Outstanding Investor Digest

Volume VII Numbers 9 &10
November 25, 1992

In recent months, market prices of financial services businesses have reverted to 2009 distressed levels. As in the early 1990s, investors are avoiding the sector. Please find Bruce Berkowitz's interview with *Outstanding Investor Digest* from November 1992. We believe that you may find the analysis informative of today's market situation and current value investment opportunities.

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Outstanding Investor Digest

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Investors featured in this Issue:

Other Investors in this Issue:

Companies & Investments in this Issue

Volume VII Numbers 9 & 10 November 25, 1992

PETER LYNCH, FORMERLY OF FIDELITY MAGELLAN,
& BAUPOST GROUP'S SETH KLARMAN
"GUESS WHAT? WE ALWAYS MAKE IT OUT OF RECESSIONS,
BUT BEWARE THE REAR VIEW MIRROR."

Before retiring in 1990 to spend more time with family and other interests, Peter Lynch directed Fidelity Magellan to the best record among all mutual funds for the preceding dozen calendar years — compounding shareholder equity at over 30% per year vs. 16.7% for the S&P 500.

We're pleased to bring you the following comments by

(continued on page 2)

AN OID INTERVIEW WITH TWEEDY, BROWNE'S
CHRIS BROWNE, WILL BROWNE, JIM CLARK & JOHN SPEARS
"WE'RE FINDING OPPORTUNITIES ABROAD.
IT'S LIKE 1974 OR 1982 ALL OVER AGAIN...."

As one of Warren Buffett's "Super Investors of Graham and Doddsville," Tweedy, Browne has a track record to match. For example, during the 33 years ended December 31, 1991, TBK Partners achieved a compound return of 19.7% per year versus 10.5% per year for the S&P 500.

Interestingly, their occasional foray into non-U.S. stocks from 1983 to 1991 was even more rewarding — with their average return on those stocks approximately 31% per year.

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BARON CAPITAL MANAGEMENT'S RON BARON
"I LOVE TO UNDERSTAND WHAT MAKES BUSINESSES TICK
AND TOKOS MEDICAL IS QUITE A TICKER...."

Ron Baron founded Baron Capital Management in 1983 — the year small-cap stocks began a stint in the doghouse. Despite that unfortunate coincidence, however, and what Baron terms "the worst year of his career" in 1990, he's still outperformed all of the major indices — earning a compound annual return of 17.8% versus 11.1% for the Russell 2000 and 17.2% for the S&P 500.

Unaudited returns for his managed accounts going back

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BRUCE BERKOWITZ AND MARK COOPER
WELLS FARGO REVISITED
"A PHENOMENAL CASE STUDY —
THE NUMBERS ARE RIGHT OUT ON THE TABLE...."

In past issues, we've brought you contributors pounding the table on Wells Fargo — Robert Noel in October 1990 (at \$41) and, more recently, Bruce Berkowitz in November 1991 (in the mid-\$60s).

Therefore, when Wells' stock price recently retreated back to the mid-\$60s (in fact, it got to \$61-1/4) and Buffett reported continuing purchases, we thought you might enjoy an in-depth update on the company and its prospects from

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WELLS FARGO
(cont'd from page 1)

two contributors whose views we've found consistently on the mark who've studied Wells and made it a core position.

First, Bruce Berkowitz is a financial consultant and portfolio manager at Shearson Lehman Brothers who's rung the bell at appropriate times in the past for Salomon, Freddie Mac and Fund American — for all the right reasons. And, incidentally, his unaudited track record reflects it. Mr. Berkowitz's views are not necessarily those of his firm.

Your editor consistently find his views both worthwhile and entertaining. And we hope you will, too:

I CAN SEE WELLS' FUTURE SO CLEARLY: A $200 TO $300 STOCK WITHIN SEVERAL YEARS....

OID: Last year, you told us that Wells Fargo was a screaming bargain in the mid-$60s. It's back in that price range. Are you buying it again?

Bruce Berkowitz: Sure. And if it keeps declining, I may make it my only position. It's absolutely incredible.

OID: So you think it's a bargain.

Berkowitz: How'd you know?

OID: Call it intuition. Why do you like it?

Berkowitz: I can see it at $200 or $300 a share.

OID: One of the better reasons — if you're right. But during our lifetime?

Berkowitz: Absolutely. I'm starting to feel about Wells the way I felt about Salomon at $21, Fund American at $30 and Freddie Mac at $11 or $12.

And you know what the sign is? The greatest sign in the world is when everyone agrees, but they think they can call the turn. A lot of people think that they can do that with Wells Fargo. That's why they're not there. Lots of people are bullish on Wells Fargo long-term. But lots of them are going to wake up one day and just find that they missed it.

Of course, someone who *is* there is Warren Buffett. I see that he bought something like 550,000 more shares at an average price of $66.

OID: How big a position is it for you right now?

Berkowitz: It's nearly 33% of my liquid net worth. And at cost, it's the biggest position I've ever had. Let's just say that I'm not fooling around here.

I'm just so focused on Wells Fargo. I have consultants working on it and people doing investigative work. And as I'm buying and buying, I just desperately want someone using factual information to tell me why I'm wrong.

OID: What's the most you've paid?

Berkowitz: I've paid up to the low $70s. And I'm buying it for new clients today. I'd like to see it get a little cheaper before I add to existing positions. But I'll be there. And I'm at the point now where I'll even sell other positions.

OID: You sound pretty serious.

Berkowitz: I'm talking with my clients. When Wells gets between $200 and $300 a share, we're going to have a party. And I think Southern California would be an appropriate location.

OID: What sort of time frame are you contemplating?

Berkowitz: Within several years. I can just see its future so clearly.

A PHENOMENAL CASE STUDY: THE NUMBERS ARE RIGHT OUT ON THE TABLE....

Berkowitz: Wells Fargo will determine whether I have any competence in investing or not. Wells is the watershed. What's incredible about Wells is that it isn't dependent on any proprietary investigative work or keen sense of analysis.

This is strictly a businessman's sense. You're talking earnings flows. You're talking human nature. You're talking about "This too shall pass." You're talking about "The angels fall. And those that are fallen shall rise again." and human emotion and business and cycles and how equilibriums change...

OID: And here I thought we were just playing with little pieces of paper.

Berkowitz: What I mean is that all of the information is out in the open. And yet there are very smart people all along the spectrum of the argument — all the way from extreme pessimism to extreme bullishness. Very smart people are buying it. Very smart people are selling it short. And there's even a much larger very smart group of people who are staying away.

It isn't as if I know something someone else doesn't. It's a classic do or die struggle. The numbers are right out on the table — on the environment, the industry and the company. And people are making business decisions. That's why for me Wells is such a phenomenal case study.

OID: After a buildup like that, we have to ask you — what's your rationale?

Berkowitz: It's a simple case of a bank with tremendous earnings power. And as a businessman, I've gone into it the way good businessmen go into businesses — in recessions — because that's the time to do it.

The argument's simple. Wells has had fantastic earning power in the past. And I just don't see any reason why it won't continue. In fact, it's growing.

Its earning power has been disguised by the intense provisioning for loan losses. But when the provisioning gets back to a normal level, you'll start to see that incredible earning power come down to the bottom line. And it's as simple as that.

BANKING ON THE BRINK FLAWED — AN OUT-OF-DATE, STATIC ANALYSIS....

OID: But as you mentioned, not everyone agrees....

Berkowitz: You could say that. For example, *Banking on the Brink* is a 388-page study done by an academic and a consultant concluding that 2,000 banks are basically bust. It seems like everybody is talking about it.

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WELLS FARGO
(cont'd from preceding page)

In effect, they concluded that *if* banks had to close down tomorrow, there'd be significant equity shortfalls. And Wells Fargo was one of those banks.

OID: It sounds like you disagree with the conclusion.

Berkowitz: I don't understand all their assumptions. However, it's basically a static analysis. The numbers are based on end-of-year 1991 — and have already changed dramatically. Wells Fargo's capital ratios are up significantly. And they're up despite both loan loss provisions and non-performing loans as a percentage of total loans being up tremendously, as well. The numbers are *much* better than they were at year-end 1991. So the whole study's based on an out-of-date snapshot.

In addition, it doesn't take into account their dynamics and their earnings power.

EVENTUALLY HALF OF WELLS WON'T BE A BANK.
AND IT'LL BE THE DARLING OF WALL STREET....

OID: Why would dynamics and earning power be a plus for banks? Aren't they lousy businesses at best and dinosaurs at worst? Aren't money market funds and CMAs making them obsolete?

Berkowitz: Wells Fargo's making *themselves* obsolete. The only reason why their employee count is up 200 is that they've hired 200 personal financial officers to sell their funds and their other new initiatives. They're moving something like $20 million a week — a billion dollars a year — from passbook accounts into their mutual funds.

OID: That's a plus? Their primary business is all but obsolete. And they're going into a new business where they're unproven? That sounds more like something the shorts would be saying.

Berkowitz: Don't forget that Wells' index business may be the largest in the country. They sold half of it to Nikko. They're not schmoes in this business.

And they're kicking butt on their mutual funds now. They're quite happy with the progress that they're making. They could become the Dreyfus of the West Coast.

Eventually, half of Wells Fargo won't be a bank. It'll be a money management operation.

OID: Because the money management operation grows or because the bank gets wiped out?

Berkowitz: It's growing like a weed. It'll be a tremendous retail operation. Let's face it. The commercial real estate business isn't going to come back for a long time — even if they wanted to lend on commercial real estate.

So both relatively and absolutely speaking, Wells' money management operations will grow. And you watch — in three to five years, Wells will be the darling of Wall Street.

OID: Does a vivid imagination run in your family?

A BANK THAT HAS A FRANCHISE?
THIS ONE PRINTS MONEY....

OID: But all of that's mostly in the future. Today, Wells is primarily a bank. Isn't that bad news?

Berkowitz: Many don't think Wells has a franchise. But I think they do.

OID: Isn't that a contradiction in terms — a bank with a franchise?

Berkowitz: Do you remember Buffett's definition of a great franchise? With his choice of management and a billion bucks, he couldn't put a dent in its franchise.

If I gave you a billion bucks and let you pick your management team, how could you rationally hurt Wells?

OID: There's only one way to find out.

Berkowitz: Everyone thinks it's a franchise not worth having today. And even if someone *did* want a franchise in California, what could they do? How could they compete against Wells Fargo? It's just *so* entrenched. There's a BankAmerica, Wells Fargo and First Interstate on almost every corner. What bank in its right mind would even try?

So you're not likely to have new competitors because nobody's entering this game.

OID: You could probably say the same thing about defense companies. Maybe they're just smart not to.

Berkowitz: Maybe so. But Wells is a tremendous marketing organization. Their branches are conveniently located. They're efficient. And they're the low-cost operator. We're also talking about a business that'll be earning well over 20% on equity when the recession finally ends.

OID: If they survive it and you live long enough.

Berkowitz: Also, it's an oligopolistic setting. BankAmerica did Wells Fargo a great favor by taking out Security Pacific.

OID: Eliminating the temptation for Wells or what?

Berkowitz: Security Pacific won't exist anymore. So BankAmerica will reduce the number of branches. People who used Security Pacific as an offset to BankAmerica will have to use Wells Fargo or First Interstate.

OID: An offset?

Berkowitz: People sometimes want to avoid having only one supplier. Basically, customers can go to one of three places — BankAmerica, First Interstate or Wells.

There'll always be community-type banks, credit unions, S&Ls and so forth. But no one's getting into this business. And even in an oligopoly, Wells should be able to print money.

OID: Tell that to the airlines.

IF MY NUMBERS ARE EVEN CLOSE TO CORRECT,
WELLS FARGO IS VERY, VERY CHEAP....

Berkowtiz: Wells is printing money *now*. Look at their net interest margin. It's over 5-1/2%. And people are saying, "Oh, it can't last. They're making a fortune off the government right now." and so forth. But they've had an incredible net interest margin the last five years — over 5%. There's no reason why they shouldn't be able to stay around

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WELLS FARGO
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that level.

OID: Even if interest rates drop a lot?

Berkowitz: I think so. But frankly, I think we're done. I think we've hit the lows in interest rates.

But Wells is earning $33 pretax and pre-provision per year *right now*. Just thinking about it gives me the shakes.

OID: Is it sustainable?

Berkowitz: Yes and no. The folks at Wells Fargo say that their margins are likely to come down a bit. So instead of being $33, let's say that stabilized earnings today are $30 before provisions and before taxes.

But then you have to add another $2 for amortization of goodwill — because it's a noncash expense. And there's probably another $2 of extra expenses in there that Wells is carrying to handle today's abnormally high level of foreclosures and problem loans.

Also, they're receiving interest on non-performing loans that they're not currently recognizing as interest income. Believe it or not, their so-called non-performing loans are generating a 6.2% current yield.

OID: Wally Gaye recently mentioned that to us as well.

Berkowitz: So there's another $2 of pretax income over and above today's reported figures.

So adding each of those figures to the $30 of pretax, pre-provision income that they'd be earning today assuming lower net interest margins and you're at $36.

OID: Before provisions for loan losses.

Berkowitz: That's right. And I don't know exactly what loan loss provisions will average going forward. But let's say that they average $6 — which is what they averaged in the 1988-90 period. If so, then Wells earns $30 pretax after normal loan loss provisions. Given Wells' 40% effective tax rate, that would mean they have normalized earnings power of approximately $18 per share after-tax.

If my numbers are even close to correct, Wells is very, very cheap.

A BANK EARNING 40% ON TANGIBLE EQUITY?
THE NUMBERS ARE JUST PHENOMENAL....

Berkowitz: And that's on a tangible book of no more than $38. On a normalized basis, this baby's earning over 40% per year on tangible book and over 25% per year on its current market price. And those are 1992 earnings. This thing is a beast.

Do you realize what a 40% after-tax return on tangible equity means over three to five years once they stop paying for Southern California? It means a Merry Christmas and a Happy New Year — the only question being which year.

OID: It means a high earnings stream. But it doesn't necessarily mean that they can reinvest those earnings at high rates of return.

Berkowitz: I don't want them to. I want them to buy the hell out of their stock.

OID: You think that's what they'll do?

Berkowitz: I do. Once California bottoms, they'll have *so* much extra money.... And remember, this 40% return isn't a forecast. That's what it is *this year* — based on today's core earnings and historical provisioning. The numbers are just phenomenal.

WELLS IS THE LOW-COST ACQUIRER WITH
SIGNIFICANT REINVESTMENT IMPLICATIONS....

OID: Let's say that your numbers are correct — that Wells is earning $33 pretax and pre-provision today and that its normalized earnings per share are $18. How fast is it likely to grow?

Berkowitz: You tell me. From 1987 to 1992, they grew by over 14% per year.

But frankly, what difference does it make? If I'm right, for this thing to be an over-the-wall one-to-remember-for-decades grand slam, how much growth do they need? Does it even need to grow 1% per year to be a terrific bargain?

OID: But isn't this a very different beast if they're able to reinvest capital at high rates?

Berkowitz: Definitely. And I believe Wells has excellent reinvestment opportunities.

OID: In a declining business? How do you figure?

Berkowitz: Simple. Just take a look at one of their recent acquisitions. They paid $465 million over book value for Great American and its $6.2 billion of deposits. So they paid a 7-1/2% premium over book value.

Wells is currently earning a 5.7% net interest margin. However, if Wells "only" earns a 5% net interest margin on the $6.2 billion of deposits, that's still $310 million. Plus they earn fees. It looks to me like they currently book about 35¢ of fees for each $1 of net interest income. There's another $109 million. So between net interest income and fees, there's $419 million of revenue.

Wells overhead ratio is currently about 54% and declining. And needless to say, Wells' margin on incremental business is far higher than 46% because of branch consolidation and so forth — especially if they're already serving the market where the acquisition is located. But let's just say they bring 50% to the bottom line. If so, Wells probably earned at least $210 million pretax and $125 million after-tax on the Great American Bank acquisition — or 27% after-tax.

OID: Not bad.

Berkowitz: And it's probably better than that — because they get to wipe out Great American's back room. They get better efficiencies on their own system.

And very conveniently, the November 7th *Economist* talks about how a new law comes into effect December 19th requiring regulators to close any banks and thrifts whose capital falls below 2%. It mentions how some of the biggest closures are likely to occur in Southern California where leading thrifts like Cal Fed are reportedly in dire straits.

OID: So?

Berkowitz: Who's the most natural bidder for parts of those properties? I'll give you a hint. It's not BankAmerica.

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OID: Why not?

Berkowitz: They're busy digesting Security Pacific. What kind of market share can they have? There's only one guy left who I can think of to go for this stuff — and pay more than Kohlberg Kravis or anyone else because they can incorporate it all.

OID: Interesting. As I recall, Tom Russo described how spirits properties are worth more to Guinness than to anyone else because of their distribution network. You're, in effect, saying the same applies to Wells?

Berkowitz: Exactly. How could Citicorp or Banc One compete with Wells? They're worth much more to Wells. Their structure is there. They can close down branches and consolidate operations. The cost savings for Wells would be huge compared to an out-of-towner.

BankAmerica could probably achieve similar savings. But BankAmerica's already 3-1/2 times Wells' size. They're busy digesting Security Pacific. And even BankAmerica's margins aren't as good as Wells'.

And frankly, even if Wells doesn't wind up acquiring parts of competitors, they might wind up acquiring their customers. They're a machine.

WELLS IS MORE OUT OF FAVOR DESPITE SUPERIOR RATIOS.

Berkowitz: For some reason, people are much more negative about Wells than they are about BankAmerica. They don't think of BankAmerica as having the problems that Wells has.

OID: I think you're right. Why is that — Wells' level of real estate and HLT loans?

Berkowitz: I don't get it. BankAmerica's net interest margin is 4.7%. Wells' is about 1% higher. In addition, Wells has significantly over twice the fees per share. And they have a significantly lower expense ratio as a percentage of revenues. For every dollar of net interest income and fee income Wells gets, 54% goes to expenses — including FDIC and repossession stuff. At BankAmerica, it's 66%.

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OID: For now, anyway. Roxbury's Kevin Riley tells us that BankAmerica's in the process of eliminating over $1 billion in overhead.

Berkowitz: That would get them down to about 53%. I can believe that. But Wells has *already* done that — with Crocker, Barclay's, Great American Bank and half a dozen other acquisitions which haven't shown up yet in their results — because they had just started to happen when the recession hit.

Wells Fargo has 12.3% of Tier 2 capital. BankAmerica has 10.9%. Wells Fargo has loan loss provisions around 5% of total loans. BankAmerica has 3.3%. Loan loss allowances at Wells Fargo are around $37 per share. At BankAmerica, they're around $12.

OID: Why then do the shorts congregate around Wells and seemingly ignore BankAmerica?

Berkowitz: BankAmerica has about $48 per share of commercial real estate loans vs. about $249 for Wells. Another reason people freak out is because BankAmerica has non-performing loans of about $12 per share or slightly over 3% of their loan portfolio. And theirs are declining. Meanwhile, Wells has $45 per share of non-performing loans or about 6% of their portfolio and theirs haven't yet begun to decline.

HAS WELLS BEEFED UP RETURNS BY ENGAGING IN RISKY BUSINESS?

OID: Some of Wells' critics suggest that any bank can earn high returns if it makes risky loans.

Berkowitz: That's true — at least in the short run. However, if they were doing that, they should also have huge charge-offs every year.

OID: Sort of like this year and last year, maybe?

Berkowitz: No. Those aren't charge-offs — only provisions for loan losses. As I understand it, they stopped making commercial loans a year and a half before everyone else did. And that's despite the fact that commercial loans are their forte. It's just that the downturn's been so intense that they've *still* needed to take these massive loan loss provisions.

OID: And yet we're told that the image of Wells' management as prudent, disciplined lenders may be very misleading — that during the glory days, one of Wells' competitors was offering loans on very imprudent terms and that Wells outbid them nine times out of ten by offering even more imprudent terms.

Berkowitz: It's not so clear to me that they've taken on riskier business than one would expect. They're more forthcoming than any bank I know of. It's not even clear to me that they've made many serious mistakes in the past. They give shareholders a snapshot of the condition of what's left of their commercial real estate loan portfolio. And it looks pretty decent.

For example, look at their occupancy rates: 92% of their apartments, 81% of their industrial, 86% of their office space and 82% of their retail. More importantly, here are the current yields on Wells' commercial real estate loan portfolio before debt service generated by each property

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divided by their outstanding indebtedness: 10.7% for apartments, 11.2% for industrial, 10.8% for office space and 9.7% for retail. And those yields have been trending upward significantly for the first six months of 1992.

Does that sound like a bank that's made serious mistakes or a portfolio that's in trouble? I don't think so. And those figures even include non-performing loans.

OID: Wow.

Berkowitz: Then there's the part being processed — the questionable part. And doesn't it strike you as unusual when the questionable part has a 6.2% cash yield in a 6% prime rate environment and their money cost is half of that?

OID: So you're suggesting they haven't come clean?

Berkowitz: Wrong. I'm saying that they appear to be doing a magnificent job processing their problems. And very simply, if what they're processing is giving them a decent yield and what's left over in the repossessed category has stabilized and the balance of their portfolio has relatively high occupancy rates and relatively high yields, then it looks like they're more than able to handle what's being thrown at them.

So my response is, "Where the hell is this bad stuff?" Statistically, it doesn't look like it's anywhere. Their cash flows as a percentage of loan balances don't suggest to me that they've made any kind of serious mistake or that they're in any kind of trouble.

That doesn't mean their portfolios wouldn't get worse if the recession deepens. But at this point in time and absent a crystal ball, these are the facts: Their commercial real estate portfolio seems to have very good leaseup rates — what's left of it. And their operating cash flow as a percent of loans is quite high.

OID: On average.

Berkowitz: That's right.

OID: Hopefully, Wells won't resemble the economist who drowned in a lake with an average depth of 1".

PROVISIONS AREN'T NECESSARILY CHARGED OFF. WHY DID WELLS PAY $350 MILLION IN TAXES?

Berkowitz: One more thing that gives me comfort — Wells took $26 per share of loan loss provisions last year and they only charged off $11.

OID: Could you distinguish between the two?

Berkowitz: Provisions are reserves for future losses — estimates of what losses will be. Charge-offs are actual losses. And only charge-offs are tax deductible. Provisions are not.

Last year, Wells earned $27 pretax and pre-provision. So as far as the IRS is concerned, they earned roughly $16 per share pretax after deducting $11 of charge-offs. That's $10 per share after-tax. Do you see what I'm getting at?

OID: Another negative — that even though they're not making money, they've still got to pay taxes?

Berkowitz: Why do you think that they're paying all of these taxes?

OID: They need a new tax accountant?

Berkowitz: Maybe. But maybe they just couldn't write off as much as they reserved. Why would anyone pay that much in taxes if they didn't have to? That's a lot of cash. You're talking between $6 and $7 a share that they paid in taxes. They paid seventeen times in taxes what they reported in GAAP earnings. What was that about?

In effect, Wells may have really made $10 last year. And that's substantiated by the fact that Wells paid $350 million in income taxes. Given their 40% effective tax rate, that suggests earnings of $875 million pretax and $525 million after-tax. There's your $10 per share in earnings. So maybe they're *not* cowboys. Maybe they're quite conservative in the way they do their business and accounting.

OID: Let's not get carried away.

Berkowitz: And if you annualize their results for the first three quarters, they're on track to charge off about $15 this year. That implies earnings of $18 before tax and $11 in earnings per share this year. And that's before all of the add-ons that I ran through before — goodwill amortization and so forth.

OID: If their charge-offs don't mount. And isn't that a mighty big if?

Berkowitz: Maybe they'll wind up charging off the huge loan loss provisions they've set aside. I doubt it, but it's possible. Meanwhile, those loan loss provisions are there available to be charged off — and those funds belong to shareholders.

And so what if Wells winds up charging off its entire loan loss provision of about $37 per share. That's only about 1-1/4 years of pretax and pre-provision earnings. Talk about a margin of safety....

WILL CALIFORNIA BE TEXAS REVISITED? THE FACTS SAY THAT WELLS IS HANDLING IT....

Berkowitz: So the bears go to the next point and say, "Well, it's coming. The recession's going to get much worse — and then you'll see it."

OID: Frankly, we've heard several very sharp people express that point of view in a very persuasive manner. Why couldn't the financial landscape in California wind up resembling Texas, where, as we understand it, all the banks went bust — weak and strong alike?

Berkowitz: I imagine it could. I may be way off on California. Maybe it'll stay in recession for years. But we're already past the average length of a recession. In my view, most of the damage in California is done. We're past the halfway mark. It's already been tougher out there than any recession since the Depression. And short of another Depression, they're prepared. The numbers suggest that they're handling it.

OID: One of our contributors did a study of Texas banks to see what those that failed had in common. And two characteristics were the kiss of death —

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WELLS FARGO
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without exception: [1] They were located in an area in which asset growth and loan yields were above the national average, and [2] They had asset growth and loan yields even greater than those of their area.

He tells us Wells Fargo fits that profile perfectly.

Berkowitz: That's interesting. But here's how I look at it. California's probably in its worst recession since the Depression and Wells Fargo hasn't lost any money yet. To the best of my knowledge, they never have.

Let me read you a quote from December 17, 1989's *San Jose Mercury News*:

"For Reichardt ... the fact that bank stocks, his own included — are so low compared with the prices of industrial shares is a source of continuing frustration and anger. 'We've been in business for 137 years,' he says, 'and to the best of my knowledge, this company's never lost money. It bugs the hell out of me that the industrials are selling at 12 times earnings and here's a company that has a great deal of predictability selling at 8 times earnings.' "

OID: Great quote.

Berkowitz: So I don't think they've never lost money in any calendar year — including the Great Depression. And it looks to me like they can keep chugging along. But it's one of the great, classic cases. Only time will tell.

Also, Southern California has a paradise-type climate. They have thousands of miles of beautiful beaches. I just can't get worried about California real estate ever becoming as depressed as Texas'. In fact, it's hard to even imagine it declining to the national average.

OID: Despite the length of the boom preceding the bust and its People's Republic of California policies?

Berkowitz: It could. However, Northern California and the Valley have reportedly bottomed out. And the only area still going down is Southern California.

OID: And what percent of Wells' loans are down there?

Berkowitz: About 50%.

OID: That's supposed to be reassuring?

THE RECESSION WILL END ONE DAY
AND WELLS WILL MAKE A FORTUNE....

Berkowitz: Look, all of that's speculation. Let's not waste time trying to predict the future. Let's stick to the facts.

What are the facts? We're two years into this very, very severe recession. And the facts say they're handling it. Based on occupancy and yields, does their commercial real estate portfolio sound like it's in trouble to you? It doesn't

(continued in next column)

to me. Furthermore, Wells Fargo's debt is rated A- and its preferred is rated BBB+. So both are doing well.

But will California wind up like Texas? I don't know. What I do know is this — Reichardt has said half a dozen or so times, as have other members of senior management, "We won't know when this recession is over until maybe six to eighteen months afterwards." That's point number one.

Point number two is that if they continue to heavily reserve for the continuation of the recession, when the recession's over, they'll be left with reserves they thought they needed, but they won't.

OID: So that they'll be over-reserved at that point.

Berkowitz: That's right. And that doesn't mean that those reserves will go to the bottom line. But if you look at what happened in the last recession, they managed to claw back a lot of those reserves. And that's how you could potentially see Wells Fargo earn over $20 a share after-tax and after provisions. The recession will end one day. And when it does, they'll make a fortune.

I just can't get too worried about Wells not earning attractive returns. Their worst case scenario has already happened in California. Last year, they basically earned nothing after loan loss provisions. This year, they're on track to earn about 9%. But for the sake of discussion, let's assume this year's a zero, too.

The three years before that were 24% to 25% per year — as reported by Wells. For the last five years, that's still an average ROE of about 15% — and above the 12% to 13% average for American industry, albeit lumpy.

IS WELLS COOKING ITS BOOKS
OR BEING PENALIZED FOR ITS SUCCESS?

OID: Of course, some say that Wells is achieving those returns via creative accounting — that they aren't coming clean with the extent of their problems.

Berkowitz: I think that's just nonsense. Wells has always been one of the first to recognize their mistakes. And I think that they're still being quite conservative today. For example, 50% of Wells Fargo's non-performing loans are current on all interest and principal payments. How's that for conservative. And that suggests to me that they're quick to recognize their problems.

Also, the fact that their non-performing loans are generating an average cash yield of 6.2% tells me that they're not hiding anything. It also says something about how well they handle and process problems.

And the fact that their level of repossessed assets seems to have stabilized suggests to me that they're quick to sell repossessed assets. It means that they're not building up on the owned end.

Meanwhile, their loan portfolio's shrunk significantly — from $46 billion to $39 billion. On a per share basis, that's down from about $850 per share to approximately $730 per share. And it looks to me like their leaseup rates and cash flows as a percentage of loan balances are very good indeed — and increasing. So where are they hiding it?

OID: I asked first.

Berkowitz: I don't think they are. Remember that the regulators are at Wells all the time. Their loans are being

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WELLS FARGO
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reviewed constantly. So I'm not sure they could sweep their problems under the carpet even if they wanted to.

WELLS PROBABLY HAS BILLIONS OF BOND EXPOSURE, BUT IT HAS A CUSHION AND A SMART CEO.

OID: Any other negatives?

Berkowitz: One negative is that Wells Fargo is forced to play this yield curve game. They don't have enough places where they can loan the money. As a result, at September 30th, they had something like $8 billion in U.S. Treasuries and government agency bonds.

OID: But are they mismatched in terms of maturities?

Berkowitz: I think they are mismatched — absolutely. They're getting yields of 7%. Maybe they're hedging, but they're going out there.

When business starts to pick up again, all these banks will be trying to sell tens or hundreds of billions of dollars of government securities to use the proceeds to make loans. And if they take losses on $8 billion of bonds.... After all, that's how the S&Ls got killed.

OID: That sounds like a big negative, all right.

Berkowitz: Maybe. The reason I don't think of it as a big negative is that I don't think that the yield curve will start picking up big time until business starts picking up big time. And they can start to make loans again. They can go back to being a commercial bank.

So worst case, they wind up taking a hit because business picks up. Well, they liquidate their bonds, they make loans and profits go up.

But they're smart guys. They'll be prepared. And anyway, they have a $250 million gain in their portfolio that they haven't taken yet.

WELLS IS EVEN RELATIVELY COVERED FOR EARTHQUAKE DAMAGE....

Berkowitz: The only thing that people come up with that you can't rebut is that California falls into the ocean.

OID: Good point. What about earthquake risk?

Berkowitz: Their commercial real estate all has earthquake insurance. They won't make the loan otherwise.

OID: What about insurance to cover the impairment of their borrowers' repayment capacity in the aftermath of an earthquake?

Berkowitz: On typical business loans, they don't require earthquake insurance. But as a practical matter, their clients have business interruption insurance and maybe some catastrophic loss insurance.

WELLS BEING HANDED TO INVESTORS ON A SILVER PLATTER....

OID: Aside from the negatives that we've discussed, what are the shorts saying?

Berkowitz: We've covered every negative I've heard — plus a few.

OID: Did I mention that parties related to yours truly have an interest in Wells Fargo?

Berkowitz: That's the most negative thing I've heard. Maybe Wells Fargo is a great short....

This is a horrible banking environment. Wells Fargo's stock has basically done nothing for five years now. And it's a tremendously well-oiled machine with a great franchise. Wells Fargo is being handed to investors on a silver platter. It's just a matter of time.

Can't you just hear the cash register ring — cacheeng, cacheeng, cacheeng...?

OID: Maybe. But are you sure it's not a fire alarm?

Berkowitz: When the recession ends, earnings start to normalize towards $18 a share, they have a peak year of $20-odd per share of earnings and sell at 10 times earnings — and thar' she blows....

I don't know when it'll happen. But the first quarter that they report good earnings, they'll be up $20.

OID: When they don't show a big loan loss provision.

Berkowitz: Yeah. It might not even take earnings — maybe only a stabilized level of non-performing assets.

It's a classic hiccup situation. It's a perverse time. The time when people should enter into investments and make commitments is when times are extremely tough. But human nature is such that most people can't. They only want to go into something when it's on a winning streak. That's just the way it works.

OID: Amen. Thank you, Mr. Berkowitz.

—OID

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