companies to increase throughout the first half of 2002, we believe higher losses should prove to be manageable for companies with solid business models and management teams that can execute. Ultimately, the interest rate cuts should help improve the growth outlook for the U.S. economy. In the meantime, lower interest rates help take pressure off the debt service burden of the highly leveraged U.S. consumer. We expect the significant decline in short-term interest rates in 2001 will help to offset higher credit losses for most consumer finance companies. We do not, however, expect to see much additional net interest margin expansion, since interest rates cannot be expected to fall much lower. Indeed, in the Federal Reserve Open Market Committee (FOMC) meeting minutes released January 31, 2002, the Federal Reserve recognized some signs of an improving economy and chose to leave interest rates unchanged.

Credit Quality

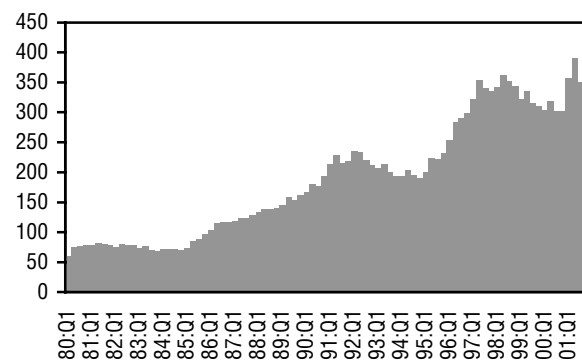
Consumer credit quality is an issue of increasing significance in our sector. As the economy

continues to slow, credit quality concerns are heightened. According to Fitch's asset-backed credit card index, charge-offs fell in January 2002 to 5.85%, the same as October 2001, and the lowest level since April 2001. Charge-offs, although still hovering near 6.00%, peaked back in June 2001 at 6.57%. Figure 14 on page 15 details the Fitch Charge-Off index since January 1997. The Fitch 60-day delinquency index has increased to 5.41%, indicating that industry loss rates could move higher in the near term. Figure 13 on page 15 details the Fitch 60-day delinquency index since January 1997, which peaked in March 2001 at 5.50%. Personal bankruptcy filings for 2001 were 20% higher than 2000, and filings for the first four weeks of 2002 and 10% higher than 2001. (See Figure 15 on page 15.) Although none reflect a clear trend of decreasing credit quality, we are concerned, especially given the state of the U.S. economy.

We believe one of the more important indicators of consumer credit quality is the rate of bankruptcy filings. We monitor weekly personal bankruptcy filings reported by Lundquist Consulting from data collected by the Administration Office of the U.S. Courts. For the first half of 2000, the growth rate in personal bankruptcies was negative. However, in the third quarter of 2000, we reached an inflection point and have remained in positive territory since. For the full year 2001, the year-over-year growth in personal bankruptcy filings was 20.0%. This is something we continue to watch closely. Figure 15 on page 15 shows a year-over-year, four-week moving average of quarterly bankruptcy filings since January 1997. We use a four-week moving average, which serves to smooth calendar changes. Beginning in 2001, bankruptcy filings increased dramatically and appeared to have peaked in late April near 40% year-over-year growth. Since the peak, the growth in the year-over-year four-week moving average has appeared to stabilize in the range of 20%. Although we believe that a rise in personal bankruptcy filings will be manageable for most sophisticated card issuers, we continue to monitor industry trends very closely. Our current estimate for personal bankruptcy growth is 15% over 2001 levels. We believe if growth in 2001 is substantially greater than 20% it could negatively affect the fundamentals of the credit card companies. In 1996 and 1997, the credit card industry loss rate doubled. Of the monoline credit card companies that existed then, most delivered solid EPS growth in spite of higher losses due to strong receivables growth. In essence, they were able to grow their way through tough industry

credit conditions because the economy was recovering from a soft landing in 1995. If loss rates for the industry increase significantly in 2002, and the economic slowdown were prolonged considerably, we believe credit card issuers will have more difficulty compared with 1996 and 1997. The reason is that consumers, given their relatively high debt burdens, could retrench and borrow less. Hence, industry growth could be negative at a time when losses are increasing. Figure 16 depicts the absolute level of personal bankruptcy filings, which remains quite high.

FIGURE 16 Quarterly Bankruptcy Filings, January 1980-September 2001

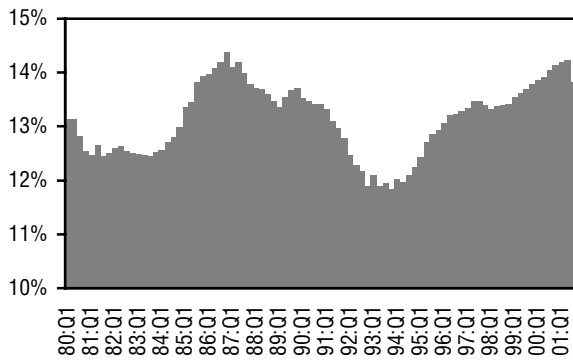


Source: Administrative Office of the U.S. Courts

State of the Consumer

Another important indicator we look at in the consumer sector is the level of consumer debt in relation to disposable personal income. Figure 16 shows the debt burden ratio and how it has fluctuated over time. It is important to focus on three separate time periods of Figure 17—the 1990 recession, the 1995 soft landing and the present. Prior to the 1990 recession, the debt burden ratio was at a very high level. The high level of the consumer debt burden ratio could have served as a constraint on additional consumer borrowing and contributed to a pullback in consumer spending which helped push the economy into a recession. The essential difference versus the soft landing experienced in 1995 is that the U.S. consumer had capacity for additional debt. At the end of 1994, the consumer debt burden ratio was 12.0%, just above a cyclical trough in 1993 from the recovery of the 1990 recession. Today, the consumer debt burden ratio is running 13.81%. This is near the historical high point of 14.38% that was obtained in the fourth quarter of 1986, but the current level is the lowest since the second quarter of 2000. Although such an analysis probably oversimplifies a very complex situation, it does give us a strong reason

FIGURE 17 Debt Payment as a Percent Of Disposable Income



Source: Federal Reserve

to look closely at the current debt burden ratio. Our main concern is that a continued slowdown in the U.S. economy is likely to lead to higher unemployment and a decline in disposable personal income. Because the consumer has little excess capacity for additional debt, we believe a decline in disposable personal income would likely be met by a reduction in consumer spending. Because approximately two-thirds of gross domestic product (GDP) is attributable to consumer spending, any meaningful reduction in consumer spending increases the odds of a hard landing, in our view.

Our outlook in 2002 is for industry credit losses to increase in the consumer sector. After all, if capital spending and corporate profits are down in 2001, it seems reasonable to us that disposable personal income for the consumer is likely to come under pressure. We believe the extent of the pressure on disposable personal income will largely be a function of how high the unemployment rate moves in 2001. We believe the unemployment rate, currently around 5.6%, could move above 6.0% toward the end of the recession. In addition to disposable personal income, another key to the level of consumer spending is consumer confidence. Consumer confidence eroded throughout 2001, first in reaction to the slowing economy, then due to increasing numbers of corporate layoffs and finally to the events of September 11. Consumer confidence has rebounded nicely in December 2001 and January 2002, primarily in the expectations component, and we are looking for continued improvement in the first half of 2002.

Fourth Quarter Summary

Summary

Capital One reported fourth quarter 2001 fully diluted earnings per share of \$0.80, a 30% increase over fourth quarter 2000. Earnings for full-year 2001 were \$2.91, a 30% increase over the \$2.24 earned in 2000. Revenues in fourth quarter 2001 were \$1.9 billion, up over 36% from fourth quarter 2000. Account growth remains very strong at COF, with 3.7 million new accounts in fourth quarter and total account growth of 30% for full-year 2001. Credit quality in fourth quarter 2001 remained well within our expectations. Managed charge-offs increased 50 basis points from 3.92% in third quarter 2001 to 4.42% in fourth quarter 2001. The increase was expected as the “under-served” portion of the portfolio continues to season. The increase was slightly less than we had modeled, and we expect the charge-off rate to continue to increase at a slower rate, over the next couple quarters. The delinquency rate in fourth quarter 2001 decreased to 4.95% from 5.20% in the previous quarter. Current favorable/stable delinquency trends should help mitigate the seasoning effect in future charge-off rates. Net interest margin contracted in the fourth quarter to 8.68% from 9.27% in the third quarter. The use of “teaser” rates in marketing new accounts and a continued mix-shift to “super-prime” accounts weighed on the portfolio margin. We anticipate that as the mix-shift is complete, and teaser rates expire, the net interest margin will stabilize in the current range and trend slightly higher through 2002. Management reiterated its expectation for 20% earnings growth in 2002. We are confident that management can obtain this goal. Our 2002 estimate remains unchanged at \$5.50. We are establishing a 2003 earnings estimate for COF of \$4.20. Our 2002 and 2003 estimates represent 20% annual earnings growth. In the current difficult economic environment, we credit COF’s ability to deliver strong organic growth, stable credit quality and strong earnings to a superior operating model and managements’ ability to adapt to changing competitive and economic conditions.

Fourth Quarter Analysis

Diluted EPS of \$0.80 increased 30% versus \$0.61 in the fourth quarter 2000. Diluted EPS of \$0.80 was in line with our estimate and consensus, despite significant spending increases in marketing and a large increase in the loan loss reserve. Total

marketing expenses for the fourth quarter were \$301.2 million, an increase of \$19.5 million from the third quarter and an increase of \$41.7 million compared with the \$259.5 million posted in fourth quarter of 2001. The loan loss reserve as of December 31 was \$840 million, an increase of \$113 million from the third quarter and increase of \$313 million from the fourth quarter of 2000. Despite the EPS impact of these two items on an after-tax basis Capital One continues to deliver solid top-line driven results in a difficult economic environment. By our calculation, these two items reduced fourth quarter EPS by approximately \$0.37 per share on an after-tax basis.

Exceptional loan growth: Capital One's 18th consecutive quarter of record-breaking earnings was driven by a 36% increase in total revenues over last year. Capital One added 3.7 million net new accounts in the fourth quarter, bringing total accounts to 43.8 million. Capital One's consumer loan balances increased by \$6.8 billion in the fourth quarter to \$45.3 billion, an increase of 18% from the third quarter. Relative to the fourth quarter of 2000, consumer loan balances increased 53%. By comparison, MBNA's managed loan growth over the last 12 months was under 10%. Capital One's net interest margin fell significantly to 8.68% in the fourth quarter versus 9.27% in the previous quarter. The margin decline was due to higher use of "teaser" rates and a continued mix shift to "super-prime" receivables that have lower APR's.

Credit quality: Capital One's managed net charge-off rate increased 50 basis points to 4.42% in the fourth quarter compared with 3.92% for the third quarter. In our model, we had forecast a managed net charge-off rate of 4.50% in the third quarter. Despite the increase, Capital One's loss rate remains the lowest in the credit card industry. Dollar net charge-offs in the fourth quarter increased to \$456.9 million, slightly lower than the \$465.5 million in net losses that we had predicted for the quarter. This compares with net losses of \$362.7 in the third quarter, an increase of \$94.2 million, and \$262.3 million in the fourth quarter of 2000, an increase of \$203.2 million. During the conference call, Capital One management reiterated its expectation that losses would move higher in the coming quarters due to internal portfolio seasoning and macroeconomic challenges.

Strong balance sheet: COF's allowance for loan losses increased by \$113 million in the fourth

quarter to \$840 million, or 4.02% of on-balance sheet receivables as of December 31, 2001, compared with 3.49% as of December 31, 2000. COF's capital to managed assets ratio fell to 6.5% from 6.9% in the third quarter, but remains well above 6.2% for the fourth quarter of 2000.

Marketing investments remain strong: Marketing expenses in 2001 totaled \$1,083.0 million, which is 104.6% of pretax income. This is the fourth consecutive year that marketing expenses have exceeded pre-tax earnings. Even though the company has continued to increase marketing expenses, efficiency has not suffered. Account growth continues to exceed growth in marketing expenses. Total marketing expenses increased nearly 20% in 2001, compared with account growth of nearly 30%. From our perspective, COF's continued investment in its future is good for shareholders. We look for marketing expenses to remain strong as long as COF continues to see high NPV opportunities in all of its major businesses.

Earnings Outlook

Our earnings model, beginning on page 21 of this report, details our assumptions for COF through 2003. Throughout our analysis, all figures referenced are on a managed basis, unless otherwise noted.

Our EPS forecast for COF is \$3.50 in 2002 and \$4.20 in 2003. Our EPS estimates represent annual growth of 20% on a compound annual basis, in-line with our five-year forecast of 20% EPS growth.

Revenue Drivers—We project managed loan growth of 20% in 2002 and 20% in 2003. Note that our 2002 forecast is below COF's historic growth rate for loans and reflects the company's intention to slow growth in this difficult credit environment.

In 2002, we have assumed a contraction in COF's net interest margin to reflect a greater mix of super-prime loans. We have assumed a 15 basis point decline in COF's net interest margin in 2002, but have then assumed a 10 basis point increase in 2003 relative to our 2002 forecast figuring the mix shift works its way through COF's portfolio. Our model projects net interest income growth of 35% in 2002 and 21% in 2003.

We project non-interest income growth of 29% in 2002 and 21% in 2003. We expect non-interest income growth to be fueled by strong account

growth and have modeled relatively stable average fee revenues per account. There might be upside to our estimate given COF's branding strategy and cross-sell success. In 2002, we project COF will add 10.2 million customer accounts, which translates into 25% growth over the 43.8 million accounts at year-end 2001. For 2003, we project COF will add 11 million customer accounts, which translates into 20% growth over our 2002 forecast. We note that COF's account growth rate for the fourth quarter of 2001 was almost 50%. Our lower projected growth rate is simply due to a larger base of accounts.

Our model projects total revenue growth of 32% for 2002 and 21% for 2003.

Expense Analysis—Our forecast for marketing expenses in 2002 is \$1.503 billion, which represents a 20% increase over 2001. For 2003, our model has total marketing expenses of \$1.612 billion, an increase of 24% over our 2002 projection. Although consumer response rates for the industry continue to trend downward, COF's response rates remain fairly constant and the company continues to see high net present value opportunities across all major business lines. We point out that management has repeatedly stated

that the marketing decision at COF is a "line of scrimmage call" that is based on opportunities available in the marketplace. To the extent industry credit quality deteriorates, we would expect a similar contraction in marketing spend from COF.

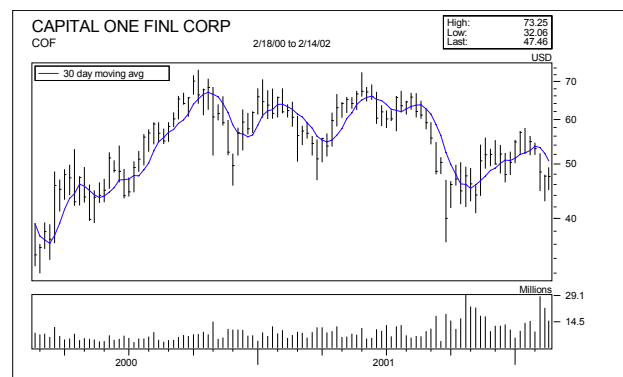
Credit Loss and Reserve Assumptions—Given the highly leveraged nature of the U.S. consumer and the sustained growth in personal bankruptcy filings, we remain cautious in our outlook for industry credit losses. Although we believe COF would fare better than most of its competitors in an economic downturn given its buffers, we have modeled for a moderate increase in credit losses and delinquencies over the next 24 months. We have assumed COF's credit loss rate gradually increases to 5.50% in the fourth quarter of 2002, which compares with 4.42% in the most recent quarter. We have also assumed that COF builds its on-balance sheet loan loss reserves \$1.0 billion (reserve ratio of 4.21%) of by year-end 2002 and \$1.2 billion (4.54%) by year-end 2003. COF's on-balance sheet loan loss reserves stood at \$840 million (4.02%) as of December 31, 2001.

See Figure 18, beginning on the next page, for our COF Earnings Model.

Selected Balance Sheet Data

December 31, 2001
(Figures in Thousands)

Cash and Marketable Securities.....	\$3,823
Consumer Loans.....	20,921
Other Assets.....	3,440
Total Assets.....	\$28,184
Deposits.....	12,839
Debt.....	9,331
Other Liabilities.....	2,691
Shareholders' Equity.....	\$3,323



Source: FACTSET Data Systems, Inc.

FIGURE 18 Earnings Model, 2001 Actual

	1Q01A	% Chg.	2Q01A	% Chg.	3Q01A	% Chg.	4Q01A	% Chg.	2001A	% Chg.
<i>Income Statement (Mgd. Basis)</i>										
Net Interest Income	\$759.3	22.7%	\$823.7	34.1%	\$926.7	39.3%	\$982.9	37.3%	\$3,492.6	33.6%
Provision for Loan Losses	356.5	57.7%	379.1	54.7%	437.6	62.7%	563.3	71.2%	1,736.5	62.4%
Net Interest Income after Provision	402.8	2.6%	444.6	20.4%	489.1	23.5%	419.6	8.4%	1,756.1	13.6%
Non-Interest Income	747.1	52.7%	796.3	43.6%	852.5	37.5%	941.5	35.2%	3,337.4	41.4%
Total Revenues	1,506.4	35.9%	1,620.0	38.6%	1,779.2	38.5%	1,924.4	36.2%	6,830.0	37.3%
Salaries and Benefits	325.7	38.7%	342.1	44.6%	349.5	32.3%	374.8	30.3%	1,392.1	36.0%
Marketing Expenses	231.2	14.5%	268.7	27.0%	281.9	20.9%	301.2	16.1%	1,083.0	19.5%
Other Operating Expenses	361.3	32.3%	379.5	29.1%	443.5	37.9%	398.6	21.0%	1,583.0	29.9%
Non-Interest Expense	918.2	29.3%	990.3	33.4%	1,074.9	31.3%	1,074.6	22.6%	4,058.0	28.9%
Pre-tax Income	231.7	34.6%	250.6	38.1%	266.7	35.4%	286.5	38.4%	1,035.5	36.7%
Income Taxes	88.0		95.2		101.3		108.9		393.4	
Net Income (ex. nonrecurring items)	143.6	34.6%	155.4	38.1%	165.4	35.4%	177.7	38.4%	642.0	36.7%
Preferred Dividends	0.0		0.0		0.0		0.0		0.0	
Net Income Available to Common	\$143.6	34.6%	\$155.4	38.1%	\$165.4	35.4%	\$177.7	38.4%	\$642.0	36.7%
Tax Rate	38.0%		38.0%		38.0%		38.0%		38.0%	
Diluted EPS	\$0.66	29.0%	\$0.70	30.2%	\$0.75	29.4%	\$0.80	30.3%	\$2.91	29.7%
Average Diluted Shares Outstanding	217.8		221.2		219.9		223.4		220.6	
EOP Shares Outstanding	207.4		210.6		211.0		215.8		215.8	
Dividends Per Share	\$0.03		\$0.03		\$0.03		\$0.03		\$0.11	
<i>Managed Portfolio</i>										
Reported Loans	\$15,572		\$16,327		\$17,480		\$20,921		\$20,921	
Securitized Loans	\$15,979		\$18,956		\$21,009		\$24,343		\$24,343	
Total Managed Loans	\$31,551	55.4%	\$35,283	61.2%	\$38,489	59.4%	\$45,264	53.3%	\$45,264	53.3%
Securitized Loans/Managed Loans	50.6%		53.7%		54.6%		53.8%		53.8%	
Number of Accounts (000's)	36,462	44.1%	38,146	40.6%	40,145	36.4%	43,815	29.7%	43,815	29.7%
Average Fee Income Per Account	\$21.27		\$21.35		\$21.78		\$22.43		\$86.83	
Average Revenue Per Account	\$42.90		\$43.43		\$45.45		\$45.84		\$177.61	
Operating Expense Per Account (annualized)	\$78.26		\$77.38		\$81.03		\$73.69		\$76.69	
Average Managed Loans	\$30,505	51.2%	\$33,440	59.9%	\$37,017	60.8%	\$41,352	56.8%	\$35,579	57.3%
Yield on Managed Portfolio										
Avg. Loans/Avg. Earning Assets	92.5%		92.4%		92.6%		91.3%		92.1%	
Average Earning Assets	\$32,983	49.7%	\$36,180	60.2%	\$39,994	61.6%	\$45,295	60.7%	\$38,613	58.3%
Net Interest Margin	9.21%		9.11%		9.27%		8.68%		9.05%	
Non-interest Income	9.06%		8.80%		8.53%		8.31%		8.64%	
Net Charge-offs (% of avg. earning assets)	3.47%		3.68%		3.63%		4.03%		3.72%	
Risk Adjusted Margin	14.80%		14.23%		14.17%		12.96%		13.96%	
Efficiency Ratio	61.0%		61.1%		60.4%		55.8%		59.4%	
Return on Average Managed Assets	1.63%		1.60%		1.53%		1.45%		1.54%	
Return on Average Equity	24.48%		23.83%		22.54%		22.05%		23.11%	
<i>Balance Sheet</i>										
Managed Loans/Managed Assets	85.9%		86.9%		86.5%		86.2%		86.2%	
Total Assets	\$20,802		\$21,660		\$23,513		\$28,184		\$28,184	
Total Managed Assets	\$36,749	57.3%	\$40,587	58.5%	\$44,497	57.9%	\$52,506	57.7%	\$52,506	57.7%
Average Managed Assets	\$35,303	50.2%	\$38,820	58.0%	\$43,363	60.5%	\$48,906	61.8%	\$41,598	58.0%
Equity/Total Assets	11.77%		12.66%		12.69%		11.79%		11.79%	
Equity/Managed Assets	6.66%		6.75%		6.70%		6.33%		6.33%	
Total Equity	\$2,449	57.9%	\$2,742	66.6%	\$2,983	68.0%	\$3,323	69.3%	\$3,323	69.3%
Average Equity	\$2,347	49.8%	\$2,608	60.4%	\$2,935	68.4%	\$3,223	72.4%	\$2,778	63.3%
Book Value Per Share	\$11.81	48.9%	\$13.02	55.2%	\$14.14	56.7%	\$15.40	54.9%	\$15.40	54.9%
Market Price Per Share	\$55.50		\$60.15		\$46.03		\$53.95			
Total Market Cap (period end)	\$11,509		\$12,667		\$9,710		\$11,645			
Dividend Payout Ratio	4.0%		3.8%		3.5%		3.4%		3.7%	
<i>Credit Quality Analysis & Assumptions</i>										
Net Charge-Offs (managed)	\$285.9	46.4%	\$332.8	60.3%	\$362.7	66.1%	\$456.9	74.2%	\$1,438.3	62.8%
Net Charge-Off Rate (managed)	3.75%		3.98%		3.92%		4.42%		4.04%	
Net Charge-Off Rate (4 quarter lag)	5.67%		6.36%		6.30%		6.93%		6.93%	
Delinquency Rate (30+ days)	4.72%		4.92%		5.20%		4.95%		4.95%	
Loan Loss Reserve (on balance sheet)	\$597.0	60.5%	\$647.0	59.0%	\$727.0	59.1%	\$840.0	59.4%	\$840.0	59.4%
Loan Loss Reserve % (on balance sheet)	3.83%		3.96%		4.16%		4.02%		4.02%	
Provision/Average Managed Loans	4.67%		4.53%		4.73%		5.45%		4.88%	
Provision/Managed Net Charge-offs	125%		114%		121%		123%		121%	

FIGURE 18 Earnings Model, 2002 Projections

	1Q02E	% Chg.	2Q02E	% Chg.	3Q02E	% Chg.	4Q02E	% Chg.	2002E	% Chg.
Income Statement (Mgd. Basis)										
Net Interest Income	\$1,078.1	42.0%	\$1,134.7	37.8%	\$1,202.6	29.8%	\$1,299.5	32.2%	\$4,714.9	35.0%
Provision for Loan Losses	602.0	68.9%	629.8	66.1%	674.9	54.2%	759.0	34.7%	2,665.7	53.5%
Net Interest Income after Provision	476.2	18.2%	504.9	13.6%	527.6	7.9%	540.5	28.8%	2,049.2	16.7%
Non-Interest Income	987.4	32.2%	1,034.6	29.9%	1,087.5	27.6%	1,192.3	26.6%	4,301.7	28.9%
Total Revenues	2,065.5	37.1%	2,169.3	33.9%	2,290.1	28.7%	2,491.8	29.5%	9,016.7	32.0%
Salaries and Benefits	431.0	32.3%	452.6	32.3%	470.7	34.7%	498.9	33.1%	1,853.1	33.1%
Marketing Expenses	295.1	27.7%	318.7	18.6%	331.5	17.6%	358.0	18.9%	1,303.4	20.4%
Other Operating Expenses	448.4	24.1%	457.4	20.5%	480.3	8.3%	521.1	30.7%	1,907.2	20.5%
Non-Interest Expense	1,174.6	27.9%	1,228.7	24.1%	1,282.4	19.3%	1,378.0	28.2%	5,063.8	24.8%
Pre-tax Income	288.9	24.7%	310.7	24.0%	332.7	24.7%	354.8	23.8%	1,287.1	24.3%
Income Taxes	109.8		118.1		126.4		134.8		489.1	
Net Income (ex. nonrecurring items)	179.1	24.7%	192.6	24.0%	206.3	24.7%	220.0	23.8%	798.0	24.3%
Preferred Dividends	0.0		0.0		0.0		0.0		0.0	
Net Income Available to Common	\$179.1	24.7%	\$192.6	24.0%	\$206.3	24.7%	\$220.0	23.8%	\$798.0	24.3%
Tax Rate	38.0%		38.0%		38.0%		38.0%		38.0%	
Diluted EPS	\$0.80	20.7%	\$0.85	20.8%	\$0.90	19.8%	\$0.95	19.8%	\$3.50	20.2%
Average Diluted Shares Outstanding	225.0		227.0		229.0		231.0		228.0	
EOP Shares Outstanding	217.0		219.0		221.0		223.0		223.0	
Dividends Per Share	\$0.03		\$0.03		\$0.03		\$0.03		\$0.11	
Managed Portfolio										
Reported Loans	\$21,134		\$22,190		\$22,793		\$24,503		\$24,503	
Securitized Loans	\$24,809		\$26,050		\$27,859		\$29,948		\$29,948	
Total Managed Loans	\$45,943	45.6%	\$48,240	36.7%	\$50,652	31.6%	\$54,451	20.3%	\$54,451	20.3%
Securitized Loans/Managed Loans	54.0%		54.0%		55.0%		55.0%		55.0%	
Number of Accounts (000's)	45,500	24.8%	47,500	24.5%	50,000	24.5%	54,000	23.2%	54,000	23.2%
Average Fee Income Per Account	\$21.70		\$21.78		\$21.75		\$22.08		\$87.31	
Average Revenue Per Account	\$46.25		\$46.65		\$46.98		\$47.92		\$187.80	
Operating Expense Per Acct. (annualized)	\$78.77		\$78.28		\$78.03		\$78.46		\$76.89	
Average Managed Loans	\$45,603	49.5%	\$47,092	40.8%	\$49,446	33.6%	\$52,552	27.1%	\$48,673	36.8%
Yield on Managed Portfolio										
Avg. Loans/Avg. Earning Assets	92.0%		91.3%		92.0%		92.0%		91.8%	
Average Earning Assets	\$49,569	50.3%	\$51,579	42.6%	\$53,746	34.4%	\$57,121	26.1%	\$53,004	37.3%
Net Interest Margin	8.70%		8.80%		8.95%		9.10%		8.90%	
Non-interest Income	7.97%		8.02%		8.09%		8.35%		8.12%	
Net Charge-offs (% of avg. earning assets)	4.42%		4.57%		4.78%		4.88%		4.67%	
Risk Adjusted Margin	12.25%		12.26%		12.26%		12.57%		12.34%	
Efficiency Ratio	56.9%		56.6%		56.0%		55.3%		56.2%	
Return on Average Managed Assets	1.36%		1.42%		1.45%		1.46%		1.42%	
Return on Average Equity	21.01%		21.46%		21.80%		22.05%		21.60%	
Balance Sheet										
Managed Loans/Managed Assets	87.0%		87.0%		87.0%		87.0%		87.0%	
Total Assets	\$27,999		\$29,399		\$30,362		\$32,639		\$32,639	
Total Managed Assets	\$52,808	43.7%	\$55,448	36.6%	\$58,221	30.8%	\$62,587	19.2%	\$62,587	19.2%
Average Managed Assets	\$52,657	49.2%	\$54,128	39.4%	\$56,835	31.1%	\$60,404	23.5%	\$56,006	34.6%
Equity/Total Assets	12.49%		12.53%		12.79%		12.56%		12.56%	
Equity/Managed Assets	6.62%		6.64%		6.67%		6.55%		6.55%	
Total Equity	\$3,497	42.8%	\$3,684	34.4%	\$3,884	30.2%	\$4,098	23.3%	\$4,098	23.3%
Average Equity	\$3,410	45.3%	\$3,590	37.7%	\$3,784	28.9%	\$3,991	23.8%	\$3,694	33.0%
Book Value Per Share	\$16.11	36.5%	\$16.82	29.2%	\$17.57	24.3%	\$18.38	19.3%	\$18.38	19.3%
Market Price Per Share										
Total Market Cap (period end)										
Dividend Payout Ratio	3.3%		3.1%		3.0%		2.8%		3.0%	
Credit Quality Analysis & Assumptions										
Net Charge-Offs (managed)	\$547.2	91.4%	\$588.6	76.9%	\$642.8	77.2%	\$696.3	52.4%	\$2,475.0	72.1%
Net Charge-Off Rate (managed)	4.80%		5.00%		5.20%		5.30%		5.08%	
Net Charge-Off Rate (4 quarter lag)	7.18%		7.04%		6.95%		6.74%		6.74%	
Delinquency Rate (30+ days)	5.00%		5.20%		5.00%		4.90%		4.90%	
Loan Loss Reserve (on balance sheet)	\$894.7	49.9%	\$935.9	44.7%	\$968.1	33.2%	\$1,030.7	22.7%	\$1,030.7	22.7%
Loan Loss Reserve % (on balance sheet)	4.23%		4.22%		4.25%		4.21%		4.21%	
Provision/Average Managed Loans	5.28%		5.35%		5.46%		5.78%		5.48%	
Provision/Managed Net Charge-offs	110%		107%		105%		109%		108%	

FIGURE 18 Earnings Model, 2003 Projections

	1Q03E	% Chg.	2Q03E	% Chg.	3Q03E	% Chg.	4Q03E	% Chg.	2003E	% Chg.
Income Statement (Mgd. Basis)										
Net Interest Income	\$1,338	24.1%	\$1,379	21.5%	\$1,448	20.4%	\$1,542	18.7%	\$5,707	21.0%
Provision for Loan Losses	735.5	22.2%	729.5	15.8%	748.9	11.0%	814.0	7.2%	3,027.8	13.6%
Net Interest Income after Provision	602.9	26.6%	649.1	28.6%	698.7	32.4%	728.2	34.7%	2,678.9	30.7%
Non-Interest Income	1,210.0	22.6%	1,254.0	21.2%	1,320.0	21.4%	1,430.0	19.9%	5,214.0	21.2%
Total Revenues	2,548.3	23.4%	2,632.6	21.4%	2,767.6	20.9%	2,972.2	19.3%	10,920.7	21.1%
Salaries and Benefits	548.8	27.3%	581.7	28.5%	605.0	28.5%	635.2	27.3%	2,370.8	27.9%
Marketing Expenses	358.0	21.3%	381.3	19.6%	419.4	26.5%	453.0	26.5%	1,611.7	23.7%
Other Operating Expenses	547.2	22.0%	558.1	22.0%	586.0	22.0%	635.8	22.0%	2,327.1	22.0%
Non-Interest Expense	1,454.0	23.8%	1,521.1	23.8%	1,610.4	25.6%	1,724.0	25.1%	6,309.5	24.6%
Pre-tax Income	358.9	24.2%	382.0	22.9%	408.3	22.7%	434.2	22.4%	1,583.3	23.0%
Income Taxes	136.4		145.2		155.1		165.0		601.7	
Net Income (ex. nonrecurring items)	222.5	24.2%	236.8	22.9%	253.1	22.7%	269.2	22.4%	981.7	23.0%
Preferred Dividends	0.0		0.0		0.0		0.0		0.0	
Net Income Available to Common	\$222.5	24.2%	\$236.8	22.9%	\$253.1	22.7%	\$269.2	22.4%	\$981.7	23.0%
Tax Rate	38.0%		38.0%		38.0%		38.0%		38.0%	
Diluted EPS	\$0.96	20.5%	\$1.02	19.8%	\$1.08	20.1%	\$1.15	20.3%	\$4.20	20.2%
Average Diluted Shares Outstanding	232.0		233.0		234.0		235.0		233.5	
EOP Shares Outstanding	220.0		220.0		220.0		220.0		220.0	
Dividends Per Share	\$0.03		\$0.03		\$0.03		\$0.03		\$0.11	
Managed Portfolio										
Reported Loans	\$24,198		\$25,408		\$26,072		\$28,158		\$28,158	
Securitized Loans	\$30,797		\$32,337		\$34,561		\$37,325		\$37,325	
Total Managed Loans	\$54,996	19.7%	\$57,745	19.7%	\$60,633	19.7%	\$65,483	20.3%	\$65,483	20.3%
Securitized Loans/Managed Loans	56.0%		56.0%		57.0%		57.0%		57.0%	
Number of Accounts (000's)	55,000	20.9%	57,000	20.0%	60,000	20.0%	65,000	20.4%	65,000	20.4%
Average Fee Income Per Account	\$22.00		\$22.00		\$22.00		\$22.00		\$88.00	
Average Revenue Per Account	\$46.76		\$47.01		\$47.31		\$47.55		\$188.63	
Operating Expense Per Account (annualized)	\$80.44		\$81.42		\$81.44		\$81.35		\$78.96	
Average Managed Loans	\$54,723	20.0%	\$56,370	19.7%	\$59,189	19.7%	\$63,058	20.0%	\$58,335	19.9%
Yield on Managed Portfolio										
Avg. Loans/Avg. Earning Assets	92.0%		92.0%		92.0%		92.0%		92.0%	
Average Earning Assets	\$59,482	20.0%	\$61,272	18.8%	\$64,336	19.7%	\$68,541	20.0%	\$63,408	19.6%
Net Interest Margin	9.00%		9.00%		9.00%		9.00%		9.00%	
Non-interest Income	8.14%		8.19%		8.21%		8.35%		8.22%	
Net Charge-offs (% of avg. earning assets)	4.71%		4.54%		4.43%		4.24%		4.47%	
Risk Adjusted Margin	12.43%		12.65%		12.77%		13.10%		12.75%	
Efficiency Ratio	57.1%		57.8%		58.2%		58.0%		57.8%	
Return on Average Managed Assets	1.42%		1.46%		1.49%		1.49%		1.46%	
Return on Average Equity	21.16%		21.38%		21.68%		21.87%		21.54%	
Balance Sheet										
Managed Loans/Managed Assets	87.0%		87.0%		87.0%		87.0%		87.0%	
Total Assets	\$32,416		\$34,037		\$35,132		\$37,943		\$37,943	
Total Managed Assets	\$63,213	19.7%	\$66,374	19.7%	\$69,693	19.7%	\$75,268	20.3%	\$75,268	20.3%
Average Managed Assets	\$62,900	19.5%	\$64,794	19.7%	\$68,033	19.7%	\$72,480	20.0%	\$67,052	19.7%
Equity/Total Assets	13.31%		13.36%		13.64%		13.33%		13.33%	
Equity/Managed Assets	6.83%		6.85%		6.88%		6.72%		6.72%	
Total Equity	\$4,315	23.4%	\$4,546	23.4%	\$4,793	23.4%	\$5,056	23.4%	\$5,056	23.4%
Average Equity	\$4,206	23.3%	\$4,430	23.4%	\$4,669	23.4%	\$4,925	23.4%	\$4,558	23.4%
Book Value Per Share	\$19.61	21.7%	\$20.66	22.8%	\$21.79	24.0%	\$22.98	25.1%	\$22.98	25.1%
Market Price Per Share										
Total Market Cap (period end)										
Dividend Payout Ratio	2.8%		2.6%		2.5%		2.3%		2.5%	
Credit Quality Analysis & Assumptions										
Net Charge-Offs (managed)	\$700.5	28.0%	\$694.8	18.0%	\$713.2	11.0%	\$726.7	4.4%	\$2,835.2	14.6%
Net Charge-Off Rate (managed)	5.12%		4.93%		4.82%		4.61%		4.86%	
Net Charge-Off Rate (4 quarter lag)	6.14%		5.90%		5.77%		5.53%		5.53%	
Delinquency Rate (30+ days)	4.80%		4.70%		4.60%		4.50%		4.50%	
Loan Loss Reserve (on balance sheet)	\$1,066	19.1%	\$1,100	17.6%	\$1,136	17.4%	\$1,223	18.7%	\$1,223	18.7%
Loan Loss Reserve % (on balance sheet)	4.40%		4.33%		4.36%		4.34%		4.34%	
Provision/Average Managed Loans	5.38%		5.18%		5.06%		5.16%		5.19%	
Provision/Managed Net Charge-offs	105%		105%		105%		112%		107%	

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