



**WACHOVIA**

A Survivor in the Financial Services Industries

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## **Executive Summary**

Starting from humble beginnings in North Carolina, the Wachovia Corporation has emerged as a leader in the banking industry after an era of competitive consolidation. Leveraging its strength in retail banking, Wachovia has diversified its product line and gained a foothold in several different financial services markets. All this has led to a period where Wachovia has enjoyed solid growth and exceeded Wall Streets expectations all while keeping clients satisfied.

However, Wachovia's lofty position is not secure and if it becomes complacent, the company's competitive position may be eroded by aggressive rivals or it may even find itself devoured by a more efficient competitor. Regulatory change has again recently sparked consolidation, this time horizontally across industrial boundaries. Furthermore, market stagnation appears to be looming on the horizon for the banking industry, increasing the importance of Wachovia's non-banking operations. If Wachovia is to remain successful and build upon their tremendous momentum, the company must decide how to efficiently allocate their resources and efforts between its various business segments in order to maintain strong earnings growth and meet expectations. The company must strengthen its investment banking operations while showing patience and discipline when evaluating potential acquisitions. Wachovia can continue to be not only a survivor but a leader as long as the company adapts to the changing economic and financial landscape.

## **Company History**

The Wachovia story begins in 1879 Winston, North Carolina with the charter of Wachovia National Bank. After numerous mergers involving several local rivals, the Wachovia Corporation holding company eventually emerged in 1968. The company continued to expand within North Carolina until 1985 when the Supreme Court upheld the constitutionality of interstate banking compacts, allowing banks to expand past state lines. This ruling ushered in an unprecedented era of consolidation within America's retail banking industry. Wachovia was on the forefront of this trend, as they merged with First Atlanta within hours of the decision. In the early 1990's Wachovia continued their rapid geographic expansion by acquiring several banks in South Carolina, Florida, Georgia, and Tennessee.

In the late 1990's Congress passed the Financial Services Modernization Act (Graham Leach-Bliley) which among others things repealed portions of the Glass-Steagall act which prohibited banks and securities firms from affiliating with one another. Under the new legislation merchant banks, investment banks, insurance companies, asset management firms, real estate companies, and other financial services operations could be joined in a new "financial holding company." After the change in regulation Wachovia and the other major regional banks began expanding the scope of services that they offered to their clients. In 1998 the company entered the underwriting and capital formation markets by forming the subsidiary Wachovia Capital Markets. To help solidify their position in these new markets Wachovia began to acquire brokerage houses and investment banks. At the same time geographic expansion of retail banking operations continued at a frenetic pace in the late 90's as Wachovia established a foothold in Northeastern states like New York, Pennsylvania, and Connecticut.

Wachovia greatly increased its size and share of the retail banking market in 2001 by merging with its rival First Union, another large North Carolina bank that had also recently undertaken an aggressive policy of acquiring banks and other financial services companies. It was only after this merger that Wachovia truly emerged as a major player in the banking and financial services industries. The resulting company has maintained a strategy of aggressive expansion exemplified by the acquisition of SouthTrust Corporation, a major southern regional bank holding company. This acquisition fit the company's overall goal of continued expansion into the South. Six new locations were opened in Texas during 2004 with

## Wachovia Corporation: A Survivor in the Financial Services Industries

approximately 200 new financial centers planned in Dallas, Houston, Austin, and other urban areas over the next three years.

Today the Wachovia Corporation (NYSE: WB) is a diversified financial services company that operates in four major segments: retail and general commercial banking, capital management, wealth management, and corporate and investment banking. Wachovia currently has a market capitalization of around \$90 billion, making it the fifth largest bank in the nation behind Citigroup, Banc of America, JP Morgan and Chase, and Wells Fargo (It is the fourth largest in terms of total assets). The retail banking division has branches located in 15 East Coast and Southern states and accounts for about half of the company's revenues. In addition, the bulk of Wachovia's capital management activities are carried out in a joint venture with Prudential Financial (Wachovia has 60% ownership) under the name Wachovia Securities. The combined operations will constitute the third-largest retail brokerage in the country, with offices located in 49 states and 33 foreign countries. Wachovia recently purchased Palmer and Cay, an insurance brokerage, to help solidify and expand the company's retail brokerage operations. The company also has a sizeable corporate and investment banking division, ranked eleventh in the country in 2004, as well as a smaller wealth management division.

The company is currently working on integration issues resulting from the SouthTrust merger, although further geographic expansion is a definite possibility for the retail banking division. Management is also considering further acquisitions to bolster Wachovia's non-banking segments, especially its retail brokerage operations. Despite the administrative costs from multiple acquisitions, Wachovia has managed to steadily grow earnings and has been one of the top performers in the banking sector. While retail banking still accounts for the majority of the company's revenues, fee income generated by the capital management, wealth management, and investment banking business segments has recently represented a growing portion of Wachovia's income. This trend is likely to continue as market saturation limits the growth potential (outside the possibility of acquisitions) in the retail banking business segment. Wachovia's current management has high hopes about the growth potential of the company's non-banking segments.

## **Competitive Analysis**

Always central to understanding the competitive position of a firm and the profitability of its business operations is the identification of the possible threats to that firm's cash flows. With Wachovia, as with most firms, the greatest threats the firm faces arise from the dynamics and structure of the industry within which it operates as well as competition from rival firms. An extremely useful tool in assessing the extent of these threats is to conduct a Porter's Five Forces analysis. However, such an analysis often becomes complicated as many firms, Wachovia included, operate in several interrelated, overlapping industries/markets. In Wachovia's case, while the majority of the company's revenues and earnings come from the firm's retail banking operations, an increasing portion comes from its investment banking and asset management activities. Therefore, it is critical to analyze the threats to Wachovia's profits arising from both the retail banking and the diversified financial services industries. Along these lines, we will consider not only Wachovia's vulnerability to the aggression of its main competitors: Citigroup, Wells Fargo, Bank of America, U. S. Bancorp, J. P. Morgan and Chase, but also possible threats from other firms that operate in the retail banking or diversified financial services industry.

### **Supplier Power**

As a retail bank and a diversified financial services firm it is difficult to clearly delineate all of Wachovia's factors of production. The basic physical inputs are in both these industries are similar to those for most any basic professional service. These include computer hardware (PC's, servers, communications networks...), business software (payroll, accounts, other database management), and real estate for office locations. Though the computer hardware industry (IBM, Dell, Hewlett Packard) and business software industry (Oracle, Microsoft, IBM) are both fairly concentrated, there are enough firms offering substitutable products such that price competition exists in those industries and no one firm has extensive pricing power. Wachovia and financial institutions in general do not depend upon any single physical input. As a result, none of these factor markets provides a serious threat to either Wachovia's profits, through monopoly rents in pricing, or market share through vertical expansion.

Wachovia's retail banking operations also require several industry specific inputs (check-processing and money handling machinery, ATM's...), but the banking industry is large enough that it provides frequent and steady enough demand to keep these supplying industries competitive. Both retail banking and financial services also rely heavily on more intangible assets such as financial securities and human capital. However, these markets are so enormous that it is difficult to imagine any one entity having pricing power in these markets. The overall conclusion to be drawn is that upstream supplying industries pose little threat to Wachovia's position.

### Buyer Power

With regards to Wachovia's retail banking operations, its customers are individuals who are unorganized, price takers. It is therefore safe to conclude that buyer power is not a significant threat to Wachovia's banking profits or market share. On the other hand, Wachovia's investment banking and asset management clients are almost exclusively large institutions (except for a few wealthy individuals). Most investment banking and asset management contracts are bid on competitively by several different firms. Investment banking and asset management contracts can be extremely large and are infrequently awarded. This means that Wachovia's larger investment banking and asset management clients do possess significant market power and for this reason financial services firms often put a great deal of effort into securing and maintaining client relationships. The buyer power of downstream clients makes Wachovia's investment banking and asset management operations vulnerable, especially when the economy and these industries experience a downturn.

### Substitutes and Complements

The relationship between substitutes, complements, and economies of scope play an extremely important role in determining the structure of firms in the banking and financial services industries. There are several reasons why Wachovia and the rest of the major players in the banking industry operate in so many different industries. For one, different financial assets and services are often close substitutes for one another. Investors (individual and institutional) have a choice between saving in a bank, investing in the financial markets through a brokerage

house, hiring someone else to manage their assets, or some other investment/savings vehicle. Since some combination of the possible choices is usually preferable, most banking and financial institutions try to offer their clients a wide variety of services.

Another reason to offer such a wide scope of services is that many consumers prefer the convenience advantages of being able to deal with one firm for as many of their needs as possible (similar to being the Wal-Mart of the financial world). The idea is that Wachovia's banking customers will be more likely to choose one of Wachovia's brokerage houses (or one of their subsidiaries such as Prudential or Evergreen), or that an corporate client that contracts a firm to manage its retirement accounts would be more likely to use that firm's connected investment bank if they need to issue debt. Cross-selling ability, where business lines within the bank co-operate to sell multiple products to clients, has become an important variable when evaluating banks. Wachovia has recently emphasized the use of its banking operations to sell its retirement services. Wachovia estimated that it received \$87 million in revenue from cross-selling between business lines in 2004, exceeding management expectations. In this sense Wachovia's diverse offering of financial services is an attempt to simultaneously limit the negative impact of substitutes while trying to maximize on the revenue gains arising from economies of scope in the banking and financial services industry.

Of course, one bank's services are a substitute for another's, but the geographic expanse of this country provides a firm's market share some protection. The banking industry is especially regionally segmented, and the major consolidated banks, like Wachovia and its main rivals, compete only on the boundaries of their respective territories. This limits the extent to which one bank's services can be substituted for another's. For instance, Wachovia mainly competes with Bank of America in certain East coast cities and with Sun Trust in the South, where as Wells Fargo competes mainly with Washington Mutual on the West Coast and with Bank of America in the Midwest. Therefore, banking at Washington Mutual may be a substitute for banking at Wells Fargo, but not necessarily Wachovia. Much of this competition is confined to the border states and cities of the market share areas as most of these premier national banks have dominating presences in some geographic regions and metropolitan areas.

From a broader perspective, the retail banking industry as a whole also competes against other extremely secure investment vehicles, such as credit unions, money market accounts, and some mutual funds, that offer many of the services normally associated with banking accounts. Such financial services/assets could also be considered a direct substitute for banking services. As mentioned before, Wachovia attempts to minimize the threat it faces from substitutes by offering many of them in its product line.

### **Entry**

As highly regulated and well established industries, there are several barriers that prevent entry into both the retail banking and the financial services industries. There are a series of formal steps in the application process to becoming a banking entity. Permission must be granted from state governments to operate locally and the federal government to operate nationally (interstate commerce). Banks must also follow extremely strict accounting and reporting procedures to ensure their operations are transparent. After formation, a bank's financial solvency and management are regularly assessed by the Federal Reserve. Similarly, investment and financial services entrants must register with the SEC and also deal with regular reporting and assessment from the market. Financial services firms must also register with the securities exchanges and other trading organizations and be familiar with their rules in order to operate in the financial markets. The knowledge, experience, and effort required to comply with these various regulations poses a serious obstacle to entrants in both industries.

Even though the banking and financial services industries are not dominated by economies of scale, network externalities give large, established firms definite advantages. Modern day banking customers expect to have full access to all their banking services over increasingly large geographic areas. This requires banking entities to have a large network of branches and ATM's, as well as an extensive customer service and online banking infrastructure, if they wish to compete nationally or even regionally. Because of these network externalities it is unlikely that a completely new firm will ever enter the banking industry and eventually end up competing with Wachovia and the other big five. However, it is likely there will be more consolidation of the remaining middle market regional banks (Washington Mutual, SunTrust, Comerica...) and it is possible that a firm resulting from one or

several of these transactions could feasibly compete with the current major national banks.

### Internal Rivalry

While retail banking is thought of as a reasonably competitive industry, it is not clear if this necessarily translates into intense price competition between participants. In the retail banking industry, intense competition for market share between rivals led to a period of consolidation that eliminated a great number of market participants and, for the reasons mentioned, it is unlikely that there will be a new entrant into the industry able to reach the scale of the big six. This increased industry concentration and geographic fragmentation should theoretically lead to reduced competition.

Despite attempts at product differentiation through attention to customer service, fee policies, online convenience, and general dedication to clients, most consumers view the banking services of the different major firms as being close substitutes. Although this lack of product differentiation might tend to increase competition in the industry, it is mitigated by the high switching costs facing a banking customer. Switching banks requires transferring funds, establishing new accounts, and replacing checks and/or debit cards among other things. Most individual consumers are reluctant to go through such a potentially time consuming process.

The strong barriers to entry, geographic segmentation of the market, and high personal cost of switching in the banking industry are all factors that might lead to a decrease in competition. However, after long periods of extended expansion and consolidation, a lack of growth opportunities will lead to an industry stagnation that will counteract these forces. Over time stagnation may single-handedly be enough to start a period of further consolidation or price competition among the major national banks.

The financial services industry is much more competitive than the retail banking industry. The industry revolves around the financial markets, and it can rapidly become stagnant or declining when the markets begin to slip. Since Wachovia is not nearly as strongly positioned in the financial services industry as it is in the banking industry, its investment banking and asset management segments could suffer significant losses of revenue if the financial markets experience a

period of turmoil that leads to intense price competition. Wachovia's fledgling investment banking and asset management operations will need strong support from the firm's banking segment to survive well into the future if times get sufficiently tough.

## Financial Analysis

As one of the largest and most successful banks in the nation, Wachovia has been enhancing its already strong financial position. Wachovia ended 2003 with over 400 billion dollars in total assets, up 17% from the previous year. Over the same time period the company managed to reduce long term debt by 7% to \$36.5 billion. This was offset, however, by a rapid 73% increase in the level of short-term borrowing to \$71 billion. If this trend is sustained in the long-run this could lead to potential liquidity and solvency problems. Total deposits increased by a steady 17%, with most of this growth coming from interest bearing deposits. However, much of this growth was a result of the recent acquisition of SouthTrust. Wachovia's loan portfolio grew a modest 2% to \$175 billion, with a slight decline in commercial loans being offset by a 7% increase in consumer loans. The company's diverse portfolio of assets provides Wachovia with sustainable growth without taking an exorbitant amount of risk. Wachovia must be careful nonetheless because its portfolio remains vulnerable to interest rate risk, especially if the Federal Reserve unexpectedly accelerated the pace at which rates have been rising.

Revenue growth for the last two years has been positive for all of Wachovia's business segments except the parent segment. Most of this growth was provided by the capital management and investment banking segments. That said, growth in the revenue of Wachovia's main business segment, retail banking, was a robust 6%. This was down significantly from the previous year and much of this can also be attributed to the SouthTrust acquisition. This is likely an indication of future stagnation in the retail banking industry, a trend that will limit the revenue growth through organic expansion by Wachovia's general banking segment in future years.

Wachovia's operating expenses have been growing at a significant rate, 18% in 2002 and 13% in 2003, largely due to acquisition and integration costs from the company's frequent acquisitions. The elimination of duplicate facilities, services, and employees resulting from the recent mergers will reduce operating expenses, but if acquisitions continue, the growth of Wachovia's operating expenses will likely remain in double figures. Overall Wachovia's revenue growth is sustainable, but with an ever increasing share coming from its wealth management, capital management, and investment banking segments.

## Wachovia and Its Competitors

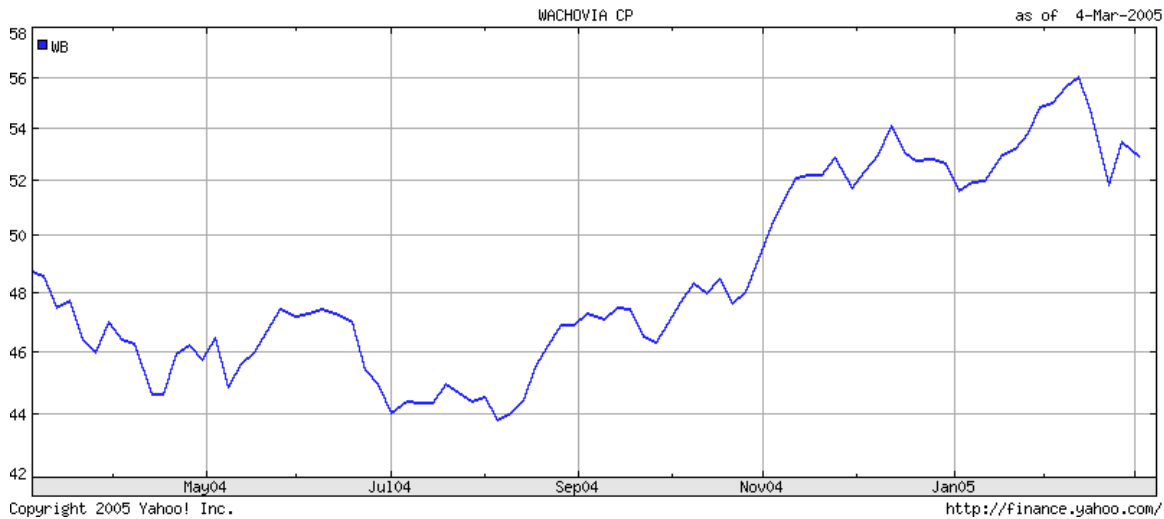
After several decades of consolidation, a few preeminent regional retail banks have emerged to dominate the banking industry. By market capitalization, Wachovia is the fifth largest bank in the country behind Citigroup, Bank of America, JP Morgan and Chase, Wells Fargo and ahead of US Bancorp. These five banks are Wachovia's chief rivals for market share and geographic expansion. A DuPont analysis was conducted on these six companies to see how Wachovia measured up to its competition. At 15.72% Wachovia's ROE is above the industry average, but much lower than most of the company's main competition. Wachovia's asset turnover ratio is also one of the lowest among the group. A net profit margin of 30.16% is substantially above the industry average, but ranks fourth among the big six. Wachovia's financial leverage is about equal to the industry average at 12.2 and is the third highest among its chief competitors. As shown by the DuPont analysis Wachovia's performance exceeds the industry advantage, but the company fails to distinguish itself from its main competition in terms of profitability.

## DuPont Analysis

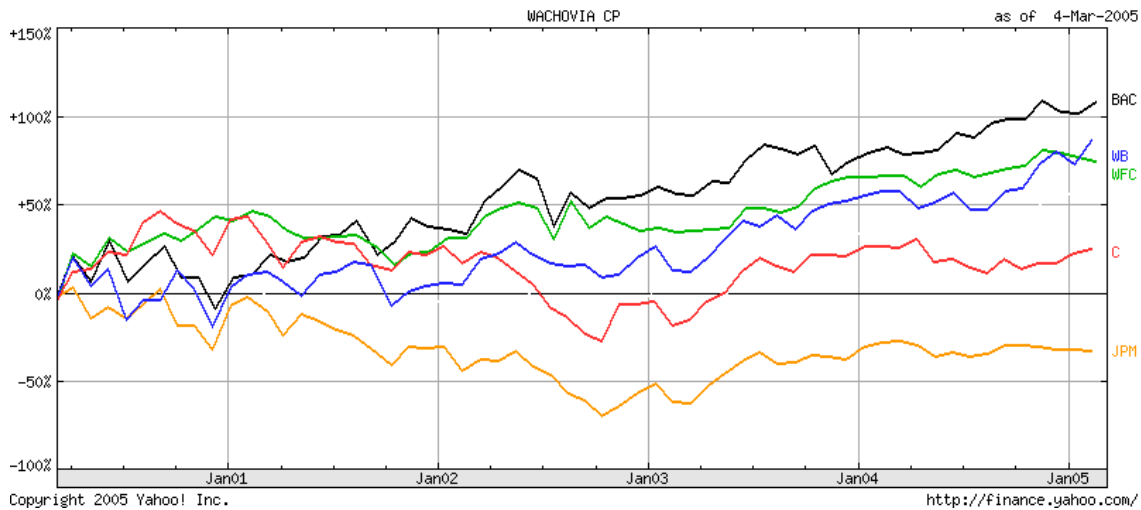
	Total Assets (millions)	Total Equity (millions)	Financial Leverage	Asset Turnover	Net Profit Margin	ROE
<b>Wachovia WB</b>	<b>\$418,865</b>	<b>\$33,162</b>	<b>12.63(x)</b>	<b>0.0413</b>	<b>30.16%</b>	<b>15.72%</b>
Citigroup C	1,350,293	100,690	13.41	0.0494	25.89%	17.15%
Bank of America BAC	872,720	72,995	11.96	0.0495	32.72%	19.38%
JP Morgan & Chase JPM	954,690	76,003	12.56	0.0275	18.05%	6.22%
Wells Fargo WFC	404,673	35,574	11.38	0.0518	33.45%	19.72%
US Bancorp USB	191,065	19,421	9.84	0.0807	45.36%	36.02%

### Market Performance and DCF Valuation Model

Wachovia's stock has performed well over the last year, experiencing an 18% increase in price over the 2004 calendar year.



The dominant American banking companies, with the exception of JP Morgan, have all been solid investments over the last five years. Wachovia in particular has been successful since the acceleration of economic recovery starting in late 2001.



Recently Wachovia had a per share price of \$50.06 with a P/E ratio of 14.03. As with the profitability metrics, Wachovia is in the middle of the pack when compared against the other major banking firms.

## Wachovia Corporation: A Survivor in the Financial Services Industries

Comparable Firms	50 day Average Price	Number of Shares (billions)	Market Capitalization (billions)	Diluted EPS	P/E
<b>Wachovia WB</b>	<b>\$53.44</b>	<b>1.59</b>	<b>\$84.97</b>	<b>\$3.81</b>	<b>14.03(x)</b>
Citigroup C	47.98	5.19	249.02	3.15	15.23
Bank of America BAC	46.05	4.05	186.50	3.7	12.45
JP Morgan and Chase JPM	38.02	3.56	135.35	2.15	17.68
Wells Fargo WFC	61.68	1.69	104.24	4.09	15.08
US Bancorp USB	30.34	1.87	56.74	2.18	13.92

When examining Wachovia's future free cash flows our simple DCF model returns a reasonable target price for the company's stock (when modest assumptions were made about the future growth of the revenues and expenses generated by the company's various business segments) of \$55.77 which is slightly below the stock's February 11<sup>th</sup> peak (\$56.33).

i	2004	2005	2006	2007	2008	2009	2010	2011	2012	Perpetuity
<b>Revenues</b>										
Interest Income										
Total Interest Income	11,790	12,668	13,476	14,186	15,118	15,700	16,247	16,753	17,278	
Provisions For Loan Losses	601	616	631	647	663	680	697	714	732	
<b>Net Interest Income</b>	<b>11,190</b>	<b>12,053</b>	<b>12,844</b>	<b>13,539</b>	<b>14,455</b>	<b>15,021</b>	<b>15,551</b>	<b>16,039</b>	<b>16,546</b>	
<b>Fee Income</b>										
Total Fee Income	10,840	12,083	13,242	14,410	19,984	20,998	22,003	22,994	24,032	
<b>Total Revenues</b>	<b>22,030</b>	<b>24,135</b>	<b>26,087</b>	<b>27,949</b>	<b>34,439</b>	<b>36,019</b>	<b>37,553</b>	<b>39,033</b>	<b>40,579</b>	
<b>Operating Expenses</b>										
Total Non-Interest Expenses	14,511	15,781	16,964	18,025	18,926	19,872	20,866	21,909	23,005	
<b>OPERATING INCOME</b>	<b>7,519</b>	<b>8,354</b>	<b>9,122</b>	<b>9,924</b>	<b>15,513</b>	<b>16,147</b>	<b>16,687</b>	<b>17,123</b>	<b>17,574</b>	
Minority Interest Dividends on Preferred Stock	147	150	154	158	162	166	170	174	179	
	5	5	5	6	6	6	6	6	7	
<b>Income Before Taxes</b>	<b>7,367</b>	<b>8,199</b>	<b>8,963</b>	<b>9,761</b>	<b>15,346</b>	<b>15,975</b>	<b>16,511</b>	<b>16,943</b>	<b>17,389</b>	
Income Tax Expense	2,136.48	2,377.66	2,599.18	2,830.70	4,450.24	4,632.74	4,788.24	4,913.43	5,042.77	
<b>Free Cash Flows</b>	<b>5,524</b>	<b>6,077</b>	<b>6,579</b>	<b>7,102</b>	<b>11,021</b>	<b>11,418</b>	<b>11,746</b>	<b>11,997</b>	<b>12,253</b>	<b>48463.26</b>
<b>Discounted Free Cash Flows</b>	<b>5,524</b>	<b>5,490.51</b>	<b>5,370.36</b>	<b>5,238.26</b>	<b>7,344.21</b>	<b>6,874.77</b>	<b>6,389.80</b>	<b>5,896.23</b>	<b>4,916.23</b>	<b>12,479.98</b>
Terminal Growth Rate	2.50%									
Sum of Free Cash Flows	78,116									
Market Value of Cash	10,564									
Market Value of Debt										
Market Value of Equity	88,680									
Number of Shares Outstanding	1,590									
Estimated Price	55.77									
Market Capitalization	85,130									
Price as of 3/1	53.61									

## **Key Issues**

While Wachovia certainly has ascended to a prominent position within the banking and financial services industries, this status will not be easy to maintain. In order for Wachovia to remain in the good graces of Wall Street it must continue to produce earnings gains comparable to those of its major rivals, which in the last few years has meant double digit earnings growth. So far this has not been an issue for the company; but as mentioned earlier problems could arise if the retail banking industry begins to find additional growth increasingly difficult as has been long predicted. The current economic climate has also begun to have a negative effect on Wachovia's future prospects. The Federal Reserve has recently implemented a policy of tightening the credit markets and raising interest rates, which affects several of Wachovia's operations. For example, the company must now offer higher rates on deposit accounts cutting into the bank's profit margins. While the rates on Wachovia's newly issued loans will adjust upward accordingly to the current interest rate environment offsetting the higher interest the company must pay, the demand for credit as a whole may well be diminished, and Wachovia's banking operations may suffer.

Given these circumstances, it will become progressively more difficult for Wachovia to maintain its robust growth in earnings. The company's enormous portfolio allows it to hedge somewhat against its vulnerabilities to rising interest rates and Wachovia is better financially positioned than the average bank to deal with the current economic conditions. However, this can only mitigate and not eliminate the effect of interest rate risk. The publicly stated policy of Wachovia's current management is to focus strengthening Wachovia's non-banking operations, while using the company's current banking clientele as a demand base for cross-selling its many product lines. This seems to be the common thinking among all the major players (the big six) in the banking industry, so Wachovia must be efficient in its implementation of this strategy if it hopes to maintain its current prominence within the industry.

But let's not restrict the range of Wachovia's possible actions. Wachovia is still faced with a strategic choice between continuing with its current effort to diversify its product lines or to relinquish this policy and focus solely on its banking operations. If Wachovia decided to narrow its scope solely to the retail banking industry, the company could divest all unrelated operations and use this newly

freed up capital to renew a policy of aggressive consolidation within the banking market. This strategy could perhaps create the nation's largest retail banking entity in every measurable way. However, this expansion would not necessarily be profitable growth. Any transaction would likely require a costly acquisition premium, one that probably outweighed any possible cost savings through synergies. A reduction in the scope of Wachovia's activities might also place them at such a disadvantage versus their main competitors that they begin losing market share.

### Solutions

Ruling out a narrowing in focus, we can assume that Wachovia will continue on its present course of action. There are two critical problems facing Wachovia. First the company must effectively grow its investment banking and asset management operations to become serious competitors within their respective markets. Second, if slow capital markets lead to a downturn in the financial services industry how does Wachovia continue to grow banking segment revenues?

Wachovia's corporate and investment banking segment is its most promising source of potential growth. This segment has recently been Wachovia's fastest growing, increasing market share in each of the last four years. The investment banking segment produces a majority of its earnings from corporate lending, equity capital markets, and merger and acquisition advisory services. However, Wachovia's investment bank is still not truly competitive with the corresponding operations of some of the other big 6 (Citigroup, JP Morgan and Chase) and the top tier independent investment banks (Goldman Sachs, Morgan Stanley). In order to become a serious player in this industry Wachovia must make significant investments in human capital. It is top flight talent that will allow Wachovia's investment bank to compete with the industry's major players and attract new substantial corporate client relationships.

However, Wachovia must be patient when trying to upgrade its corporate and investment banking operations. In the investment banking industry investing in human capital typically means buying talent rather than developing it internally over time. It will be difficult and expensive to add talent while the investment banking industry is doing well, as it is now, because the labor market is much tighter. It is therefore logical that Wachovia should either wait for a down cycle in

the industry before adding talent or take a more opportunistic approach. Wachovia could try to take advantage of strife and uncertainty when it arises in a rival, as it recently has with Morgan Stanley (see the SageGroup report on Morgan Stanley), to hire away experienced investment bankers with the corporate contacts that would most help to grow its investment bank. There is plenty of growth potential for Wachovia's investment bank, but the company must be able to match its rivals in quality of personnel, industry experience, and corporate networking ability.

Wachovia's capital management segment is coming off a period of underperformance that has been largely due to integration with Prudential. Through that and many other acquisitions, Wachovia's retail brokerage services are now the third largest in the country. The recent addition of Palmer and Cay insurance brokerages has only further strengthened this position. The problem is that capital management is not an exceptionally profitable business, especially during slow financial markets. Wachovia will soon start enjoy the cost savings of the Prudential integration, but this will only be a one-time boost. Like every other major banking institution, Wachovia is depending on more effective cross-selling between the retail bank and capital management segments to boost the latter's revenues. More productive cross-selling is also Wachovia's main strategy for growing the wealth management segment's earnings.

Only time will tell if a focus on cross-selling will turn out to be a successful strategy, but not investing in cross-selling capabilities would leave Wachovia at an extreme disadvantage versus its main competition if it is indeed the winning formula. That said Wachovia's management should remain open to the possibility of divesting its retail brokerage and asset management operations, in case cross-selling is not as profitable as the industry is anticipating. The freed up capital could be devoted to the investment bank's acquisition of talent. At the very least Wachovia should halt any further expansion of these segments through acquisition until management is sure that they are completely committed to current strategies.

Wachovia's management fully realizes that deterioration of current economic conditions and a consequent downturn in the financial markets would most likely severely limit profits from its non-banking segments. In this eventuality the company plans on maintaining earnings growth by reducing expenses. Wachovia plans on reducing its current efficiency ratio, a healthy 52%, to 47% over the next several years. Some of these cost savings will come from completing the

integration of SouthTrust by closing duplicate facilities and eliminating redundant employees. Wachovia also has plans to outsource some technology jobs in order to reduce IT costs. Wachovia's management has done a thorough job of analyzing its operations to identify inefficiencies.

In the worst case scenario, Wachovia could raise some of their basic banking fees to provide a temporary revenue cushion that could later be reversed once market conditions were more favorable. Wachovia's strong market share positions (it is either number one or two in 90% of major urban areas within their geographic footprint/market) and customer loyalty would mitigate losses of current deposits. However, banks have increasingly tried to differentiate their services by paying close attention to their fee policies, and raising fees could potentially damage Wachovia's brand name and image. It is imperative that Wachovia maintains its recently acquired reputation as a top tier retail bank and a leader in customer service and satisfaction. Wachovia is fortunate that some of its main geographic areas, Texas and the South, have more potential for organic growth than some of the more urban geographic areas in the Northeast. This should ease some of the pressure on Wachovia's management and allow them to take a disciplined approach to growing its retail banking operations. As with investment banking, the best policy for Wachovia's retail banking segment is patience, especially when considering possible acquisitions.

## **Conclusion**

Wachovia has used effective management and efficient growth to rise to its current place of prominence in the banking and financial services industries. The company has now reached an important crossroads. To continue its ascent through the banking industry Wachovia's management must grow its investment banking operations as successfully as they have grown its retail bank. If Wachovia can navigate the changing industrial landscape as successfully in the near future as has done the in the recent past, the company will not only survive but thrive.

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