Yale School of Management

Providian
(PVN)

December 3, 2001

Stock Data

Latest Close	$2.67
52 Week Range	$64-2
YTD Price Change	-94.2%
Mkt. Cap. (mm)	$758.9
Dividend Yield	4.49%
EPS (3Q 01)	1.83
P/E	1.10
Beta	2.00

Buy

Providian, based in San Francisco, is the largest issuer of secured credit cards in the US as well as one of the top ten card issuers. With over 16 million customers, the company has supported having a higher risk customer base by charging higher interest rates than the market average.

Key Issues

- Credit downgrades due to poor performance in maintaining a healthy Net Credit Loss rate.
- Government supervision of future company's restructuring plan.
- Strategic sale of unprofitable and riskier business modules.
- Eventual re-activation of the US economy and consumer spending through consumer credit.
- Recent changes in Management.

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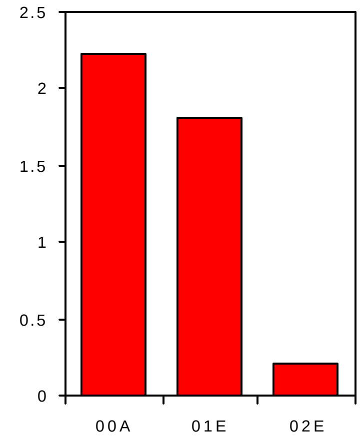
Executive Summary

Providian is a financial services provider, specializing in the issuance of credit cards to high-risk customers. Providian has arguably been the most aggressive domestic advertiser and distributor of credit cards over the past four years. As of Q3 2001 Providian claimed over 166 million customers and growth in revenues of over 377% over the past four years. This revenue growth also came with profitability, as EPS grew from $.67 is 1997 to $2.23 in 2000. Solid growth in profitability continued through the second quarter of 2001 with that quarter's EPS growing to $.79 from $.16 in 2Q 1997. In July of 2001 Providian's profitability situation changed dramatically, and earnings plummeted. Third quarter 2001 EPS dropped to $0.15, while many analysts predicted a loss for the fourth quarter. In response to these disappointing developments the stock price shed over 96% of its value, and remains less than one dollar off its lows[1].

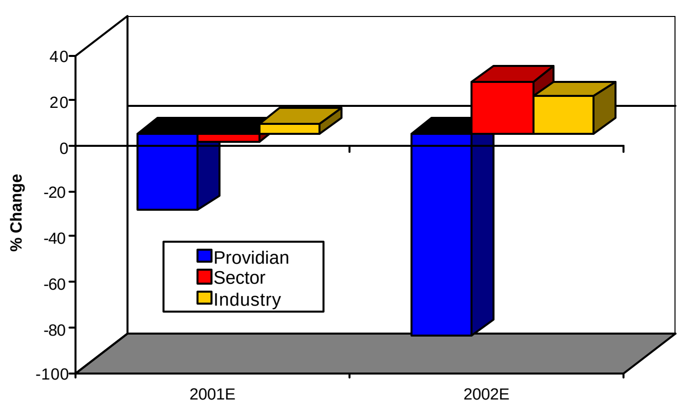
Earnings per Share
2000-2002



Source: Yahoo Finance (12/01/01)

We feel that the market went too far in slashing capitalization from Providian. Providian was sharply overvalued at it highs, but the market has over-corrected as the stock is still 96% lower than it was in July. Providian's P/E ratio of 1.06 [2] is so low that it is meaningless. Much of the reason for the low P/E ratio is that historical earnings that the market no longer counts on are factored into the calculation. It also shows how far the price has dropped on a profitable company. There is no denying that weaknesses have been shown in Providian's business model. It no longer deserves to be regarded as the darling of the credit card industry, as it once was. However, Providian has shown the ability to be successful in gaining market share and profits. There are a multitude of risks, weaknesses have been exposed, and Providian may not survive as an independent company, but all things considered and with less speculation than the market, we rate Providian as a **BUY**.

Earnings per Share
Estimated growth



Source: Yahoo Finance (12/01/01)

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[1] All EPS and return data from Standard and Poor's Providian stock report November 1, 2001
[2] P/E From Bloomberg Financial, November 30, 2001

Analysis

Providian has a beta of 2.0[3], and its business cycle has shown every bit of that market exposure. Providian's strategy of focusing on high credit-risk clients served it very well in good economic times. Providian tailored a successful marketing plan and seemed able to price the risk correctly. However, as the economy turned sour, a wave a bad debt came crashing down on Providian. While credit loans grew from $23 billion in 3Q 2000 to $31.3 billion in 3Q 2001, the percentage of bad debt also surged from 7.61% to 10.33% over the same period. By the end of October over 12% of loans had gone bad. To make matters worse, Providian itself estimates that credit losses could rise as high as 18% to 20% of their loan portfolio[4].

While other companies in the industry have also suffered from the declining economy (notably First USA), most competitors anticipated this business erosion and prepared for it by strengthening their portfolios. This has shown to be wise as competitors have been able to keep their chargeoffs low, and thus maintain a lower loan loss reserve

Relative Size and Portfolio Strength

	Managed Assets (BB)	Loan growth *Q3*	Chargeoffs *Q3*	% Loan Loss Reserve *Q3*
Advanta	16	30%	n.a.	10.60%
Capital One	39	36%	3.90%	3.70%
First USA	70	36%	6.20%	*2.40%*
MBNA	89	38%	4.90%	1.90%
Providian	31	36%	11.97%	10.50%
American Express	31	11%	*5.60%*	
Citigroup	100		*5.50%*	

Source: finance.yahoo.com

Providian's business plan was to gain a competitive advantage through expertise in two main areas: marketing and pricing. Providian's marketing model specifically sought the underserved "sub-prime" market, or those lenders with a high chance of defaulting. This was done through aggressive direct marketing campaigns, "Jerry Springer" style publicity stunts, and low introductory rates used to attract their target borrower. Providian believed that any credit risk could be profitably priced, and that they had superior expertise pricing them. Providian was famous for their proprietary computer models that had supposedly reinvented credit scoring. They expected higher losses on their loan portfolio, but felt that with higher interest rates they were coming out ahead on a risk adjusted basis. Further, Providian developed the "hidden charges" pricing model. Because Providian customers had already been refused credit by other companies, Providian found they could charge an "initiation fee" and other monthly fees to offset the risk of these customers. They appeared to be extremely successful at this in good economic times. However, as the economy slowed they suffered staggering losses, and found that despite high interest rates they had a poor risk adjusted portfolio.

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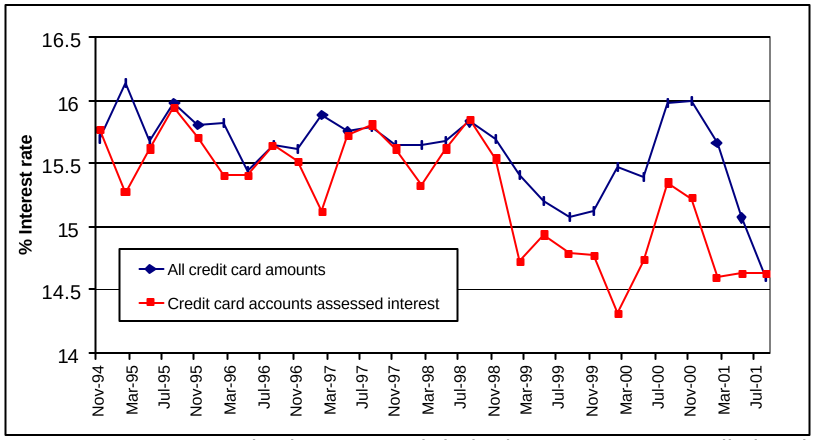
[3] Beta calculated with a regression between PVN and S&P 500 (Data from 1996-2001)

[4] Loss actual and estimates from AP Business writer, Michael Liedtke. Wall Street Hammers Providian. November 17, 2001

Providian now admits that some risk cannot be successfully priced. A higher interest rate increases the chance of borrower bankruptcy. Some borrowers have a risk sufficiently high that a fair interest rate would raise the risk of bankruptcy beyond what could be priced. Further increases in the interest rate to compensate for the higher borrower risk would only drive the bankruptcy risk higher. This cycle will continue until the interest rate is infinite and bankruptcy is certain. Some credit customers have no profitable price. There is also a strong adverse selection problem, as higher interest rates attract worse customers. With a high enough interest rate only customer who have no ability to pay will borrow.

Interest rates

Credit Cards

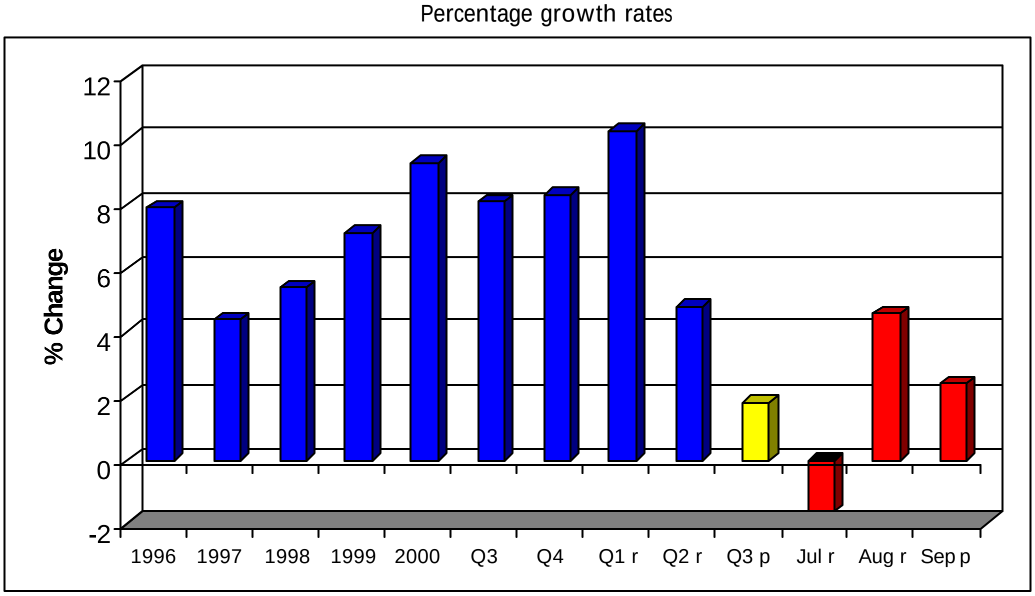


Source: Federal reserve statistical release. Consumer credit (G.19)

Providian is currently restructuring many aspects of their business. Possibly the most important aspect of the restructuring is the elimination of the worst risks from their loan portfolio. Providian is doing this in two ways. First, they are bundling and selling their high-risk receivables in the secondary market. They will have to sell them at a deep discount, but removing the worst debt from the balance sheet will produce cash flow and reduce uncertainty. Secondly, they are being more selective in the customers they underwrite. This will hurt their growth in customer base, but the high credit losses are proving their growth rates to be unsustainable. Providian is also saving cash by eliminating 5% of its workforce and eliminating their dividend.

US Consumer Credit

Percentage growth rates



Source: Federal reserve statistical release (11/07/2001)

In addition, the growth scenario for consumer credit in the US is not as good as it has been in previous years, and we expect that growth levels for 2002 to be similar to those in 1997. Our estimates are that the company will experience a modest growth in year 2002, which will be a year for recovery (with a maximum growth of 2.5% quarterly – according to Federal laws), and gradually increase its growth rate in the upcoming years up to 10% annually (the company was growing at 30% annually over the last three years.

Competition

Looking at the historical figures for Providian, we see they have shown strong returns relative to peers. These returns are indicative of success in the business model of targeting sub-prime lenders and charging appropriate upfront fees and higher interest rates. While the fact that Providian's Return on Equity is due to a relatively low equity position, the high returns on assets can only be compared to MBNA, often seen as the industry standard.

Comparable companies

Historical performance (ttm)

	% Return on Assets	% Return on Equity
Advanta	-2.10%	-12.33%
Capital One	2.93%	24.87%
First USA	0.59%	8.44%
MBNA	4.03%	23.17%
Providian (PVN)	3.63%	33.02%
Average	1.82%	15.43%
PVN vs. avg.	1.81%	17.59%

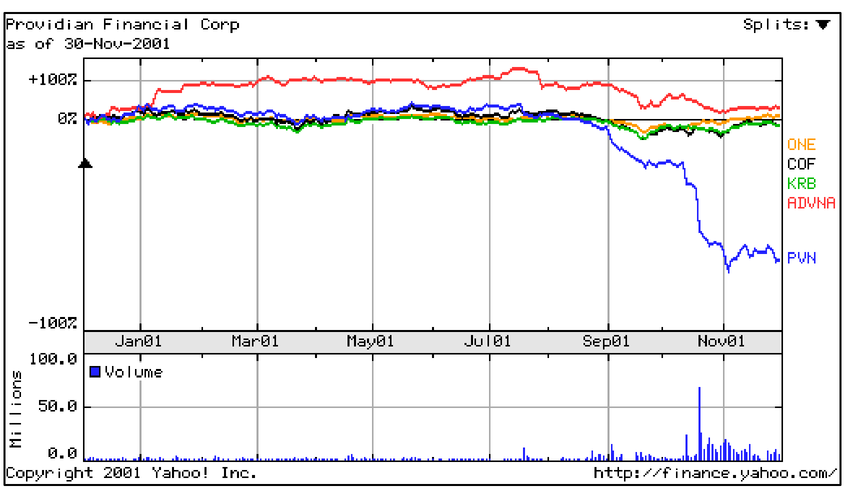
Source: finance.yahoo.com

Stock Performance

	Recent Price	52 wk Low	52 wk high	Chg. from High
Advanta	9.05	7	19.1	53%
Capital One	50.03	36.4	72.58	31%
First USA	37.44	27	41.56	10%
MBNA	32.24	23.43	39.56	19%
Providian	**2.67**	**2**	**64**	**96%**

Source: finance.yahoo.com

However, the poor decision made by management was to ignore the stormclouds on the horizon and not prepare for a weakening economy. As such, the returns on assets are expected to fall dramatically in the coming quarters. Along with management shakeups, this fall in future returns is what has been driving the value of the stock down. We believe this reaction is overstated.



In comparing Providian comparables to competitors, the stock is priced at a discount. The market/book value is 85% lower than competitors, and its price/earnings are 79% lower, which would imply future earnings and values at similar rates.

Stock price

Relative market valuations

	Market/Book Current	Price/Earnings 2001E
Advanta	0.6	6.3
Capital One	3.54	15.8
First USA	2.16	13.4
MBNA	4.06	15.9
Providian (PVN)	**0.32**	**1.1**
Average	*2.14*	10.74
PVN vs. avg.	*-85%*	-79%

Source: finance.yahoo.com

Future Cash Flows

Analysts expectations

	EPS 2001	EPS 2002
Advanta	1.41	2.34
Capital One	2.91	3.54
First USA	2.45	2.8
MBNA	1.89	2.27
Providian (PVN)	**1.68**	**0.36**
Average	$2.07	$2.26
PVN vs. avg.	*-19%*	*-84%*

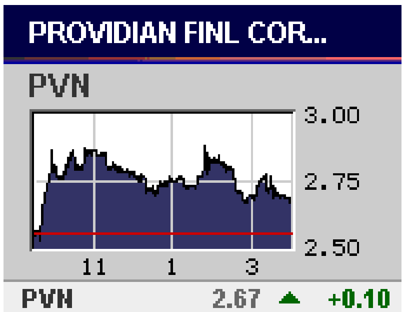
Source: finance.yahoo.com

However, market these extremely low valuations are not reflected in analysts expectations of future cash flows. Not only are future cash flow expectations *positive* (surprising for a company that is essentially valued to go bankrupt), but they are higher than the performance of comparable valuations.

There are several conservative measures we used to develop a range of values for Providian. The first, valuing the price relative to comparable 2001E price earnings ratio yields a value of $12.47[5]. A second measure is to compare the expected future price/earnings and earnings per share, which yields a valuation of $3.86 on 2001 earnings[6]. Finally it is worth observing that Providian's assets are priced at 1/3 their book value, relative to the industry average of just over 2. This would imply that, based solely on it's assets, Providian is undervalued by 6.

We carefully note that these valuations do not take into account future expected cash flows of the company. However, we feel that the future cash flows for Providian will remain positive; the company is not expected to go bankrupt. Once the market recognizes the deep discount placed on such positive future cash flows, we believe an upward correction will occur.

[5] This is the (Current Price) / (Current Price/Earnings) * (average Price/Earnings) = Price (based on average Price Earnings).
[6] This is done by multiplying the Price/Earnings (2001) * Earnings/Share (2001) = Price/Share (2001).



Ever since the stock price plummeting on Oct. 19, Providian hasn't been able to recover even with the announcement of its new CEO and projected favorable expectations for the first two quarters of 02.

The stock represented an attractive opportunity for investors in early 2000 which generated a number of initiation of coverage efforts. The outperforming stock reached levels above $120 (down from $40 at early 00) by September 00. The stock managed to trade at those levels for almost one year until it started its downgrade rally derived from losses in percentage points over one of its main business indicators: Net Credit Loss.

During the 3Q-01, Providian changed its policy to accelerate the recognition of the estimated uncollectible portion of accrued finance charges on accounts that were 90 or more days delinquent. Before these changes, the finance charges were reversed against current period interest income at the time of charge-off of the related accounts. The effect of adopting the change was to advance the timing of finance charge income reversals, resulting in a decrease in loans receivable and finance charge income of $63.7 million which was taken as a ONE-TIME charge in the third quarter of 2001*.

Loans receivable and allowance for credit losses

(Dollars in thousands)	Sept. 30, 2001	Dec. 31, 2000
Credit cards	14,263,572	13,734,789
Other loans	50,153	35,368
Allowance for credit losses	-1,713,734	-1,445,638
Total Loans receivable after allowance for credit losses	12,599,991	12,324,519
Net Credit Loss rate	**11.97%**	**10.50%**

Source: SEC Filings (11/14/2001)

Allowance for credit losses

(dollars in thousands)	Nine months ended September 30,	
	2001	2000
Balance at beginning of period	1,445,638	1,028,377
Provision for credit losses	1,366,288	1,067,044
Credit losses	-1,205,119	-841,246
Recoveries	106,789	84,590
Other	138	-22,580
Balance at end of period	**1,713,734**	**1,316,185**

Source: SEC Filings (11/14/2001)

* Extracted from SEC filings (11/14/2001).

The main component determining the stock price is the loan loss provision. Historically, the loan loss provision as total sales has been in the 50%-60% rate except for 2001, for the reasons mentioned before. We expect the company to continue operating at the historical levels, starting at 60% and decreasing at 2 percentage points annually.

Loan Loss Provision rate

As percentage of Total Sales

1996	1997	1998	1999	2000	1Q 2001	2Q 2001	3Q 2001	2001E
22%	26%	65%	68%	56%	58%	54%	85%	72%

2002E	2003E	2004E	2005E	2006E	2007E	2008E	2009E	2010E
60%	58%	56%	54%	52%	50%	48%	46%	44%

Pro-forma Income Statement

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Interest Income	2285.0	2513.5	2764.9	3041.3	3345.5	3680.0	4048.0	4452.8	4898.1
Total Sales	**2285.0**	**2513.5**	**2764.9**	**3041.3**	**3345.5**	**3680.0**	**4048.0**	**4452.8**	**4898.1**
Interest Expense	859.8	945.8	1040.4	1144.4	1258.9	1384.8	1523.3	1675.6	1843.1
Loan Loss Provision	1371.0	1457.8	1548.3	1642.3	1739.6	1840.0	1943.0	2048.3	2155.2
Total Expenses	**2230.8**	**2403.6**	**2588.7**	**2786.8**	**2998.5**	**3224.8**	**3466.3**	**3723.9**	**3998.3**
Non-Interest Income	2994.8	3294.3	3623.8	3986.1	4384.7	4823.2	5305.5	5836.1	6419.7
Non-Interest Expense	-2224.6	-2447.0	-2691.8	-2960.9	-3257.0	-3582.7	-3941.0	-4335.1	-4768.6
Pre-Tax Income	**824.4**	**957.1**	**1108.1**	**1279.8**	**1474.7**	**1695.7**	**1946.3**	**2229.9**	**2550.9**
Income Taxes	329.8	382.8	443.3	511.9	589.9	678.3	778.5	892.0	1020.4
Income After Taxes	**494.6**	**574.3**	**664.9**	**767.9**	**884.8**	**1017.4**	**1167.8**	**1338.0**	**1530.5**
Net Income	**494.6**	**574.3**	**664.9**	**767.9**	**884.8**	**1017.4**	**1167.8**	**1338.0**	**1530.5**

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Terminal
	@10%	@10%	@10%	@10%	@10%	@10%	@10%	@10%	@10%	@10%	@3%
Net Income	515.0	494.6	574.3	664.9	767.9	884.8	1017.4	1167.8	1338.0	1530.5	
No. of Shares	284	284	284	284	284	284	284	284	284	284	284
EPS	1.81	1.74	2.02	2.34	2.70	3.12	3.58	4.11	4.71	5.39	30.37
PV (stock price)	**$14.37**										

Discount rate

EPS (2000)	2.29
r	0.2075
g	-65.02%
Price	$2.67
risk free rate	0.0475
Beta	2.00
Market Premium	0.08
P/E Ratio	1.17

We believe that the stock price should be trading around $14.37, if the company achieves to lower its loan loss provision rate as a percentage of sales. Is in the Federal Government's best interest that Providian achieves a healthy financial status, therefore we are confident that it will perform at the projected levels.

Concerns facing Providian

While we believe in the valuation and the strategic analysis puts a BUY rating on the company at this price, there are a few concerns an investor should be aware of. First, Providian faces the morass of lawsuits that plague any company in its position. These lawsuits stem from questionable marketing tactics and mismanagement of some loan accounts. The former CEO (recently replaced) gave admittedly misleading statements to shareholders. Now the predictable storm of class-action lawsuits has come flooding in. Union pensions and institutional investors are also suing Providian over items that were excluded from the Net Income calculation as "extraordinary". There are also allegations of stock fraud as former members of management allegedly sold stock at inflated prices just before the sharp price drop. Although we are not happy that Providian will have to face a bevy of lawsuits as they attempt to restructure, we do believe that the enormity of the claims is one of the reasons the stock price dropped over 96%. Courts do not normally allow lawsuits to drive companies into bankruptcy. With this in mind, we cannot imagine that a 96% drop in value is not sufficient discounting for the legal claims. Still, it is an issue, as the situation is so fluid Providian does not even yet know how much they are being sued for.

Second, the stock is viewed poorly due to the recent departure of the founder and CEO. We believe this departure is related to the misleading statements as discussed above. There is some concern his departure is indicative of more troubling problems facing the company. However, we see his departure as not necessarily a bad thing. The company is in the midst of a restructuring, the CEO has clearly made some errors in his leadership, and we feel this departure is within the best interest of the shareholders. The newly announced CEO, Joseph Saunders, brings 25 years of senior management experience working with a successful credit card portfolio, Fleet Credit Card.

After considering these management strategies, as well as the best interest of the Federal Government, we believe that the stock price is undervalued and that it should start trading at levels around $14 early 2002.