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'.

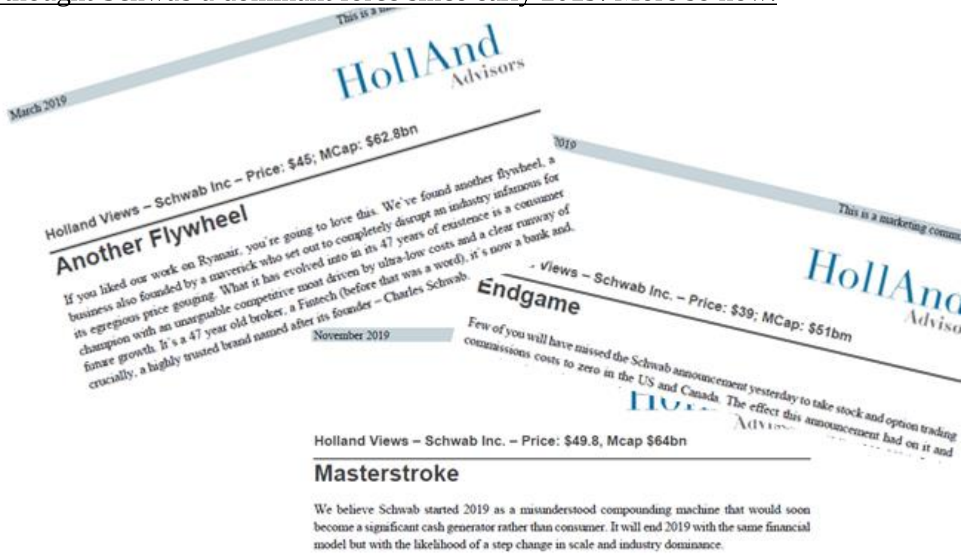
1. Firstly, Schwab reminded us all that its disruptive nature was very much alive. In Q319, it abruptly cut commission rates to zero forcing the entire discount broking industry to follow suit. A reminder too, if it was needed, that Schwab thrives on deflation.

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 <u>all-time low</u> 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.

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


March 2019

HollAnd Advisors

Holland Views – Schwab Inc – Price: $45; MCap: $62.8bn

Another Flywheel

If you liked our work on Ryanair, you're going to love this. We've found another flywheel, a business also founded by a maverick who set out to completely disrupt an industry infamous for its egregious price gouging. What it has evolved into in its 47 years of existence is a consumer champion with an unarguable competitive moat driven by ultra-low costs and a clear runway of future growth. It's a 47 year old broker, a Fintech (before that was a word), it's now a bank and, crucially, a highly trusted brand named after its founder – Charles Schwab.

This is a marketing communication

HollAnd Advisors

Holland Views – Schwab Inc. – Price: $39; MCap: $51bn

Endgame

Few of you will have missed the Schwab announcement yesterday to take stock and option trading commissions costs to zero in the US and Canada. The effect this announcement had on it and

November 2019

Holland Views – Schwab Inc. – Price: $49.8, Mcap $64bn

Masterstroke

We believe Schwab started 2019 as a misunderstood compounding machine that would soon become a significant cash generator rather than consumer. It will end 2019 with the same financial model but with the likelihood of a step change in scale and industry dominance.

Source: Holland Views 2019

Our past Schwab work – A reminder:

- *Holland Views – Another flywheel (March 2019).* A near-perfect Holland Franchise. An owner-manager EDLP flywheel with a runway of structural growth and excess capital always well deployed.
- *Holland Views – Endgame (October 2019).*
- *Holland Views – Masterstroke (November 2019).*

  'What do we make of the deal that Schwab has announced in buying TD Ameritrade? In short, we think it is a masterstroke that will cement Schwab's place as the preeminent <u>global</u> online platform provider of investment services. The scale and resilience of the business this creates we think cannot be over-emphasised'.

In this note, we make three new points on Schwab

1. As each year passes, **Schwab's moat** widens. That is still very true, even in 2020!
2. We ought to remember Schwab remains **a simple business** at heart. To that end we remind ourselves not to get bogged-down in bank capital complexity.
3. Above all, we suggest that investors should take advantage of **the perfect storm** that is today's share price discount to intrinsic value.

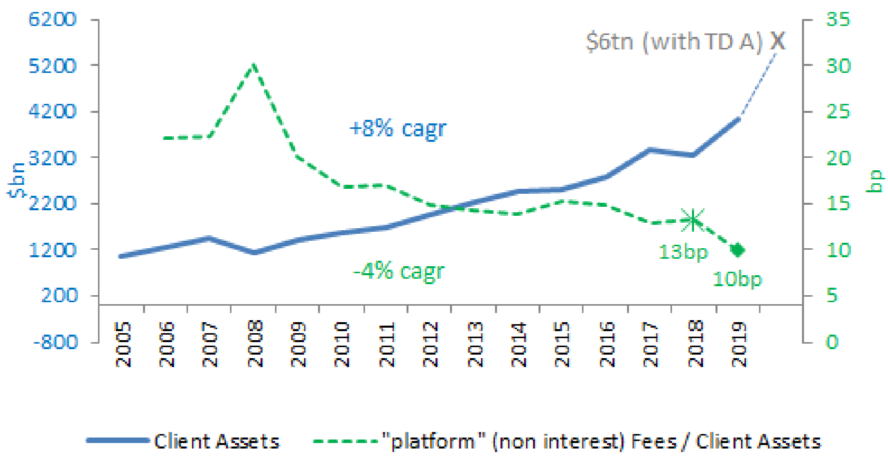
1. The ever-widening moat

"The best proof of innovation is customer commitment" – **James Hamilton, early engineer at Amazon Web Services**

We really like the above quote from an Amazon middle manager. We might offer our own version that the best proof of *business success* is also customer commitment aka loyal, sticky customers. $6tn is a massive commitment indeed. Amidst all of the action and noise from this busy, competitive sector, we are minded to ask ourselves the question – *isn't Schwab to Financial Services in 2020 what Amazon was to retail in 2010*? It is easy to be overly sensationalist in our line of work but we think it is entirely appropriate to point out similarities between Schwab and Amazon. For now, let's just say that we thought 18 months ago, with some conviction, that Schwab was increasingly dominating its chosen market. It was doing so in a manner that was symbiotic to clients and itself. We outlined this symbiosis and the resulting flywheel in our original note.

We come back to that point in the next section. First, we remind ourselves what a dominant flywheel business looks like. Here is the chart we used in our original flywheel note slowing growth in customer assets at lower platform fees. Now we update it to Q3 2020.

Fig.2: The Schwab flywheel: every year lower prices



Source: Holland Advisors

Fig.2 reminds us that the Schwab flywheel, sector dominance and 'moat' is even more entrenched today. Even before the momentous TD Ameritrade deal was completed, Schwab had been organically growing assets by c.5% though 2020. Today, Schwab has $6tn AUM (post TDA) with average platform fees down from 13bp in 2018 to 10bp in 2019 (i.e. before TDA was bolted on!). We expect this cost reduction trend to continue post the merger and clients to be the main beneficiary.

Gorilla in the midst

> (re: competitors) *"it is an intensely competitive world and all lines are sort of blurred as to who works in which space* – **Walt Bettinger, CEO Schwab**

Schwab's original competitors in the 1970s were the wirehouses and staid broker dealers like Merrills and Morgan Stanley. Schwab's competition continued to evolve over time. First were the discount brokers in the late 1990s, then index firms like Vanguard in the 2000s and more recently Fintechs and Blackrock. Schwab now has serious AUM scale (c.$6tn) relative to Vanguard ($6.2tn AUM) and is also closing the gap on Blackrock's $7.3tn juggernaut. Vanguard is of course a mutual company but Blackrock enjoys a market cap of $109bn vs. Schwab's $89bn (both similarly valued at c.1.5% of AUM).

Blackrock, was a pioneer in the ETF space (iShares brand) and as a true 800lb wealth management gorilla now makes for an interesting peer for Schwab investors to consider. Please see the link below for an authoritative write-up on Blackrock[1].

If imitation is the sincerest form of flattery, it is clear to us that Blackrock is taking some notice of Schwab. Blackrock, like Schwab, has been acquiring personalised index companies, broadening its DTC distribution (Schwab is a reseller/distributor of Blackrock's iShares products) and advisory capabilities (Blackrock acquired Futureadvisor). As Bettinger says above, the competitive lines are indeed increasingly blurred. But what still marks Schwab out amongst practically all the competition[2] is **price**. We thought the following comment therefore interesting in the context of Blackrock's recent acquisitions and overlap with Schwab. We would add that Blackrock might have similar scale but it does not have the culture to emulate Schwab's low cost client philosophy.

> *BlackRock has said it has no desire to buy rival firms simply to drive down costs through economies of scale but would look to tactically grow in select areas, including expanding its distribution reach.* – **WSJ article on Blackrock, 24 Nov 2020**

Anecdote from a sticky Schwab RIA client

The aforementioned ultra-low pricing by Schwab is key to client happiness, retention and future sustained growth. Schwab's successful reach into the RIA (registered investment advisor) market almost a decade ago is instructive. Advisor Services are now a $3bn revenue business for Schwab (28% of total). Here Schwab offers a myriad of low-cost advisory, tax, indexation and custodian services for the huge swathe of RIA-managed money in the American market. It seems to us that Schwab is under-earning in this area (28% of revenues from a segment that contributes half of its AUM).

> *Nearly half of Schwab's total customer assets are now managed by roughly 7,500 independent advisory firms that use Schwab as custodian*[3].

So these customers are getting great value and look to be 'sticky'. The following is a great insight into Schwab's value-add in this area and a reason for its increased dominance (and competitive moat).

> *Matthew Celenza, an independent financial adviser in Los Angeles, is among the converts (to Schwab). Mr. Celenza this year launched his own wealth-advisory business, Boulevard Family Wealth, with about $1 billion in assets after a six-year run with Merrill Lynch's private banking and investment group. "Going independent gives us better*

[1] https://netinterest.substack.com/p/the-aws-of-finance

[2] Bogle-heads, as the Vanguard community are called might disagree but Vanguard is a much narrower business in that is sole offering is index funds.

[3] https://www.wsj.com/articles/how-schwab-ate-wall-street-11556474103

> *positioning in the business," Mr. Celenza said when he left Merrill in July. Yet without the infrastructure provided by a traditional brokerage, finding a place to keep clients' money was one of the first things Mr. Celenza had to do upon going independent.* ***He went with Schwab and estimates that his clients save 0.15% to 0.20% in annual fees now that their assets are held at the discount brokerage versus his former firm****. "I know the perception is that Schwab is a discount brokerage," Mr. Celenza said, but "they offer every service a large brokerage service would* – **WSJ[4] (emphasis ours)**

2. Keep it simple, Sir

> *"There are two types of companies in the world: those that work to charge more and those that work to charge less"* – **Jeff Bezos**

We understand why investors might look at Schwab accounts for the first time in mid-2020 and conclude that it this is a damn complicated business – too complicated perhaps. It wouldn't be the first time that investors, us included, mistook simple for complicated. We will try to show here why Schwab's impeccable four-decade track record results from what is actually a very simple business proposition.

Parallels to Amazon – A customer journey

As a thought experiment we pose the question that perhaps Amazon watchers asked themselves in 2005 or even 2010? *Is this Amazon business (in 2005) a tech platform, a retailer, a wholesaler, an auction house or a cloud computing company?* Actually, it turns out, Amazon was at heart a customer company, albeit a ginormous one. Amazon aggregates and retains masses of customers[5] by offering them tremendous service and value for money. It makes money itself by making a very small spread (a tax of sorts) on retail activity of all those users. Simple if you know how!

For Schwab watchers in 2020, they similarly might ask, *is Schwab (in 2020) a discount broker, an asset manager, a custodian, a bank or a technology distribution platform?* The answer might be 'yes' to all of the above but actually at heart, Schwab, like Amazon is also just a customer company. It too aggregates masses of financial customers by offering them tremendous service and value. Schwab too makes money by making a very small spread (also akin to a very small tax of sorts) on customer assets held in Schwab's custody. Above all else, Schwab, just like Amazon, prioritises customer trust over short-term profits.

By the way, look at how similar Charles Schwab's mantra was to Bezos' (20 years before Bezos even arrived on the scene!).

> *"Keep prices low and the rest will follow"* – **Charles Schwab[6]**

We remember reading a WSJ article citing a middle manager at Schwab who recounted that in his 16 years at Schwab, someone asked at every meeting: "*Can we do it cheaper*?" Business really doesn't really get much simpler than that. The EDLP businesses that we love at Holland Advisors; the Costco's, the Amazon's, the Ryanair's, the Wetherspoons', the Geico's, and the Schwab's all do this one seemingly simple thing extremely well. They offer the lowest prices (and typically great service), they gather customers and make a small spread on those vast numbers of customers. It's not a coincidence that all are pre-eminent compounders too. The compounding coming from customer loyalty and new customers being attracted to the value proposition they offer.

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[4] https://www.wsj.com/articles/behind-discount-brokers-boom-advisers-not-day-traders-1513284443?mod=article_inline

[5] Amazon grew customers 6x fold 2005-2015 to 304m

[6] www.wsj.com/articles/how-schwab-ate-wall-street-11556474103

Schwab and monetisation

The Devil's advocates might retort that even if one accepts that Schwab can further succeed at EDLP, there is another greater question. That is, *how will Schwab make money if it continues to rely on Schwab Bank to generate a NIM and interest rates stay lower for longer or forever*? We feel well prepared to answer such a question as it is one we have debated ourselves at some length. Indeed it is the only question other analysts on the stock ever ask about!

Not to overuse the Amazon analogy but again it is a useful one. In 2005, did anyone foresee Amazon Web Service, Amazon Prime, Amazon payments as successful new income streams for Amazon? Very few people did. One of the reasons that platforms are attractive is that their scale and network relationships with customers offer a myriad of options on monetisation. Take Ryanair, who could have envisaged, 20 years ago that priority boarding/bags would account for 30% of sales? The broader point is that when you have 100m customers, finding an extra €1 of value to give each is well within reach from a customer perspective but multiplied by 100m and soon we are talking proper money from a P&L perspective!

When one looks at the fees being charged for advice in the wealth management industry, it is clear to us that opportunities abound for Schwab to up its 'take rate' just a little across a huge customer base. We recognise that creaming commissions is a well-worn strategy in financial services very often at the expense of customers' interests. We are confident that this is not the Schwab way. Instead it is attuned to finding ways to offer greater help/service to its customers on a 'win-win' basis.

So could Schwab offset 'lower for longer' NIM spread? We think so. Easily bearing in mind Schwab has a 50 year track record of moving-up the value chain in asset management here is some food for thought:

- **Technology** – Blackrock's Aladdin generates c.$1bn in very high margin revenues (see that Net Interest article linked above). Blackrock is the benchmark for monetising proprietary B2B investment technology. Bettinger has been making noises lately that RIA's have been utilising Schwab tools without 'sharing' the value derived.
- **Tools** such as proprietary index building (see Schwab's *motif* acquisition), tax services (also acquired via the *Wasmer Schroeder* business) and robo-advisors are clear value-add tools that customers, both RIA and retail, will see value in.
- **Advisory service** – the Appendix shows how Schwab's Asset Management (i.e. non-bank) fees are derived. In the most recent 3 month period, Schwab derived asset management fees in aggregate of just 17bp – but on just 50% or half of its AUM ($2tn out of $4tn). Of that $2tn, just $308bn actually derived an advisory fee. There's that runway again!

The discounter changes gear to a "Modern Wealth Manager"

Schwab has started using the term 'Modern Wealth Manager' as a tag line to coincide with the announcement of the TD Ameritrade deal in Nov 2019[7]. We think this is more than marketing fluff and underpins a very real effort to now balance how Schwab is monetising its business. It also ties in with our earlier comments re Blackrock and Schwab increasingly going head to head.

With all that in mind, we can see below that the CEO is thinking more like a Bezos (or a Fink) in terms of turning an expense line into a revenue line. This is something that Amazon has been exceptionally clever at. Amazon turned legacy costs (cloud computing most famously, but also fulfilment etc.) from operating expenses into revenue segments. Blackrock's Aladdin does the

[7] https://content.schwab.com/web/retail/public/about-schwab/SCHW-AMTD_Announcement_deck.pdf

same. It originated as an in-house Fixed Income pricing system and is now sold extensively to asset managers globally.

> **Analyst**: if we are in a lower rate environment for much longer than anyone thinks, I guess, what are your thoughts on globally migrating the revenue mix away from interest rate sensitive types of areas?
>
> **Walt Bettinger CEO**: "*we do have a longer term goal of striving for a balance between spread income and other forms of revenue. And of course, that plays out in two of our three strategic initiatives, very clearly in monetization and segmentation. And the thing that I would just emphasize is that all of our monetization efforts are -- we want to ensure are done in terms of them being good for clients. But you can see them unfolding before you whether it's the acquisition of the technology and the talent from Motif, the acquisition of Wasmer Schroeder, the negotiations that we are having with firms, who effectively capitalize on our platform and we provide services they would otherwise have to provide, but yet don't provide any offsetting compensation for those services. These are all in line with actions that we're taking as well as continue to build our advisory solution… But I think we're fairly confident in our plans to get to a more balanced approach within a reasonable period of time and are taking all prudent actions to get there* **– Q3 2020 conference call (emphasis ours)**
>
> *I think clearly the greatest opportunity today when we look at the revenue that our clients are generating for third parties is in the asset management space. And so that is a focus of ours in evaluating whether the consumer is getting the absolute best service, best value, best outcomes for what they're paying or are there alternatives that might be better for them overall. And at the same time, potentially shift some of the revenue from third parties to us. But again, only in the context, if it's in the best interest of the client* **– Walt Bettinger, April 2020**

Now, we are not saying this will be an easy process. Indeed Schwab will have to walk a delicate line if it is to extract more revenue-sharing from a key client constituent that is the RIA advisors – (especially from the larger ones who may be more resistant). But no-one understands win-win better than Schwab. After all, this is a company whose motto is actually true to its culture: "Through clients' eyes".

3. Take advantage of a near-perfect storm

Getting back to brass tacks, on the front page of this note we suggested that the Schwab business is under-earning and that the earnings power of the business today is closer to $5.00 in EPS. That will seem very fanciful to readers so we'd better explain ourselves.

The previous two sections in this note were intended to show, at a high level, Schwab's tremendous scale and increasing ability to both create and derive further value from its chosen wealth management markets. Clearly, these prospects have been over-shadowed by a perfect storm of events this year. To remind you, the perfect storm derives from:

1. The **interest rate cycle**. Who would have thought, at the start of 2019 that NIM spreads would fall to 130bp, an all-time low, within 18 months? Schwab's ROE has been negatively hit as a result of this.
2. Volatile markets and higher client cash balances led to **higher regulatory capital needs**. The duration uncertainty of that higher capital requirement seems to be the primary concern of Schwab-watchers.

3. Finally, the **TDA deal** is clouding Schwab's earnings power. To our eyes, it is quite a straightforward deal with clearly defined operating cost and fee synergies. That said, there are layers to the synergies that need to be peeled back to fully appreciate the opportunity.

The bright side is that all these events are, we think, temporary in nature, and have weighed excessively on the Schwab share price thus offering an opportunity. **Importantly our $5.00 of EPS earnings power does not rely on the expectation of new streams of fee income we allude to above only already identified cost savings synergies**.

A recap on Schwab Bank's capital

We wrote at length on the interaction between client cash balances, Schwab Bank deposits and regulatory capital in our note of March 2019. In short: in periods of market volatility, Schwab clients, like many rattled equity investors, raise their cash balances. Schwab rationality choses to sweep these new balances into its bank to earn a NIM spread (i.e. greater profits). The capital cost of this is, however, not insignificant and regulatory rules forces commensurate balance sheet growth to underpin these client liabilities.

Fig.3 below shows an update of the table we originally created in early 2019 summarising this trend. At that time, Schwab Bank equity capital had been levelling off and we were enthusiastic on the boost that this could lead-to in Schwab's group *future* ROE – all else being equal.

Of course, events since have conspired against us. But, we believed then and continue to believe today that Schwab is at heart an asset-light platform business. In due course, cash balances will revert to more normal levels and rising group ROEs will result.

In the longer run, as investor cash balances fall and fee income is diversified, equity capital will once again grow at a slower rate than AUM thereby unleashing higher ROEs and ultimately, excess capital.

Fig.3: Cash balance up, equity capital up, ROE down – but not permanently

Bank Capital	2012	2013	2014	2015	2016	2017	2018	2019	Q1 20	Q2 20	Q320
Schwab Bank Deposits	79.3	93	102	130	163	169	231	220	278	302	320
qoq									26%	9%	6%
yoy		17%	10%	27%	25%	4%	37%	-5%			53%
						2012-18 cagr %		16%			
							Deposit growt	8%			
Equity Capital											
CSB (Schwab Bank)		6550	7700	9314	11726	13224	15615	14832	18862	20960	21606
qoq			18%	21%	26%	13%	18%	-5%	27%	11%	3%
CSC (Platform business) incl intangibles					1912	2508	2262	4120		4592	4462
TOTAL (excl prefs)					**13638**	**15732**	**17877**	**18952**		**25552**	**26068**
Preferred Stock							2793	2793	impacted by mark-to-market gain in 'for sale' portfolio (which increased bank capital but not regulatory capital)		5263
Total Stockholder Equity							**20670**	**21745**			**31331**
bank regulatory capital (less intangibles)								14819			16648
								6.6%			5.4%
MINIMUM bank capital								8389			

Source: Holland Advisors

Fig.3 shows that with cash balances now 50% higher compared to nine months ago, one can see that Schwab Bank equity capital has grown in the short term.

For those that wish to skip some detail on this capital complexity, please skip this paragraph! The table above also shows that bank equity capital ($21.6bn) has in fact risen much faster than regulatory capital ($16.6bn) thanks largely to the unrealised gains in Schwab's bond portfolio (see excel comment in Fig.3). These unrealised gains could be drawn on to increase regulatory capital (possibly at the expense of future NIM) or Schwab could see to continue to issue preferred equity. The latter seems more likely in the near term. For a further sense of the complexity around this area, consider the following. As part of the TDA deal, Schwab will have the option to start sweeping a regular portion of the TDA cash balances (that used to be held by TD Bank) into Schwab

Bank. This too will of course require capital buffers. The deal agreement is skewed in favour of Schwab over TDA bank though. So, whilst TD Bank will no doubt be keen to retain some of these deposits it will not have much negotiating leverage to insist beyond the transition period. This leaves optionality for Schwab.

In short, we are fully aware of the Schwab's current capital needs and the negative impact on group ROE but we strongly urge readers not to get bogged-down in this complexity but to focus on the bigger picture. That is the strength of its platform business and its ability to generate strong cashflows once it is outside its chosen heavy investment phase.

The crux of it: Schwab shares are on sale at 10x earnings power

In this section we try to identify and unearth the layers of under-earning that is embedded within the Schwab-TDA business. Today we suggest there are three layers to prudently assess the extent of this earnings power. Fig.4 below shows a simple outline of three scenarios.

1. A simple bolt-on of the two businesses plus stated opex synergies = $3.38 EPS
2. As 1. above, plus the uplift from TDA cash deposits swept to Schwab Bank = $3.83 EPS
3. As 2. above, plus a continuation of the underlying 7% asset growth = $5.02 EPS

We always strive to be approximately right rather than precisely wrong and the sector-specialists will no doubt quibble with the timeframe in which these synergies are actually realisable ("that's years away", or "*NIMs were even lower in Q3 20 than last 12m*" they might say). Our point is to demonstrate the inherent earnings-power and it is our contention that the market is has not yet begun to consider the impacts of scenarios 2 and 3. It cannot ignore them for long.

Fig.4: Unpeeling the onion

Scenario		1	2	3
Pro-forma	2019	Last 12m	Last 12m + TD Sweep benefit	Last 12m + TD Sweep benefit + 4Yr compounding
Schwab Pre Tax Profit	**4848**	**3824**	**3824**	**3824**
@ NIM spread of	2.43%	1.91%	1.91%	1.91%
TD Pre Tax Profit	**2919**	**2700**	**2700**	**2700**
+ TDA synergies (2-3 years out)	1800	1800	1800	1800
+ TD Bank sweep synergies (see below)	0	0	1264	1264
Pro forma SCHWAB-TD pre-tax	**9567**	**8324**	**9588**	**9588**
taxed	7654	6659	7670	7670
Pref divi	332	332	500	500
Net Income	7322	6327	7170	7170
new share count	*1874*	*1874*	1874	1874
per-share Cagr trend growth				7%
pro-forma TD-SCHWAB EPS	3.91	3.38	3.83	5.02
P/E	12.5x	14.5x	12.8x	9.8x
Notional pro-forma Return on Tangible Equity			26%	
TD Bank NIM synergy upside			**last 12m**	
reported bank dep based revs $m			1670	
av bank deposit balances $bn			154bn	
implied effective TD bank NIM Last 12m			1.08%	
vs schwab est NIM Last 12m			**1.91%**	
differential			0.82%	
upside/Sweep Synergy $m			1264	

Source: Holland Advisors

In further defence of our prudence, and this is an important point, we should remind readers that we are assuming that NIM rates stay relatively depressed at c.191bp[8] in this analysis and that none of the Fee diversification potential outlined earlier is realised in the medium term.

[8] We recognise that Q3 NIM was even lower (mid 130s) but in the context of historical NIM (see Appendix Fig.5a) that a still-depressed 191bp is prudent

Briefly then, the three scenarios in Fig.4 explained

Schwab made $4.8bn in pre-tax profit in 2019 and c.$3.8bn in the last 12 months to Sept 2020 as shown in Fig.4 above. The main difference in those two starting points is the lower NIM spread realised through 2020. We use the last 12 months as our starting point and offer three scenarios.

1. We start with the assumption that Schwab realises the entire $1.8bn of TDA operating cost synergies which it originally guided investors to and recently reiterated. On that basis, and remember it assumes a depressed NIM of 191bp in the last 12 months, then pro-forma earnings would be **c.$3.38** implying a pro-forma P/E of c.14.5x. We think that is broadly how the market is thinking about Schwab's valuation today.
2. However, there is another, substantial kicker to Schwab earnings resulting from this deal. In the Appendix Fig.6, we show TDA's simple income statement and standalone profit streams, a portion of which is also derived from a NIM spread on TDA's customer cash balances. However, TDA's historical reported NIM is about half that of Schwab[9]. TDA's lower NIM is because TDA shares the NIM with its partner, Canada's TD-Bank.

   Post-deal, Schwab-TDA has the opportunity to gradually sweep those acquired balances from TD-Bank over to Schwab Bank thereby allowing it to monetise those assets at its own higher NIM. This scenario is shown in the scenario 2. At today's depressed NIM spreads, this would suggest another (admittedly further-out) upside of c.$1.264bn synergies thus boosting pro-forma earnings to **c.$3.83** (and lower today's P/E on those earnings to 12.8x).
3. In both scenarios above, the adjustments are all considered before any assumption that underlying growth of the business will continue. In the context of AUM which continues to grow 5-8% organically (+5% most recently), we are confident that Schwab will not stop growing organically any time soon.

   Scenario 3 simply assumes a continuation of the 7% growth rate for four years which would turn $3.83 into a **$5.02 EPS** in four years. (NB: This 7% growth assumed rate in EPS is likely lower than the outcome rate the company normally achieves of 10-12% when reporting 5-6% asset growth).

In Conclusion

We've said from day one that Schwab is the quintessential 'flywheel business'. Real-world mechanical flywheels are designed to conserve and store energy. Ergo, by definition a flywheel has pent-up energy stored within it. Furthermore, the amount of energy is exponentially related to the size of the wheel and the enlarged Schwab-TDA fits the bill perfectly. We believe that Schwab-TDA has masses of pent-up earnings power yet to be unleashed.

We can see why analysts might get tied up in a knot over Schwab. Market volatility, regulatory capital requirements and falling bond yields all weave a complicated web at first glance. So with this business, one must keep an eye on the big picture, the track record, its scale and the opportunity it has to entrench dominance. But also on the power of its network and its focus on giving customers great value.

The recovery in Schwab's share price in recent weeks likely reflects the uptick in bond yields and thus prospects for a slightly better NIM outlook. In other words, Mr Market is starting to look back at the 2019 income levels to value the business. However we are not so sure Mr Market is yet giving Schwab full value for TD deal synergies yet. Nor is it assuming a significant recovery in interest rates.

[9] we estimate c108bp vs. Schwab's 191bp in the last 12m as shown in Fig.4 green shaded area

As for valuing the company on an Amazon-esq industry dominating flywheel whose marginal returns could accelerate as it offers incremental services to its loyal customers? Well, we are a long way short of Mr Market coming to that conclusion. Were it to think along those lines we think our $100 target share price might look a lot less silly than maybe it does today!

We finish with an apt insight from Mr Buffett.

> *I have always been attracted to the low cost operator in any business and, when you can find a combination of i) an extremely large business, (ii) a more or less homogenous product, and (iii) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation.* – **Warren Buffett**

Buy Schwab, the gorilla in our midst.

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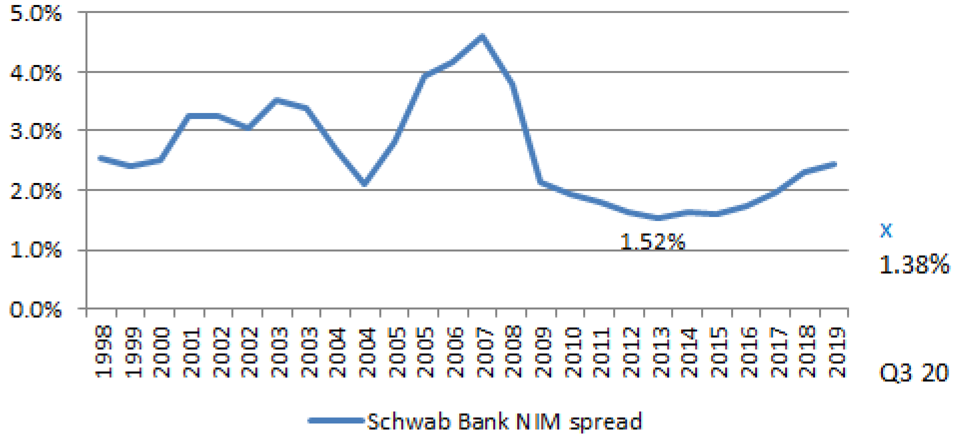
Appendix

Fig.5a: NIM spread



Source: Schwab, Holland Advisors

Fig.5b: Professional Forecasters!

Source: Bianco Research

Fig.5c: Schwab Asset Management fees

	Three Months Ended September 30,						Nine Months Ended September 30,					
	2020			2019			2020			2019		
	Average Client Assets	Revenue	Average Fee	Average Client Assets	Revenue	Average Fee	Average Client Assets	Revenue	Average Fee	Average Client Assets	Revenue	Average Fee
Schwab money market funds before fee waivers	$ 199,822	$ 153	0.30%	$ 177,892	$ 133	0.30%	$ 205,544	$ 469	0.30%	$ 166,053	$ 378	0.30%
Fee waivers		(44)			—			(59)			—	
Schwab money market funds	199,822	$ 109	0.22%	177,892	133	0.30%	205,544	410	0.27%	166,053	378	0.30%
Schwab equity and bond funds, ETFs, and collective trust funds (CTFs)	306,899	75	0.10%	274,005	75	0.11%	290,759	219	0.10%	260,034	219	0.11%
Mutual Fund OneSource® and other non-transaction fee funds	197,809	154	0.31%	192,409	153	0.32%	187,153	436	0.31%	190,847	452	0.32%
Other third-party mutual funds and ETFs (1)	469,822	85	0.07%	486,285	84	0.07%	446,007	235	0.07%	469,901	238	0.07%
Total mutual funds, ETFs, and CTFs (2)	$ 1,174,352	423	0.14%	$ 1,130,591	445	0.16%	$ 1,129,463	1,300	0.15%	$ 1,086,835	1,287	0.16%
Advice solutions (2)												
Fee-based	$ 307,983	373	0.48%	$ 251,591	305	0.48%	$ 277,297	999	0.48%	$ 241,678	878	0.49%
Non-fee-based	73,850	—	—	71,195	—	—	71,438	—	—	69,136	—	—
Total advice solutions	$ 381,833	373	0.39%	$ 322,786	305	0.37%	$ 348,735	999	0.38%	$ 310,814	878	0.38%
Other balance-based fees (3)	443,929	51	0.05%	421,241	56	0.05%	428,191	150	0.05%	407,762	162	0.05%
Other (4)		13			19			39			39	
Total asset management and administration fees		**$ 860**			**$ 825**			**$ 2,488**			**$ 2,366**	
TOTAL Asset Mgmt	$ 2,000,114	$ 860	0.172%									

Source: Schwab, Holland Advisors

Fig.6: TDA income streams

Standalone TD model

TD Ameritrade

TD bank NIM share	1670
TDAM margin interest	1394
other	552
Total Spread Fees	**3616**
Transaction trading fees	2099
other trading	283
Total trading	**2382**
Net Revenue	**5998**
Opex	3192
D&A	171
amortisation of intang	116
	Jun-20
s/h equity	9568
gw & intang	5341
TBV	4227
AUM	1588bn
Spread-based assets	202bn
% total AUM	13%
of which Bank deposits	154bn
of which margin balances	48bn

Source: Holland Advisors

Fig.7: Our simple estimate of upside to TD-A NIM at Schwab bank

TD Bank NIM synergy upside	**last 12m**
reported bank dep based revs $m	1670
av bank deposit balances $bn	154bn
implied effective TD bank NIM Last 12m	1.08%
vs schwab est NIM Last 12m	**1.91%**
differential	0.82%
upside/Sweep Synergy $m	1264

Source: Holland Advisors

Fig.8: Schwab KPIs

	2012	2013	2014	2015	2016	2017	2018	2019	Q1 20	Q2 20	Q320	SCHWAB-TD Q4 20
AUM	3800 blackrock aum						6300					
Headline 'AUM' $bn	1951	2249	2463	2513	2779	3361	3250	4040	3500	4110	4,395bn	5,983bn
									addressable AUM market			45,000bn
of which interest generating											386bn	
as % of AUM											9%	
at a NIM of											1.38%	
of which derives Asset Mgmt Fees								1,110bn			1,174bn	
with an av fee of											0.14%	
of which derives Advice Fees								317bn			382bn	
with an av fee of											0.39%	
of which 'other balance based Fees" derived from								432bn			444bn	
with an av fee of											0.05%	
Total AUM which derive 'balance-based' fees								1,859bn			2,000bn	
% total AIUM								46.01%			45.51%	

	2012	2013	2014	2015	2016	2017	2018	2019	Q1 20	Q2 20	Q320
adj ROTE						16%	22%	21%			11.5%
Interest earning assets						217bn	252bn	268bn	292bn	362bn	386bn
NIM spread	1.62%	1.52%	1.64%	1.60%	1.73%	1.97%	2.29%	2.43%			1.38%
											1.91%
Segment Revenue $m	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**Q1 20**	**Q2 20**	**Q320**
TOTAL NIM	1764	1980	2272	2525	3322	4282	5823	6516			1343
TOTAL Asset Mgmt Fees	2043	2315	2533	2650	3055	3392	3229	3211			860
TOTAL Trading	868	913	907	1194	1096	944	1080	994			245
investor services						6200	7321	7623			
advisors services						2418	2811	3098			
						8618	**10132**	**10721**			

Source: Holland Advisors

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