Author: Michael Gorlon
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Sum Zero All Star Management Contest
Company: Wells Fargo (WFC)
Market Capitalization: $101.72B
Enterprise Value: $102.80B
Current Price: $24.69
Target Price: $46.56
Expected Return: 88%
Disclosure: I have an ownership in shares of Wells Fargo at the time of writing

Business Background

Wells Fargo is currently the 4th largest bank by market cap and assets with $1.95 trillion in assets on their balance sheet. Their business is split into community banking, wholesale banking and wealth management[1].

Consumers and small businesses make up the community banking segment with products that include deposit accounts, credit/debit cards, student loans, mortgages and home equity loans. The whole banking segment is made up of larger companies with products such as corporate loans, commercial real estate loans and capital markets. The wealth management segment consists of brokerage business, trust services and retirement.

What Went Wrong and Why is the Market Giving Investors an Opportunity?

Wells Fargo's Market Cap in Billions

Source: Macrotrends

Intense pressure from upper management on sales targets led to employees at Wells Fargo to create 3.5 million[2] fraudulent accounts for their clients without their consent. The accounts that were fraudulently opened were deposit and credit card accounts which led to unnecessary fees and possible deterioration in their client's credit ratings. A portion of their clients affected were also enrolled in automatic bill pay without their consent and forced into unneeded auto insurance. This brought on fines from the Consumer Financial Protection Bureau of a combined $185 million and additional criminal and civil lawsuits of $2-3 billion.

In addition to the fines and lawsuits, the Federal Reserve imposed a penalty of an asset cap on Wells Fargo which prevents the bank from increasing their assets above $1.95 trillion until they can demonstrate that they have reformed themselves from the fake account scandal. Bloomberg estimates

[1] https://www.morningstar.com/stocks/xnys/wfc/quote
[2] https://money.cnn.com/2017/08/31/investing/wells-fargo-fake-accounts/index.html

that the Fed's asset cap is one of the costliest penalties ever at $4 billion when the opportunity cost of the profits that Wells missed out on are taken into account.[3]

The account scandal was already causing Wells' stock price to languish but then the coronavirus pandemic followed. The coronavirus pandemic has created many headwinds for Wells Fargo such as an increased unemployment rate, lower interest rates, increased bankruptcies, higher defaults and forbearances for mortgages and loans.

Q4 2020	0.29	Concensus Est. EPS
Q3 2020	0.35	Concensus Est. EPS
Q2 2020	-0.66	Actual EPS
Q1 2020	0.01	Actual EPS
Q4 2019	0.60	Actual EPS
Q3 2019	0.92	Actual EPS
Q2 2019	1.30	Actual EPS
Q1 2019	1.20	Actual EPS

Source: Fidelity

The effects of the coronavirus led to a sharp decline in profits for Wells Fargo through the first 6 months of 2020 and an 80% decline in their dividend payout. Q1 2020 earnings were 1 cent per share or $653 million in net income which included the impact from a reserve build of $3.1 billion or -.56 a share and an impairment of $950 million on securities.[4] Then in the 2nd quarter Wells Fargo reported their first quarterly loss since the great financial crisis in 2008. They reported a loss of $2.4 billion or -.66 a share due to an $8.4 billion increase in their credit loss reserve and lower net interest income because of lower interest rates.

The asset cap brought on by the account scandal continues to plague Wells Fargo especially during a time when Wells could have alleviated some of the lost net interest income by increasing their interest income from loans at a time when lots of businesses are raising more capital to make up for the uncertainty brought on by the virus.

The coronavirus continues to hurt business throughout America, especially small businesses, and there isn't any exact timeframe of when the pandemic will end, and businesses will recover. This uncertainty from the virus along with the asset cap has caused Wells Fargo to trade at levels not seen in over 10 years. Wells Fargo's market cap is currently $101B which was last seen during the 08-09 recession and the mid 2000's.

Pessimism is high but Wells Fargo brought in a new CEO in October of 2019 and although there is still a lot of work to do, he has done a great job so far in response to everything going on to position Wells Fargo to do very well coming out of the current recession.

[3] https://www.bloomberg.com/news/articles/2020-08-24/wells-fargo-asset-cap-is-now-one-of-the-costliest-bank-penalties

[4] https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/earnings/first-quarter-2020-earnings.pdf

CEO

On October 21, 2019 Charles Scharf took over as CEO of Wells Fargo. Before this, Charles served as CEO of Bank of NY Mellon from July 2017 to October 2019, Chairman of the Board of Bank of NY Mellon from January 2018 to October 2018 and as CEO of Visa from November 2012 to December 2016.[5] He has 24 years of experience in the financial services industry including experience working with one of the most notable bankers in the industry, Jamie Dimon. While working at JP Morgan Chase, Charles had numerous management positions where he was a managing director at One Equity Partners, the Chief Executive Officer of retail at Bank One Corp, CFO of Bank One, CFO of Global Corporate and Investment Bank and CFO of Solomon Smith Barney.

After Charlie was hired by Wells in October, Jamie Dimon called him "an excellent choice to run Wells Fargo" but Charles will have his work cut out for him following a 2016 account scandal that still plagues the company and now a global pandemic. So far, Charles has been very focused and intent on removing the asset cap and helping Wells restore its image that was damaged following the account scandal. It's been less than a year so he has more work to be done but so far he has done a good job in my opinion.

In response to the falling share price on March 13, 2020, Charles bought $4.963 million worth of stock at a purchase price of $28.69 a share which better aligns his interests with shareholders and demonstrates that he views the share price as undervalued.

How has the CEO Positioned Wells Fargo To Succeed?

Cut the dividend 80% and suspended share buybacks – Following the new restrictions from the Federal Reserve on June 25, 2020[6], Wells Fargo cut their dividend by 80%. The Fed said that dividend payments will be tied to a formula based on earnings. Share buybacks were already suspended at the start of the pandemic to preserve capital in response to the uncertainty of losses that could result from the pandemic.

There was some uncertainty to how much Wells Fargo would cut their dividend but not many were expecting a cut as much as 80%. Although the 80% cut was probably steeper than Wells Fargo needed to go, I view a larger and more conservative dividend cut as a better decision because cutting the dividend once is much better than having to cut it twice if provision expense in Q3 and Q4 turns out to be higher than expected. Preserving more capital to maintain a larger margin of safety for their CET1 ratio to be above the 9% regulatory minimum should be viewed more favorably from the Federal Reserve also to help them get the asset cap lifted in the future.

"We believe it's prudent to be extremely cautious until we see a clear path to broad economic improvement. We're confident that this eventual economic improvement combined with our actions to increase our margins will allow our wonderful franchise to support a higher dividend in the future. We're extremely disappointed to take this action and do understand that many rely on this stream of income. However, we must be prudent in this environment."

– Charles Scharf, Q2 2020 Earnings Call

[5] https://www.wellsfargo.com/about/corporate/governance/scharf/

[6] https://www.cnbc.com/2020/06/25/fed-puts-restrictions-on-bank-dividends-after-test-finds-some-banks-could-be-stressed-in-pandemic.html

Will cut $10B of costs – Charles Scharf acknowledged the excess costs and the inefficiency of Wells, especially compared to their peers - Citi, JP Morgan and Bank of America – and stated that he will begin to take actions which won't affect the company's risk and regulatory work. Charles is aiming to cut $10 billion in costs but doesn't give a timeframe yet of when those cost cuts will fully be completed. He has already started to act by laying off workers who were going to be laid off prior to the coronavirus pandemic but got put on hold, and by closing some retail branches.

The costs he plans to cut relate to Wells Fargo having too many management levels and resources dedicated to activities that aren't a priority. [7] Bringing Wells' efficiency level more in line with peers should result in lower expenses for shareholders and less bureaucracy at the management level to make it easier and quicker for decisions to be made. Consultant spending will be cut as well and there will be more transitioning to online banking. Retail branches have already started to close including 3 in Philadelphia.[8]

"We have too many management layers, spans of controls for managers are too narrow. And we have resources dedicated to activities that are not a priority today. This cannot continue. Over the medium term, we have the opportunity to materially reduce our expense, including increasing digital adoption for retail and commercial clients, reducing third-party spend, consolidating locations including branches, field offices and corporate sites and applying technology differently."

– Charles Scharf, Q2 Earnings Call

New hires to change culture – Charlie is working on reorganizing the organizational structure and making upper-level management shifts by bringing in new hires. Several of the new hires have come from Charlie's former employers JP Morgan and Bank of NY Mellon. These new hires will change the corporate culture and replace almost all of the previous executives who were around during the 2016 account scandal. Changing the culture is paramount to demonstrating that they have moved on from the account scandal and are moving in the right direction to get the asset cap lifted.

"As a reminder, during the quarter, we announced new organizational structure with five lines of business reporting directly to me. I've also spoken of our business reviews we've had put in place. Those agendas have changed and are now oriented toward issues related to operating in the current stressed environment."

"During the quarter, we hired a new Chief Operational Risk Officer, a new Chief Risk Officer for Consumer Lending and the Chief Control Executive. We continue to add additional talent to the senior leadership team since I joined the company nine months ago, I've announced six new members to the operating committee, all coming from outside of Wells Fargo with strong and relevant industry experience, over two-thirds of our operating committee have joined Wells Fargo since 2018."

– Charles Scharf, Q1 Earnings Call

[7] https://www.financial-planning.com/articles/wells-fargo-ceo-vows-to-cut-10b-in-costs
[8] https://www.bizjournals.com/philadelphia/news/2020/07/31/wells-fargo-trimming-more-local-branches.html#:~:text=Wells%20Fargo%20has%20now%20announced,Egg%20Harbor%20in%20New%20Jersey.

Working to comply with regulatory minimums and get the asset cap lifted – Wells Fargo has been providing needed capital to businesses of all sizes whether it be through PPP loans, lines of credit or bond issuances when businesses have needed it most. They worked with the Federal Reserve to get a temporary relief on the asset cap to increase PPP loans with all of the fees generated from this temporary asset cap removal to be remitted to the treasury or donated to a charity that supports small businesses of Wells Fargo's choosing. They have also deferred mortgage payments, waived fees, suspended foreclosures and taken other actions to help clients during the pandemic. Charlie Scharf highlighted some of the assistance Wells Fargo has been providing on the first quarter conference call which I mention below.

"We're providing significant credit to our clients. In the month of March alone, our commercial customers utilized over $80 billion of their loan commitments, and we're providing accommodations for clients that need. Through April 10, we helped more than 1.3 million consumers and small business customers by deferring payments and waiving fees. We deferred over 1 million payments, representing almost $2.8 billion of principal and interest payments and provided over 900,000 fee waivers exceeding $30 million. We've suspended residential property foreclosure sales, evictions and involuntary auto repossessions. And we continue to work with hub, the GSEs or trade groups, others in the industry, as well as government officials and not-for-profits to identify other ways to assist customers facing financial challenges in the current environment."

– Charles Scharf, Q1 2020 Earnings Call

Unfortunately, there was some controversy as well. Wells put some mortgages into forbearance for customers who didn't ask for this and this has brought negative attention to them, especially from Elizabeth Warren. Wells' response to this was by saying 'they may have misinterpreted some customers' intentions'[9] and although it isn't exactly clear at the moment if they were more incentivized to have these customers in forbearance, they took all customers out of forbearance who requested to be taken out and are working with them to make sure there is no negative impact on their credit scores.

From what I've seen, there has still been a lot more help provided by Wells for customers, clients and employees in Wells Fargo's response to the pandemic whether it be for safety through working from home, capital issuance to businesses, extra healthcare benefits for childcare, maturity date extensions, fee waivers for late fees and overdrafts, and mortgage forbearance all while remaining in compliant with regulatory minimums.

"Even with the loss this quarter, our CET1 ratio increased to 10.9% from 10.7% last quarter, and it's well above our regulatory minimum of 9%. As a reminder, our regulatory minimum reflects our expected stress capital buffer of 2.5% the minimum possible. As you know, Wells Fargo is predominantly a U.S. bank that takes deposits and makes loans. Our balance sheet composition is 80% cash loans in our investment portfolio and consumers, small businesses, middle market companies and corporate suffer, we do as well. As the economic environment brought on by COVID negatively impacts our customers and clients, it will filter through to our results primarily in the form of outsized credit losses, and compressed net interest margins."

– Charles Scharf, Q2 2020 Earnings Call

[9] https://www.bankingdive.com/news/wells-fargo-forbearance-mortgage-payments/582284/

I do agree that they haven't been perfect especially when considering the accusation that Wells and the other big banks directed PPP loans toward their larger clients to generate higher fees in addition to Wells putting customers in forbearance who didn't request it. It's hard to tell exactly to what extent Wells Fargo was involved in this but Charlie on the 2nd quarter earnings call mentioned that they funded 179,000 PPP loans totaling $10.1 billion and the average loan size was $6,000 so judging by this it seems that Wells might not have been the big culprit in this.

Wells also had less incentive to issue PPP loans to larger companies since a lot of the fees needed to be sent back to the Treasury or donated due to the temporary removal of the asset cap. Overall, I don't see these two things affecting Wells that much and I thought Charles Scharf and his team at Wells Fargo did a good job managing a lot of different headwinds at once during the pandemic which should put them in a much better position for the 2nd half of 2020 and beyond.

Moat

Wells Fargo possesses a moat based on switching costs and economies of scale. Wells Fargo is able to gather deposits at a very low cost since they have one of the largest retail branch networks in the United States and they can offer a wide variety of products to their customers. The expenses that Wells Fargo incurs to run their business are then spread out over a large amount of product revenue that is generated from their customers.

The high regulatory costs that banks have been subject to following the Great Financial Crisis in 08-09 make it more difficult for smaller and medium size banks to compete at the same scale as Wells Fargo and some of the other large banks such as JP Morgan, BOA and Citi. The bigger banks are able to spread out these high regulatory costs over a much larger client base much easier resulting in a benefit from economies of scale. They can also spread other fixed costs like technology, salaries and the cost to operate the retail branches over a larger revenue stream generated from their large customer base as well.

Wells Fargo also possesses a moat derived from the stickiness of their business related to switching costs. Despite the account scandal in 2016, Wells Fargo was still able to hold on to the majority of their clients which shows that the costs for their clients to switch banks can be higher than perceived.

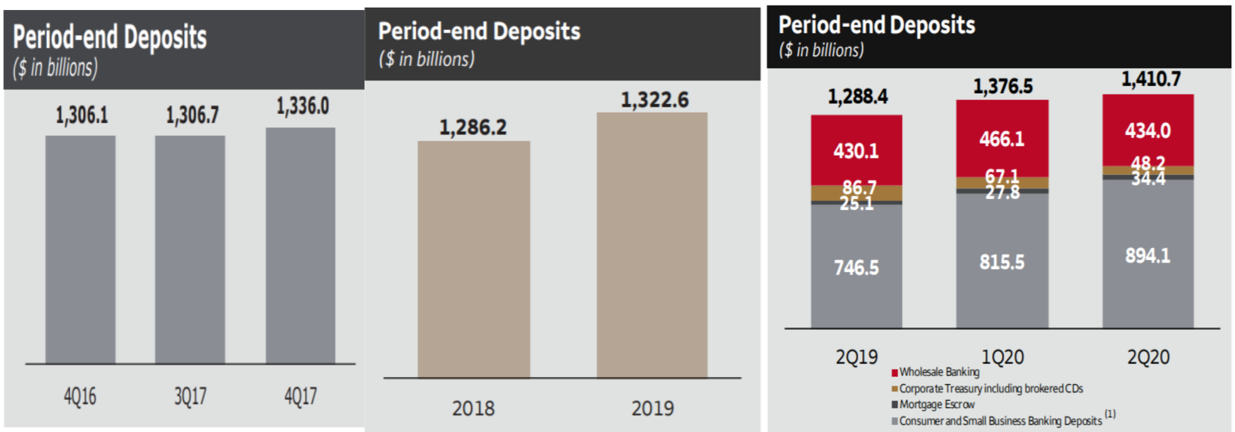
Customers who have a Wells Fargo ATM or retail branch located very close to their home will be much less willing to switch their bank due to the convenience of being able to have easy access to cash from an ATM or access to a bank associate at a branch for banking questions. Businesses may be less willing to switch for these very same reasons of having the convenience of their branch located next to their office for banking questions or because the business is so accustomed to the procedures put in place at their company for banking transactions like wire payments, deposits or autopayments to vendors. Switching banks can be a hassle as well if a customer has several financial products all at one bank. The customer may not want to go through the time and effort to switch so they end up staying with the same bank.

As shown below, return on equity for Wells Fargo remained above 10% through the account scandal until the coronavirus pandemic which led to lower interest income and higher provision credit expense.

	2013	2014	2015	2016	2017	2018	2019	TTM
Return on Equity	14%	13.68%	12.78%	11.78%	11.53%	11.67%	10.60%	2.35%

Source: Morningstar

Deposit growth, as shown below, has also been pretty resilient through the account scandal and even through the pandemic. Despite a drop from period end 2017 of $1,336 billion to period-end 2018 of $1,286 billion, deposit growth bounced back and is now at $1,410.7 billion at the end of Q2 2020.



Source: Wells Fargo Quarterly Earnings Supplementary Documents

<u>Financial Ratios</u>

	TTM	3 Yr Average	5 Yr Average
P/B	0.64	1.40	1.37
P/TB	0.82	1.85	1.96
P/E	25.89	12.98	12.58
P/S	1.35	2.94	2.89
ROE	2.10%	9.91%	11.12%

Source: Gurufocus and my calculations

Wells Fargo offers great value right now with multiples well below their 3- and 5-year averages except for their price-to-earnings ratio due to the cyclical nature of a bank's earnings during a recession. As earnings rebound through the next market cycle then the share price will likely follow and revert the price-to-earnings multiple back to its average of around 12. This will also improve their return on equity back to its average as well.

Price-to-book and price-to-tangible-book are more than cut in half at today's prices due to low interest rates and the possibility of loan defaults. Perhaps the book value isn't as valuable since the earning power of the assets declined from before the coronavirus when the net interest margin was higher and commercial loans were more valuable and office buildings were less vacant but I view the large discount in price-to-book to reflect this pessimism in the price and creates upside that offers a compelling opportunity.

Intrinsic Value

Based on a 5-year discount model, I projected out noninterest and interest income, noninterest and interest expense, and provision for credit losses out 5 years. I assumed a 21% current tax rate which could change depending on the outcome of the election. I also assumed a consistent preferred dividend payment although this could change as well but I don't see it having a material effect on the overall valuation.

The biggest drivers of the value will be net interest income and provision for credit losses. I assumed a 35% drop in interest income for 2020 and a 30% drop in interest expense in the first 2 years due to a low interest rate environment and then grew both revenue by a 3% growth rate up until 2026. For provision for credit losses, I assumed a big loss of $19.5 billion for 2020 and then a drop of 50% for the next 2 years and then I have provision for credit losses leveling off to a more moderate level. I don't see Wells Fargo making a full recovery over the next 5 years to where their earning power was from 2013-2018 when they were earning $20 billion but believe it's possible for them to achieve 75% of that earning power.

I used a 10% required rate of return which is more of a personal cost of equity for myself but is consistent with the market rate of return for the S&P 500 of around 10% and is only 1% higher than the cost of equity that Morningstar estimates of 9%[10]. I also used a P/E multiple of 15 which is a little above their 5-year average. A multiple in line with their 5-year average of 12.5 would result in a value of $40.70 and a 65% expected return.

	Growth	3.0%					
	Required return	10.0%					
	Terminal Growth	2%					
	0	1	2	3	4	5	Terminal Value
	2020	2021	2022	2023	2024	2025	2026
Net Income	$ (2,377.00)	$ 7,674.00	$ 12,004.00	$ 14,269.00	$ 14,736.00	$ 15,218.00	$ 15,534.00
Discount Rates		0.91	0.83	0.75	0.68	0.62	
Discounted FCF		$ 6,976.36	$ 9,920.66	$ 10,720.51	$ 10,064.89	$ 9,449.18	
Sum of Discounted FCF	$ 47,131.60						
FCF in 2025	$ 15,534.00						
Multiple	15						
Terminal Value	$ 233,010.00						
Discount Rate	0.62						
Discounted Terminal Value	$ 144,680.88						
Terminal Value Plus Total Disc cash flows	$ 191,812.48						
Shares Outstanding	4,120.00						
Value Per share	$ 46.56						
*All data except per share and percentages are in millions							

[10] https://www.morningstar.com/stocks/xnys/wfc/quote

Conclusion

Wells Fargo currently sells at an attractive price with a solid balance sheet and a wide moat. Their common equity tier 1 capital ratio, a measure used to judge how sound a bank's liquidity is to withstand a capital crisis, is currently at 10.9% at the end of the 2nd quarter and their total cash and equivalents is $262 billion while total debt is $241.5 billion.

Charlie Scharf is a capable CEO who has lots of banking experience as a CEO of some of the largest financial institutions in the U.S. and in various other banking roles, including roles under Jamie Dimon. He has done a good job of positioning Wells Fargo since he started in October 2019 and during the first half 2020. It will take a few years but I expect Charles to eventually have the asset cap lifted, make Wells Fargo more efficient and successfully navigate Wells Fargo through the pandemic.

The bank currently trades at .64 times book value and .82 times tangible book value. The earnings are currently depressed due to the economic environment but have high upside if interest rates move higher (the 10 year treasury yield has already started to move slightly higher after the Fed's new policy for inflation), they can get the asset cap lifted, a vaccine helps stop or materially control the spread of the coronavirus or they can get their efficiency ratio more in line with peers.

At a current price of $24.69 at the close of the market on August 28,2020, I view the shares as undervalued with a target price of $46.56 and 88% upside over 5 years.