Title:
An Analysis of Wells Fargo & Company (WFC)

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Summary:
A value investor analyzes Wells Fargo & Company (WFC) from both a qualitative and quantitative perspective to determine if the current stock price is attractive.

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WFC, bank, banks, wells, fargo, banking, value, investor, stock, stocks, market, investing, finance

Article Body:

Wells Fargo & Company (WFC) is a huge Western and Midwestern bank that provides a diverse array of financial services to its more than 23 million customers. The company employs more than 150,000 people at its over 6,000 locations nationwide. Wells Fargo has about $500 billion in assets.

While the company continues to derive more than half its revenues from interest income (about $26 billion), its activities are not limited to collecting deposits and lending money. Wells Fargo engages in other businesses such as brokerage services, asset management, and investment banking. The company also makes venture capital investments.

Over the last ten years, Wells Fargo has averaged a 1.57% return on assets and an 18.19% return on equity.

Location

Wells Fargo is closely associated with California in the minds of most investors. The company now operates in 23 different states. However, the concentration in California remains.

Mortgage lending in California accounts for approximately 14% of Wells Fargo’s total loan portfolio. Commercial real estate loans in California account for another 5% of the company’s total loans. No other single state accounts for a similarly sized portion of total loans. In fact, neither mortgage lending nor commercial real estate lending in any other state accounts for more than 2% of Wells Fargo’s total loans.

Cross-Selling

Wells Fargo’s focus on cross-selling is well known. The company has a stated goal of doubling the number of products the average consumer and business customer has with Wells Fargo to eight products per customer (from the current four products per customer).

Cross-selling increases customer stickiness. It also helps increase profitability by decreasing expenses relative to revenues. The need for a large physical footprint is reduced – as is the need for a large number of bankers. Instead, the existing infrastructure is able to provide additional revenue from the same customers.

Wells Fargo’s Chairman & CEO, Richard Kovacevich, explains the importance of the company’s cross-selling in the “Vision & Values” section of the corporate website:

"Cross-selling — or what we call “needs-based” selling — is our most important strategy. Why? Because it is an “increasing returns” business model. It’s like the “network effect” of e-commerce. It multiplies opportunities geometrically. The more you sell customers the more you know about them. The more you know about them the easier it is to sell them more products. The more products customers have with you the better value they receive and the more loyal they are. The longer they stay with you the more opportunities you have to meet even more of their financial needs. The more you sell them the higher the profit because the added cost of selling another product to an existing customer is often only about ten percent of the cost of selling that same product to a new customer. This gives us—as an aggregator — a significant cost advantage over one product or one channel companies. Cross-selling re-invents how financial services are aggregated and sold to customers — just like other aggregators such as Wal-Mart (general merchandise), Home Depot (home improvement products) and Staples (office supplies)."

Mr. Kovacevich’s enthusiasm for the cross-selling model is well justified. It is difficult to quantify the importance of meeting all the varied needs of your customers, because you can not measure the opportunities you missed. However, it is obvious that reducing each customer’s interest in considering a competitor’s services will greatly increase long-term profitability for any company engaged in any line of business – not just for a bank.

Later, in the same website section, Mr. Kovacevich addresses the importance of customer stickiness:

"(Cross-selling) is our most important customer-related sales metric. We want to earn 100 percent of our customers’ business. The more products customers have with Wells Fargo the better deal they get, the more loyal they are, and the longer they stay with the company, improving retention. Eighty percent of our revenue growth comes from selling more products to existing customers."

This focus on retention is an important part of a long-term plan to maintain Wells Fargo’s above-average returns on assets and equity. Extraordinary profitability comes from differentiating your product or service from those of your competitors. Increasing customer stickiness and reducing “comparison shopping” is a key part of maintaining extraordinary profitability.

Some businesses are blessed with enviable economics because of their product’s natural prominence in the minds of their customers. Most businesses are obsessed with market share. But, how many really think about “mind share”? Obviously, a product like Coke (KO), Hershey (HSY), or Snickers is going to have a positive association in the minds of consumers.

For many people, these products will also have a prominent place in each customer’s mind (relative to other products and services on which money can be spent). A few other businesses have a healthy mind share without the positive association; GEICO is the most obvious example. The company’s brand conjures up nothing but the words “auto insurance”. Of course, that’s all the GEICO brand has to do.

So, what does all this have to do with Wells Fargo? Mind share isn’t just the result of exposure to advertising. In fact, in most cases, exposure to advertising can not duplicate the kind of results that a direct, differentiated experience creates. Entertainment properties are by far the leaders in mind share. People who saw and loved Star Wars remember the film. In fact, they don’t just remember the film, they actually file it away (or, more precisely, cross reference it) in countless ways within their mind.

The evidence for this particular example is abundant. There are countless references to Star Wars in other media. The name, the music, the opening text and countless other elements are immediately recognizable. Even the films Star Wars fans hated made more money than almost any other movies in the history of cinema – and this was decades after the original came out. So, obviously Star Wars has the kind of lasting mind share any business should aspire to if it hopes to continuously earn extraordinary profits.

Unfortunately, most businesses, however well run, can not attain this kind of mind share. The products and services they provide can never be as differentiated and memorable as a motion picture. Just as importantly, the positive associations will not be present, simply because the product or service is not inherently exciting, entertaining, or pleasant. This is clearly the case in financial services.

So, what can a financial services company do to improve its mind share? The most obvious tactic is simply to “wow” its customers. In fact, Wells Fargo’s CEO discusses this particular option in the “Vision and Values” section of the company’s website:

" We have to 'wow!' them. We know what that feels like because we’re all customers. We go to the cleaners, the grocery store, a restaurant or whatever, and we find a situation where we’re 'wowed!' We walk out and we say, those people really listened to me and helped me get what I need. All of us hear stories about customers, say, who pick a certain line at the supermarket because they know the person who bags the groceries connects with customers — smiles, greets regular customers by name, asks how their families are doing. When a personal banker helps a customer in one of our stores, or when a customer gets help from one of our phone bankers or does transactions on wellsfargo.com we want them to say, 'That was great. I can’t wait to tell someone.'"

Another option worth pursuing is widening the associations present in the customer’s mind. Financial services is a business where associations tend to be more conscious, categorized, and hierarchical than the associations formed in more heavily branded businesses. Put simply, the (potential) customer usually thinks of a “set” before thinking of an “element” within that set. Like many mental associations, the information can be returned in either direction. For example, the customer may normally think “banks” and then think “Wells Fargo”, but will also be able to return the word “bank” if prompted by the name “Wells Fargo”. This categorization is important, because it provides (limited) permission for Wells Fargo to expand its mind share horizontally (across service categories).

In other words, providing a diverse range of financial services doesn’t just make sense from the provider’s perspective, it also makes sense from the user’s perspective, because the user of financial services has already grouped deposits, borrowing, credit cards, insurance, brokerage services, asset management, etc. together in a very loose way within his mind. As a result of this mental network, one positive experience with Wells Fargo will greatly affect a customer’s desire to pay for an additional service, even if the two services are not really all that similar.

The three key elements here are: a broader definition of what Wells Fargo is (a place that does “money things”, not just a bank), a positive experience, and some sense of trust that the quality of service will be consistent. The last requirement is the easiest to meet, because it’s natural for a customer to assume that the positive experience was not a fluke, much the way a diner assumes the good meal he had at a particular restaurant was not caused by his picking the best offering from the menu. The diner usually assumes the overall quality of the restaurant’s various entrees is superior. Likewise, a good experience with one of Wells Fargo’s products or services will likely rub off on its other offerings.

Valuation

Shares of Wells Fargo currently yield just over 3%. The stock trades at a price-to-book ratio of just under 2.75 and a price-to-earnings ratio of less than 15.

Conclusion

Over the last 5, 10, 15, and 20 years shareholders of Wells Fargo & Company have fared better than the S&P 500. As of the end of last year, WFC’s total return over the last ten years was 17% vs. 9% for the S&P. Over the last 20 years, WFC outpaced the S&P 500 by an even wider margin: 21% vs. 12%.

Wells Fargo has a stellar reputation with investors. The company is the only U.S. bank to earn Moody’s highest credit rating. Wells Fargo also boasts a well-known major shareholder. The largest owner of the company’s common stock is Berkshire Hathaway. Warren Buffett’s holding company has a roughly 5.5% stake in Wells Fargo. Berkshire’s last reported purchase occurred during the first quarter of this year.

Wells Fargo has a stated goal of achieving double-digit growth in earnings and revenue while managing a return on assets over 1.75% and a return on equity over 20%. Those are both very ambitious goals. The company has achieved some of the highest returns on assets and equity of any major U.S. bank. However, Wells Fargo will probably need to increase the percentage of revenue it derives from fee businesses if it is to achieve these goals.

In the years ahead, the company may well become more of a diversified financial services business. In fact, that’s what I expect will happen. The company’s commitment to cross-selling is not some fad. Eventually, this commitment will change the way investors think about Wells Fargo. Soon, it may be considered much more than a bank.

Wells Fargo’s CEO makes the case that his company’s P/E is simply too low. Wells Fargo has a solid history of strong growth and profitability. So, why should it be valued similarly to most other banks? Shouldn’t it be awarded a multiple more in line with a growth company?

There’s actually some merit to this argument. Wells Fargo is unusually well positioned for a bank. Often, those banks that seem certain to earn very high returns on assets and equity for many years to come are poorly positioned for future growth. These banks are often smaller than their competitors and focused on a specific geographic niche. Any acquisitions would dilute the exceptional profitability of the bank’s niche.

Of course, there are also many consolidators in the banking industry. Unfortunately, many of these banks do not have a history of earning the kind of returns on assets and equity that Wells Fargo has achieved. Even more importantly, there is little differentiation between these titans of the banking industry and their national competitors. Therefore, their moats are highly suspect.

Wells Fargo is a different kind of bank. It has a history of extraordinary growth and profitability. There are two obvious opportunities for future growth: geographic expansion and cross-selling. Of these two opportunities, it's clear I’m more enamored with the latter. An eastward push is not necessary, and certainly not via an ill-advised acquisition.

There is a lot of value in the Wells Fargo franchise and there is plenty of room within that franchise for future growth. That’s one of the great advantages of the financial services industry. With the right model, limits to growth are almost non-existent. In other highly-profitable industries, there is often nowhere to reinvest new capital at a similar rate of return.

If Wells Fargo is a growth stock, it is a peculiar sort of growth stock. Maybe that is what attracted Buffett to the company in the first place. Here is a business with a strong franchise that can grow for many years to come. Perhaps most importantly, it is a growth business that frequently trades in the market at value like multiples, simply because it’s a bank.

At the current market price, Wells Fargo is the sort of investment you make once and forget. The valuation is not so cheap as to promise a good return if the business falters. But, the business is not so suspect as to require the margin of safety be provided by a low P/E ratio. Sometimes, near certain growth is the margin of safety.