

Yellow Tree Fund

Capital One Financial Corp.

COF | \$213

Buy | Target Price: \$293

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Card Issuer transforming into a major end to end payments player

Our view: We recommend a BUY with a \$293 target stock price for COF. COF is a high-quality financial institution that has closed a transformational acquisition of the Discover network, positioning it as the largest card issuer in the USA, and along with AMEX, one of only two integrated card companies that both issue cards and process transactions. While the stock is up 22% YTD we believe there is significantly more upside potential as the full benefits of the acquisition are captured. Q3 results reinforced our bullish view, with strong results, and management optimism about the forward-looking picture. Net revenue increased 23%, pre provision earnings increased 29% and net interest margin increased 74 basis points. COF announced a \$16Bn share repurchase authorization and a dividend increase for the upcoming quarter. Synergies from the Discover acquisition are expected to accelerate in Q42025 and 2026.

COF is now the largest card issuer in the USA, unlocking superior economics for a bank holding company. In its June earnings call, credit card loans increased 72%, net interest margin increased 69 basis points, and net interest income surged 25%. As full integration continues these numbers will continue to grow. **The Discover deal is transformational longer term** and will benefit consumers and merchants as it positions COF as a credible competitor to AMEX and MC/Visa. The deal also delivers numerous value creation opportunities for COF including (1) \$1.5Bn cost synergies (2) moving COF volume from Visa/MC to the Discover network in order to capture both issuer and high margin merchant economics, starting with debit cards in Q1 2026 which will yield \$1.2Bn in network synergies (3) building out Discover's international network overtime to further reduce reliance on Visa/MC, (4) leveraging combined scale to further build out the premium card offering including associated infrastructure such as lounges etc. to compete with Amex and JPM who have aggressively raised fees in that segment (29% and 47% respectively). **COF has the right team to execute the integration.** COF considers itself to be a technology company first and has undertaken its own technology transformation over the past 10 years, completing a major AWS public cloud migration in 2020. Along with JP Morgan Chase it is also considered to be a leader in developing and adopting AI capabilities in financial services. This experience will enable it to successfully modernize and integrate the Discover platform.

Valuation: We have set a target price of \$293 per share, representing 35.5% upside on the current value of \$216.59. The base case assumptions are: a 6-year sales CAGR of 9.5%, a dividend growth assumption of 2.5% and a cost of equity of 7.8%. We are using a residual income model with a terminal growth rate of 3%.

Risks and Mitigants: We see two major risks to our thesis. **(1)** Rising delinquencies with a deteriorating economy are always a concern however COF is highly sophisticated company that is well equipped to manage through downcycles. At this point we do not see significant issues, and this should not be a major concern for long-term investors. **(2)** Acquisitions of the size of Discover will present executions risk however management is very happy with progress on the Q3 earnings call and COF's deep technology capabilities makes them well placed for a successful execution.

Clientele: COF's clientele are considerably less affluent than AXP's, this provides risk of economic shocks, however that does not necessarily need to persist. This means that consumer strength matters more in the short term, but makes less of an impact in the long term. Also, with COF's discovery merger, the issuer may be able to break into the higher end client area.

Variant View: COF currently trades with a forward P/E of ~11 which is on the low-end of a bank holding company (C: ~13, JPM: ~15.5). AMEX trades at 20 and Visa and MC around 30. With the growth and margin expansion that this acquisition provides as well as the longer-term transformational themes we believe that COF's PE will converge with AXP's.