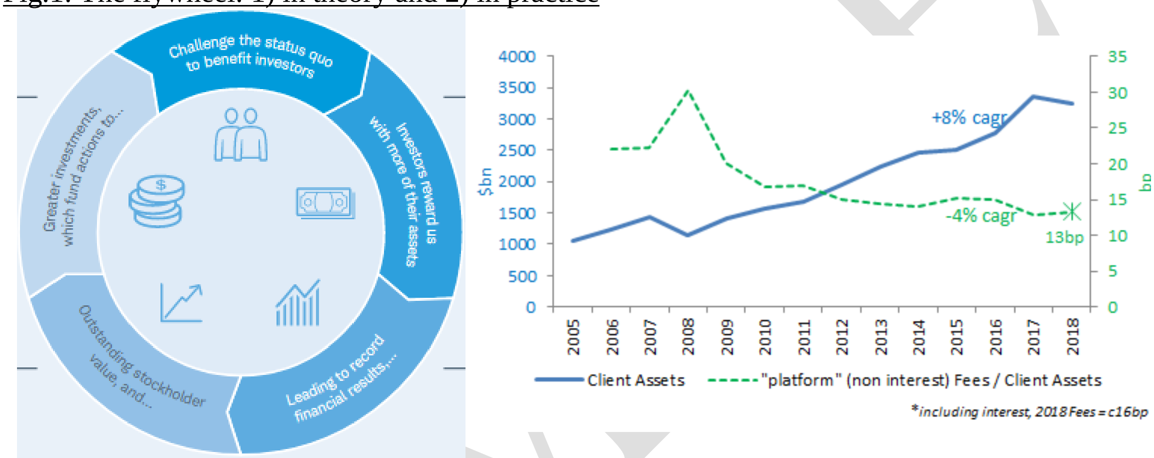
HollAnd
Advisors

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.

Fig.1: The flywheel: 1) in theory and 2) in practice



Source: Schwab 2017 annual report, Holland Advisors

1. Schwab is a **quintessential flywheel business** and is, we think, a 'Franchise' stock…
   - …enjoying a classic EDLP model
   - based upon a "customer obsessed" service culture
   - that constantly reinvests in its customer offering via lower pricing and enhanced services
   - using technological innovation to lower costs and enhance services
   - Its founder, the eponymous Charles Schwab, is still immersed in the business

2. With a unique **hybrid monetisation** business model [i.e. Fees + Net interest margin]
   - Asset-light platform business (a 'fund supermarket' ala Hargreaves Lansdowne)
   - plus, an FDIC-insured Bank (with cheap and very sticky deposits swept from clients!)

3. With **ample growth opportunity**:

   *"The company now handles more than 7 percent of the $45 trillion that people in the U.S. have available to invest. In the next five or so years, **I would be disappointed if that weren't doubled**"* – Bloomberg interview with Charles Schwab, founder, Chairman and 11% shareholder, Oct 2018[1] (emphasis ours)

Given all these attributes we find Schwab shares reasonably priced at 16x December '19 earnings. What's more, it has a cushion to market corrections as such events see client risk aversion and

[1] https://www.bloomberg.com/news/features/2018-10-02/charles-schwab-on-his-3-6-trillion-edge-on-the-fintechs

thus rising cash balances which in turn provide better interest income to the company (Q4 2018 being an example).

Schwab is a hard stock to find fault in. This is a founder-run, dream business with a compounding bank bolted on with a demonstrable growth runway.

Thinking differently

Our perspective as generalists, albeit ones with experience in US banks, Amex, PayPal, Hargreaves Lansdown and Ryanair etc., we hope, brings a fresh approach to Schwab. As generalists we actively seek these flywheel businesses across all sectors. The reason being that they are a proven way to secure future growth. Those closer to the sector might underestimate the importance of this flywheel driver having perhaps seen it only rarely before.

We have three angles on this business that we think are under appreciated by Mr Market currently:

1. A period of exceptional Schwab Bank deposit growth (+30% cagr since 2006) has required significant capital to be retained by the company. As deposit growth now normalises, Schwab's **marginal ROEs** will be much higher from here on. Schwab can/will likely still grow (8-10% revenue growth is our best guess) but now will be able to maintain a structurally higher pay-out ratio (c.70% we suggest). This means the group more closely resembles a capital light 'Dream' business going forward as opposed to more recently looking like a capital heavy bank model. Dream business (should and do) trade on higher PE's due to their more powerful per share compounding characteristics. The groups 16x multiple does not reflect this fact.
2. Looking over a long-time horizon, Schwab's Dec 2019 PE multiple of 16x should be taken in context. We accept that it has been a beneficiary of the rising interest income it has made on captive deposits as rates rose, but it is far from overearning. Its **2018 Net Interest Margin (NIM), at 229bp, is closer to its trough than its peak**.
3. The growth in Schwab's client assets and the associated bank deposit base (both, being very sticky) cycle-to-cycle ought to have a meaningful impact on **reducing the cyclicality of the business**.

In Summary

We have worked hard to condense the many aspects of the Schwab investment case before putting pen to paper. As a result, we conclude that Schwab's business can actually be assessed reasonably straightforwardly.

We have said in the past that the best businesses articulate their purpose, strategy and culture with the utmost clarity. Next plc in the UK is a great example of this. Next explains its corporate purpose and thinking with such clarity and openness, that the need for subjective external analysis is limited. We think Schwab conducts itself similarly.

We strongly suggest as a starting point, therefore, investors read at least the first 15 pages of the most recent Schwab annual report (2018 out any day now). Few annual reports read with such clarity of purpose as Schwab's does. An important early conclusion from which is that this is a company that *demonstrably* puts the customer first in everything it does and all its financial success, past and future, is derived from this point. The analogies with Amazon in this regard are many though Schwab has a track record twice as long. Schwab, like Amazon enjoys a 'flywheel' business model.

Disclaimer

This document does not consist of investment research as it has not been prepared in accordance with UK legal requirements designed to promote the independence of investment research. Therefore even if it contains a research recommendation it should be treated as a marketing communication and as such will be fair, clear and not misleading in line with Financial Conduct Authority rules. Holland Advisors is authorised and regulated by the Financial Conduct Authority. This presentation is intended for institutional investors and high net worth experienced investors who understand the risks involved with the investment being promoted within this document. This communication should not be distributed to anyone other than the intended recipients and should not be relied upon by retail clients (as defined by Financial Conduct Authority). This communication is being supplied to you solely for your information and may not be reproduced, re-distributed or passed to any other person or published in whole or in part for any purpose. This communication is provided for information purposes only and should not be regarded as an offer or solicitation to buy or sell any security or other financial instrument. Any opinions cited in this communication are subject to change without notice. This communication is not a personal recommendation to you. Holland Advisors takes all reasonable care to ensure that the information is accurate and complete; however no warranty, representation, or undertaking is given that it is free from inaccuracies or omissions. This communication is based on and contains current public information, data, opinions, estimates and projections obtained from sources we believe to be reliable. Past performance is not necessarily a guide to future performance. The content of this communication may have been disclosed to the issuer(s) prior to dissemination in order to verify its factual accuracy. Investments in general involve some degree of risk therefore Prospective Investors should be aware that the value of any investment may rise and fall and you may get back less than you invested. Value and income may be adversely affected by exchange rates, interest rates and other factors. The investment discussed in this communication may not be eligible for sale in some states or countries and may not be suitable for all investors. If you are unsure about the suitability of this investment given your financial objectives, resources and risk appetite, please contact your financial advisor before taking any further action. This document is for informational purposes only and should not be regarded as an offer or solicitation to buy the securities or other instruments mentioned in it. Holland Advisors and/or its officers, directors and employees may have or take positions in securities or derivatives mentioned in this document (or in any related investment) and may from time to time dispose of any such securities (or instrument). Holland Advisors manage conflicts of interest in regard to this communication internally via their compliance procedures.