Recommendation: HOLD **Estimated Fair Value: $33 – $40***

1. Reasons for the Recommendation

Reason #1
Wells Fargo's ability to continue to implement relationship-based banking, even with its already high volume and scale, will further its competitive advantage. This is especially valuable in an industry under fire and highly disliked since the ramifications of the financial crisis of 2008. Relationship banking has proven to have higher retention of customers but normally larger banks are unable to implement this strategy. Larger banks normally focus on transactional banking, which may serve to allow Wells Fargo to continue to gain market share away from its competitors. Cross selling is among the best tools Wells Fargo uses and they are the best in the industry at doings so. The strategy improves value to its clients with a wide array of financial products. Wells Fargo, on average, is able to cross sell 3 to 4 products to new clients and, on average, clients with Wells Fargo over the long term avail of 6 different financial products. Their cross-selling strategy and wide array of financial services has proven to fit right in with their strategy of relationship banking on a large scale.
Reason #2
Wells Fargo's management has shown time after time to be one of the strongest banks at increasing share value through key acquisitions and implementations of those acquisitions to create value for consumers, institutions, and its correspondent banks. Wells Fargo was able to capitalize during the weakest times the industry has ever seen during the financial crisis by acquiring Wachovia, nearly doubling its size. Wells Fargo has the largest branch-banking network in the United States with over 6,314 retail branches nationwide, which allows for a presence that is unmatched among its competitors. Wells Fargo has also had other key acquisitions and recently acquired operating assets of a wholly owned subsidiary of the Bank of Ireland, Foreign Currency Exchange Corporation (FCE). They are also increasing their global footprint with acquisition of a portion of Anglo Irish Banks portfolio for about $3 to $3.5 billion.
Reason #3
Project compass is a cost cutting initiative, that will allow Wells Fargo to be able to weather the major headwinds facing the industry, such as continued tightening of credit standards, increased regulation (Dodd-Frank Act), increased regulatory capital standards (Basel III), high unemployment (9.1%), litigation/lawsuits and the housing market. The project has been implemented for over a year although the company has lacked transparency on what exactly the specifics entail. Wells Fargo has disclosed that the program focuses on boosting efficiency, staff, technology, loan resolution, loss mitigation, automating certain processes, exiting certain business segments going forward such as Wells Fargo Financial and reverse mortgages. The cost cutting initiative is supposed to reduce noninterest expense to $11 billion in the fourth quarter down $1.5 billion without hindering hiring, increased east coast branch expansion, and further growth. The cost cutting will further enhance its strong capital position, which is among the industry's best, and will allow for further dividend increases and share repurchases as regulators continue to permit. Wells Fargo was among the group of banks with capital plans approved by its regulators.
Reason #4
The quality of its loan portfolio is among the industry's best, specifically among the four largest banks with the lowest delinquency and foreclosure rate, and a lower overall rate of more than 300 basis points in these categories compared to the industry average. This is extremely important with Wells Fargo's high exposure to the 1-4 family mortgages with over 40% of their overall loan portfolio (both primary and secondary mortgages) in this segment, which has seen significant distress for all banks in the industry since housing bubble. Management has shown success in managing these headwinds and although many believe that the housing market will take longer to recover, it has improved from its all time lows and Wells Fargo looks poised to continue to manage the risks associated in this business segment.

Multiples Analysis

Comparing Wells Fargo's multiples to that of the industry and S&P 500 shows the stock is undervalued, specifically compared to the S&P 500. Wells Fargo has a forward P/E ratio that is higher by 0.3 than the industry average and exactly the median, which is warranted as it has the highest projected growth rate among its main competitors. Wells Fargo is also trading at a much higher median P/B ratio than the industry, which is about .30 above every one of its main competitors this is warranted as it has the 2nd highest ROE in the industry. One of the key reasons I believe it is undervalued is mainly in the comparison to its historical performance vs. the S&P 500. I believe Wells Faro's negligible exposure to Europe has allowed its stock price to be less affected from the European financial crisis. Wells Fargo over the last 10 years has traded on average at about 15% lower P/E ratio compared to the S&P 500 and is currently trading at a 32% lower P/E ratio. The P/B ratio for Wells Fargo over the last 10 years has traded about 16% below that of the S&P 500 but is currently trading around 45% lower than that of the S&P 500.

2. Company Analysis

Strengths
Wells Fargo is the biggest U.S. home lender and recently originated over $89 billion of mortgages in the third quarter, which was more than JPMorgan, and Bank of America combined. While many of its close competitors are slowing, Wells Fargo posted record quarterly profits. They currently originate one in every four mortgages in the U.S. Wells Fargo is the number one home loan originator, small business lender, commercial real estate lender, used car lender, and have the highest number of branches in the United States. They are also an industry leader in loan modifications for homeowners. The acquisition of Wachovia gives a substantial growth scenario considering their tremendous success in cross selling products. Wells Fargo is one of the most respected names in banking, which is of huge value within an industry plagued with dislike. Wells Fargo ranks as the number one large bank in customer satisfaction. Wells Fargo has a very diversified banking business model, which allows them to spread risk out effectively and thus perform even in difficult times such as those we are experiencing now. Wells Fargo is in over 84 different financial businesses, and looks to continue to diversify. They use their major competitive advantage of cross-selling all their products to keep the highest retention and loyalty among its competitors. They cross sell on average 3 to 4 products to new customers and on average overtime, consumers have over 6 products. Wells Fargo has one of the lowest delinquency rates among mortgages, which is mainly due to their higher credit quality standards during the financial crisis as well as in general compared to those of its peers. Wells Fargo has also continued to show strong growth in terms of deposits, growing over 40 billion, which is among the highest on record for the company in the 3rd quarter of 2011. Wells Fargo’s greatest strength in its ability to maintain a strong relationship based banking model even with its large asset and customer base. All of Wells Fargo’s subsidiary banks, regulated under the FRB (Federal Reserve Board) and OCC (Office of the Comptroller of the Currency) have deemed them “well-capitalized” under the applicable regulatory capital adequacy guidelines, which will allow for financial flexibility that many of its competitors are trying to obtain and maintain as new regulatory guidelines, such as Basel III, starting to be implemented. If Basel III were implemented today under Wells Fargo’s interpretation of the guidelines although not final, they would be 35 basis point above the Tier 1 common equity to total-risk weighted assets anticipated under Basel III.

Weaknesses
Wells Fargo's major weakness is their limited international presence, although this can be seen as strength as of now due to the European financial crisis this could prove to be a major downfall in the long term. The acquisition of Wachovia did enhance their global position but it is nowhere near competitive when compared to Citigroup or JPMorgan Chase in particular. Large exposure to real estate, specifically 1-4 family mortgages homes. The housing market is very distressed and is expected to stay this way for the next 2-3 years if not longer. Wells Faro will experience quarterly losses of approximately $250 million per quarter after tax due to the Durbin Amendment in the Dodd-Franck Act. Wells Fargo will have to hold an additional 1 to 2.5 percentage points more capital due to Basel III. This will most likely negatively impact common stock dividends, repurchase of common stock, and the ability to grow the business.

Opportunities
They have a great opportunity with the acquisition of Wachovia to substantially grow their revenues as well as implement their excellent cross-selling strategy to further enhance stockholder value. The reduction of competition along with consolidation of the industry has given great opportunity for Wells Fargo to be able to gain new market share, while also looking to acquire more banks and financial service companies due to their excellent capital levels. Although the financial crisis was horrible in many ways the opportunities that have presented themselves will continue to allow Wells Fargo to improve their market share and expand their business. Excellent management may prove to be extremely beneficial when economic conditions, along with the housing market improve. The greatest opportunities lies with in Wells Fargo to expand their business internationally in order to not only take advantage of emerging markets such as Brazil, Russia, India, China, and South Africa but also capitalize on the weaknesses that may arise from the European financial crisis.

Threats
Increased and elevated regulatory restrictions, which would possibly cause them to have to change certain business models, thus reducing revenues, increasing costs and possibly adversely affect their business operations. Regulations are among the biggest threats to Wells Fargo as it can create adverse effects quite quickly. Mortgage and bankruptcy law changes could possibly force loan modifications, causing writing down of principal as well as increasing the risks of increasingly higher losses on second lien position in which Wells Fargo holds. If bankruptcy laws become more favorable due to new legislation this could prove to be a significant threat for increased bankruptcy filings and defaults

Litigation and lawsuits is among the greatest threats in the industry and although Wells is not experiencing it to the same degree of its competitors such as Bank of America, it will continue run the risks of lawsuits and Mortgage put back, due to improper loan documentation among other possibilities that were a result of the housing bubble. Government intervention poses substantial risks. Another threat is the full integration of Wachovia without substantial losses of both customers and unpredicted losses of assets due to further economic deteriorations. Although Europe may not impose specific exposure, it could cause substantial negative effects in capital markets as well as interbank lending causing systemic risks among the industry, which could cause financial distress.

3. Industry Analysis

The Financial Sector of the S&P 500 includes banks, credit card companies, mortgage companies, insurance companies, investment firms, stock brokerage firms, and other publicly traded financial businesses. Financials Sector makes up 13.74% (as of September 09, 2011 by adjust market cap) of the 10-sector breakdown provided by S&P 500 GICS sector classification. The Financial Sector is the 2nd largest sector in this classification. A total of 81 Financial Companies make up this sector out of the total 500 companies that make up the entire S&P 500.

Wells Fargo is in the “Diversified Banks” sub-Industry, which makes up 11.73% of the entire Financial Sector. The Financial Sector is broken into 20 sub-industries’, which include Asset Management, Consumer Finance, Diversified REITs, Diversified Banks, Industrial REITs, Insurance Brokers, Investment Banking & Brokerage, Life & health insurance, among others. The “Diversified Banks” are companies that do Commercial banking which have businesses that are derived primarily from commercial lending operations and have significant business activity in retail banking and small and medium corporate lending. However, many would argue that much of Wells Fargo’s direct competition, due to their overall size, isn’t within in this sub industry but rather more effectively compared along side JPMorgan, Bank of America, and Citigroup.

Revenues show a true picture of how hurt the “Diversified Banks” sub industry is since the financial crisis and new regulations that have been implemented. Revenue has continued to stay depressed post the financial crisis for a number of reasons. The main reason is loan growth which is the main source of revenue for “Diversified Banks” .The reason for some of the recovery is due to the stimulus that was done by the Federal Reserve (monetary policy), such as Quantitative Easing 1 & 2 (QE1, QE2), lower interest rates, along with government support (fiscal policy), such as first time home buyer incentive among others, which showed to be short lived for this particular industry. The recent monetary policy operation twist could enhance revenue but overall would hurt their margins to a great deal. With that in mind, unless the economy was to change overnight the slightly increased volume would not make up for the additional loss of margin (flattening of the yield curve) that would further hurt this industry. Interest rates are at historical lows and I believe a further reduction in rates is unlikely to help spur loan creation; specifically mortgage origination or refinancing in the industry as many of the borrowers who qualified under tighter credit conditions or were not under water on their mortgage have already done so.
The industry is unlikely to experience increased volumes in loan growth and non-interest income, which is the other major source of revenue for diversified banks until economic conditions improve, mainly the housing market which throughout history has always preceded an economic recovery. Major headwinds facing the industry are increased tightening of credit standards, increased regulation (Dodd-Frank Act), increased regulatory capital standards (Basel III), high unemployment (9.1%), litigation/lawsuits and the housing market.

Economies of scale definitely play a huge role in banking as banks with a much larger asset base are able to charge lower interest rates and smaller fees, (usually because they are focused more on transactional banking rather than relationship banking, although Wells Fargo prides itself on trying to do both) than that of smaller sized banks due to the higher overall volume of loans and services that are generated by these 4 firms. The 4 firms coined the “four headed horseman” by many, mainly for the reason that they make up 54% of all banking assets in the United States.

The sub industry will have to continue to consolidate in order to grow during this period of poor economic conditions. Wells Fargo with the Acquisition of Wachovia has really elevated itself to stand alone if you classify it among this industry. The main reason they fall within in this sub-industry is their specialization in consumer banking/retail banking. The overall volume of mergers and acquisition is down substantially since 2007 mainly due to increased regulation, which has insisted that banks and financial companies raise capital levels. With that in mind the number of large mergers and acquisitions that took place after the financial crisis definitely changed this sub industry. Bank of America, acquired Merrill Lynch, an Investment bank as well as Countrywide, the largest mortgage lender during the sub-prime crisis. JPMorgan acquired Bank One a few years after the Graham Leach Bliley act was passed and then went on to acquire Bear Stearns and Washington Mutual in 2008 at the peak of the financial crisis and recently became the largest bank in terms of assets in the United States. Wells Fargo nearly doubled its size during the financial crisis by acquiring Wachovia.

Appendix: ***Methodology**

The estimated fair value was calculated using the Discounted Cash Flow (DCF) model, specifically the Dividend Discount Model (DDM). The dividend discount model was modified to use share repurchases in order to give a more accurate valuation. I used three scenarios that were based on three different main assumptions. The estimated growth rates in the scenarios were based foundationally on using return on equity and the modified payout ratio. The estimated growth rates were then adjusted according to my scenario assumptions. Scenario one was based on new regulation being implemented (Dodd Frank) and Wells Fargo being able to effectively change their business models, which I assumed, would give them a nominal growth rate of 4% for 3 years as they adjusts accordingly and then are able to grow at 7.82% for the next 3 years after that and then taper off to a stable nominal growth rate of 6% for the foreseeable future, the estimated fair value calculated was $36. Scenario two was based on new regulation being completely implemented and Wells Fargo not being able to effectively change their banking model, which I forecasted, would make a nominal growth rate of 4% for 3 years as Wells Fargo adjusts accordingly and then are able to grow at 6% for the foreseeable future, the estimated fair value was $33. Scenario three is based on the assumptions that new regulation (Dodd-Frank) is not fully implemented, possibly completely thrown out in order to enhance economic growth or even to prevent a possible recession. The first year was forecasted at a nominal rate of 4% and 7.82% for the next 3 years, and then tapers off to a stable growth rate of 6% by year 10, the estimated fair value was $40. The growth rate estimates and assumptions all take into consideration the economy and thus reflect the lower growth rate initially. The higher valuation compared to the current price I believe is due to the uncertainty and black clouds that overhang the industry. Specifically the economy and European financial crisis, which I believe the stock has discounted most of the downside risks. Wells Fargo although doesn't have specific exposure would still have systemic risks from Europe.

Appendix: Multiples

Comparable Firms

Firms	P/E (ttm)	Forward P/E	PEG ratio (5 yr expected)	P/B	P/S ttm	EV/EBITDA	EV/Sales	growth	ROE	Profit Margin	Operating Margin
Bank of America	N/A	6.4	-9.42	0.31	0.87	N/A	2.7	14.67%	-0.78%	-2.37%	1.08%
Citigroup	8.14	6.87	0.65	0.5	1.35	N/A	-1.06	11.66%	6.66%	17.36%	22.19%
JPM	7.27	6.92	0.82	0.75	1.4	N/A	-0.28	9.13%	11.28%	21.49%	39.92%
Wells Fargo	9.44	7.87	0.71	1.05	1.8	N/A	2.09	12.89%	11.74%	20.83%	35.65%
U.S. Bancorp	11.42	9.78	0.94	1.59	3.1	N/A	6.27	11.49%	13.77%	28.56%	40.39%
Average	9.666666667	7.568	-1.26	0.7	1.704	N/A	1.944	11.97%	7.85%	0.17174	0.27846
Median	9.44	6.92	0.71	0.75	1.4	N/A	2.09	0.1166	0.1128	0.2083	0.3565

Sources: Google Finance and Yahoo! Finance

**growth rates are average growth rates from analysts covering the stock. The growth rate used in the DCF are based on fundamental growth rates.*

Historical multiples

Wells Fargo												
S&P 500												
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	ttm	
Price/Earnings												
WFC	22.2	14.1	16.2	15.2	14	14.4	12.7	42.2	15.4	14	9.3	
S&P 500	23.2	19.7	21.1	19.2	17.2	16.8	16.5	10.9	18.6	15.5	13.8	
	4.31%	28.43%	23.22%	20.83%	18.60%	14.29%	23.03%	-287.16%	17.20%	9.68%	32.61%	15.96%
Price/Book												
WFC	2.7	2.6	2.9	2.8	2.6	2.7	2.1	1.4	1.4	1.4	1.1	
S&P 500	3.3	2.5	3.1	3.1	2.9	2.9	2.7	1.7	2.2	2.2	2	
	18.18%	-4.00%	6.45%	9.68%	10.34%	6.90%	22.22%	17.65%	36.36%	36.36%	45.00%	16.01%
Price/Sales												
WFC	3.8	3.3	3.5	3.5	3.3	3.4	2.6	2.4	1.4	1.9	1.6	
S&P 500	1.5	1.3	1.6	1.6	1.5	1.6	1.5	0.9	1.2	1.3	1.2	
Price/Cash Flow												
WFC	-6.7	-5.8	3.2	5.3	-11.5	3.8	11.2	-20.7	4.3	8.7	4.4	
S&P 500	12.4	9.9	11.9	11.6	10.8	11.1	11.6	6.8	9.1	9.3	8.8	

Source: Morningstar, Inc.