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Wells Fargo—Unexciting Idea, But Exciting Value

I have spent a lot of time over the years discussing the large US banks. I've invested in them on two different occasions over the past five years, and I think we are at a time where opportunity is knocking yet again. This time, I'm investing in Wells Fargo.

I did a podcast interview recently, and I discussed how my portfolio is strangely invested in large caps. I don't anticipate this to be the case most of the time, and I don't necessarily prefer this, but it's where I'm finding value in the current market. As I've mentioned before, large cap stocks can often get significantly mispriced. I often use Apple as an example of this point, because despite being the most followed company in the world, it has compounded at roughly 30% annually in the past three years. Wells Fargo is not as good of a business as Apple, but I do think the stock is at a level that will meet my own investment hurdle rate going forward with a limited amount of risk.

Wells Fargo isn't an exciting investment idea, and it's not going to win any stock picking contests, but it is a very durable business with a very sticky customer base, and that leads to a very predictable revenue stream. That revenue stream produces a significant amount of free cash flow, almost all of which is being returned to shareholders via buybacks and dividends.

The stock currently trades at around 9 times earnings, meaning the combined yield is roughly 15% (we're getting a 4% dividend and a 11% increase in our share of earnings from the buyback at this price). I think the yield is attractive, but I think the market is undervaluing the stock because of the negative headlines, and I think at some point this pessimism subsides, which will lead to a more reasonable valuation and an above average investment result from this level.

Culture and Incentives

First, I'll address the "headlines": Wells Fargo is, and likely will continue to be up to next year's Presidential Election, a punching bag for Democrats (specifically Elizabeth Warren). I don't agree with Ms. Warren on most of her policy views, but in this case, she was absolutely correct that John Stumpf, the CEO at the time of the cross-selling scandal, deserved to be fired (which happened) and deserved to have a large portion of his huge compensation package clawed back (which did not).

I do think Wells Fargo had a major problem to address. I don't think it was a cultural problem, I think it was an incentive problem. As we know, incentives drive behavior. If people are incentivized (even indirectly) to open new accounts, there will be a small portion of a large body of people (250,000 in Wells Fargo's case) who will behave unethically in an effort to open accounts at any cost. In my discussions with employees at Wells Fargo, I think the bank is firmly focused on correcting the incentive system they had in place, and if anything, they are probably overcompensating in terms of customer service in an effort to move past this issue that has plagued them since 2016.

So, I don't think Wells Fargo has an issue that can't be corrected in time, and after comparing their business practices with their competitors, I actually doubt their culture is much different than the other large banks like J.P. Morgan and Bank of America. All of the banks, just like most companies in other businesses, attempt to sell their current customers additional products. I don't think that business model is a problem. I think the way that Wells Fargo incentivized their employees to implement that business model was a problem. And as Charlie Munger likes to say, I think that was a cancer that can be removed from the patient, and I think in this case, the patient is going to make a full recovery.

Sticky Business

I've continued to follow the bank closely since 2016, and the one thing that has impressed me is how sticky their customer base really is. I'm an example of this. When the scandal broke and John Stumpf refused to resign, I really was disgusted with the bank, and considered moving my accounts elsewhere. This proved to be painful to even consider. I began thinking about my personal bank accounts, my business bank accounts, my business credit cards, and my automatic billpay. All of the vendors I pay and all of the services I buy each month using the bank's billpay would have to be changed, which is not a hassle free task.

It is really difficult to change banks, which is why I think the deposits have been so stable over the past three years, even when the bank was making front page headlines day after day. The headlines did impact the bank's ability to open new accounts for a period of time, but this has been changing as the scandal recedes into the rearview mirror, and the deposits, at a whopping $1.3 trillion, have remained intact throughout the scandal.

Deposit Growth

One reason Wells Fargo's business is so durable is because overall deposit growth in the US banking system is so predictable. For 70 consecutive years, total deposits in the banking system have grown each and every year. There have only been 3 years since 1934 where deposits have declined, and all three years (1934, 1946, and 1948) were very small declines.

	US Bank Deposits (billions)
2014	$10,953
2004	$5,593
1994	$2,874
1984	$1,963
1974	$746
1964	$306
1954	$183
1944	$126
1934	$39

Regardless of economic conditions, deposits continue to grow, and deposits are the raw material that banks use to make money. Wells Fargo gathers these deposits cheaper than just about any other bank. The sticky nature of banking, the switching costs involved with changing banks, and Wells Fargo's size makes it very likely they'll continue to grab a piece of these new deposits as their current customers grow their wealth and save more money over time.

Fed Restriction

Another reason why I think the stock is cheap is because the Fed has restricted Wells Fargo's ability to grow its assets. Basically, Wells can't grow its balance sheet over $1.95 trillion until it proves to the Fed that it has addressed its management issues and board governance practices.

On the surface, this seems like a bad thing for Wells Fargo. A bank's earning power is tethered to the size of its balance sheet; the assets are the raw material a bank uses to generate revenue, and without the ability to increase the amount of raw material, the only way earnings can grow is through efficiency gains (cost cutting).

However, I don't think the growth restriction is all that bad. For one thing, when you have nearly $2 trillion in assets, you're not going to be growing very much to begin with. Secondly, the Fed order is temporary, and will likely get released in the coming year or two. But regardless of when that occurs, I actually believe that a restriction on growth is not a bad thing for a large bank. Wells Fargo won't be tempted to go after the marginal loans that many banks inevitably go after as the business cycle continues heating up and credit quality gets looser. The Fed's restriction basically forces them to only take the most prudent loans, because there is no incentive to go after riskier loans in an effort to grow.

Buyback

Last week, the Federal Reserve published the results of their annual Comprehensive Capital Analysis and Review (CCAR). The CCAR and its cousin, the Dodd-Frank Act stress tests, are a big portion of the regulatory framework that the Fed uses to supervise the big banks in the United States. Part of this regulation gives the Federal Reserve the authority to the approve capital allocation program of the banks.

Basically, each bank submits the dollar amount of capital that they'd like to return to shareholders over the coming 4 quarters, and the Fed, based on their review of how the bank performed during the stress tests, either approves that amount or rejects it. In recent years, most of the big banks have built up sizable capital positions, and they've had no real trouble getting Fed-approval for their buyback and dividend.

Here is a table showing the dollar amount (in billions) that the four largest banks are allowed to return to shareholders via buybacks. It then shows the "yield" for the buyback (which is the percentage of the total outstanding shares that the company could buy back in the next 12 months at the current price). It also shows the current dividend yield (each bank also got approval to raise their dividends). And finally, the total "yield" (buyback + dividend):

Total Yield for Banks (Buybacks and Dividends)					
	Buyback Approval	Market Cap	Buyback Yield	Dividend Yield	Total Yield
WFC	$23.1	$216	10.7%	4.3%	15.0%
JPM	$29.4	$368	8.0%	3.2%	11.2%
BAC	$30.9	$280	11.0%	2.7%	13.8%
C	$17.1	$165	10.4%	2.9%	13.2%

I think the amount of capital that each bank will return during the coming year is remarkable. Another thing I'd point out is that the buyback program at these banks is really predictable. If JPM gets approval to buy back $29 billion of stock, you can take it to the bank (no pun intended) that they will in fact use all of that authorization.

Programatic buybacks aren't always a good thing (I'd prefer companies to have some method of estimating the intrinsic value of their stocks and then use that to determine the timing of their buybacks) but in this case, since the banks are undervalued, this predictable buyback works in shareholders favor in a big way. Also, as the stock price declines, each dollar is acquiring more value for remaining owners, which is why Buffett always points out that lower prices are better for long-term values.

For WFC, we're getting a 4.3% dividend yield, and if the stock price doesn't move, we'll own a 10.8% greater piece of the company's earning power in a year. The basic idea is that all of the cash earnings (and then some since the banks currently have more capital than they need) are coming back to us each year: partly as a dividend and partly as a bigger piece of ownership.

Over time, our investment result should roughly approximate this "yield", and that's even before any bump we might get from the market revaluing the shares (which I think could certainly occur with WFC trading around 9 times earnings).

Valuation

The investment case is quite simple. The stock trades at about **9 times earnings**. I estimate that Wells Fargo will earn roughly $100 billion of free cash flow over the next 4-5 years, which is about half of the current market cap. Because Wells Fargo has plenty of capital, it's likely that all of those earnings will get returned to shareholders as dividends and buybacks.

At this price, Wells can retire around 300 million shares per year, which would leave it with fewer than 4 billion shares in 2 years. Even with no growth in earnings, this would equate to over $5.50 of earnings per share. At a valuation of 12 P/E, we're looking at a price of $66 per share, which is a 25% CAGR including dividends over the next couple years.

Even at just 10 times earnings, we'd still reap a 15% annualized return over two years with no growth, thanks to the buyback and dividend.

I think there is upside potential as well: maybe the Fed releases their restriction, or maybe Wells gets its efficiency ratio more closely in line with competitors (the costs have risen as a result of the scandal, and some costs are likely to be permanent, but it's likely some will subside as well).

But again, total earnings growth is not even necessary for this investment to work out quite well at this price.

To Sum It Up

We have a good business with a sticky customer base, a recurring free cash flow stream, and a predictable capital allocation program, but we have a stock that is undervalued because of significant pessimism. I think the pessimism will subside eventually. In the meantime, we're getting a 15% total "yield" to wait for that appreciation to occur, which on its own is not a bad outcome.

It's not an exciting company to invest in, but I think there is little chance of permanent downside at the current price, which makes it an attractive risk/reward investment.

John Huber is the founder of Saber Capital Management, LLC. Saber is the general partner and manager of Saber Investment Fund, LP, an investment partnership. Saber's strategy is to make very carefully selected investments in undervalued stocks of great businesses.

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