

MORE MORTGAGE MELTDOWN

6 Ways to Profit in These Bad Times



WHITNEY TILSON
T2 PARTNERS LLC **GLENN TONGUE**

Praise for

MORE MORTGAGE MELTDOWN

"You couldn't ask for better guides than Whitney and Glenn to take you through the tough times. They saw the mortgage meltdown coming and their new book can help get you through it with timely, useful, and sage advice."

— **Joel Greenblatt, Managing Partner, Gotham Capital; author of *The Little Book That Beats the Market* and *You Can Be a Stock Market Genius***

"Two great students of investing explain the great economic debacle and teach us what to do about it."

— **David Einhorn, founder, Greenlight Capital; author of *Fooling Some of the People All of the Time***

"A cogent guide to current financial events and sourcebook with investment case studies for value investing practitioners and aspirants. I strongly recommend that you give it a thorough and careful read."

— **William Ackman, founder, Pershing Square Capital Management, LP**

"With clarity and their typical attention to detail, Whitney and Glenn deftly illustrate key plot lines for our economic horror show. They thankfully offer some hope that all won't be lost when the house lights go up."

— **Steven Romick, Partner, First Pacific Advisors, LLC**

"Whitney and Glenn have done an extraordinary job alerting all who would listen of deep, and in many instances irreversible, perils confronting financial industry investors with exposure to U.S. mortgage industry securities. While most bank analysts busied themselves rearranging deck chairs on our financial *Titanic*, Whitney and Glenn fixed their vision on mortgage industry icebergs. While there is surely enough blame to be spread around as a result of the financial industry's shameful conduct, they deserve credit for speaking out with their early and accurate warnings."

— **Thomas A. Russo, Partner, Gardner Russo & Gardner**

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Front Flap

The housing market has imploded and the stock market has followed suit, with stock portfolios, retirement accounts, and pension funds cut in half. The U.S. economy is reeling from the real estate meltdown and credit crunch. Not stopping at the border, the storm has broadened to Europe, Asia, and beyond throughout 2008 and into 2009. Is there anyone on the planet who has not been touched by this disaster?

Even though we've all been affected by the calamity and have heard no shortage of news about it, it still seems unfathomable and utterly incomprehensible to most people that the actions of certain banks, mortgage companies, and Wall Street firms could bring the economic engine of the world to a grinding halt. Now, for the first time, and in terms everyone can grasp, noted analyst and value investing expert Whitney Tilson, along with his partner Glenn Tongue, explains not only how it happened, but shows that the tsunami of credit problems isn't over. Another even larger wave is yet to come. If you know catastrophe is looming, you can sidestep the train wreck, and even profit, but you need to understand how bad times present opportunity and where to look.

Tilson, a columnist for *Kiplinger's Personal Finance*, featured on *60 Minutes*, and a regular on CNBC, started presenting his findings to everyday people and found them clamoring for more. Now in *More Mortgage Meltdown*, Tilson explains in a clear and understandable way how misguided assumptions, insatiable greed, reckless risk taking, and government inaction led to the creation of the greatest asset bubble in history, the aftermath of which is the perfect economic storm. Then, he shows you why there's still much more pain to come and what we can expect from the ongoing crisis over the next few years.

Finally, *More Mortgage Meltdown* teaches you how to find investment opportunities within the rubble and position your portfolio to take advantage of the crisis. The book uses in-depth case studies of individual companies and stocks to show how to evaluate investments in these uncertain times. You will learn how to spot warning flags in the financial statements of companies that can help you avoid losing your hard-earned money. And you will learn how to spot undervalued businesses with competitive advantages or hidden assets that will likely emerge stronger from the crisis. It is important for all of us to understand how the credit and mortgage crisis happened. Equally important is the chance to potentially profit in its aftermath.

Back Flap

WHITNEY TILSON and **GLENN TONGUE** are the Managing Partners of T2 Partners LLC and the Tilson Mutual Funds. The former firm manages three value-oriented hedge funds while the latter is comprised of two mutual funds, Tilson Focus Fund and Tilson Dividend Fund.

MR. TILSON is the cofounder and Chairman of the Value Investing Congress, a biannual investment conference in New York City and Los Angeles, as well as the investment newsletters *Value Investor Insight* and *SuperInvestor Insight*. He writes a regular column on value investing for *Kiplinger's Personal Finance*, has written for the *Financial Times* and *TheStreet.com*, and was one of the authors of *Poor Charlie's Almanack*, the definitive book on Berkshire Hathaway Vice Chairman Charlie Munger. He was featured on *60 Minutes* in December 2008, was one of five investors included in *SmartMoney's* 2006 Power 30, was named by *Institutional Investor* in 2007 as one of twenty Rising Stars, and appears regularly on CNBC and Bloomberg TV. He received an MBA with high distinction from the Harvard Business School, where he was elected a Baker Scholar, and graduated magna cum laude from Harvard College with a bachelor's degree in government.

MR. TONGUE spent seventeen years on Wall Street prior to joining T2 Partners, most recently as an investment banker at UBS, where he was a managing director specializing in acquisitions and leveraged finance. Before UBS, Mr. Tongue was at Donaldson, Lufkin & Jenrette for thirteen years, the last three of which he served as the president of NYSE-listed DLJdirect, the consistently top-rated online brokerage firm. Prior to DLJdirect, Mr. Tongue was a managing director in the investment bank at DLJ, where he worked on over 100 transactions, aggregating more than \$40 billion. He received an MBA with distinction from the Wharton School of Business and received a Bachelor of Science in electrical engineering and computer science from Princeton University.

Visit www.moremortgagemeltdown.com to ask Whitney and Glenn questions, read their latest thoughts on the companies they analyze in the book, see updated color versions of the book's charts, and much more.

Chapter 13

An Ill-Fated Acquisition?

Case Study: Wells Fargo

Given that we covered our remaining short position in Wells Fargo at around \$10 during the first week of March 2009 – and are now long the stock – you might wonder why we’re writing about it here. There are two answers: first, because when we decided to write this book in early January 2009, it was one of our favorite short ideas because the stock was around \$30 – it’s truly stunning how quickly the stock fell in only two months. Second, because it’s an interesting case study of how a company can be a great short at one time and price, but one that should be covered, or even be a long position, at another time and price.

As the credit crunch deepened over the course of 2008, we profitably shorted a number of banks like Washington Mutual and Wachovia that we believed had not reserved adequately for likely losses. Well Fargo was not on our list because we thought it had a great franchise and that its reserves might be sufficient. However, when it became clear that Wells Fargo would be acquiring Wachovia, we shorted it at around \$30.

Our investment thesis rested on two pillars: first, having been short Wachovia, we thought Wells Fargo was buying some big losses, especially in Wachovia’s option ARM and home equity portfolios. Second, we thought Wells Fargo’s stock price reflected an unrealistically rosy scenario in light of what was happening in the overall mortgage and credit markets. When we first shorted it, the stock was trading at roughly three times and twelve times our estimates for book value and earnings, respectively, at the time, so we thought there was a lot of room for the stock to fall if our investment thesis was correct – and was unlikely to run against us very much if we were wrong. This is precisely the type of “heads-we-win-a-lot, tails-we-don’t-lose-very-much” scenario that make for a good investment, long or short.

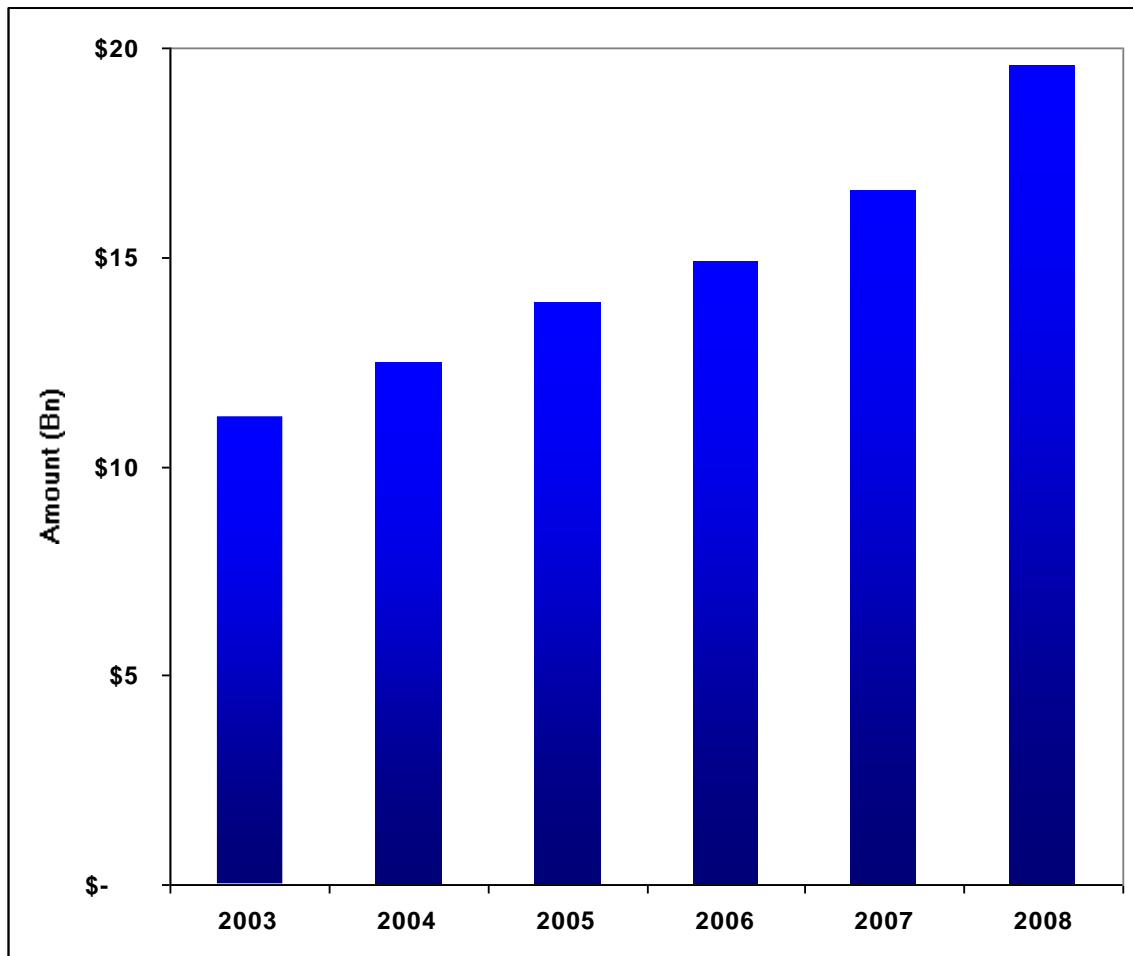
The Bull Case for Wells Fargo

There is much to admire about Wells Fargo. By all accounts it has a great management team and a very strong franchise that will likely become even stronger with the acquisition of Wachovia, which gives it a coast-to-coast presence and propels it to the top, or near the top, of U.S. banks. The combined company is number one in bank branches (6,610), small business lending, middle market commercial lending, agriculture lending, commercial real estate lending and brokerage, and bank-owned insurance brokerage (number five worldwide). It’s also number two in banking deposits in the U.S.

(11.2 percent, a hair behind Bank of America, which has 11.3 percent), mortgage originations and servicing, retail brokerage and debit cards.

Wells Fargo's pre-Wachovia business was highly profitable, earning \$19.6 billion pre-tax in 2008 before provisions for loan losses (which were enormous – net income was only \$2.9 billion; peak net income was \$8.4 billion in 2006). Figure 13.1 shows the dramatic growth over the six years between 2003 and 2008.

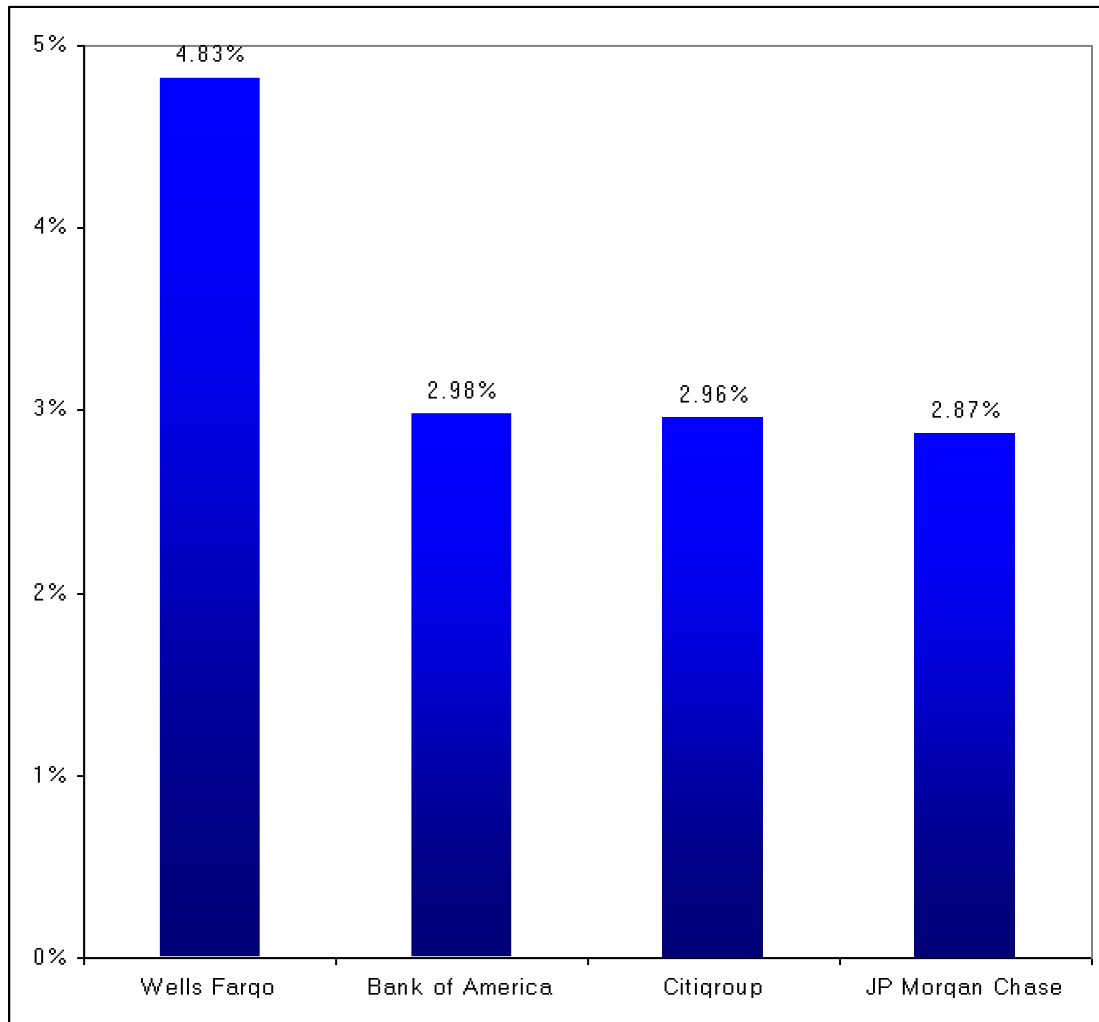
Figure 13.1 Wells Fargo Pretax, Pre-Provision Earnings (2003-2008)



Source: Wells Fargo Q4 08 financial results presentation, 1/28/09, p. 10.

Wells Fargo's robust earnings were primarily driven by the company's net interest margin, which in 2008 vastly exceeded those of its three largest competitors, as shown in Figure 13.2.

Figure 13.2 Net Interest Margin of the Four Largest U.S. Banks (2008)



Source: Wells Fargo Q4 08 financial results presentation, 1/28/09, p. 15.

Wells Fargo not only had higher margins, but was also growing its revenues and pretax, pre-provision earnings faster than its peers, as shown in Table 13.1.

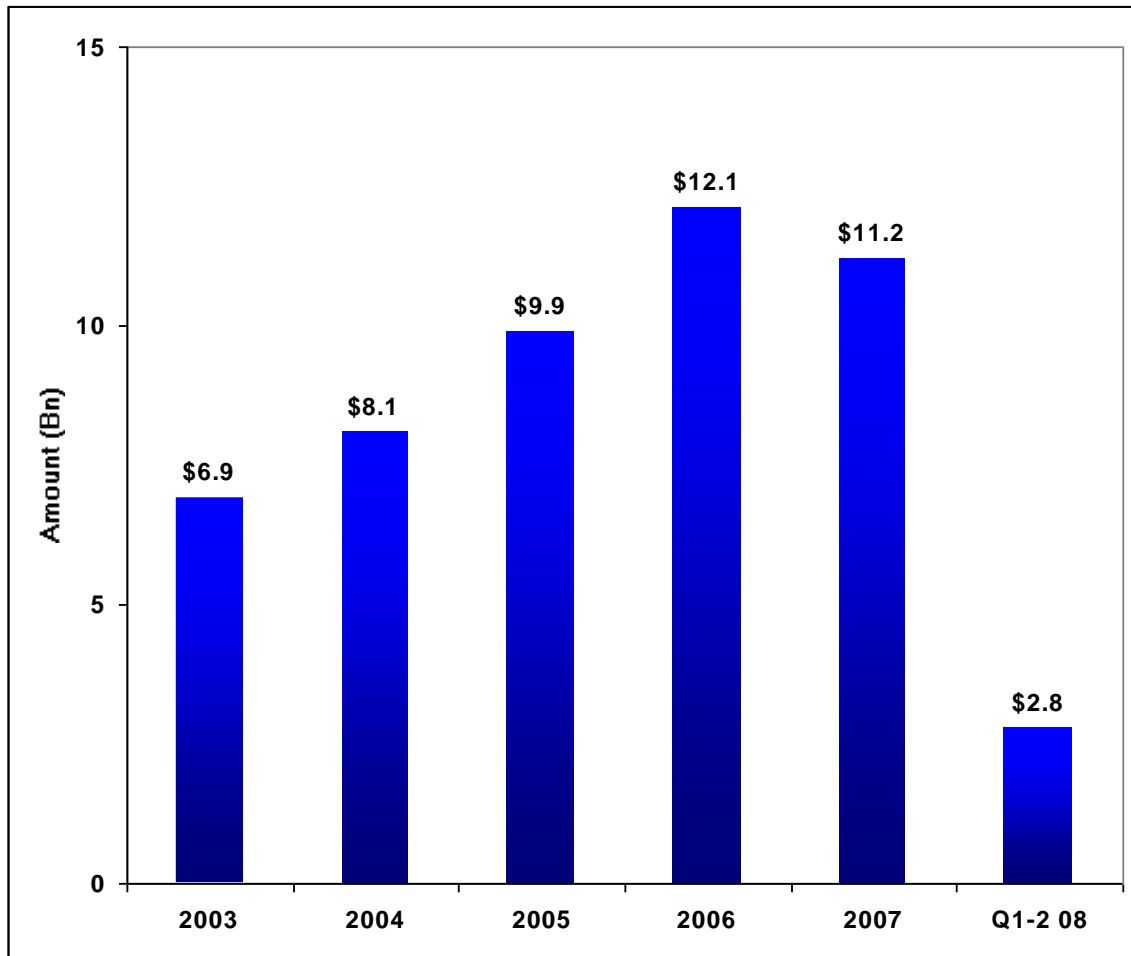
Table 13.1 Growth in Pretax, Pre-Provision Earnings and Revenue

	Pretax, Pre-Provision Earnings Growth		Revenue Growth
	2008	5 Year	2008
Wells Fargo	17.4%	11.3%	6.1%
JP Morgan, Citigroup, BofA	-60.5%	-60.4%	-16.7%
Top 9 Peers	-47.9%	-41.7%	-2.1%

Source: Wells Fargo Q4 08 financial results presentation, 1/28/09.

Turning to Wachovia, Figure 13.3 shows its pretax, pre-provision earnings for the past six years, which are approximately 60 percent of Wells Fargo's.

Figure 13.3 Wachovia Pretax, Pre-Provision Earnings (2003-mid 2008)



Source: Wachovia 10-K 2007 and 10-Q Q3 08.

The combined earnings power of the two companies is enormous. We estimate that with interest spreads at record levels currently, the pretax, pre-provision income of the original Wells Fargo will rise slightly to \$20 billion to \$22 billion in 2009 plus we add \$10 billion to \$12 billion from Wachovia, so that's \$30 billion to \$34 billion. On top of this, Wells Fargo estimates \$5 billion in cost savings and synergies, so let's assume \$4 billion to \$6 billion, for a grand total of \$34 billion to \$40 billion in normalized pretax, pre-provision earnings (it may take a little while to realize the cost savings). This is consistent with what Warren Buffett estimated when he was interviewed by CNBC on March 9, 2009: "I would expect \$40 billion a year pre-provision income."

Buffett added: "And under normal conditions, I would expect maybe \$10-\$12 billion a year of losses." That's 25 to 30 percent of \$40 billion, so applying the same percentage to \$34 billion, that's \$8.5 billion to \$10.2 billion in losses, leaving pretax income of \$23.8 billion to \$25.5 billion. Now subtract 33 percent for taxes and divide by 4.2 billion shares and the result is earnings per share (EPS) of between \$3.78 and \$4.05. The

same calculations at \$40 billion of pretax, pre-provision income, minus \$10-\$12 billion of losses result in EPS of \$4.44 to \$4.76. Any way you cut it, that's a lot of earnings for a stock that closed on March 12, 2009 at \$13.95.

2009 is off to a good start according to CFO Howard Atkins, who made some bullish comments in a press release on March 6, 2009: "Our strong operating results for the first two months of 2009 have been driven by continued growth in lending, deposits and mortgage volumes. Mortgage originations for the first two months alone were \$59 billion, exceeding in two months the exceptionally strong fourth quarter of 2008, and mortgage applications were \$107 billion."¹

Regarding its balance sheet, in the same press release Wells Fargo announced that it was cutting its dividend by 85 percent, which will save the company \$5 billion annually – a very smart move. In another smart move, Wells Fargo was aggressive in booking impairments and taking write-downs in Wachovia's portfolio, as shown in Table 13.2.

Table 13.2 Credit Impairments and Write-Downs Taken By Wells Fargo on Wachovia

Portfolio	Credit Impaired Loan Balance (Bn)	Credit Write-Down (Bn)
Pick-a-Pay mortgages (option ARMs)	\$59.8	\$24.3
Other consumer loans	\$5.1	\$2.8
Commercial real estate	\$20.5	\$7.7
Other commercial loans	\$5.9	\$1.5
Other	<u>\$2.6</u>	<u>\$0.9</u>
TOTAL	\$93.9	\$37.2

Source: Wells Fargo Q4 08 financial results presentation, 1/28/09.

In the March 9th press release, Atkins summarized why Wells Fargo believes that its capital position is strong:

Our capital position, adjusted for risk, is near the top of our peer group. At December 31, 2008, stockholders' equity was \$99 billion with Tier 1 Capital at 7.84 percent – 30 percent above the 6 percent regulatory minimum for well-capitalized banks. Our tangible common equity was \$36 billion, 2.86 percent of tangible assets and 3.32 percent of regulatory risk-weighted assets. These ratios are after significantly reducing the risk in the Wachovia loan and securities portfolios, about half of the combined balance sheet of the new Wells Fargo. By immediately writing down loans and securities at Wachovia through purchase accounting adjustments at close, we have already significantly reduced the risk of loss to tangible common equity. Since these losses have already been recognized, our future earnings will be higher and therefore tangible common equity can now grow faster. Adjusted for the fact that we already accounted for these future losses, our tangible common equity as a percent of regulatory risk-weighted assets would have been 5.2 percent at December 31, 2008.

Buffett certainly thinks Wells Fargo is attractive, but worries about what the government might do. Here's what he said during the March 9th CNBC interview:

Warren Buffett: ...Our stocks we plan to hold a very long time...overall I like to buy them with the idea of owning forever. And the quotes don't make much difference.

¹ Wells Fargo press release, 3/6/09, www.wellsfargo.com/press/2009/20090306_Dividend

Now, if I looked at the performance of Wells Fargo, we'll say, I see that, you know, in a couple years – and management doesn't have anything to do with what I'm saying here – I would expect \$40 billion a year pre-provision income. And under normal conditions I would expect maybe 10 to \$12 billion a year of losses. I mean, you lose money in banking, you just try not to lose too much.

So, you know, you get to very interesting figures. I mean, the spreads are enormous on what they're doing. They're getting the money at bargain rates. So if there were no quote on Wells Fargo and I just owned it like I own my farm, I would look at the way the business is developing, and I would say, you know, “These are a couple of tough years for losses in the banking business, but you expect a couple tough years every now and then.” And that the earning power is...going to be greater by far than it's ever been when you get all through with it.

The only worry in that is the government will force you to sell shares at some terribly low price. And I hope they're wise enough not to do that. That's what's spooking the banking market to a big extent.

Becky Quick, CNBC: You worry about that, too.

Warren Buffett: Yeah, sure.

Becky Quick, CNBC:: That's why you'd like some clarity out of Washington on what they're planning to do...

Warren Buffett: I think clarity is a good thing for the whole country...Any issue to do with people's money, clarity's important. People want to be clear about their money. But I would say that...Wells Fargo, their prospects three years out are better than ever.

To summarize, Buffett loves the stock, it's trading at 3 to 4 times normalized earnings and the company has taken large write-downs for Wachovia, so why isn't every investor buying it? The answer lies in the balance sheet, in particular a minimal amount of equity, which may yet put Wells Fargo in the same dire position as Citigroup.

Wells Fargo's Balance Sheet

Table 13.3 shows Wells Fargo's balance sheet, which includes Wachovia, as it appears in the 2008 10-K. You might think it would be easy to determine Wells Fargo's stockholders' equity, the single most important element of the balance sheet – just read the second-to-last line at the bottom of the balance sheet, right? But it's not so easy. (For more discussion of equity, see the appendix at the end of this chapter.)

Table 13.3 Wells Fargo's Balance Sheet

(in millions)	December 31,	
	2008	2007
ASSETS		
Cash and due from banks	\$23,763	\$14,757
Federal funds sold, securities purchased under resale agreements &	49,433	2,754
Trading assets	54,884	7,727
Securities available for sale	151,569	72,951
Mortgages held for sale (includes \$18,754 and \$24,998 carried at	20,088	26,815
Loans held for sale (includes \$398 carried at fair value at December	6,228	948
Loans	864,830	382,195
Allowance for loan losses	-21,013	-5,307
Net loans	843,817	376,888
Mortgage servicing rights:		
Measured at fair value (residential MSRs)	14,714	16,763
Amortized	1,446	466
Premises and equipment, net	11,269	5,122
Goodwill	22,627	13,106
Other assets	109,801	37,145
Total assets	\$1,309,639	\$575,44
LIABILITIES		
Noninterest-bearing deposits	\$150,837	\$84,348
Interest-bearing deposits	630,565	260,112
Total deposits	781,402	344,460
Short-term borrowings	108,074	53,255
Accrued expenses and other liabilities	53,921	30,706
Long-term debt	267,158	99,393
Total liabilities	1,210,555	527,814
STOCKHOLDERS EQUITY		
Preferred stock	31,332	450
Common stock \$1.67 par value, authorized 6 billion shares; issued	7,273	5,788
Additional paid-in capital	36,026	8,212
Retained earnings	36,543	38,970
Cumulative other comprehensive income (loss)	-6,869	725
Treasury stock 135,290,540 shares and 175,659,842 shares	-4,666	-6,035
Unearned ESOP shares	-555	-482
Total stockholders' equity	99,084	47,628
Total liabilities and stockholders' equity	\$1,309,639	\$575,44

Source: Wells Fargo 2008 10-K.

What we, as investors, care about is Well Fargo's ability to weather the current storm, so we want to focus on tangible common equity – the word “tangible” meaning that it excludes goodwill and other intangibles and the word “common” meaning it only includes common stock, not preferred stock. Intangibles are excluded because, as noted earlier, things like brands don't help cover losses. As for preferred stock, it's a hybrid security that has characteristics of both debt and equity since it typically pays a dividend, but often can also be converted into stock. It's valuable capital in that it can absorb losses and help avert a company going bankrupt, but it's senior to the common stock, meaning the common stockholders usually takes all losses until they're wiped out before the preferred stockholders start to take losses. Therefore, shareholders of Wells Fargo's stock should be most concerned with the amount of tangible common equity.

So we start with stated equity of \$99,084 (all numbers hereafter in millions) and then subtract \$31,332 of preferred stock and \$22,627 of goodwill, for a total of \$45,125 (\$45.1 billion). But wait, there's more.

Due to some odd twist in generally accepted accounting principles (GAAP), mortgage servicing rights (MSRs) appear on the balance sheet. Wells Fargo is in the business of servicing mortgages and the value of this business, based on Wells Fargo's estimate of future profits, appears as an asset. This makes no sense as this is clearly an intangible asset – in fact, the Financial Accounting Standards Board (FASB) defines *all* servicing rights as intangible assets. So, \$45,125 minus \$14,714 of “Measured at fair value (residential MSRs)” and \$1,446 of “amortized MSRs” results in tangible common equity of \$28,965 (\$29.0 billion).

We're not done yet, however. Wells Fargo has “Other assets” of \$109,801 and when one reads the footnotes in the 10-K, one sees that the company has buried some intangible assets in this line rather than breaking them out separately. Table 13.4 appears in Note 7 of Wells Fargo's 2008 10-K.

Table 13.4 Wells Fargo's Other Assets

(in millions)	December 31,	
	2008	2007
Total nonmarketable equity investments	\$16,782	\$6,930
Operating lease assets	\$2,251	\$2,218
Accounts receivable	\$22,493	\$10,913
Interest receivable	\$5,746	\$2,977
<i>Core deposit intangibles</i>	<i>\$11,999</i>	<i>\$435</i>
<i>Customer relationship & other intangibles</i>	<i>\$3,516</i>	<i>\$319</i>
Foreclosed assets:		
GNMA loans	\$667	\$535
Other	\$1,526	\$649
Due from customers on acceptances	\$615	\$62
Other	\$44,206	\$12,107
TOTAL OTHER ASSETS	\$109,801	\$37,145

Source: Wells Fargo's 2008 10-K, Note 7, page 110.

The two lines in italics, “core deposit intangibles” and “customer relationship & other intangibles,” totaling \$15,515 (\$15.5 billion) also need to be subtracted in the calculation of tangible common equity, so \$28,965 - \$15,515 = \$13,450 (\$13.5 billion). (Incidentally, note the huge rise to \$44.206 billion of “other,” up from \$12.1 billion the previous year. A sum this large should be broken down and described in detail, but it’s not. Such a big increase almost certainly has to do with the Wachovia acquisition and part of it could be intangibles as well.)

Phew! All done, right? Nope. One more step. Once a year, accounting rules (specifically FAS 107, “Disclosures about Fair Value of Financial Instruments”) require companies to report “fair value estimates...for financial instruments...for which carrying amounts approximate fair value, and excluding financial instruments recorded at fair value on a recurring basis.”² In the case of Wells Fargo, FAS 107 requires the company to value the loans on its balance sheet (as well as certain other assets and liabilities) at market value, rather than simply carrying them at par, which it normally does unless a write-down is taken. Companies are often slow to take write-downs, so FAS 107 can provide insight into this. Table 13.5 shows a table that appears in Note 17 of Wells Fargo’s 2008 10-K

Table 13.5 FAS 107: Disclosures about Fair Value of Financial Instruments

	December 31,		December 31,	
	2008	2008	2007	2007
(in millions)	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
FINANCIAL ASSETS				
Mortgages held for sale	\$1,334	\$1,333	\$1,817	\$1,817
Loans held for sale	\$5,830	\$5,876	\$948	\$955
Loans, net	\$843,817	\$829,603	\$376,888	\$377,219
Nonmarketable equity investments (cost method)	<u>\$11,104</u>	<u>\$11,220</u>	<u>\$5,855</u>	<u>\$6,076</u>
TOTAL	\$862,085	\$848,032	\$385,508	\$386,067
Difference		-\$14,053		\$559
FINANCIAL LIABILITIES				
Deposits	\$781,402	\$781,964	\$344,460	\$344,484
Long-term debt	<u>\$267,055</u>	<u>\$266,023</u>	<u>\$99,373</u>	<u>\$98,449</u>
TOTAL	\$1,048,457	\$1,047,987	\$443,833	\$442,933
Difference		-\$470		-\$900
NET DIFFERENCE		-\$13,583		\$1,459

Source: Wells Fargo’s 2008 10-K, Note 17, page 143.

² Wells Fargo’s 2008 10-K, Note 17, page 143

We can see that in 2007, there was virtually no difference between the carrying amount and estimated fair value for either financial assets or liabilities, but it was quite a different story in 2008. In particular, Wells discloses that the \$843.8 billion of loans held on its balance sheet have a fair (i.e., market) value of only \$829.6 billion, \$14.2 billion less. (Note that fair value is determined by the company, which has obviously has strong incentives to estimate as high of a number as possible.)

Calculating the differences across all FAS 107 financial assets and liabilities results in a net difference in 2008 of fair value being \$13,583 lower than what Wells Fargo reports on its balance sheet – quite a difference from 2007, when it was \$1,459 higher.

So this is the final adjustment we make to Wells Fargo's equity: \$13,450 minus the FAS 107 adjustment of \$13,583 results in the company having adjusted tangible common equity of *negative* \$133 million!

Reasonable people would argue whether this means that Wells Fargo is insolvent, but there's no question that the company has virtually no cushion on its current balance sheet to withstand future losses beyond its \$21.7 billion provision for credit losses. To see whether this provision is likely to be sufficient, let's now analyze the company's potential losses.

Losses

Wells Fargo, to its credit, did not become involved to any meaningful degree in toxic securitized products, as did so many of its peers, so the analysis of possible losses focuses on the loans Wells Fargo holds on its balance sheet. Table 13.6 shows the breakdown of Wells Fargo's \$864.8 billions of loans (including Wachovia's book) as of yearend 2008, with our range of loss estimates for each category, discussed further below.

Table 13.6 Loan Portfolio With Estimated Losses

	Wells Fargo <u>12/31/08 (Bn)</u>	Estimated Range of Cumulative <u>Losses (%)</u>	Estimated Range of Cumulative <u>Losses (Bn)</u>
Commercial and commercial real estate:			
Commercial	\$202		
Other real estate mortgage	\$103		
Real estate construction	\$35		
Lease financing	\$16		
Total commercial and commercial real estate	\$356	5 - 10%	\$18 - \$36
Consumer:			
Real estate 1-4 family first mortgage - Option ARM*	\$95	6 - 40%	\$6 - \$39
Real estate 1-4 family first mortgage	\$153	5 - 10%	\$8 - \$15
Real estate 1-4 family junior lien mortgage	\$110	10 - 15%	\$11 - \$17
Credit card	\$24	7 -12%	\$2 - \$3
Other revolving credit and installment	\$93	7 -12%	\$7 - \$11
Total consumer	\$475		
Foreign	\$34	3 - 10%	\$1 - \$3
TOTAL LOANS	\$865		\$52 - \$124

Source: Wells Fargo Q4 08 release, 1/28/09, page 25; T2 estimates.

*Note: We break out option ARMs separately from “Real estate 1-4 family first mortgage,” using the table on page 38. Also, the \$6 billion to \$39 billion of estimated option ARM losses are in addition to the \$24.3 write-down taken to date.

While it’s virtually impossible to estimate losses on such a large and complex loan book, based on the data and trends analyzed in the first half of this book, we are able to make some estimates, especially in the consumer loan area.

Option ARMs

Let’s start with option ARMs. Table 13.7 appears on page 38 of Wells Fargo’s Q4 08 earnings release, reflecting Wachovia’s “Pick-a-Pay” portfolio (its name for option ARMs; to its credit, Wells Fargo never wrote a single one of these toxic loans).

Table 13.7 Pick-a-Pay (Option ARM) Loan Portfolio

December 31, 2008						
	Non-SOP 03-3 loans			SOP 03-3 loans		
			Balance prior to non- accretable	Current LTV ratio	Carrying amount	Ratio of carrying amount to current value
(in millions)	<u>Outstanding balance</u>	<u>Current LTV ratio</u>	<u>discount</u>	<u>LTV ratio</u>	<u>amount</u>	<u>current value</u>
California	\$28,107	86%	\$42,650	133%	\$25,472	85%
Florida	\$6,099	89%	\$5,992	119%	\$3,439	76%
New Jersey	\$3,545	74%	\$1,809	94%	\$1,246	60%
Texas	\$2,231	61%	\$562	72%	\$385	49%
Arizona	\$1,449	95%	\$1,552	133%	\$895	85%
Other states	\$16,269	75%	\$9,381	92%	\$6,178	61%
TOTAL	\$57,700		\$61,946		\$37,615	

Source: Wells Fargo Q4 08 earnings release, 1/28/09, page 38.

What this table is showing us is that Wells Fargo, when it acquired Wachovia, went through its \$119.6 billion option ARM portfolio, separated the best \$57.7 billion into a non-credit impaired portfolio and put the remaining \$61.9 billion of risky/defaulted loans into a credit-impaired portfolio (labeled “SOP 03-3 loans”). Then, it wrote down the credit impaired loans by \$24.3 billion, leaving \$37.6 billion. Thus, Wells Fargo’s total option ARM portfolio as of yearend 2008 was \$57.7 billion plus \$37.6 billion = \$95.3 billion. Of these loans, 56 percent are in California and 10 percent are in Florida.

The \$57.7 billion of non-credit impaired loans are performing extremely well so far, with only 0.10 percent having missed even one payment and a loan-to-value of 80 percent based on November 2008 home prices. This sounds impressive until one considers that by definition this portfolio will be performing exceptionally well –because Wells Fargo cherry picked only performing loans to be part of it!

As we showed in Chapter 4, option ARMs are defaulting at catastrophic rates, but that’s driven almost entirely by the loans that have hit their resets – before then, roughly 80 percent of the borrowers are paying only the ultra-low teaser rate, so very few will default no matter what the LTV is. Wells Fargo doesn’t disclose what percentage of its non-credit impaired loans have hit their reset (our bet: almost none), nor what percentage are negatively amortizing (our bet: the vast majority).

Wells Fargo tried to put lipstick on this pig during its Q4 earnings call when it said: “We do believe that Wachovia’s option ARM portfolio, or Pick-a-Pay, is the highest-quality option ARM portfolio in the industry.” To us, that’s like claiming to be the best downhill skier in Somalia.

And while it might appear that Wells Fargo was very conservative in writing down Wachovia's option ARMs by \$24.3 billion, or 20.3 percent, we think more losses are in store. In Chapter 4, we estimated that of all option ARMs ever written (Wachovia had roughly one-sixth of them), 70 percent would default with 60 percent severity, resulting in 42 percent losses. If we give Wells Fargo the benefit of the doubt and assume that 50 percent of the original \$119.6 billion will default with 50 percent severity, that's a 25 percent loss or \$29.9 billion, \$5.6 billion more than the write-down Wells Fargo has taken to date. But we wouldn't be surprised to see 70 percent default with 70 percent severity, a 49 percent loss or \$58.6 billion, \$34.3 billion more than the write-down taken to date.

Home Equity Portfolio

Our second-biggest area of concern is Wells Fargo's home equity portfolio, which grew by approximately \$55 billion (more than 50 percent) with the acquisition of Wachovia. Here's some data on the portfolio, as disclosed on page 37 of the Q4 earnings release and during the January 28, 2009 conference call:

- The combined portfolio as of yearend 2008 was \$129.5 billion;
- Wells Fargo categorized \$10.3 billion (8 percent) as the "liquidating portfolio," similar to the option ARM credit impaired portfolio;
- 76 percent of the liquidating portfolio and 40 percent of the core portfolio (43 percent overall) has a combined loan-to-value above 90 percent, a worrisome level given how rapidly home prices are falling, especially in Wells Fargo's two biggest home equity loan markets, California and Florida;
- 27.5 percent of the loans are in California and 9.5 percent are in Florida, a total of 37 percent, a *very* worrisome level;
- Only 15 percent of the loans are first lien; the remaining 85 percent are second lien, meaning that upon default, severity will likely approach 100 percent; and
- 2.48 percent of the loans were two or more payments past due as of yearend 2008 and the annualized loss rate is 2.87 percent, both good numbers (assisted by Wachovia's 1.62 percent and 1.84 percent figures, respectively), but the delinquency trend is rising.

In Chapter 4, we estimate that home equity loan losses across the entire \$1.1 trillion outstanding will ultimately be 15 to 25 percent. Again, if we give Wells Fargo the benefit of the doubt and assume its losses will be 10 to 15 percent and only apply this to the \$110 billion of second lien home equity loans, that's \$11 billion to \$17 billion in losses.

First Lien Mortgages

Wells Fargo has \$153 billion of first lien mortgages (excluding option ARMs), of which \$18.7 billion are home equity loans. 21 percent of the \$153 billion are in California and 11 percent are in Florida, for a total of 32 percent. It's difficult to estimate the possible losses here because Wells Fargo doesn't break out delinquencies for this segment, nor do we know how many are jumbo loans, but we'd guess they comprise the majority of the California and Florida loans, given how high home prices got in those states (also, if they weren't jumbo loans, Wells Fargo would probably have sold them to the government-sponsored enterprises [GSEs], Fannie and Freddie).

In Chapter 4 we estimated that all prime loans will show 5 to 10 percent losses and jumbo price will have 7 to 12 percent losses, so let's use the low end for Wells Fargo, 5 to 10 percent. Applied to a \$153 billion portfolio, that's \$8 billion to \$15 billion in losses.

Other Consumer Loans

Based on our knowledge of the credit card industry, we estimate that Wells Fargo's credit card, other revolving credit and installment loan portfolio will incur losses in the 7 to 12 percent range, equal to \$9 billion to \$14 billion.

Commercial and Commercial Real Estate

It's difficult to estimate what the losses might be for Wells Fargo's \$356 billion of commercial and commercial real estate loans, which account for 41 percent of the company's total loan book. The only area for which the company provides meaningful disclosure is in commercial real estate and construction, where the original Wells Fargo had \$68 billion in outstanding loans with a 0.55 percent annualized charge-off rate in Q4 08, more than double the previous quarter's 0.27 percent and eight times the 0.07 percent in Q4 07. Wachovia's \$70 billion portfolio was showing much greater stress, with a 5.92 percent annualized charge-off rate in Q4 08, more than double the previous quarter's 2.64 percent and five times the 1.09 percent in Q4 07.

Commercial real estate, to which Wells Fargo has \$103 billion of exposure, is going to be an enormous train wreck, but actually losses and charge-offs to date remain quite low primarily because the loans typically don't reset for at least five years, so the bad loans written during the peak bubble years of 2005-07 haven't reset and therefore banks can hold them at or near par.

Real estate construction loans, to which Wells Fargo has \$35 billion of exposure, will likely be an even bigger train wreck.

In total, we estimate that Wells Fargo will have 5 to 10 percent losses across its commercial and commercial real estate loan book, which translates into another \$18 billion to \$36 billion in losses.

Conclusion

In total as noted in Table 13.6, we estimate that Wells Fargo will incur \$52 billion to \$124 billion of losses on its \$865 billion loan book, or 6 to 14 percent. Even the low end is more than double Wells Fargo's \$21.7 billion provision for credit losses, so in light of the company having little or no real equity, does this mean we think Wells Fargo is likely to meet the same fate as Citigroup? Not necessarily. Allow us to explain.

Wells Fargo is currently in a race for its life. Its losses are digging a hole every quarter, which will continue for the foreseeable future, so Wells Fargo's challenge is to earn profits fast enough to fill the hole before it engulfs the company. We think it's likely to do so, which is why we now own the stock. It's going to be a close call, however, which is why it's not a very big position – there's still a real possibility of a bad outcome.

Everything hinges on how quickly the losses come in and how much money Wells can earn. The \$21.7 billion provision for credit losses provides a bit of a cushion, which Wells Fargo said during its January 28, 2009 conference call “covers 12 months of estimated losses for consumer loans and at least 24 months for commercial loans.” We think that's optimistic, but it still underscores the good news for the company that its loans will take time to default. Unlike toxic securitized finance products like RMBSs and CDOs, which have to be marked down very quickly, actual loans take time to season and companies have some leeway as to when they take charge-offs and recognize losses. For example, Wells Fargo is aggressively working with many at-risk homeowners and businesses to modify loans and reduce the chances of default. In a race against time, it's critically important that Wells Fargo have these tools at its disposal.

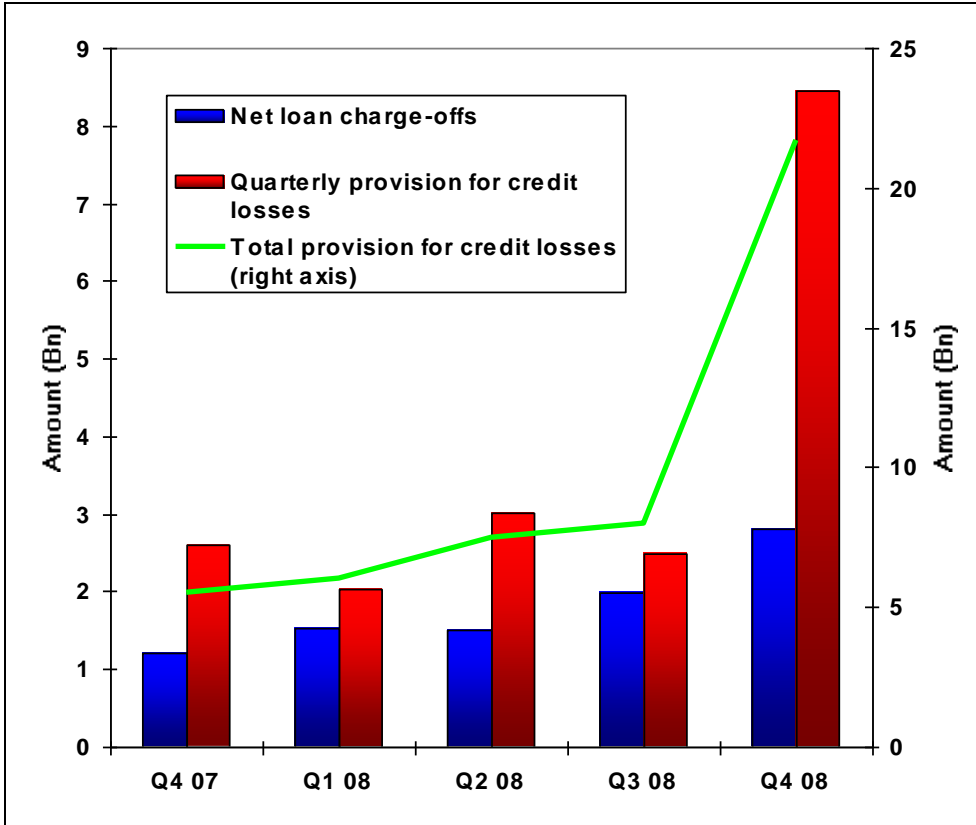
Another plus is that Wells Fargo's management finally seems to have awakened to how perilous the situation really is, which led it to slash the dividend and even more aggressively cut costs.

As we showed at the beginning of this chapter, Wells Fargo is generating pretax, pre-provision earnings of approximately \$30 billion to \$34 billion annually (\$7.5 billion to \$8.5 billion per quarter) even before \$5 billion in cost cuts and synergies kick in, which will likely boost this to \$10 billion per quarter.

When combined with the \$21.7 billion provision for credit losses, are these profits enough for Wells Fargo to keep ahead of the \$52 billion to \$124 billion of losses to come? We think it's likely, but it depends on the level of profits and losses and, equally importantly, their timing. If big losses materialize quickly but profits are weaker than we expect, Wells Fargo will be in big trouble.

Figure 13.4 shows Wells Fargo's net loan charge-offs and its provision for credit losses for each of the past five quarters. The good news is that the loan charge offs in every quarter are lower than the credit losses being taken, meaning the company is building its total provision for credit losses, especially in the fourth quarter of 2008 when it took a huge charge to boost its reserves upon acquiring Wachovia.

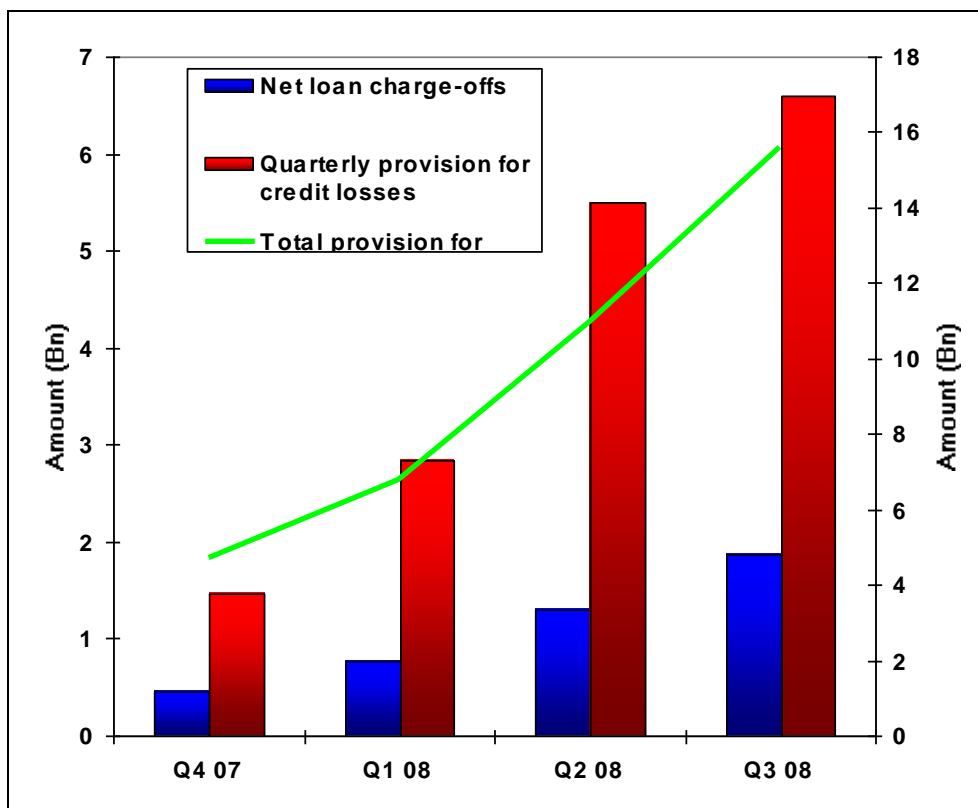
Figure 13.4 Wells Fargo (pre-Wachovia) Quarterly Net Loan Charge-Offs and Provision for Credit Losses, and Total Provision for Credit Losses



Source: Wells Fargo Q4 08 release, 1/28/09, page 27.

Figure 13.5 shows the same data for Wachovia over the same period (excluding Q4 08 due to the acquisition).

Figure 13.5 Wachovia Quarterly Net Loan Charge-Offs and Provision for Credit Losses, and Total Provision for Credit Losses



Source: Wachovia 10-Q Q3 08, p. 33.

Note how Wachovia massively increased its provision for credit losses in its last two quarters of existence, far above the increase in loan charge-offs. This was a desperate – and ultimately unsuccessful – attempt to catch up from prior periods of under-reserving and stave off distress. By Q3 08, it had built its total provision for credit losses to \$15.6 billion, but investors judged this inadequate and crushed the stock, forcing Wachovia into the arms of Wells Fargo. (It turns out that investors were right, given that Wells Fargo took \$37.2 billion in write-downs upon acquiring Wachovia, as shown earlier in Table 13.2.)

Now we have the information to estimate what the combined company's quarterly loan charge-offs and provision for credit losses for might be. We can see that Wachovia's loan charge-offs were rising rapidly before it was acquired. Assuming that these trends in Wachovia's loan book continue, quarterly loan charge-offs might be \$3 billion in Q1 09, rising to \$4 billion by the end of 2009 and then stabilizing, so to keep ahead of this, let's assume that Wells Fargo will want to take a \$4 billion provision for credit losses in Q1 09 and then increase this to \$5 billion by the end of 2009.

Coincidentally, Wells Fargo's loan losses prior to the acquisition were running at a similar pace, so let's assume its charge-offs and credit losses rise at a similar pace. This would imply that the combined company's quarterly provision for credit losses would be \$8 billion in early 2009, rising to \$10 billion by the end of the year.

As high as this is, it is almost precisely matched by the \$8 billion to \$10 billion of quarterly pretax, pre-provision profits we expect Wells Fargo to earn, so its current \$21.7 billion cushion would see little impairment and the company would likely make it through the storm. As noted earlier, however, if some combination of weaker profits and higher losses occurs, Wells Fargo might end up a ward of the government, like Citigroup.

In summary, we think if Wells Fargo makes it through the storm without significant dilution of its shareholders, perhaps a 70 percent likelihood in our estimation, it will earn \$4 to \$5 per share, which would translate into a \$40 to \$60 stock. That kind of upside offsets the very real downside risk and makes the risk-reward equation highly favorable when the stock is in the \$10 to \$15 range, which is why we now own it.

Appendix: Background on Equity

The single most important figure on a balance sheet is equity. Mathematically, assets are equal to liabilities plus equity ($A=L+E$) – that’s why it’s called a balance sheet: assets must balance liabilities plus equity. Another way to think about equity is that it’s the amount by which assets exceed liabilities ($E=A-L$). Thus, equity is a measure of financial strength: a company with \$100 billion in equity (like Berkshire Hathaway) is financially stronger than a company like Resource America, which has \$141 million in equity, because Berkshire has a \$100 billion asset cushion above all of its liabilities to withstand such shocks to the business as a loss of assets (writing down inventory, for example) or an unexpected jump in liabilities (e.g., insurance claims from a big hurricane).

From a shareholder’s perspective, equity is both good and bad. It’s good because it provides a company with protection against unexpected calamities such as the economic environment we’re currently experiencing. Companies of all sorts, not just financial institutions, that have lots of equity will weather this storm and may even profit from it by being able to take market share from or acquire weaker competitors.

But equity also represents shareholders’ capital that’s tied up in the business – that’s why its full name is “stockholders’ equity” (it’s also known as “book value”). But as an investor, I don’t want my capital tied up in a business – I’d prefer that the business use as little capital as possible because that increases the return on equity and lets me keep more of my capital so that I can invest it elsewhere.

Pretty much every business requires a certain amount of equity to operate, but above a minimum level, boards and management teams have a great deal of latitude as to how to capitalize a business, which raises tough questions with no clear answers. For example, if a company is profitable over time and accumulates a lot of cash, should it hold onto the cash in case a recession hits or a juicy acquisition target comes along, or should the company return the capital to shareholders in the form of dividends or share repurchases, thereby reducing its equity? Shareholders generally love dividends and share repurchases, but consider how many companies returned billions in cash to shareholders only a year or two ago and are now desperately in need of capital amid the current crisis.

The reason this is important is that the U.S. (and world) financial system is on its knees is because most companies don’t have enough equity to withstand the losses that are occurring. Even using generous definitions of equity, Wall Street firms were levered 25 to 1 and even up to 35 to 1, meaning their assets were 25 to 35 times as large as their equity – and banks weren’t far behind. For example, in its March 6th press release, Wells Fargo noted that its Tier 1 capital (the most generous equity-like measure) was at 7.84 percent. While that was “30 percent above the 6 percent regulatory minimum for well-capitalized banks,” according to Atkins, it’s still 12.8 times leverage. And if you use tangible equity rather than Tier 1 capital, the leverage jumps to 35 to 1! (Of course, Wells Fargo’s leverage is infinite if you use our calculations that show its equity is

negative.) Wells Fargo, like most financial institutions, is highly leveraged and has little margin for error.

Goodwill and Intangible Assets

It's not just the dollar amount of equity that matters – it's often more important exactly what are the assets and liabilities that determine the equity. In some cases, a company's assets aren't worth what they're carried on the books for or it has hidden liabilities, both of which would make actual equity lower than reported.

The most important adjustment that often needs to be made to equity is to subtract intangible assets, the largest of which is usually goodwill, which is created when a company acquires another for more than its asset value. For example, imagine a company paid cash to acquire Coca Cola for its current market capitalization of \$95 billion. Coke has \$16 billion of tangible book value, so the acquirer would see its cash balance go down by \$95 billion and it would take Coke's assets and liabilities onto its own balance sheet. Because Coke's tangible assets exceed its liabilities by \$16 billion, this would offset the decline in cash, resulting in a \$79 billion decline on the asset side of the acquirer's balance sheet.

This presents an accounting quandary, however. Remember, $A=L+E$. Assets just went down by \$79 billion net, so the equation is no longer in balance. Should the acquirer be required to write down its equity by \$79 billion as a reflection of the fact that it grossly overpaid for Coke? Think about it: why would someone buy Coke for more than its tangible assets? The obvious answer is that Coke's value is not embedded in its cash, receivables, inventory, trucks, computers, buildings and all other assets that appear on its balance sheet. Rather, by far its most valuable asset is its brand, which has been built, cultivated and nurtured by the company since its inception in 1892. It's the brand that, more than anything, that allowed the company to earn nearly \$6 billion in profits in 2007 and 2008, which in turn justifies the \$95 billion market cap (as of March 12, 2009).

So the acquiring company is paying \$79 billion above the tangible asset value for Coke's intangible assets. To resolve the accounting quandary and balance the balance sheet, therefore, the acquiring company would add \$79 to its balance sheet on a line under assets called "Goodwill."

There are other types of intangible assets, which usually appear on a separate line under assets on the balance sheet called "Intangible assets" or "Other intangible assets." For example, imagine a pharmaceutical company that buys a patent from another company for \$1 billion, giving it the right to produce a lucrative drug. In this case, the acquirer's cash would go down by \$1 billion and intangible assets would go up by \$1 billion.

When calculating a company's financial strength, many analysts exclude goodwill and other intangibles primarily because if a company runs into trouble, its intangible assets are likely worth little or nothing, whereas its tangible assets like cash, receivables, inventory and even sometimes property, plant and equipment can be monetized to, say, pay off debt.