

June 16, 2016

Wells Fargo & Co. (NYSE: WFC)

Trading Price: \$46.78
52-week Range: \$44.50-58.77

EPS Estimates:
2015A: \$4.17
2016E: \$4.10
2017E: \$4.37
2Q16E: \$1.01 (vs. \$1.03 2Q15)

Tangible Book Value: \$31.08 (estimated)
Price/TBV: 1.51x
Dividend/Yield: \$1.50 / 3.13%
Market Capitalization: \$245.4 billion

Nancy A. Bush, CFA
NAB Research, LLC
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- Sometimes it pays to go away from a company for a while...
 - A big question presently—Has this company suddenly come into the crosshairs of its regulators?
 - WFC has a unique problem...It started at the top...
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Sometimes it absolutely pays to not think too much about a company for a while...

That thought struck us as we were attending Wells Fargo's biennial analyst meeting in San Francisco a few weeks ago. We had not attended WFC's 2014 meeting with analysts, due to our relocation from New Jersey to Georgia during that time, so it had been four eventful years since we had sat in a room and listened to presentations from the full Wells Fargo management team. While the mood of CEO John Stumpf and his senior managers was optimistic—and why wouldn't it be?—there nonetheless seemed to be a much more sober tone to the company's commentary and projections and a real effort to dampen near-term expectations.

Why would that be? We've been pondering that question in recent days, and several possibilities come to mind. The first is that while the **acquisition of the Wachovia franchise** – which we continue to believe will go down as one of the great deals of banking history – has **proven to be transformational for Wells Fargo**, the reality is that **the magic of purchase accounting accretion** lessens as the years go on, and we think that WFC reached that point in the last couple of years or so. (Quarterly accretion into net interest income from the PCI portfolio continues at the \$300 million-plus pace – versus an average of \$500 million or so per quarter over the seven year period ending 12/31/15.) **The “juice” has gone out of the story in that old Wachovia customers are now old Wells Fargo customers, and the potential for that all-important cross-sell goes down as customer tenure grows longer.**

We also think that WFC's management has been proactive in warning about the persistence of low rates, which has been a turn-off for some potential investors. Much was made about the fact that John Stumpf lowered the bank's ROE target by 1% at the Analyst Day – to a range of 11%-14% (from a 14.25% ROE in 1Q16) – but that now looks like a prescient and proactive move. The company has championed a “lower for longer” interest rate scenario – at a time when many in the industry have been looking for more rate increases this year – and as such has chosen to take a “dry powder” approach to putting cash and other liquid assets to work on the balance sheet. While this strategy has put some marginal pressure on the NIM in the last couple of quarters – it seems to be flattening out in the 2.90% range presently – it seems to us that discretion should be the better part of valor in the current environment, lest a violent whipsaw be the unexpected result. **In any case, the company has projected year-over-year increases in net interest income even with this cautious investment stance, and we take them at their word.**

Are regulatory concerns one of the reasons for management's caution? This is where the outlook for the company gets a little stickier. **Wells Fargo was clearly singled out for rough treatment** on April 12, when its plan for resolution – a.k.a., its “**living will**” – was basically kicked to the curb by the Fed and the FDIC and the company was told to resubmit its plan by October 16. WFC's rejection by the joint agencies was accompanied by some pretty harsh language – issues with the living will “call into question the executability of the 2015 plan, as the lack of effective resolution planning governance raises concerns regarding quality control, senior management oversight, and recovery and resolution planning staffing.” (Our editorial comment – yikes!)

This is no longer just an academic exercise. One of Wells' avenues for resolution calls for the bank to be broken up and disposed of on a regional basis, and the Fed found fault with this part of their plan, saying that the company did not “demonstrate that the firm could achieve that separability” and then pointing out the detail that would be needed to convince them that such regional units could be supported and that “separation and sale are sufficiently actionable” was lacking. And when this plan is perfected, then Wells Fargo management must – in reality, not just on paper – maintain the systems, staffing, etc., necessary to actually implement a regional break-up. **We asked the question at the Analyst Day as to whether this “living will” process has now evolved into extra infrastructure (and accompanying expense) that must now be maintained, and the answer was an unequivocal “Yes”.**

This regulatory singling out was a surprise to the Street. While there were five banks (out of the big eight) that had their living wills rejected, the verbiage surrounding the Wells Fargo rejection was by far the most extensive and specific, and this was a surprise to us – mainly because our assumption had been that Wells Fargo management maintained a pretty good relationship with their regulators and would be cognizant of what was expected of them. (Since Wells Fargo had been the only large bank to pass the living will process without any exceptions in 2014, that seemed to be a pretty good bet.) And in speaking with Wells' management in San

Francisco after the meeting, it was pretty clear that they had believed that they understood the Fed's requirements as well, and were very surprised that that was not the case.

So—is something else at work here? It has not escaped our attention that the Fed has in the past used the CCAR process to deliver messages to both the industry and to specific companies, and we wonder if the same thing has not begun to happen with the living will submissions as well. Wells Fargo has generally been seen to be the least complex of the systemically important banks, and as the bank least likely to raise regulatory angst through the maintenance of large capital markets operations, a big trading book, etc., etc. Perhaps this was a reminder from the Fed about the importance of maintaining that structural simplicity—or perhaps the Fed expects to see a constantly increasing degree of sophistication in resolution planning and WFC management simply did not figure that out. (Whatever.) **In any case, we will be anxiously awaiting the results of the DFAST and the CCAR—to be released on June 23 and June 29, respectively—and if Wells Fargo receives a “special mention” in those results as well, it will be pretty clear that there’s a problem.**

That’s sort of a segue into the issue of capital markets... When we revisited the fundamentals of Synovus (SNV) for our Profile piece on that company back in April, we remarked on the revelations that we gained in redoing our earnings model. Well—ditto for Wells Fargo, Wells Fargo’s earnings have always been pretty straightforward to model—there was decent loan growth (mid-single digits is our latest projection), NIM did not move around wildly and was mostly predictable, loan loss reserves were modest, and expenses generally got ratcheted down on a quarterly basis. **Now a few things have changed.** The loan loss reserves will be elevated for the next couple of years—due to the company’s well-publicized and much discussed \$17.8 billion oil and gas loan portfolio—but the **biggest issue for us are the lumpy revenue lines that come along with increased participation in capital markets activities.**

How big do they want to be there? While these revenues are still a minor part of the overall revenue picture at Wells Fargo—roughly 7% of fee income in 1Q16, when we combine debt and equity gains and gains from trading activities—we worry about the seductive nature of these activities and the damage that a greater identification with Wall Street would carry for this company’s image and its stock. **John Stumpf has said often the Wells Fargo is “the bank of the real economy”—i.e., not the bank of the financial economy—and we hope it stays that way.**

The fact that the company had to come out last February and flat-out deny that it was buying the investment banking activities of Credit Suisse should give management some pause. While the company did something unusual—they issued a formal denial of the rumors—we do not think that these whispers would have gained any traction had there not been a growing perception in the markets that Wells Fargo wishes to become a bigger player on the Wall Street scene. Management made clear on May 24 that they see further diversification into wholesale lending to be a lucrative growth path for the company, and we agree—but we also would posit our view that this can be accomplished without adding much to the capital markets platform that exists there already. **In our view, this company must continue to maintain and heighten an identity distinct from those of competitors Bank of America (BAC), J.P. Morgan Chase (JPM) and Citigroup (C)—or the stock and its holders will suffer the consequences.**

Bottom Line: This is arguably the nation’s most important bank, and it is very important to the Southeast... Some followers have asked us why we include Wells Fargo in Southeastern bank coverage. Our answer—look at the numbers. One need only look at the FDIC deposit market share totals (although they’re almost a year old) to see the degree to which Wells Fargo (through the old Wachovia presence) influences major markets

in the Southeast. The company commands 19% of deposits in Atlanta, 17% in Charlotte, 25% in Charleston, 12% in Birmingham, 14% in the District of Columbia—and on and on.

We would also put forth our view that the advent of Wells Fargo into the Southeast in 2008 made a huge difference in the path of Southeastern banking. We think that the real value of the Wells Fargo presence in the Southeast has been that of a rationalizing factor in the deposit markets, which has brought a halt (for now, at least) to the deposit pricing wars that tended to break out here prior to the Financial Crisis. The bank came into the Southeast with the reputation as the nation's lowest deposit rate payer, and that stinginess (unfortunately for depositors) has translated into an overall much more favorable deposit pricing environment for banks both large and small. We would also posit the view that Wells Fargo's preference for branches, its distinctive brand, its plethora of consumer products, and its ferociously competitive culture have been good for consumers and businesses alike in the region (and have particularly stabilized the economic fortunes of the important Charlotte market.)

They have moved swiftly into the era of fintech. While Bank of America has claimed the bulk of investor attention with its aggressive program to move customers onto mobile and digital platforms and out of its branches, Wells Fargo has been moving in that direction for some time. The company had a "Culture of Innovation" presentation at the Analysts Day, and they presented the technologies that would aid with "customer experience, trust, and efficiency". The development of the mobile wallet—technology that enables the consumer to see all his financial relationships on one mobile platform—seems to be the primary thrust in retail banking, but it seems that authentication (biometric, primarily) is the area in which WFC is aiming to truly differentiate its efforts.

But there was also an important statement about fintech made at the meeting. Steve Ellis, the bank's Head of Innovation, said forthrightly: "**We are not a technology company...We will deliver technology in an appropriate way at an appropriate cost.**" To us, this statement signifies an important difference for the banking industry from its dalliance with technology in the late 1990's-early 2000's, when some banks tried to claim the mantle of technology companies (some going so far as to abandon branches) and suffered a crash with the technology industry as a result. We think that Wells Fargo and others will see technology differently this time around—as a useful tool, not as a reason to be or a model to emulate—and that the benefits of fintech will be longer-lasting and more valuable to shareholders and customers alike as a result.

It all comes down to Wells Fargo's stock. Wells Fargo remains the best-performing of the major banks—on both an ROA and on an ROE basis—and is the only major bank at this juncture that we are certain is earning its cost of capital. But the stock is not particularly highly valued at this point, selling at 11.0X next year's estimate, roughly 1.5x its tangible book value, and yielding a whopping 3.1%. **On a stock performance basis, the stock is down roughly 12% YTD—trailing only industry whipping boy Bank of America as an underperformer.**

It's hard to start at the top, because there's only one way to go. We have discussed in this report the issues that we see as bedeviling this stock presently, but **we must also emphasize that we see these challenges as both transitory and short-lived.** This bank has been lionized and has been historically prized by conservative investors due to its identification with investor Warren Buffett. But in the current environment those positives seem not to matter so much as the desire of some in the market to own beaten-down bank stocks that may give a pop on the off chance of a Fed rate increase or a couple of extra pennies of earnings surprise.

Our long-held view of banks and bank stocks is that quality always wins, and we see no reason to change that view now. To say that Wells Fargo's stock is a core holding in any bank stock portfolio may be a truism, but that also doesn't mean that it's not true. (We especially see the stock's dividend yield—and the prospect of significant dividend growth in the future—as compelling in an era when income is prized.) Bank stock fads may come and go—but we think that WFC's bent toward quality and the appeal of the Big Red Stagecoach will endure.

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Table 1
Wells Fargo
Earnings Estimates
(\$ Millions, Except Per Share Data)

	Q4 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016E	2015A	2016E	Percent Change	2017E	16E/15A	17E/16E
Net Interest Income	\$11,418.0	\$11,228.0	\$11,540.0	\$11,725.0	\$11,904.0	\$11,957.0	\$12,071.3	\$46,397.0	\$47,850.0	\$50,025.0	3	5	
Tax Equivalent Adjustment	238.0	242.0	270.0	268.0	316.0	290.0	285.0	1,096.0	1,200.0	1,300.0	9	8	
Loan Loss Provision	485.0	608.0	300.0	703.0	831.0	1,086.0	900.0	2,442.0	4,400.0	5,000.0	80	14	
Subtotal	10,695.0	10,378.0	10,970.0	10,754.0	10,757.0	10,581.0	10,886.3	42,859.0	42,250.0	43,725.0	(1)	3	
Noninterest Income													
Service Charges on Deposit Accounts	1,241.0	1,215.0	1,289.0	1,335.0	1,329.0	1,309.0	1,350.0	5,168.0	5,275.0	5,400.0	2	2	
Trust and Investment Fees	3,705.0	3,677.0	3,710.0	3,570.0	3,511.0	3,385.0	3,500.0	14,468.0	14,200.0	15,000.0	(2)	6	
Card Fees	925.0	871.0	930.0	953.0	966.0	941.0	950.0	3,720.0	4,000.0	4,300.0	8	8	
Other Fees	1,124.0	1,078.0	1,107.0	1,099.0	1,040.0	933.0	975.0	4,324.0	4,100.0	4,200.0	(5)	2	
Mortgage Banking	1,515.0	1,547.0	1,705.0	1,589.0	1,660.0	1,598.0	1,700.0	6,501.0	6,700.0	6,000.0	3	(10)	
Insurance	382.0	430.0	461.0	376.0	427.0	427.0	425.0	1,694.0	1,700.0	1,700.0	0	0	
Net gains from Trading	179.0	408.0	133.0	(26.0)	99.0	200.0	200.0	614.0	600.0	700.0	(2)	17	
Net debt gains	186.0	278.0	181.0	147.0	346.0	244.0	250.0	952.0	900.0	1,000.0	(5)	11	
Equity Gains	372.0	370.0	517.0	920.0	423.0	244.0	200.0	2,230.0	1,000.0	1,000.0	(55)	0	
Lease Income	186.0	278.0	181.0	147.0	145.0	373.0	250.0	751.0	900.0	900.0	20	0	
Other Income	507.0	286.0	(140.0)	266.0	52.0	874.0	300.0	464.0	600.0	600.0	29	0	
Total Noninterest Income	10,322.0	10,438.0	10,074.0	10,376.0	9,998.0	10,528.0	10,100.0	40,886.0	39,975.0	40,800.0	(2)	2	
Noninterest Expense													
Salaries, Commissions, Benefits	7,644.0	8,013.0	7,648.0	7,460.0	7,560.0	8,207.0	8,000.0	30,681.0	31,500.0	32,000.0	3	2	
Occupancy & Equipment Exp.	1,311.0	1,217.0	1,180.0	1,187.0	1,365.0	1,239.0	1,225.0	4,949.0	5,000.0	5,150.0	1	3	
Core deposit & other intangibles	338.0	312.0	312.0	311.0	311.0	293.0	300.0	1,246.0	1,200.0	1,200.0	(4)	0	
FDIC assessments	231.0	248.0	222.0	245.0	258.0	250.0	275.0	973.0	1,200.0	1,400.0	23	17	
Other Expenses	3,123.0	2,717.0	3,107.0	3,196.0	2,905.0	3,039.0	3,000.0	11,925.0	12,000.0	12,250.0	1	2	
Total Noninterest Exp.	12,647.0	12,507.0	12,469.0	12,399.0	12,399.0	13,028.0	12,800.0	49,774.0	50,900.0	52,000.0	2	2	
Pretax Income	8,370.0	8,309.0	8,575.0	8,731.0	8,356.0	8,081.0	8,186.3	33,971.0	31,325.0	32,525.0	(8)	4	
Income Taxes/(Benefit)	2,519.0	2,279.0	2,763.0	2,790.0	2,599.0	2,567.0	2,600.0	10,431.0	10,200.0	10,500.0	(2)	3	
Net Income before Non. Interests	5,851.0	6,030.0	5,812.0	5,941.0	5,757.0	5,514.0	5,586.3	23,540.0	21,125.0	22,025.0	(10)	4	
Noncontrolling Interests	83.0	80.0	67.0	187.0	48.0	52.0	50.0	382.0	200.0	200.0	(48)	0	
Wells Fargo Net Income	5,768.0	5,950.0	5,745.0	5,754.0	5,709.0	5,462.0	5,536.3	23,158.0	20,925.0	21,825.0	(10)	4	
Less: Preferred Dividends	327.0	343.0	356.0	353.0	372.0	377.0	375.0	1,424.0	1,500.0	1,500.0			
Net Income Available to Common	5,382.0	5,461.0	5,363.0	5,443.0	5,337.0	5,085.0	5,161.3	21,734.0	19,425.0	20,325.0			
Average Diluted Shares	5,279.2	5,243.6	5,220.5	5,193.8	5,177.9	5,139.4	5,120.0	5,209.0	5,100.0	5,000.0	(2)	(2)	
Net Income per Dil. Share	1.02	1.04	1.03	1.05	1.03	0.99	1.01	4.17	4.10	4.37	(2)	6	
Dividends per Share	0.35	0.35	0.3750	0.3750	0.3750	0.3750	0.40	1.475	1.58	1.70	7	8	
Tax Rate	30.10	27.43	32.22	31.96	31.10	31.77	31.76	30.71	32.56	32.28	6	(1)	
Adjusted Tax Rate	32.03	29.48	34.29	33.98	33.61	34.13	34.06	32.87	35.05	34.89	7	(0)	
Net Interest Margin	3.04%	2.95%	2.96%	2.96%	2.92%	2.90%	2.90%	2.95%	2.90%	2.90%	(2)	0	
Average Earning Assets	1,496,803	1,534,202	1,545,318	1,576,080	1,620,696	1,651,667	1,665,000	1,569,074	1,650,000	1,725,000	5	5	
Overhead Ratio %	58.2%	57.7%	57.7%	56.1%	56.6%	57.9%	57.7%	57.0%	58.0%	57.3%	2	(1)	
Tangible Book Value	\$29.00	\$29.23	\$29.84	\$30.09	\$30.42	\$31.08	\$31.69	\$30.42	\$32.94	\$35.61	8	8	
Revenues	21,740.0	21,666.0	21,614.0	22,101.0	21,902.0	22,485.0	22,171.3	87,283.0	87,825.0	90,825.0			
Fees as % of Total Revenue	47.5	48.2	46.6	46.9	45.6	46.8	45.6	46.8	45.6	44.9			

Dated: 6/13/16
NAB Research, LLC

Table 2
Wells Fargo Corp.
Average Balance Sheet Summary and Analysis
(\$ Billions)

	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016	% Change vs. Last Quarter	% Change vs. Last Year
Earning Assets							
Fed funds sold and other ST investments	275.7	267.1	250.1	274.6	284.7	4	3
Trading Assets	63.0	67.6	67.2	68.8	80.5	17	28
Investment Securities :							
Treasury & Agency Securities & Munis	71.1	78.8	83.9	83.9	84.9	1	19
MBS	126.1	120.7	120.3	123.8	117.3	(5)	(7)
Other debt and equity securities	47.1	48.8	50.4	52.7	53.6	2	14
Total AFS Securities	244.3	248.3	254.6	260.4	255.8	(2)	5
Total HTM Securities	62.9	73.9	79.3	79.9	79.5	(1)	26
Total investment securities	307.2	322.2	333.9	340.3	335.3	(1)	9
Loans & mortgages held for sale	20.3	24.2	24.8	19.6	18.2	(7)	(10)
Commercial Loans	416.1	422.9	442.2	454.5	467.6	3	12
Consumer Loans	447.2	447.5	452.9	457.8	459.6	0	3
Total Loans	863.3	870.4	895.1	912.3	927.2	2	7
Other EA	4.7	4.8	5.0	5.1	5.8	14	23
Total Earning Assets	1,534.2	1,556.3	1,576.1	1,620.7	1,651.7	2	8
Funding Sources							
Deposits:							
Interest-bearing checking	39.2	38.6	37.8	39.1	38.7	(1)	(1)
MM & other savings	613.4	619.8	628.1	640.5	651.5	2	6
CD's	34.6	32.5	30.9	29.6	27.9	(6)	(19)
Other time & foreign deposits	162.0	156.5	160.2	156.9	155.9	(1)	(4)
Total IB deposits	849.2	847.4	857.0	866.1	874.0	1	3
ST borrowings	71.7	84.5	90.4	102.9	107.9	5	50
LT debt	183.8	185.1	180.6	190.9	216.9	14	18
Other liabilities	16.9	16.4	16.4	16.5	16.5	0	(2)
Total IB Liabilities	1,121.6	1,133.4	1,144.4	1,176.4	1,215.3	3	8
Portion of NIB funding sources	412.6	422.9	431.7	444.3	436.4	(2)	6
Total Funding Sources	1,534.2	1,556.3	1,576.1	1,620.7	1,651.7	2	8
Non-interest earning assets	173.6	173.0	170.3	166.6	168.2	1	(3)
NIB Deposits	325.6	337.9	341.9	350.7	345.4	(2)	6
Other liabilities	72.0	67.6	67.9	65.2	62.6	(4)	(13)
Total equity	188.6	190.4	192.2	195.0	196.6	1	4
NIB funding sources used to fund EA	(412.6)	(422.9)	(431.7)	(444.3)	(436.4)	(2)	6
Net NIB funding sources	173.6	173.0	170.3	166.6	168.2	1	(3)

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NAB Research, LLC

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