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Wells Fargo & Company

Still Under a Regulatory Cloud and Wading Through the Pandemic

Primary Report

November 3, 2020

Shares of Well Fargo have been under a regulatory cloud ever since the Federal Reserve placed a cap on its total assets in April 2018. To lift the cap, the company must demonstrate that it has implemented an effective remediation plan that guards against a repeat of the abusive sales practices that led to the creation of millions of deposit and credit card accounts without customers' consent.

Since that scandal came to light, three CEOs have come and gone. The fourth and current CEO, Charles Scharf, who formerly led BNY Mellon, came aboard in October 2019. Besides beefing up the bank's risk management function (to address the Fed's greatest concern), Mr. Scharf has initiated a reorganization of Wells Fargo's businesses, increasing the number of business units from three to five to mirror organizational structures of its money center peers. Recent press reports indicate that the company may be looking to exit certain businesses, such as corporate trust and asset management. Mr. Scharf has also installed new executives in key positions, including most recently CFO Mike Santomassino.

Since the Fed's asset cap has been in place for two-and-a-half years, far longer than most would have expected, the timing of its removal is now firmly in Wells Fargo's hands.

One obvious reason for the delay is the pandemic, which has required much of management's attention, delaying the completion of the organizational restructuring. Wells Fargo and its peers beefed up their loan loss reserves in 20Q2, but the long-term impact of the pandemic is unclear. Obviously, the quicker it ends, the less chance that it will permanently harm Wells Fargo's profitability and capital position. This uncertainty has weighed on all banks' share prices, which have underperformed the market significantly so far this year.

Despite the recent spike in COVID-19 infections, most of the economic disruption caused by the pandemic is likely in the rear view mirror. Management should be able to complete its organization revamping and exit the asset cap early next year. This should give a boost to Wells Fargo's beleaguered share price.

Wells Fargo's stock trades at just 0.67 times tangible book value per share, well below its peer group average of 1.2 times. The discount amounts to \$44.5 billion, which far exceeds potential losses under the Supervisory Severely Adverse Scenario in its 2020 Dodd-Frank Act stress tests. Even so, a meaningful rebound in Wells Fargo's share price requires a change in market sentiment toward the stock that embraces the belief that the company's profitability is on a recovery path toward pre-pandemic levels, helped by a steady restoration of the dividend. While the course of the pandemic is still uncertain, I believe that the economy will recover over time and consequently that the new management team can achieve a turnaround in the company's financial performance. Accordingly, my 12- to 18-month price target for the stock is \$32 or one times book value, which equates to a potential gain of 50%.

Common Stock Performance Rating: **2**; Safety Rating: **C**

S&P 500: **3269.96** (10/30/20)

| Shares Outst. (mil.) | Common Stock | 10/30/20 Price | Div. per Share | Div. Yield | Tangible Book Val. | Proj '20 GAAP EPS (a) | 2020 P/E | Proj. '21 GAAP EPS (a) | 2021 P/E |
|-------------------------|------------------------|-------------------|-------------------|---------------|-----------------------|--------------------------|----------|---------------------------|----------|
| 4,132.5 | Wells Fargo (NYSE:WFC) | 21.45 | \$0.40 | 1.9% | \$32.23 | 0.32 | NM | 2.09 | 11.4 |

(a) Lark Research projections and estimates.

Selected Debt Issues (a)

| Amt Outst (\$m) | CUSIP | Type | Recent Price | Coupon (b) | Maturity | Yield | Spread | Call Date | Call Price (c) | Credit Ratings |
|-----------------|-----------|---------------------------|--------------|------------|----------|-------|--------|-----------|----------------|----------------|
| 2,000 | 949746S11 | Global Floating Rate Note | 101.36 | 3MoL+123bp | 10/31/23 | 0.76% | 54bp | 10/31/22 | 100.0 | A2/BBB+ |
| 3,500 | 949746RW3 | Senior Unsec. Debenture | 108.92 | 3.000% | 4/22/26 | 1.31% | 92bp | None | NA | A2/BBB+ |
| 3,250 | 95000U2S1 | Senior Unsecured MTN | 103.93 | 2.393% | 6/2/28 | 1.76% | 114bp | 6/2/27 | 100.0 | A2/BBB+ |
| 3,000 | 95000U2J1 | Senior Unsecured MTN | 104.10 | 2.572% | 2/11/31 | 2.08% | 120bp | 2/11/30 | 100.0 | A2/BBB+ |
| 3,500 | 95000U2Q5 | Senior Unsecured MTN | 103.46 | 3.068% (d) | 4/30/41 | 2.84% | 116bp | 5/7/21 | MW+30 | A2/BBB+ |
| 5,500 | 95000U2M4 | Senior Unsecured MTN | 135.29 | 5.013% (e) | 4/4/51 | 3.16% | 152bp | 4/6/21 | MW+50 | A2/BBB+ |

(b) All prices as of October 30, 2020. Prices, yields and spreads obtained from S&P Global Market Intelligence.

(c) 3MoL = 3-Month LIBOR. Support for LIBOR as a benchmark is scheduled to end at year-end 2021.

(d) MW = Make Whole (Premium).

(e) After 2/11/30, the 2.572% Notes due 2031 pay interest at 3-Month LIBOR plus 100 basis points (bp).

(f) After 4/4/50, the 5.013% Notes due 2051 pay interest at 3-Month LIBOR plus 370 bp.

Selected Preferred Stock Issues (f)

| Amt. Outst. (\$m) | Ticker | Description (g)(h) | Recent Price (g) | Annual Dividend Rate | Maturity | Current Yield | Call Date | Call Price | Credit Ratings |
|-------------------|------------|--|------------------|----------------------|-----------|---------------|-----------|------------|----------------|
| 4,025 | WFCpL | Class A, Series L Convertible (i) | 1,348.76 | 7.500% | Perpetual | 5.54% | Now (i) | 1,300 | Baa2/BB+ |
| 2,000 | Trades OTC | Class A, Series U Fixed to Flt. Rate (j) | 107.29 | 5.875% | Perpetual | 5.48% | 6/15/25 | 100 | Baa2/BB+ |
| 1,150 | WFCpX | Class A, Series X | 25.47 | 5.500% | Perpetual | 5.40% | Now | 25 | Baa2/BB+ |
| 2,000 | WFCpZ | Class A, Series Z | 24.98 | 4.750% | Perpetual | 4.75% | 3/15/25 | 25 | Baa2/BB+ |

(g) As of 6/30/20, Wells Fargo had 14 series of Class A preferred outstanding with a total liquidation preference of \$21.9 billion. All preferred stock prices as of October 30, 2020. Prices obtained from S&P Global Market Intelligence.

(h) All preferred issues listed here (and probably all WFC preferred issues) are non-cumulative.

(i) Convertible into 6.3814 shares of WFC common stock (equivalent to a share price of \$156.71) at any time by the holder. WFC can force conversion if its common share price exceeds 130% of the conversion price or \$203.72.

(j) Dividend payment converts to floating-rate at 3-month LIBOR plus 3.99% on September 15, 2025

Positive Investment Considerations

- Wells Fargo is among the largest banks in the U.S. and a market leader in key businesses. The company ranked 30th on the 2020 Fortune 500, 6th in total assets, 8th in total profits (for 2019) and was the 20th largest employer in the U.S. It is the nation's largest home loan servicer, second largest retail mortgage lender, third largest auto lender and largest bank provider of private student loans. It is also the second largest master servicer of commercial real estate loans by volume and third largest full-service retail brokerage provider. These leading market positions give it a solid base upon which it can begin to grow again, once the FRB's asset cap is lifted and as the negative economic consequences of the pandemic recede.
- Wells Fargo is in the final stages of implementing an organizational restructuring that should meet the Federal Reserve Board's requirements to lift the asset cap sometime early in 2021. It has adopted a new organizational structure that is more consistent with its large money center peers. It has also revamped its risk management function, hiring risk officers for each of its five business segments and to oversee operational and strategic risk management across the entire company. This beefing up of the risk management function should address the FRB's concerns.
- The company is pulling all available levers to improve its profitability and returns on capital. It is seeking to exit or shrink non-core businesses, reduce operating costs wherever possible and position its businesses to compete more aggressively for new business once the asset cap has lifted. Wells

Fargo should also benefit as loans granted forbearance during the pandemic become current again, as unemployment throughout the economy continues to recede.

4. The company has boosted its loan loss reserves by more than \$14 billion so far this year, which should be more than sufficient to cover expected charge-offs due to the pandemic. I estimate that charge-offs on loans that have received forbearances or been modified year-to-date will ultimately be between \$2 billion and \$10 billion, well below its allowance for loan losses of \$20.5 billion at Sept. 30, 2020.
5. The common stock dividend should rise from its recently reduced quarterly rate of \$0.10 per share beginning in 21Q3, after the one-year anniversary of the large 20Q2 provision for loan losses. In order to maintain and support the liquidity and financial strength of major U.S. banks, the Federal Reserve has limited common stock dividends to average trailing four quarter net income. Assuming that Wells Fargo does not require any additional large loan loss provisions, which is likely for the foreseeable future in my view, it should be able to raise the dividend when the 20Q2 loss falls out of the four quarter average (in 21Q3 and beyond).
6. Wells Fargo's stock is currently valued at a price-to-book value ratio of only 67%, well below the peer group average of 1.2 times. This low valuation suggests that the market is concerned that losses will be far worse than those projected in its 2020 Comprehensive Capital Analysis and Review stress tests administered by the Federal Reserve. Based upon the current consensus economic outlook and my analysis of the potential losses on modified loans (which have received payment deferrals), this valuation discount is not justified.

Negative Investment Considerations

1. Wells Fargo's profitability has been squeezed by the pandemic. It has incurred a net loss applicable to common stock of \$932 million year-to-date (through Sept. 30), compared with net income of \$15.4 billion in the prior year period. Its results have been hurt by a 47 basis point (bp) reduction in NIM to 2.32% and an increase in its efficiency ratio of 13.4 points to 78.7. NIM should improve as modified loans are reinstated (i.e. become current). I estimate that deferred loan payments reduced NIM by 17 bp in 20Q2 and 11 bp in 20Q3. NIM should also improve as interest rates begin to rise with continued recovery in the economy. WFC's efficiency ratio should fall below 70 as the corporate makeover costs recede and the company grows assets again, after the asset cap is lifted.
2. Wells Fargo has lost market share as a result of the Federal Reserve's asset cap. Competitors have apparently taken advantage of its misfortune, gaining market share since the cap was put in place in April 2018. Some of the negative impact of this year's decline in net interest margin (NIM) on WFC's key profitability ratios (i.e. ROA, ROE and ROTCE) may have been cushioned, if the company had been able to grow its assets. This is a key factor in Wells Fargo's recent poor relative performance vs. peers.
3. Bank stocks have underperformed the market significantly in 2020. Year-to-date, through October 30, the KBW Bank Stock Index is down 32.1%, far worse than the S&P 500's 1.2% gain. The poor relative performance of bank stocks is due to the sharp decline in profitability that banks have suffered as a result of the pandemic.
4. Wells Fargo's 2020 stock price and financial performance have significantly underperformed its peer group. Year-to-date, through October 30, WFC has lost 60.1% of its value. This is due primarily to the collapse in its profitability, as noted above, and ongoing uncertainty about economic recovery. By comparison, the profits of its large bank peers are down 35%-50%. As a result, WFC's stock looks much more expensive than its peers as a multiple of 2020 earnings. (Its 2020 forward price-to-adjusted (non-GAAP) earnings ratio is 33 vs. the peer group average of 14.0.)

5. Achieving my target stock price of \$32 will require a significant improvement in profitability from recent levels. Although I anticipate a sharp recovery in the company's earnings in 2021, the stock at the current price is valued in line with peers at 10 times my projected 2021 EPS of \$2.09 (which is roughly in line with consensus). Thus, my target price of \$32 requires either that the company's 2021 actual results far exceed my expectations or that its earnings growth outlook for 2022 and beyond significantly exceeds the peer group average. While this seems like a tall order today, Wells Fargo achieved earnings in excess of \$4.00 per share each year from 2014 to 2019, so growth beyond \$2.09 per share in 2021 should be achievable as long as the company's core competitive advantages have not diminished and the broader economy's ability to recover remains intact.
6. From a technical perspective, the stock remains in a downtrend. Although its rate of decline has moderated, Wells Fargo's stock traded last week at an eleven-year low. There is no clear evidence as yet that the stock has bottomed.

The Scandal and The Remedy. In 2016, press reports revealed that Wells Fargo consumer banking employees had fraudulently created as many as three million checking, savings and credit card accounts for bank customers who did not request them and also issued life and renters insurance policies without their consent. Employees were said to be under pressure from unrealistic goals set by management. Furthermore, the company reportedly charged customers unfairly, often ignoring contract terms for such products as automobile collateral protection insurance and interest rate locks on mortgage loans. In September 2016, CEO John Stumpf was grilled about these practices in congressional hearings. He resigned in October 2016 and was replaced by President and COO Timothy Sloan.

In April 2018, Wells Fargo entered into a consent order with the Federal Reserve Board of Governors (FRB) that capped its total consolidated assets at the December 31, 2017 level until it demonstrated improved risk management controls. The FRB ordered the Board of Directors to submit a plan to improve oversight and governance. It also required the company to submit and implement a plan to address weaknesses in its compliance and operations risk management functions.

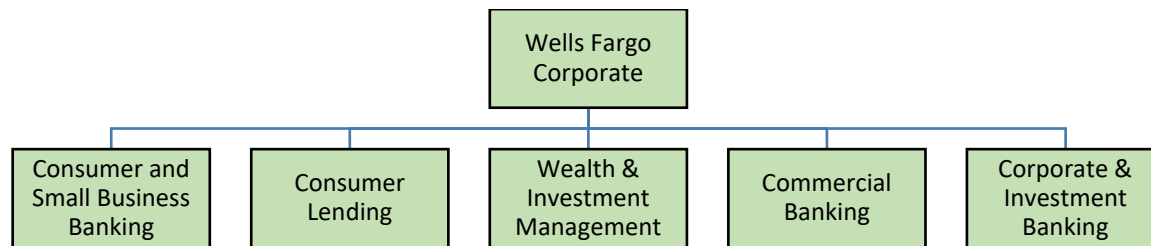
Once these plans have been implemented, the consent order requires a third-party review of their implementation. Upon receiving a favorable third-party review, the Federal Reserve will lift the asset cap.

In March 2019, Mr. Sloan stepped down as CEO and was replaced by C. Allen Parker, who had recently joined Wells Fargo as general counsel. As a long-standing member of senior management, Mr. Sloan was viewed as culpable politically and by the media for the company's fraudulent and abusive sales practices. Yet, he held the CEO position for two-and-a-half years before stepping down, so that explanation seems questionable. More likely, in my view, the Board decided that it needed a CEO with Wall Street experience to implement a more far-reaching, strategic reorganization of Wells Fargo's businesses.

The New Organization. In October 2019, Wells Fargo hired Charles Scharf, who had been CEO of BNY Mellon. Mr. Scharf had also served as CEO of Visa and in executive positions at JP Morgan Chase, Bank One, Citigroup and Salmon Smith Barney.

In March 2020, Wells Fargo appointed Charles Noski, the retired Vice Chairman and former CFO of Bank of America Corporation, as Chairman of its Board of Directors, replacing Elizabeth Duke.

Since Mr. Scharf arrived, the company has announced a reorganization that expands its business segments from three to five. Under its previous organizational structure, it conducted its operations through its Consumer Banking, Commercial Banking and Wealth & Investment Management segments. Under the new organization, its five operating segments are shown in the chart on the next page:



The change more closely aligns the company's organizational structure with its money center peers, especially J.P. Morgan. Wells Fargo's Consumer Lending and Small Business banking business is aligned with its branch operations; whereas the Consumer Lending businesses are national in scope and centered around the company's core competencies in residential mortgage lending and banking. Wealth & Investment Management is largely unchanged. The split between Commercial Banking and Corporate & Investment Banking is based upon whether the business is relationship- or transaction-oriented. The demarcation between small business lending and commercial banking has been set at \$5 million.

This organizational change will be reflected in the company's financial statements beginning in 2021. The new reporting format will first appear in Wells Fargo's 2020 annual financial statements (10-K). The change will be led by new CFO Mike Santomassino, who has stepped in for the retiring John Shrewsberry.

Although the company is expanding the number of its business segments, it is also seeking to improve its operating efficiency by streamlining: eliminating layers of management and increasing management's span of control within each of the remaining layers.

Shortly after his arrival, Mr. Scharf hired Scott Powell, formerly the CEO of Santander Holdings USA, Inc. and Santander Consumer USA Holdings, Inc. as Chief Operating Officer. Mr. Powell led Santander USA's financial turnaround, resolving regulatory issues related to the supervision of customer-focused employees and the maintenance of associated financial and operating controls. Mr. Powell previously served in senior roles at JP Morgan Chase and Bank One.

Under Mr. Scharf, Wells Fargo has hired executives to fill key positions in the new organizational structure. It has also rebuilt and broadened the scope of its risk management organization under Chief Risk Officer Mandy Norton, hiring CROs for each of the business segments and for other functions such as operational and strategic enterprise risk management. This should address the FRB's concerns about Wells Fargo's risk management controls.

While the organizational restructuring clearly appears to be on target, investors remain concerned about Wells Fargo's cost structure, competitive position and therefore its ability to return to (or exceed) peer group average profitability levels and metrics. Chief among these is the company's efficiency ratio, which is noninterest expense divided by revenues. Since reaching its consent agreement with the FRB, Wells Fargo's efficiency ratio has increased from the mid-60s, which was in line with peers, to the low 80s, which is clearly high. The higher expense level is due in large part to lower net interest income (both from the asset cap and squeeze on net interest margin) and also to higher professional expenses and other costs associated with its organizational restructuring.

Recent Financial Performance. As with its peers, Wells Fargo's financial performance has been hurt by the pandemic. The company reported a 2020 second quarter loss applicable to common stock of \$2.7 billion or \$0.66 per share, due to a \$2.3 billion reduction in its net interest income (with NIM falling 57 bp to 2.24%), the recording of a pandemic-driven \$9.5 billion loan loss provision and a \$1.1 billion increase in noninterest expense. Taken together, these three components produced a pretax loss of \$6.2 billion that was partially offset by a \$3.9 billion income tax benefit. By comparison, Wells reported net income of \$5.8 billion or \$1.30 per share in the 2019 second quarter.

Table 1
Wells Fargo & Company and Subsidiaries
 Summary Consolidated Statements of Income
 (\$ millions)

| | 12 Months 31-Dec-18 | 3 Months 31-Mar-19 | 3 Months 30-Jun-19 | 3 Months 30-Sep-19 | 3 Months 31-Dec-19 | 12 Months 31-Dec-19 | 3 Months 31-Mar-20 | 3 Months 30-Jun-20 | 3 Months 30-Sep-20 |
|---------------------------------------|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|------------------------|-----------------------|-----------------------|-----------------------|
| Total interest income | 64,647 | 17,003 | 16,986 | 16,499 | 15,595 | 66,083 | 14,727 | 11,801 | 10,800 |
| Total interest expense | 14,652 | 4,692 | 4,891 | 4,874 | 4,395 | 18,852 | 3,415 | 1,921 | 1,432 |
| Net interest income | 49,995 | 12,311 | 12,095 | 11,625 | 11,200 | 47,231 | 11,312 | 9,880 | 9,368 |
| Net interest margin | 2.91% | 2.88% | 2.81% | 2.67% | 2.55% | 2.73% | 2.57% | 2.24% | 2.14% |
| Provision for credit losses | 1,744 | 845 | 503 | 695 | 644 | 2,687 | 4,005 | 9,534 | 769 |
| Net int. inc. after credit loss prov. | 48,251 | 11,466 | 11,592 | 10,930 | 10,556 | 44,544 | 7,307 | 346 | 8,599 |
| Noninterest income | 36,413 | 9,298 | 9,489 | 10,385 | 8,660 | 37,832 | 6,405 | 7,956 | 9,494 |
| Noninterest expense | 56,126 | 13,916 | 13,449 | 15,199 | 15,614 | 58,178 | 13,048 | 14,551 | 15,229 |
| Efficiency ratio | 65.0 | 64.4 | 62.3 | 69.1 | 78.6 | 68.4 | 73.6 | 81.6 | 80.7 |
| Income before income tax exp. | 28,538 | 6,848 | 7,632 | 6,116 | 3,602 | 24,198 | 664 | (6,249) | 2,864 |
| Income tax expense | 5,662 | 881 | 1,294 | 1,304 | 678 | 4,157 | 159 | (3,917) | 645 |
| Income tax rate | 19.8% | 12.9% | 17.0% | 21.3% | 18.8% | 17.2% | 23.9% | 62.7% | 22.5% |
| Net inc. before noncontrol. int. | 22,876 | 5,967 | 6,338 | 4,812 | 2,924 | 20,041 | 505 | (2,332) | 2,219 |
| Less: Net inc. from noncontrol. int. | 483 | 107 | 132 | 202 | 51 | 492 | (148) | 47 | 184 |
| WFC net income | 22,393 | 5,860 | 6,206 | 4,610 | 2,873 | 19,549 | 653 | (2,379) | 2,035 |
| Less: Pref. stock div. & other | 1,704 | 353 | 358 | 573 | 327 | 1,611 | 611 | 315 | 315 |
| WFC net inc. applic. to common | 20,689 | 5,507 | 5,848 | 4,037 | 2,546 | 17,938 | 42 | (2,694) | 1,720 |
| Diluted earnings per common share | \$ 4.28 | \$ 1.20 | \$ 1.30 | \$ 0.92 | \$ 0.60 | \$ 4.05 | \$ 0.01 | \$ (0.66) | \$ 0.42 |
| Dil. avg. common shares outstanding | 4,838.4 | 4,584.0 | 4,495.0 | 4,389.6 | 4,234.6 | 4,425.4 | 4,135.0 | 4,105.5 | 4,132.2 |
| Dividends per common share | \$ 1.64 | \$ 0.45 | \$ 0.45 | \$ 0.51 | \$ 0.51 | \$ 1.92 | \$ 0.51 | \$ 0.51 | \$ 0.10 |

Source: Wells Fargo financial statements and Lark Research calculations.

In the 2020 third quarter, net interest income declined further to \$9.4 billion, as NIM slipped another 10 bp to 2.14%. But the loan loss provision also fell to just \$769 million because loan reserves are ample at this time. (With loan forbearances and modifications still in place, it is too early to tell what the write-offs will ultimately be). Noninterest income fell 8.6% or \$891 million, due entirely to a drop in "other" noninterest income. Noninterest expense was flat at \$15.3 billion, but the efficiency ratio increased by 11.6 points to 80.7 due to the declines in net interest income and noninterest income. As a result of all of these factors, Wells recorded a third quarter profit attributable to shareholders of \$1.7 billion or \$0.42 per share, but that was less than half of the \$4.0 billion and \$0.92 per share of net income posted in the 2019 third quarter.

Profits at other large banks are down significantly, by 35%-50%, so far this year; but Wells Fargo is the only large bank to post a loss year-to-date, equal to \$0.23 per share, compared with net income of \$3.43 in the comparable prior year period. Clearly, the company's poor relative performance explains why its stock has significantly underperformed its peer group this year, falling 60% vs. the KBW Bank Index's 32% decline. Investors apparently remain concerned about the long delay in exiting the FRB's asset cap, but its noticeably weaker profit performance also raises doubts about the potential magnitude and timing of a recovery in its earnings. One important factor that will help shape the Wells Fargo's post-asset cap and post-COVID recovery is the impact of loan forbearances.

Loan Forbearances (Modifications). Based upon regulatory guidance, Wells Fargo has not classified a substantial majority of its loan forbearances as past due. Early on in the pandemic (on March 22), banking regulators, including the FDIC, FRB and state banking commissions, issued an "Interagency Statement on Loan Modifications by Financial Institutions Working with Customers Affected by the Coronavirus." The statement encourages financial institutions to work constructively with such customers. Regulators will not criticize institutions for prudent loan modifications or automatically categorize such modifications as troubled debt restructurings (TDRs). As confirmed with the staff of the FASB, short-term modifications made in good faith to borrowers who were current prior to COVID-19 need not be categorized as TDRs. Similarly, modifications of one-to-four family residential mortgage loans that were prudently underwritten and not past due or classified as nonaccruals prior to COVID do not require reclassification (to higher risk categories) under risk-based capital rules. Deferred loan payments do not need to be classified as past due unless or until it becomes clear that such loans will not be repaid.

In its 20Q3 earnings conference call, Wells Fargo management said that it had granted forbearances to 3.2 million customers since March. As of June 30, it had extended \$10.1 billion in loans under the Paycheck Protection Program to more than 179,000 borrowers. Since most of the principal amount of these loans will probably be forgiven, Wells Fargo will be reimbursed by the Federal government.

The company has also received payments from the Small Business Administration (SBA) on behalf of customers who are eligible for the SBA's Six Month Payment Assistance program. As of 20Q2, it had received \$193 million in payments from the SBA on behalf of more than 20,000 lending customers.

In its 20Q3 financial supplement, Wells Fargo disclosed that \$23.5 billion of consumer loans, equal to 5% of total consumer loans outstanding at Sept. 30, have been granted deferrals due to COVID-19 that are still continuing. This compares to \$37.2 billion of such loans or 9% of the total at June 30.

This does not include \$19.1 billion of 1-4 family mortgage loans at Sept. 30 (\$7.1 billion at June 30) that were insured by FHA or guaranteed by VA that were repurchased from GNMA loan securitization pools (because they were nonperforming). These FHA/VA mortgages are entitled to payment deferrals of up to one year, but will eventually be paid by the respective government agencies, if not brought current by the borrowers. With payment assured by the governmental insurance/guarantee, Wells probably is continuing to record interest income on them.

In its 20Q2 10-Q, Wells Fargo disclosed that it had modified (i.e. granted deferrals on) commercial loans with a total unpaid balance of \$38.2 billion in the six months ended June 30, 2020. This included \$20.7 billion of commercial and industrial loans, \$16.2 billion of real estate loans and \$1.3 billion of lease financing. It did not disclose whether any of these loans had been brought current. The \$38.2 billion of forbearances represents 7% of the total commercial loan portfolio. Such loans are covered within the scope of the Interagency statement, so the company is not required to classify them as nonaccruals.

While most loans granted forbearance due to COVID-19 need not be classified as past due, it is not completely clear how Wells Fargo and other banks are accounting for them. Wells has disclosed that "loans that were accruing at the time the relief is provided will generally not be placed on nonaccrual status during the deferral period." Although such loans are still "on accrual", it is unclear whether Wells and the others are recognizing interest income on them. If the company anticipates that the total amount of the deferral will be paid in cash at the end of the deferral period, then it would be appropriate to record interest income on that portion of the payment deemed to be interest. However, if the deferral amount is added eventually to the principal amount of the loan, then it should recognize only a small portion of the deferred amount currently as interest income (as calculated under the effective interest method). Any portion of the deferred amount that is deemed to be uncollectible should be charged off (i.e. written off against the allowance for credit losses). Since it is likely that most deferrals will be added to principal, these loan modifications have contributed to the reduction in net interest margin that all banks have experienced since the onset of the pandemic.

Net Interest Margin. Since 19Q4, Wells Fargo's quarterly net interest margin (NIM) has declined by 41 bp from 2.55% to 2.14%. The sequential quarterly decline in NIM was greatest in 20Q2, down 31 bp, but it eased to 10 bp in 20Q3.

Much of the drop in NIM is due to the pandemic-driven decline in interest rates, assisted by unprecedented Federal Reserve actions to bolster liquidity throughout the financial system and avoid a collapse in asset prices. Lower interest rates affect both the interest income that the bank receives on its earning assets (primarily loans and debt securities) and its costs of funding those assets. The average yield on WFC's earning assets has fallen 107 bp from 3.53% in 19Q4 to 2.46% in 20Q3, due to a combination of interest rate declines, mix shifts in the portfolios (cause by refinancings and repayments and investment purchases and sales) and the lost interest from loan deferrals. Meanwhile, the average rate paid on funding sources has dropped by 67 bp from 0.99% to 0.32%.

Table 2

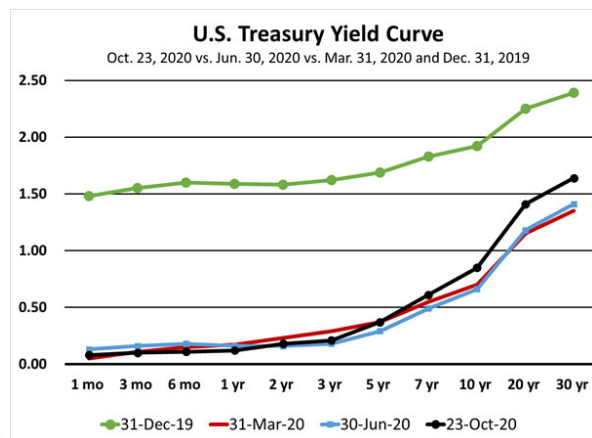
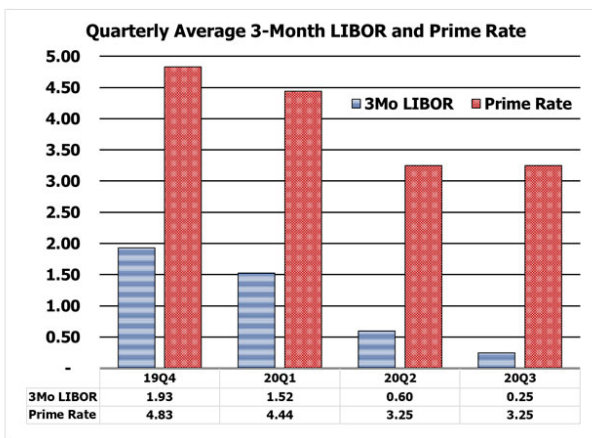
Wells Fargo & Company and Subsidiaries
Components of Net Interest Margin: 2018-2020

| | 12 Months 31-Dec-18 | 3 Months 31-Mar-19 | 3 Months 30-Jun-19 | 3 Months 30-Sep-19 | 3 Months 31-Dec-19 | 12 Months 31-Dec-19 | 3 Months 31-Mar-20 | 3 Months 30-Jun-20 | 3 Months 30-Sep-20 |
|------------------------------------|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|------------------------|-----------------------|-----------------------|-----------------------|
| Earning assets | | | | | | | | | |
| Debt securities | 3.02% | 3.24% | 3.16% | 3.00% | 2.84% | 3.06% | 2.81% | 2.46% | 2.11% |
| Loans | 4.66% | 4.79% | 4.79% | 4.64% | 4.40% | 4.65% | 4.18% | 3.49% | 3.42% |
| Total earning assets | 3.76% | 3.97% | 3.94% | 3.78% | 3.53% | 3.80% | 3.34% | 2.68% | 2.46% |
| Funding sources | | | | | | | | | |
| Interest-bearing deposits | 0.61% | 0.88% | 0.95% | 0.98% | 0.85% | 0.92% | 0.70% | 0.24% | 0.13% |
| Short-term borrowings | 1.65% | 2.20% | 2.25% | 2.08% | 1.51% | 2.01% | 1.13% | -0.11% | -0.08% |
| Long-term debt | 2.99% | 3.31% | 3.21% | 3.10% | 3.03% | 3.16% | 2.17% | 2.13% | 1.86% |
| Total interest bearing liabilities | 1.15% | 1.45% | 1.50% | 1.47% | 1.31% | 1.43% | 1.01% | 0.59% | 0.45% |
| Total funding sources | 0.84% | 1.08% | 1.12% | 1.11% | 0.99% | 1.07% | 0.77% | 0.43% | 0.32% |
| Net interest margin | 2.91% | 2.88% | 2.81% | 2.67% | 2.55% | 2.73% | 2.57% | 2.24% | 2.14% |

Source: Wells Fargo financial statements, earnings press releases and financial supplements.

The income from certain loans and investments, especially corporate loans, are tied directly to changes in interest rates, but even these changes operate with a lag (for example, three months in the case of LIBOR). Other loans, like mortgages, are mostly fixed rate, or may be repriced infrequently, such as 5-year/1-year adjustable rate mortgages. Much of the change in portfolio yield, therefore, is typically caused by mix shifts, from repayments and refinancings, for example. Still, changes in interest rates have a significant impact on NIM, especially over time.

The magnitude of the decline in interest rates is illustrated by the downshift in the U.S. Treasury yield curve (shown in the chart on the next page on the right) and also from the trend in two key banking benchmarks: 3-month LIBOR and the prime rate (on the left). Interest rates plunged as the pandemic washed on to U.S. shores. From the start of the year, U.S. Treasury yields have fallen nearly 150 bp on the short end and by almost as much on the long end. Treasury yields have barely budged since the onset of the pandemic, but the long end of the yield curve (from 7-year out to 30-year maturities) has moved modestly higher in recent weeks. This is perhaps a sign that the economy is beginning to shake off the effects of the pandemic.



Banking benchmarks have followed a similar trajectory. 3-Month LIBOR, which is the base rate for most corporate and many consumer loans has dropped steadily from 1.90% at the beginning of the year to just 0.22% currently. The quarterly average for 3-month LIBOR has fallen from 1.52% in 20Q1 to 0.60% in 20Q2 and then to 0.25% in 20Q3. LIBOR’s rate of decline has clearly slowed with the passage of time, but it is not clear quite yet that it has bottomed.

The prime rate, an alternative banking benchmark now used mostly for small business and personal loans, declined from 4.75% at the beginning of the year to 4.25% on March 4 and then to 3.25% on March 16. The quarterly average prime rate was 4.44% in 20Q1 and 3.25% in 20Q2 and 20Q3.

Although the decline in interest rates is a significant cause of the drop in Wells Fargo’s NIM, other factors have been at work. Loan repayments and refinancings of corporate and residential mortgage loans have affected its average yield on interest earning assets. Large, publicly-traded companies have tapped the capital markets since the start of the pandemic to repay bank loans and near maturity debt issues.

Wells Fargo’s total U.S commercial loans jumped 7.5% to \$310 billion during 20Q2 mostly because businesses tapped credit lines to build up their cash reserves and ensure their liquidity. As capital markets began to reopen and businesses gained greater confidence that an economic bottom was at hand, they paid down their bank loans through the issuance of public debt. Wells Fargo’s average loans outstanding fell 12.7% to \$271 billion from 20Q2 to 20Q3.

As commercial loan balances have whipsawed over the past couple of quarters, the average yield on those loans declined by 96 bp to 2.57% in 20Q2 and then levelled off, easing by only 3 bp to 2.54% in 20Q3. The 20Q2 decline was roughly in line with the general decline in interest rates and bank benchmarks; but the 20Q3 leveling off is more correlated to the steady prime rate. Thus, the composition of Wells Fargo’s commercial loan portfolio has probably shifted toward smaller borrowers.

By comparison, commercial real estate mortgages, construction loans and lease financings have been steady, but their average yields have declined commensurately with the interest rates. Certain real estate sectors – retails and lodging, for example – have been hit hard by the pandemic. Construction projects have also been delayed and permanent financing has been tougher to get. Some of the decline in yield on these assets is undoubtedly due to forbearances.

In consumer, total outstanding loans were down 4.2% in 20Q2, but increased 1.9% in 20Q3. Outstanding balances have been affected by refinancings, loan modifications and portfolio moves. In 20Q3, the company repurchased \$21.9 billion of non-performing FHA/VA insured or guaranteed mortgage loans from GNMA securitization pools. Since these loans carry government guarantees, WFC generally does not place them on nonaccrual status.

Estimating the Impact of Forbearances. Wells Fargo has disclosed in its quarterly SEC filings the total amount of loans that have been and continue to be subject to loan modifications or deferrals. Although it has disclosed in its financial supplement the consumer loans that were still subject to modification as of Sept. 30, it did not disclose commercial loan modifications. Complete figures should be available when it files its 20Q3 10-Q later this week. Consequently, my analysis will focus on the 20Q2 disclosures, with commentary on 20Q3 consumer loan developments. My estimate of the impact of loan deferrals on the company's NIM are given in the table below:

Table 3

Wells Fargo & Company and Subsidiaries

Estimated impact of loan deferrals on net interest income and margin for the 2020 second quarter
(in \$ millions, except percentages)

| Loan Category | Unpaid principal balance of modified loans | Assumed annualized yield, if current | Estimated impact on net interest income |
|--|--|--------------------------------------|---|
| Commercial and industrial | 20,656 | 2.60% | 134 |
| Real estate mortgage and construction | 16,229 | 3.20% | 130 |
| Lease financing | 1,287 | 3.35% | 11 |
| Total commercial | 38,172 | 2.88% | 275 |
| Real estate 1-4 family first mortgage | 32,253 | 3.50% | 282 |
| Real estate 1-4 family junior mortgage | 2,812 | 4.30% | 30 |
| Credit card | 2,616 | 12.00% | 78 |
| Automobile | 4,880 | 5.00% | 61 |
| Other revolving credit and installment | 1,673 | 5.50% | 23 |
| Total consumer | 44,234 | 4.29% | 475 |
| Total loans | 82,406 | 3.64% | 750 |
| As reported | 1,782,016 | 2.24% | 9,999 |
| Assuming modified loans were current | 1,782,016 | 2.41% | 10,749 |
| Estimated impact on NII and NIM | | 0.17% | 750 |

Source: Wells Fargo financial statements, earnings press releases and financial supplements and Lark Research calculations and estimates.

The unpaid principal balance of consumer loans represents loans that were still in deferral as of the end of 20Q2. Modified consumer loans include \$7.1 billion of mortgages repurchased from GNMA securitization pools. Commercial loans are those that were modified in the six months ended June 30, 2020. WFC did not disclose what portion of these loans were still in deferral at the end of 20Q3.

Based upon the company's disclosures - assuming all of the \$38.2 billion of commercial loans modified since the start of the pandemic were still in deferral at the end of 20Q2 and ignoring the impact of partial payments made on 35% of modified consumer loans, I estimate that Wells Fargo lost as much as \$750 million of interest income to loan deferrals and that the loss of this interest income reduced its NIM by 17 bp in the quarter. That represents about half of the reported 31 bp decline in NIM in the quarter.

In its 20Q3 financial supplement, Wells Fargo disclosed that the unpaid principal balance on modified consumer loans still in deferral, excluding GNMA repurchases, declined 36.8% to \$23.5 billion or 5% of total consumer loans outstanding from \$37.2 billion or 9% at June 30, 2020. However, the quarter end mortgage loans still outstanding from GNMA securitization pool repurchases increased from \$7.1 billion at June 30 to \$19.1 billion at Sept. 30. Management further reported that the trailing seven day average of new daily payment deferrals granted on consumer loans has declined 97% from the early April peak.

Using the same analysis for the \$23.5 billion of modified consumer loans still in deferral at 20Q3 and assuming that modified commercial loans held steady at \$38.2 billion, I estimate that all of the 10 bp reduction in 20Q3 NIM was due to loan modifications.

If the economy is now definitely on the mend so that loan payment deferrals will continue to decline with each passing quarter, Wells Fargo (and all the banks for that matter) should see improvement in NIM as the modified loans become current. Similarly, an improving economy should eventually result in rising interest rates and a steepening yield curve, which would likewise benefit net interest margin.

Estimated Loan Losses in a Severely Adverse Scenario. On the other hand, in light of the recent increase in the rate of COVID-19 infections and the uncertainty about when an effective vaccine may become available, it is possible that the economic recovery could be delayed. That would keep more people out of work for longer and almost certainly either forestall a reduction in modified loans still subject to deferral or even spark an increase in deferral requests. This would raise the probability that many of these loans will ultimately go into default and have to be written off.

If Wells Fargo ultimate experiences a default on the entire estimated \$62 billion of modified loans still in deferral at the end of 20Q3 and it incurs a loss equal to 10% of the principal amount, it would have to charge off \$6.2 billion against its allowance for loan losses (ALL). This represents 32.8% of the company's \$18.9 billion ALL (excluding the ALL for loan commitments) at Sept. 30, 2020.

Table 4

Wells Fargo & Company and Subsidiaries
Estimated Loans and Possible Loan Losses from Forbearances

| | |
|--|---------|
| Loans outstanding at Sep. 30, 2020 (\$ mil.) | 900,619 |
| Est. loans subject to modification (\$ mil.) | 62,000 |
| Est. loans subject to forbearance as % of total loans | 6.9% |
| Est. loss percentage on loans subject to forbearance | 10.0% |
| Potential losses on loans subject to forbearance (\$ mil.) | 6,200 |
| Allowance for loan losses at Sept. 30, 2020 (\$ mil.) | 18,926 |
| Potential losses on loans as % of loan loss allowance | 32.8% |

Source: Wells Fargo financial statements and Lark Research calculations and estimates. The \$62 billion of loans subject to modification consists of \$38.2 billion of modified commercial loans (as of June 30, 2020) and \$23.5 billion of modified consumer loans (as of Sept. 30, 2020)

My 10% loss rate assumption is significantly greater than the loss rate used by Wells Fargo in its 2020 Dodd-Frank Act stress tests and Comprehensive Capital Analysis & Review. Table 5 on the next page shows the cumulative loss rate assumptions used by the company in its 2020 CCAR for the nine quarters ended March 31, 2022, as required under the Federal Reserve's guidelines.

Table 5

Wells Fargo & Company and Subsidiaries

Projected Loan Losses by Type of Loan Under the Supervisory Severely Adverse Scenario.
2020 Comprehensive Capital Analysis & Review Tests

| | Cumulative Portfolio Loss Rate |
|----------------------------------|--------------------------------|
| First lien mortgages, domestic | 0.4% |
| Junior lien and HELOCs | 2.6% |
| Commercial & industrial loans | 4.3% |
| Commercial real estate, domestic | 2.8% |
| Credit card | 17.5% |
| Other consumer | 4.3% |
| All other loans | 3.0% |
| Projected loan losses | 3.1% |

Source: Wells Fargo Annual Company-Run Stress Tests, June 25, 2020.

The stress test resulted in total projected cumulative portfolio loss rate of 3.1%, well below my assumed loss rate of 10.0% in Table 4 on the previous page. While the loss rates for certain categories, like first lien mortgages, junior lien mortgages and HELOCs and commercial real estate seem low, these loans are collateralized by assets whose estimated values are well in excess of the loan amounts.

In determining the projected cumulative portfolio loss rate, Wells Fargo utilized the assumptions published by the Federal Reserve. These included peak-to-trough declines (from year-end 2019) of 28% in home prices, 35% in commercial real estate prices and a 50% drop in the stock market.

Table 6 below shows how my loan loss estimate on forbearances changes with different assumed values for the total amount of defaults and estimated loss percentages. At the extremes of a 17.5% loss rate on \$100 billion of defaulted loans, the company would incur \$17.5 billion of charge-offs, still less than the current ALL of \$18.9 billion.

Table 6

Wells Fargo & Company and Subsidiaries

Sensitivity of Possible Loan Losses to Various Estimated Total Loan Defaults and Loss Percentages
(in \$ millions)

| | | Estimated Total Loan Defaults | | | | |
|---------------------------|-------|-------------------------------|--------|--------|--------|---------|
| | | 20,000 | 40,000 | 62,000 | 80,000 | 100,000 |
| Estimated Loss Percentage | 2.5% | 500 | 1,000 | 1,550 | 2,000 | 2,500 |
| | 5.0% | 1,000 | 2,000 | 3,100 | 4,000 | 5,000 |
| | 7.5% | 1,500 | 3,000 | 4,650 | 6,000 | 7,500 |
| | 10.0% | 2,000 | 4,000 | 6,200 | 8,000 | 10,000 |
| | 12.5% | 2,500 | 5,000 | 7,750 | 10,000 | 12,500 |
| | 15.0% | 3,000 | 6,000 | 9,300 | 12,000 | 15,000 |
| | 17.5% | 3,500 | 7,000 | 10,850 | 14,000 | 17,500 |

Source: Lark Research calculations and estimates.

Although my projected loss rate on modified loans is significantly above Wells Fargo's cumulative portfolio loss rate under the stress tests, this is a simplified analysis that assumes that the company suffers no charge-offs on the remaining 93.1% of the loan portfolio. Clearly, this is a less severe scenario than Supervisory Severely Adverse Scenario used for the stress tests.

Still, it is worth noting that under the stress tests, Wells Fargo projects that it would record \$27.7 billion of pre-tax losses; its minimum Common Equity Tier 1 ratio would be 11.3%, more than twice the required regulatory minimum of 4.5%; and its projected Tier 1 risk-based capital ratio of 11.3% is nearly twice the required regulatory minimum of 6.0%.

Compare that to the company's 20Q3 tangible book value of \$133.2 billion or \$32.23 per share and its equity market capitalization (at Oct. 30) of \$88.6 billion or \$21.45 per share. The market is apparently anticipating that the company could suffer an after-tax loss of \$44.5 billion or \$10.78 per share, far worse than the \$27.7 billion pre-tax loss under the stress tests. Even assuming an extended delay in the economic recovery due to COVID, this huge discount to book value seems unjustified.

Earnings Improvement: The Other Half of the Valuation Equation. If the asset and equity book values are true but Wells Fargo cannot generate sufficient profitability to cause its stock to trade above book value that would argue for liquidating or selling the company. Indeed, Wells Fargo's earnings performance this year has substantially lagged its peers, which best explains its stock's poor relative performance this year vs. peers. In light of the collapse in its profitability, investors are apparently questioning whether the company's core franchises have somehow been damaged while it has operated under a regulatory cloud.

Lifting the Asset Cap. In order to restore its profitability, management is now seeking to pull all available levers. Getting the FRB to lift the asset cap would allow the company to begin to grow assets again, which can help offset part of the squeeze on NIM and reduce the efficiency ratio. Over the past two years, since the asset cap was put in place, the company's competitors have grown assets at mid-single digit annual rates, which has allowed them to expand their earnings base and help offset part of this year's decline in NIM and higher loan loss provisions.

Growing NIM Again. While banks have the ability to manage asset quality, changes in NIM are often driven by factors out of their control. This year, as I have already discussed at some length, NIM has been pressured by the downshifting and flattening of the yield curve and also the imperative of granting forbearances to commercial and consumer borrowers whose operations and employment status have been hurt by the pandemic. Assuming that the worst of the pandemic is now behind us, Wells and its peers should benefit from a NIM tailwind, as borrowers regain the capacity to make their payments and the yield curve steepens in response to the improving economic outlook. To the extent that regulatory scrutiny has served to impede Wells Fargo's ability to obtain higher quality assets and low or no cost deposits, its NIM may also benefit from the lifting of the asset cap.

Reducing the Efficiency Ratio. Investors have taken note of the rather sharp increase in Wells Fargo's efficiency ratio (noninterest expense divided by revenues) this year, which has risen to the low 80s from the mid-60s over the past two years. Some of the increase is due to organizational restructuring initiatives, which have kept personnel costs high and raised other costs, such as contract services, other professional services and related expenses, some of which are categorized as other operating losses.

Wells Fargo is making a concerted effort to bring down its noninterest expense. Besides the expenses that will automatically go away when the complications associated with the retail sales practices scandal are resolved, the company is looking for ways to lower its cost base, like reducing its real estate footprint, and reorganizing operations to make do with less staff. In October, the company announced that it was reducing staffing in its commercial banking business by 700 positions and in its fixed income research division, which represents the first wave of layoffs that are expected to be in excess of 10,000 positions.

Still, bringing the efficiency ratio back down to the mid-60s cannot be done entirely by cost cutting. To do so would require annualized cuts of \$10 billion or 17% of total noninterest expense, which is almost certainly not achievable without a major restructuring of operations. Achieving a mid-60s efficiency ratio therefore requires a combination of cost cutting and revenue increases.

Strategic Refocusing on Core Operations. Wells Fargo appears to be doubling down on its consumer banking and lending businesses, where it ranks among the top three nationally, while pursuing niche strategies in businesses, where it believes it can generate acceptable returns with the proper focus. Last week, Bloomberg reported that the company was actively pursuing the sale of its corporate trust and wealth management businesses for a combined price of more than \$4.0 billion.

Stay Tuned. Although Wells Fargo has implemented a new organizational structure, with five business segments instead of three, the company may continue to adjust its business strategy over time. CEO Charles Scharf has indicated that management will provide a more detailed review of the changes completed and underway at Wells Fargo at an investor meeting early in 2021.

Restoring the Dividend. In addition to the normal stress test, the FRB in June of this year conducted a sensitivity analysis to assess the resiliency of large banks under three downside scenarios that could result from the pandemic. Based upon the results of that sensitivity analysis, the Board has ordered large banks to preserve their capital by suspending share repurchases and capping dividend payments according to a formula that limits quarterly dividends to the average net income generated over the four preceding calendar quarters. However, this cap does not restrict the banks from paying the full amount of dividends due on Tier 1 and Tier 2 instruments (e.g. preferred stock).

Based upon this directive, Wells Fargo cut its quarterly common stock dividend from \$0.51 per share to \$0.10 per share in June. The FRB could change or drop this policy at any time. Assuming that this cap remains in place throughout 2021, I calculate that, based upon my 2021 earnings projection, Wells Fargo could increase the quarterly dividend from \$0.10 to \$0.20 in the second half of 2021. That works out to an annual dividend of \$0.80 per share and a payout ratio of 38%.

An annual dividend of \$0.80 per share equates to a 3.7% dividend yield at the current (10/30) share price of \$21.45. After the Fed drops this dividend cap, the company would be free to set its dividend wherever it wants (but it would still be subject to FRB approval). From 2014 to 2018, Wells Fargo's dividend averaged \$1.50 annually and its payout ratio averaged 36.5%. The payout ratio jumped to 47% in 2019 after a big (and in hindsight, temporary) boost in the dividend.

Projections. Here I offer crude projections of WFC's financial performance for 20Q4 and 2021. I plan to refine my projections after it reports 2020 fourth quarter and full results under the new segment reporting format and perhaps after it hosts its upcoming investor meeting, where it will offer a detailed review of its strategy and outlook. This presumably will also coincide with the lifting of the asset cap.

For 20Q4, I anticipate that Wells Fargo will report net income applicable to common stock of \$2.26 billion or \$0.55 per share. My projections assume that NIM will increase by 15 bp sequentially to 2.29% and that the efficiency ratio will ease 3.7 points to 77.0.

For 2021, I project that the company will post earnings applicable to common of \$8.77 billion or \$2.09 per share. Revenues will ease by 0.9% to \$72.2 billion due entirely to a decline in noninterest income. NIM increases by 5 bp to 2.39% and the efficiency ratio improves by 3.3 points to 75.0. I also assume a tax rate of 23.0%, \$500 million of income allocated to noncontrolling interests, \$1.56 billion of preferred dividends and 4.2 billion common shares outstanding.

My 2021 projection assumes only a gradual improvement based upon the assumption that the economic recovery will remain slow for at least the first half of the year. Accordingly, there is upside to my projections, if the economic recovery proves to be stronger than currently anticipated (and also assuming that the company begins to reap the benefits from its strategic reorganization).

My 2021 projection further assumes that the company will increase the quarterly dividend to \$0.20 in the second half of the year.

Table 7

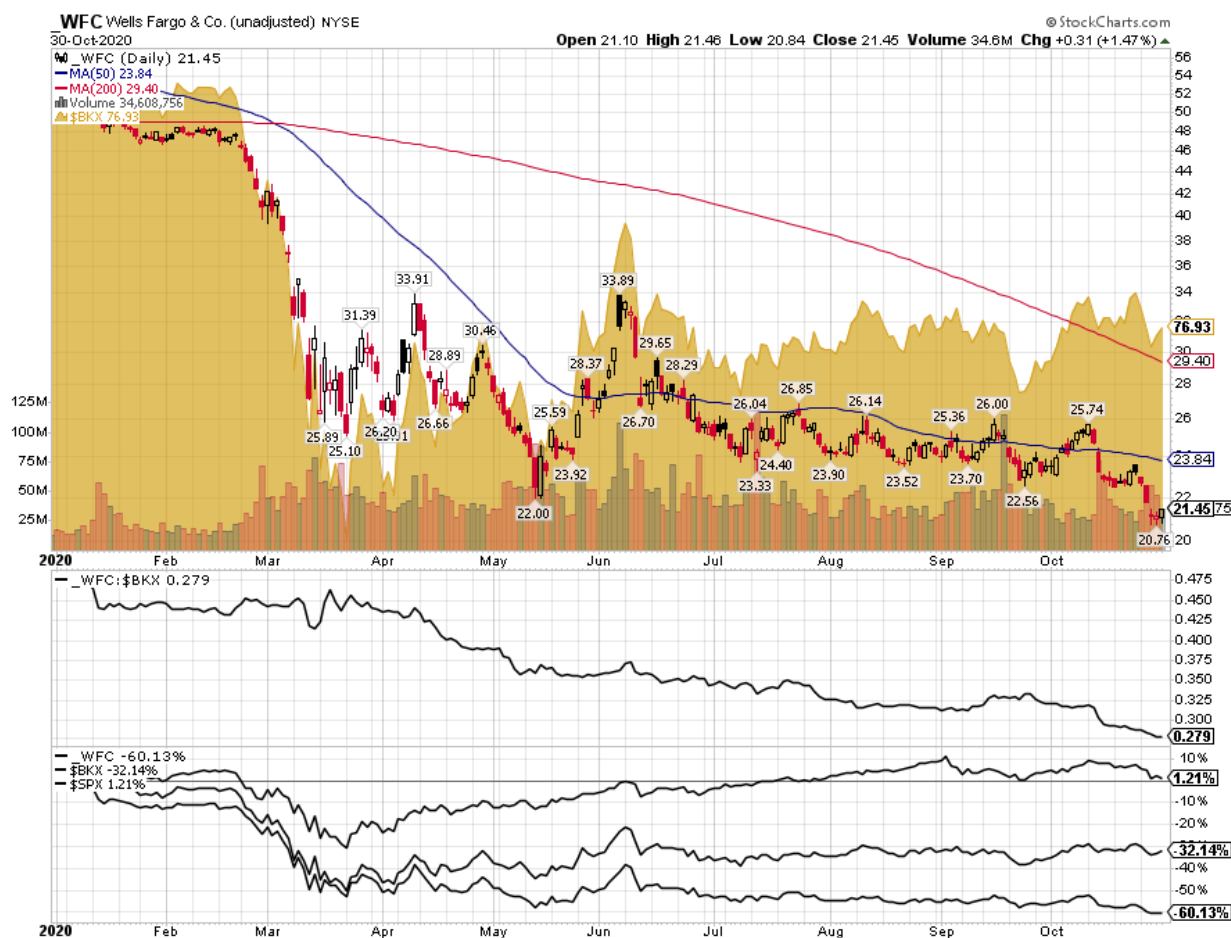
Wells Fargo & Company and Subsidiaries
 Historical and Projected Financial Performance: 2019-2021F
 (in \$millions)

| | 12 Months 31-Dec-19 | 3 Months 31-Mar-20 | 3 Months 30-Jun-20 | 3 Months 30-Sep-20 | 3 Months 31-Dec-20 | 12 Months 31-Dec-20 | 12 Months 31-Dec-21 |
|--|------------------------|-----------------------|-----------------------|-----------------------|-----------------------|------------------------|------------------------|
| Total interest income | 66,083 | 14,727 | 11,801 | 10,800 | 11,300 | 48,628 | 49,441 |
| Total interest expense | 18,852 | 3,415 | 1,921 | 1,432 | 1,841 | 8,609 | 8,199 |
| Net interest income | 47,231 | 11,312 | 9,880 | 9,368 | 9,459 | 40,019 | 41,242 |
| Net interest margin | 2.73% | 2.57% | 2.24% | 2.14% | 2.29% | 2.34% | 2.39% |
| Provision for credit losses | 2,687 | 4,005 | 9,534 | 769 | 800 | 15,108 | 4,000 |
| Net interest margin after credit loss prov. | 44,544 | 7,307 | 346 | 8,599 | 8,659 | 24,911 | 37,242 |
| Noninterest income | 37,832 | 6,405 | 7,956 | 9,494 | 9,000 | 32,855 | 31,000 |
| Noninterest expense | 58,178 | 13,048 | 14,551 | 15,229 | 14,214 | 57,042 | 54,182 |
| Efficiency ratio | 68.4 | 73.6 | 81.6 | 80.7 | 77.0 | 78.3 | 75.0 |
| Income before income tax expense | 24,198 | 664 | (6,249) | 2,864 | 3,446 | 725 | 14,061 |
| Income tax expense | 4,157 | 159 | (3,917) | 645 | 724 | (2,389) | 3,234 |
| Income tax rate | 17.2% | 23.9% | 62.7% | 22.5% | 21.0% | -329.8% | 23.0% |
| Net income before noncontrolling interests | 20,041 | 505 | (2,332) | 2,219 | 2,722 | 3,114 | 10,827 |
| Less: Net income from noncontrolling interests | 492 | (148) | 47 | 184 | 150 | 233 | 500 |
| Wells Fargo net income | 19,549 | 653 | (2,379) | 2,035 | 2,572 | 2,881 | 10,327 |
| Less: Preferred stock dividends and other | 1,611 | 611 | 315 | 315 | 315 | 1,556 | 1,560 |
| Wells Fargo net inc. applic. to common stock | 17,938 | 42 | (2,694) | 1,720 | 2,257 | 1,325 | 8,767 |
| Diluted earnings per common share | \$ 4.05 | \$ 0.01 | \$(0.66) | \$ 0.42 | \$ 0.55 | \$ 0.32 | \$ 2.09 |
| Diluted average common shares outstanding | 4,425.4 | 4,135.0 | 4,105.5 | 4,132.2 | 4,140.0 | 4,187.6 | 4,200.0 |
| Dividends per common share | \$ 1.92 | \$ 0.51 | \$ 0.51 | \$ 0.10 | \$ 0.10 | \$ 1.22 | \$ 0.60 |
| Average yield on earning assets | 3.80% | 3.34% | 2.68% | 2.46% | 2.82% | 2.95% | 2.97% |
| Average cost of funding sources | 1.07% | 0.77% | 0.43% | 0.32% | 0.53% | 0.61% | 0.58% |
| Net interest margin | 2.73% | 2.57% | 2.24% | 2.14% | 2.29% | 2.34% | 2.39% |
| | 31-Dec-19 | 31-Mar-20 | 30-Jun-20 | 30-Sep-20 | 31-Dec-20 | 31-Dec-20 | 31-Dec-21 |
| Cash and cash equivalents | 141,250 | 150,809 | 262,503 | 246,770 | 240,000 | 250,000 | 150,000 |
| Federal funds sold and repos | 102,140 | 86,465 | 79,289 | 69,304 | 70,000 | 80,000 | 85,000 |
| Debt securities | 497,125 | 501,563 | 472,580 | 476,421 | 475,000 | 480,000 | 510,000 |
| Loans | 952,714 | 998,580 | 916,229 | 900,619 | 900,000 | 900,000 | 950,000 |
| Other assets | 234,326 | 243,932 | 238,165 | 229,106 | 230,000 | 230,000 | 255,000 |
| Total assets | 1,927,555 | 1,981,349 | 1,968,766 | 1,922,220 | 1,915,000 | 1,940,000 | 1,950,000 |
| Deposits | 1,322,626 | 1,376,532 | 1,410,711 | 1,383,215 | 1,386,000 | 1,386,000 | 1,425,000 |
| Debt | 332,703 | 329,631 | 291,406 | 270,935 | 260,982 | 279,982 | 245,575 |
| Other liabilities | 84,242 | 91,856 | 86,527 | 86,038 | 84,000 | 90,000 | 90,000 |
| Noncontrolling interests | 838 | 612 | 736 | 859 | 1,000 | 1,000 | 1,000 |
| Preferred stock | 21,549 | 21,347 | 21,098 | 21,098 | 21,100 | 21,100 | 21,100 |
| Common equity | 165,597 | 161,371 | 158,288 | 160,075 | 161,918 | 161,918 | 167,325 |
| Total liabilities and equity | 1,927,555 | 1,981,349 | 1,968,766 | 1,922,220 | 1,915,000 | 1,940,000 | 1,950,000 |

Source: Wells Fargo financial statements and Lark Research calculations and estimates.

Technical Analysis. As shown in the stock chart below, Wells Fargo’s stock reached a new low for the year this past week. At the October 30 price, its shares have lost 60.1% of their value so far this year. That compares with the 32.1% decline in the KBW Bank Stock Index and the 1.2% gain in the S&P 500. The stock has steadily underperformed the KBW Index and the S&P 500 throughout 2020.

Last week’s price action took Wells Fargo’s stock to an eleven-year low, a level not seen since the 2008 financial crisis. Since the stock achieved a new 52-week low last week, I cannot conclude, from a technical point of view, that the stock has bottomed. Typically, technical analysts require evidence before reaching such a conclusion. Such evidence often requires that the stock has formed a base (i.e. traded sideways for some period of time). When the stock rises above this base and then falls to a low that is higher than the previous low (i.e. the stock successfully retests the prior low), most chart watchers would say that there is sufficient evidence to call a bottom.



Source: StockCharts.com.

Yet, stocks do not always form “textbook” bottoms and investors are often called to make decisions without such evidence. Despite the lack of evidence here, the rate of decline in Wells Fargo’s stock has diminished since the onset of the pandemic. Since the stock is now trading at only 67% of its tangible book value and I have concluded from my analysis that it has up to 50% upside from current levels, I believe that there is less downside risk today and that the risk-reward balance favors the upside. Risk tolerant investors who believe, as I do, that the economy is likely to continue to recover should therefore be willing to bet that they will achieve an attractive return on this investment, even if the stock trades lower temporarily (due perhaps to fallout from the U.S. presidential election or other transitory events).

Lark Research ratings methodology:

The **Performance** rating is scaled from 1 to 5, with a rating of 1 indicating "strong outperformance" vs. the broader market and a rating of 5 indicating "significant underperformance" vs. the broader market. The rating anticipates this performance over a 6- to 12-month time frame.

The **Safety** rating is scaled from A to E, with a rating of A indicating the highest safety profile and a rating of E indicating the lowest safety. E rated investments carry the highest risk and face a high probability of significant loss.

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The **Safety** rating is scaled from A to E, with a rating of A indicating the highest safety profile and a rating of E indicating the lowest safety. E rated investments carry the highest risk and face a high probability of significant loss.

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