HollAnd Advisors

Holland Views: Schwab – Price: $49; MCap: $89bn; Target Price $100

Gorilla in the midst

Charles Schwab has now built a network of epic scale and ultra-low cost. It is loved by customers for the superior value and convenience it offers. It now also looks set to offer a greater array of services via this platform, but ones that are always first and foremost 'best for its clients'. Does that sound familiar at all?

A proven flywheel

Our earlier work on Schwab demonstrated its flywheel model i.e. its ability to achieve long term asset growth (+7% pa) by giving back to customers some of its scale benefits. Post the TD-Ameritrade (TDA) merger we feel this flywheel is now owned by a market-dominating gorilla who will be impossible to displace by challengers. Schwab is now poised to use this platform to sell an array of new services that will grow fee income at incremental margins and ROEs. A glance at your Bloomberg screen suggests you are paying c.21x PE for this company. Not so fast. We think Schwab is trading nearer 10x our best estimate of the earnings it will make in 3-4x years' time…and that is using today's low interest rates not any assumption about them improving much.

Schwab at its core is (and was originally) a simple trading and wealth management platform business. That it is now regulated and has complex capital needs is something it chose to do. Its peers like Hargreaves Lansdown and TD Ameritrade did not make this choice. Schwab's regulatory capital and interest rate complexities we think distract many investors from the company's true platform nature. Today Schwab, looks capital heavy once again due to the requirements of its deposit base as clients have stored cash in volatile markets. This will not always be the case as our previous work has shown. At the same time its Net Interest Income is severely depressed due to low interest rates that all are convinced will never again rise. But if they did the company would benefit royally.

In summer 2020 when analysing a European airport, we talked about the 'time to buy a road toll is when there is no-one is using it'. Maybe we could extend that analogy? The time to buy a **powerful**, **highly profitable**, **asset light** network is when its profits are **depressed** and its **capital requirements** are elevated. The lesson for all of us that missed investing in a certain Seattle based platform business would suggest that to be true. We think Schwab can earn $5.00 once its cost synergies on acquiring TDA are realised fully. Were Mr Market then to see what we see (i.e. a profitable, growing network and low cost leader) – then a 20x multiple = $100.

Events, dear boy, events

We first put pen to paper on Schwab in March 2019 and we think our work on it is among our best in demystifying a misunderstood and mispriced business. In the last 18 months, to paraphrase MacMillan, Mr Market's view on Schwab has been blown off course by a litany of 'events'.

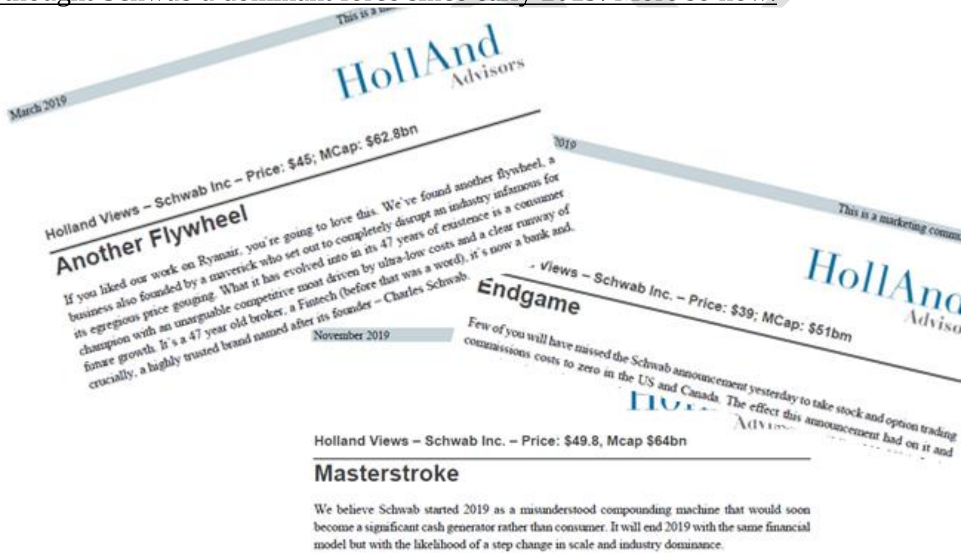
1. Firstly, Schwab reminded us all that its disruptive nature was very much alive. In Q319, it abruptly cut commission rates to zero forcing the entire discount broking industry to follow suit. A reminder too, if it was needed, that Schwab thrives on deflation.

2. Then came the follow on masterstroke when Schwab swiftly acquired major competitor TD Ameritrade (and its $1.6tn of client assets) at a marked-down valuation. In the space of 18 months, Schwab's market share has rocketed from c.8% to c.13%.
3. Not content with such 'elbows-out' creative destruction, the company has also been hoovering up technology businesses as it continues to add indexing and tax services to clients who still enjoy – by far – the lowest costs in the industry.
4. Then along came Covid which turned the tide on recovering bond yields. Schwab's Q320 NIM margins at c.130bp now compare to a previous all-time low of 152bp in 2013! The double whammy of reduced NIM spread with higher retained capital is plain to see as Schwab ROE declined to 12%…

Of these four events, notably the first three were all 'self-inflicted.' Deliberate acts of a management team with a track record of market disruption and long-term thinking to drive their future dominance. Yes, the fall in bond yields hurts earnings in the near term – no question. But it is our core contention in this note that Schwab is a far more dominant business today than it was when we first wrote on it in early 2019. As per the front page, we believe that its intrinsic value is double today's market value.

In noisy years like this one, it is easy for good ideas and good research to be lost. We humbly suggest, it is well worth re-reading those Holland Views highlighted in Fig.1 and re-attached.

Fig.1: We thought Schwab a dominant force since early 2019. More so now.



Source: Holland Views 2019

To view the remainder of this in-depth report, please contact Andrew Hollingworth, Andrew@hollandadvisors.co.uk for a complete PDF copy.

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