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Holland Views: Schwab – Price $48; Market Cap $61bn

Bigger, better and harder to catch

Last week Schwab had an investor/analyst day to give greater insight into its business. Despite having listened to it in its entirety we just share some key messages that we think emerged. Most of which are consistent with our view that Schwab is the winner low-cost flywheel business in US and global financial services.

Our view – Our Model

Our earlier work on Schwab is either attached or available on request. What was a key finding to us in our study of the company was its "what's best for the customer?" obsession. This we have witnessed in a few other winning lowest cost businesses. When we have found this to be a genuine drive to lower customer pricing/give the customer constantly better value for money the same end result has almost always occurred at each company. This being that growth has rarely ever faded, at least never in the way that outside observers of the company anticipated it would. Interestingly on reading Schwab's recent year analyst calls this is clearly a question that is in investors' minds.

The other factor making us very interested in Schwab was the company's recent transition to a more asset light financial model in future post the decade long decision to build capital for its banking division.

These two crucial observations we made before the company's busy 2019 when it both cut dealing commission costs to zero and took over its closest rival, TD Ameritrade. In our initial work (March 2019) we modelled how we felt the company's sustainable growth and likely future cash generation could compound equity investor capital at a 14%pa rate. This model can be found in the Appendix. Interestingly whilst much has changed at Schwab during the last year the core two tenets of this simplified forecast (sustainable growth and greater cash generation we think still hold true).

Today its starting PE valuation is similar to a year ago (c.18x), but crucially this is now struck off of a lower earnings base (due to clients now paying zero commissions). However, its starting point is a far superior competitive positioning due to its increased scale (post TDA) and the now less attractive zero commission market for any new entrant. **We remain buyers of Schwab**

Fig.1. Less capital now needs to be retained

Bank Capital	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Schwab Bank Deposits	79.3	93	102	130	163	169	231	249	271	294
						2012-18 cagr %		18%		
							Deposit growt	8%	8%	8%
Equity Capital										
CSB (Schwab Bank)		6550	7700	9314	11726	13224	15615	17022	18447	19991
CSC (Platform business)					1912	2508	2262			
TOTAL (excl prefs)					**13638**	**15732**	**17877**			
retained Bank Capital			1150	1614	2412	1498	2391	1407	1424	1544
as % of net income			91%	118%	138%	69%	72%	38%	34%	34%
equity aS % bank deposits		7.1%	7.5%	7.2%	7.2%	7.8%	6.8%	6.8%	6.8%	6.8%

Source: Schwab 10K/Holland Advisors

"So, in the near-term, you may not see as much buybacks as you might be expecting, but longer-term, I want to emphasize longer-term, it is a very, very important part of our financial formula. And I see no reason why our capital return approach should be any different post-acquisition as it is – as it has been up until this point" ***CEO - Feb 2020 Investor Day***

Extracts/Insights' from the company's Investor Day

Below we give a few highlights that arose from last week's investor day. Following which we include a few executive quotes that we think support our thinking on the company.

On Growth

- *"We still feel we can grow this business assets at c.7% pa, even despite its larger size"*
- Schwab still anticipate 5-7% asset growth pa + some market appreciation = 8-9% LT revenue growth
- They expect operating leverage with operating costs now to grow slower than sales
- They also then expect EPS to grow at a higher rate again due to share buy-back cancelations with excess cash (See these quotes in full below and the Appendix for Holland simplified model)

On TD Ameritrade + the Flywheel model we are attracted to

"The main rationale for this deal was the scale it creates more than just saving expenses – some cost benefits can be shared with customers and some can accrue to shareholders."

"We are always looking to build scale, but not dropping all the benefits it creates to the bottom line, rather using some of them to drive profitable future growth."

On competitor pricing risk

Q. What are the areas where the group could now be vulnerable to pricing competition?

A. *"Pre October* (i.e. when they went to zero commissions) *there was always a risk that someone else could try and trip us up with zero commissions pricing. No that is in the past it is hard to see where pricing pressure can now come from."*

We note in earlier calls when addressing this subject, Schwab stated that they do not believe competition will now just switch to cash balance interest rate reductions as earning NIM returns on current account type balances is a model that has been in existence for many decades now.

TD Ameritrade (TDA) numbers:

- Cost synergies will be $1.8-$2bn – this is c.19% of the combined co. cost base or a huge 60-65% of TDA cost base
- They are not assuming any revenue synergies at this time to be prudent
- Despite the $1.9bn being c.40% of the combined company Net Income they are assuming the deal to be 15-20% accretive for three main reasons:
    - They assume c.4% of TDA customer may leave
    - They will be re-pricing all of TDA customers onto their more favourable dealing terms (i.e. at zero commissions and low annual charges)
    - There is a $1.6bn cost of implementing the synergies

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