Wells Fargo

Industry: Financial Services

CEO: Charles Scharf

Assets: 1.9 trillion dollars

Shares Outstanding: 4.41 B

Current Share Price: $49.21

Price Target: $25.0

Business Overview

Wells Fargo is a financial services company with three main sectors: community banking, wholesale banking and wealth management. Wells Fargo has 7,800 locations and 13,000 ATMs with 259,000 full-time employees. Wells Fargo is the thirteenth largest bank in the world based on assets, which stand at 1.9 trillion dollars. Wells Fargo is the fourth-largest bank in the world based on market cap and the fourth largest bank in the US. overall. It was founded in 1852 and is headquartered in San Francisco California with offices in 37 countries.

Financial Services Offered by Wells Fargo:

Community banking services: Consumer checking and savings, home mortgages, personal credit cards, new & used auto loans, student loans, personal loans and investment accounts

Wholesale banking services: Business checking and savings, business loans, commercial mortgages, corporate credit cards, short term lending, construction loans, payroll services, underwriting, mergers & acquisitions and financial consulting

Wealth management services: Financial planning, investment management, client trading, option & derivative trading, and insurance & family planning

Financial services can be thought of as a utility like water or electricity that are needed to keep things running smoothly in society. Providing capital to businesses and individuals who need it is no different. Banks play an essential part of any business. Banks help keep the payroll paid, infrastructure and municipal projects on track, and innovation moving forward. Banks are interwoven into the very fabric of the economic system in the United States and all developed nations. The utility aspect of the financial services industry allows businesses to grow and invest in future projects and product lines. Risk management determines who to lend money to and who is approved to borrow from the bank.

Wells Fargo History

2008 was such a devastating year because the flow of capital slowed to a mere drip, forcing businesses to survive on their own merit therefore either cutting costs or selling assets of the businesses to survive. Those businesses that did survive past 2008, we're stronger for it. Most of the banks that caused 2008 got off the hook relatively unpunished and with the help of Uncle Sam. The retail banks knew they were too big to fail.

"We are steadfast in our commitment to building and protecting the long-term value of the company."

That quote is from Wells Fargo's 2018 Annual Report. This is strange for a mission statement. It's very self-centered and only states that it cares for the company's preservation. Under normal circumstances, you would want to hear about them wanting to build a loyal customer base or earning back the trust it so willingly threw away especially when they've committed the violations they have. I would want to hear something along the lines of "We are committed to our clients and the community to rejuvenate our reputation in the wake of recent events." or something more focused on fixing their reputation and not shareholder value.

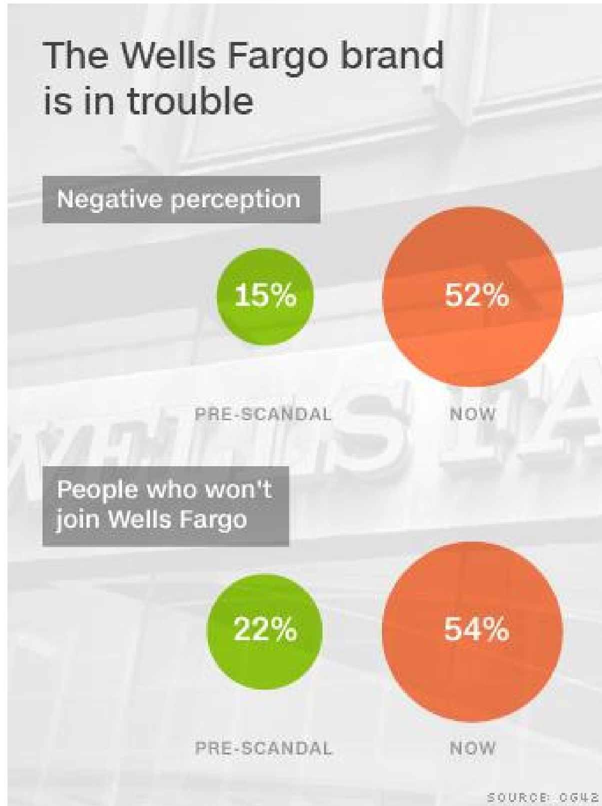
When Wells Fargo failed to recognize the deception that was going on, they also failed the shareholders. They need to renew faith back into the company. Arguably this is the worst time in history for the brand, as market sentiment seems to suggest they are America's 11th most hated brand. It makes sense when they do things like create 3.5 million fraudulent accounts.

Wells Fargo's reputation precedes itself as deceptive, poorly run and having non-existent ethical standards. Over the last 4 years, Wells Fargo has been the center of several scandals becoming the laughing stock of the banking world and rightfully so. These scandals have put their credibility into question.

The problem now becomes if we can trust anything they report. It's hard to believe their ethical standard or lack thereof hasn't seeped into their accounting and reporting standards. Generally, ethics are embedded in an organization through leadership and reflect poorly on the credibility of the organization. Banking is about trust. Trust with money that was earned through blood, sweat, and tears. I strongly believe Wells Fargo has betrayed the trust of the American people.

I had an account with Wells Fargo when I was a child, but a couple of years ago I happily closed the account in person. Three years later, I received a letter from Wells Fargo saying I owed over 250 dollars for fees related to failure to maintain a minimum balance. I disputed the letter and they took care of it. At the time I thought it was just a mistake, but now I'm considering it was intentional and fraudulent.

Wells Fargo Scandal



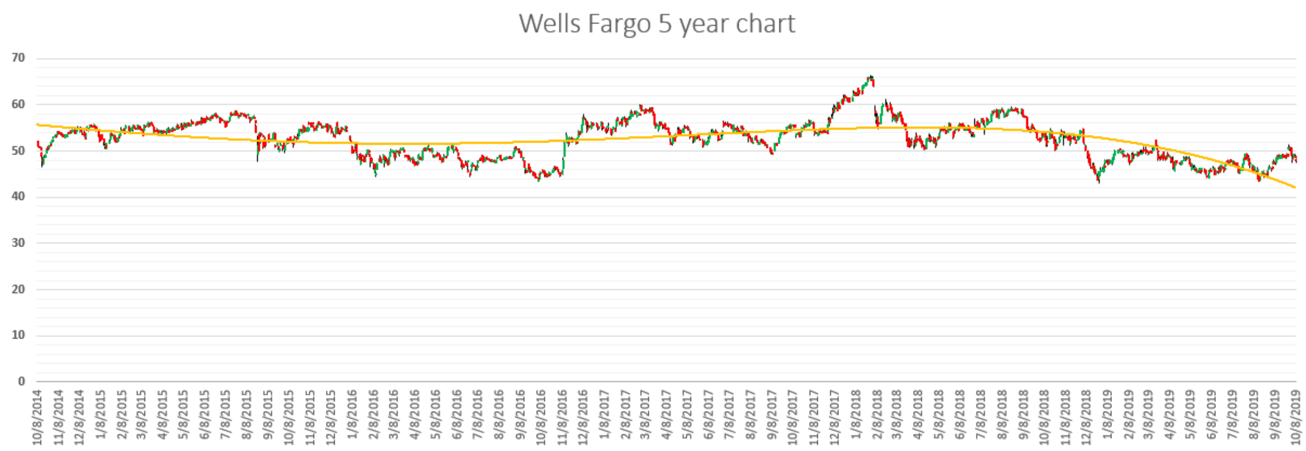
After the 2016 scandal of the fraudulent accounts were uncovered, it was determined that 3.5 million fake accounts were created. You're telling me that no one noticed anything wrong for several years when about 5% of the total accounts were fraudulent. That's ridiculous! The company only stated a few bad actors at the center of the scandal, but 3.5 million fake accounts are not a result of "a few bad actors". This is a much deeper issue. Between 2011 and 2016, Wells Fargo terminated 5,300 employees due to fraudulent activity.

Incentivized sales practices lead to fraudulent account creation forcing a quota for account creation and firing those who don't reach those goals. This is not banking; this is sales. This is clearly not in the best interest of the clients and was a policy designed to grow the business. Fortunately for the clients, Wells Fargo has started to make some effort in rebuilding its reputation. Creating 3.5 million fake accounts equivalent to 1% of all accounts of the US population is an unforgivable sin. If you know 100 people, they're more likely to tell you about a negative experience with Wells Fargo as opposed to positive ones. For this reason, I believe Wells Fargo is looking at a serious problem in their consumer banking sector in the upcoming years.

Wells Fargo understands they must rebuild their reputation and are taking steps to do so. However, I don't think the wake of this scandal has been fully realized yet. If you ever want to go down a hilarious rabbit hole, just look up Wells Fargo on Reddit, the comments are all negative. I couldn't find a single positive comment in 2 hours while researching on Reddit.

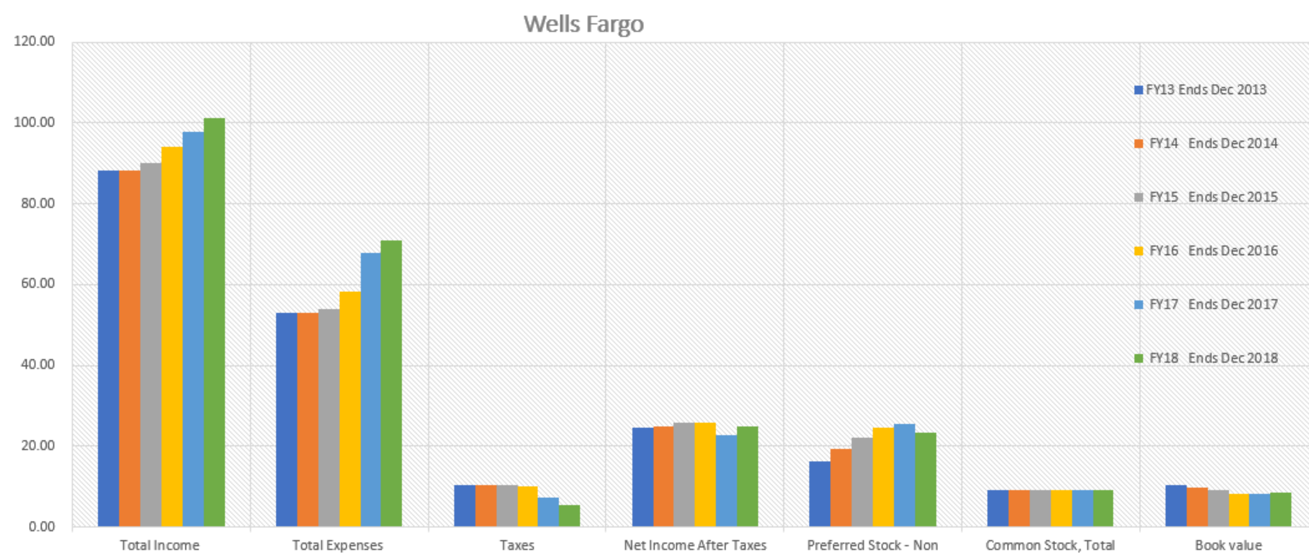
Charles Scharf, the newly minted CEO, is a step in the right direction with his background at BNY Mellon and a former board member of Microsoft. This is not going to change the culture overnight amongst some 259,000 employees. Obviously, not everyone who works for Wells Fargo lacks in the ethics department, but it would seem they have a culture built around turning a blind eye to fraudulent behavior.

Wells Fargo 5-year Chart



Wells Fargo Valuation and Historical Performance

Historical Performance



Valuation

The chart above depicts Wells Fargo's Income, expense, taxes, net income after taxes, preferred stock outstanding, common stock and book value. The story is easy to follow. Net income has increased along with expenses at a faster pace. Taxes have been slashed in half and income has fallen or has remained flat.

Risk Factors of Wells Fargo:

Interest and credit rate risk: Wells Fargo prides itself on its prudent underwriting. However, I don't believe the integrity of these figures and believe the quality of debt is much lower than believed. The Federal Reserve interest rate has been low, keeping interest rates low hurting banks potential income on treasury bonds. Wells Fargo has around 250 billion dollars in US treasury bonds. The lower the rate, the lower overall NII (Net Interest Income) will be. The NII is supposed to fall too low single digits according to Wells Fargo management.

Reputational risk: As stated previously, the reputational risk is the most pressing danger to the banks' long term survival. The millennial generation does not like Wells Fargo, Within 20 years, spending is going to be primarily in the hand of Millenials, and this could be a large risk despite investing heavily in technology and mobile banking. The movement for better business practices is strong with Millenials. Personally, I think the damage is already done, so I think the bank will be in big trouble within the next 20 years.

Audit risk: KPMG has been the auditor for Wells Fargo's financial statements since 1931**.** However, the public audit only audit reports from management, so they don't actually audit the entire company. These audits are done internally and by regulators, so a lot of their documentation is reliant on the managers to generate accurate reports on the internal auditing processes using software supplied through internal sources and in proprietary. My concern is that the managers who allowed 3.5 million fake accounts to be created are the same ones worrying because KPMG did not discover the fraudulent 3.5 million accounts. I generally believe the ethical principles displayed in the accounting scandal would bleed over to other aspects of the business and it's difficult for me to trust the viability of these reports.

Political risk: In the US, Wells Fargo has been scrutinized by regulators since the scandal took place. This has been putting deserved scrutiny by politicians who have been very outspoken on the bank's practices. There is a lot of risk exposure in California and the Euro Zone including the UK. The risk in California is very political as the state continues to pour millions upon millions of dollars into social programs and cutting funding to important infrastructure like the 100 billion spent on the bullet train that seems to be very unpopular. In 2018, California lost an estimated 250,000 jobs to other states amounting to roughly 80 billion in revenue.

Financial risk: Of 1.9 trillion in assets, 169.6 billion are mortgage-backed securities, 506.5 billion are commercial loans and 439.85 billion in consumer loans. The company is generally well-capitalized. However, liquidity is roughly 250 billion. The commercial and industrial loans and lease financing portfolio totaled to around $369.9 billion, or 39% of total loans. Commercial real estate has skyrocketed in price as corporate debt has continued to rise. In a call on their Q3 report, Wells Fargo stated commercial real estate loans have slowed due to late-cycle, which is the primary concern for the economy in the short term. Wells Fargo received a 25 billion dollar bailout which was repaid by selling company stock soon after.

How Wells Fargo is Making Good:

Wells Fargo is trying to change its public perception through philanthropy, donating 444 million in 2018 to over 11k nonprofit organizations. As well as planning to invest 200 billion in clean projects and renewable energy by 2030. Wells Fargo increased its dividend to 45 cents in 2018 returning over 25 billion to shareholders. They have continued to share buybacks and repurchased 6% of outstanding shares to try and increase shareholder value. Technology investment continues to make online banking more user-friendly as the Wells Fargo app is highly rated. The convenience of Wells Fargo locations continues to drive traffic, and the quality of real estate seems to be prime. The bank has been dumping underperforming assets over the last 18 months. Low tax rate, and use of incentives. Asset price increase has helped increase fees and lower transaction fees.

Financial Statements

Income statement (Billions)	**2018**	**2017**	**2016**
Net interest income	49995	49557	47754
Noninterest income	36413	38832	40513
Revenue	86408	88389	88267
Provision for credit losses	1744	2528	3770
Noninterest expense	56126	58484	52377
Net income before noncontrolling interests	22876	22460	22045
Less: Net income from noncontrolling interests	483	277	107
Wells Fargo net income	22393	22183	21938
Earnings per common share	4.31	4.14	4.03
Diluted earnings per common share	4.28	4.1	3.99
Dividends declared per common share	1.64	1.54	1.515

Balance sheet (at year-end)	**2018**	**2017**	**2016**
Debt securities	484689	473366	459038
Loans	953110	956770	967604
Allowance for loan losses	9775	11004	11419
Goodwill	26418	26587	26693
Equity securities	55148	62497	49110
Assets	1895883	1951757	1930115
Deposits	1286170	1335991	1306079
Long-term debt	229044	225020	255077
Wells Fargo stockholders’ equity	196166	206936	199581
Noncontrolling interests	900	1143	916
Total equity	197066	208079	200497

Conclusion:

Wells Fargo has damaged their reputation beyond repair in the short term and will suffer from this. The Quality of assets is worse than reported and continues to inflate due to the broader real estate market. The costs are quickly outpacing income and will not be able to sustain if asset prices fall and defaults worsen. We can't forget about the 3 billion in potential legal risk is looming. And last but not least I firmly believe their prudent lending is not as prudent as they say, as meeting loan and saving quotas go hand in hand with the fraudulent accounts, I wouldn't put it past the same managers to allow lending to unqualified parties if it meant they would advance their career.

Wells Fargo is closing locations around the US to focus largely on its online banking platform, which is a way to reduce overhead costs. They also plan on reducing the total number of locations by 800 to limit locations to 7,000 across the US before 2021.

Book value is 8.62 at current asset valuations, which we believe are inflated. We believe book value to be closer to 6.50 based on the fair market value. Considering the retail mortgages and their auto book which we believe should be discounted by 15-20% and the auto book upwards of 30% as new cars increase in price and depreciation also increases.

Wells Fargo has started to reduce credit card exposure and has stopped selling credit card debt. They will increase their auto book, new and used, which is also a signal of late-cycle. Wells Fargo has sold its retirement and financial trust for 1.2 billion dollars to pay for legal fees. The total estimate of fees for litigation risk from the looming 2016 account scandal was calculated in the fourth quarter of 2019 estimate to be around 3 billion dollars. Additionally, inside the report, I discovered certain language around 'mortgage lending", stating only mortgages larger than $250,000 dollars require an appraisal, which seems odd when the average home cost in the United States is $225,000 leaving me questioning the quality of assets.

Wells Fargo is a direct competitor to Bank of America, JP Morgan Chase and Citigroup. These banks have comparable locations and sizes, retail banking and wealth management. Chase is of course linked with JP Morgan, and Bank of America is linked with Merrill lynch as their wealth management legs of the business, well-respected names in the industry. Wells Fargo comes in third ahead of CITI group on the list for overall size but first in outstanding loans despite being the 3rd largest of the 4. Wells Fargo does rank highest in website traffic of the four and makes the Alexa top 200 list. Of the top 4, Wells Fargo ranks lowest in twitter engagement, but also as the least amount of followers 40,000 more than the number of employees they have, coming in at just over 300k. Wells Fargo has the most employees of the 4, over 60k more than the others. Wells Fargo services more loans than the rest and has the most locations, as they also originate more home loans due to the amount of locations boasting 165 billion in mortgage debt.