Charles Schwab Corp.

Channel checks indicate lower Thinkorswim attrition risk; Maintain U/P

Reiterate Rating: UNDERPERFORM | PO: 58.00 USD | Price: 63.92 USD

24 January 2024

Equity

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Channel checks indicate lower Thinkorswim attrition risk

Following multiple channel checks in the active trader segment, including with the leadership of Thinkorswim's biggest competitors and with investors/clients, we are less concerned with the risk of attrition. In May, 1.7M active trader clients from Ameritrade's Thinkorswim platform will undergo a clearing conversion and be migrated to the SCHW app. Following attrition headwinds from the RIA integrations, we previously viewed the May conversions as a risk and believed SCHW saved the riskiest segment for last.

Factors for why we feel better with ToS attrition risk:

Competition is not actively marketing to ToS's clients, and we now have a better understanding of how active traders operate (pivot activities versus closing accounts). Also, SCHW had no major issues with its smaller active trader conversions in November. Most ToS customers already know the competitor offerings and may already have accounts opened with them. We also think the migration to the SCHW app is not that big of a deal and ToS clients will lose no capabilities unlike AMTD's RIA clients which lost Veo One. Plus we don't believe SCHW will actively try and cross-sell them advisory solutions (at least initially).

Continue to forecast risk to SCHW's 5-7% NNA target

After three consecutive quarters of NNAs below 5%, we look for SCHW to continuing missing this growth rate into the future. This is driven by the law of large numbers, maturity of SCHW's businesses and the intensifying competitive landscape (in RIA and retail). We also estimate seasonal headwinds in 1H24 and residual AMTD attrition. The unique characteristics of the covid pandemic juiced online brokerage results in 2020-21 to unsustainable levels which we don't expect to return (even in a strong bull market). We also note that SCHW's true organic growth, monitored by account growth, is running significantly below its public peers: SCHW at 3% vs. IBKR at 23%. If SCHW has to lower its target or if its NNAs continue to miss, we think this could erode the stock's premium valuation.

Expect cash sorting to improve but linger in 2024

This is driven by both RIA and retail channels and three seasonal factors in 1Q24.

Estimates (Dec) (US$)	**2021A**	**2022A**	**2023E**	**2024E**	**2025E**
EPS	3.26	3.91	3.14	3.33	3.81
GAAP EPS	2.83	3.51	2.54	2.96	3.45
EPS Change (YoY)	35.2%	20.0%	-19.7%	6.1%	14.6%
Consensus EPS (Bloomberg)			3.11	3.47	4.47
DPS	0.74	0.84	1.00	1.10	1.21
Valuation (Dec)					
P/E	19.6x	16.4x	20.4x	19.2x	16.8x
GAAP P/E	22.6x	18.2x	25.2x	21.6x	18.5x
Dividend Yield	1.2%	1.3%	1.6%	1.7%	1.9%

Stock Data

Price	63.92 USD
Price Objective	58.00 USD
Date Established	17-Jan-2024
Investment Opinion	B-3-7
52-Week Range	45.00 USD -81.96 USD
Mrkt Val / Shares Out (mn)	113,246 USD / 1,771.7
Free Float	80.9%
Average Daily Value	659.39 USD
BofA Ticker / Exchange	SCHW / NYS
Bloomberg / Reuters	SCHW US / SCHW.N
ROE (2023E)	0%
ESGMeter™	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

Refer to important disclosures on page 11 to 14. Analyst Certification on page 9. Price Objective Basis/Risk on page 9. **12649737**

See page 8 for abbreviations

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Income Statement Data (Dec)	2021A	2022A	2023E	2024E	2025E
(US$ Millions)					
Net Revenues	18,521	20,762	18,837	19,552	21,408
Compensation & Benefits	(6,444)	(6,968)	(7,373)	(6,779)	(7,223)
% of Net Revenue	34.8%	33.6%	39.1%	34.7%	33.7%
Non-Compensation Expenses	(4,363)	(4,406)	(5,086)	(4,991)	(5,261)
Net Income to Ordinary Shareholders	5,361	6,635	4,649	5,415	6,258

Balance Sheet Data (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Total Assets	667,270	551,772	493,200	468,105	508,411
Deposits	443,778	366,724	290,000	0	0
Long Term Debt	18,914	20,828	26,100	26,100	26,100
Total Equity	56,261	36,608	41,000	46,416	51,104

Sector Metrics (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
DARTs	6,507	5,925	5,393	5,382	5,518
Net Interest Margin	3.38%	3.49%	4.00%	4.62%	4.88%
Interest Earning Assets	588,125	533,318	441,339	415,784	455,630
Net New Assets	516	407	337	243	434
Growth	7.7%	5.0%	4.8%	2.9%	4.7%
Total Client Assets	8,139	7,051	8,517	9,282	10,291

Performance Metrics (Dec)

(US$ Millions)	2021A	2022A	2023E	2024E	2025E
Operating Margin	41.7%	45.2%	33.9%	39.8%	41.7%
Net Profit Margin	33.3%	35.6%	30.5%	31.1%	32.3%
Comp Expense/Revenue	34.8%	33.6%	39.1%	34.7%	33.7%
Non-Comp Expense / Revenue	23.6%	21.2%	27.0%	25.5%	24.6%
Net Revenue Growth	58.4%	12.1%	-9.3%	3.8%	9.5%

Company Sector

Asset Management

Company Description

SCHW is a financial services firm that services retail and RIA customers directly through its online brokerage and institutional services platform. The company also operates a number of other businesses including a bank, asset management and custody businesses. Collectively, it manages over $9Tn in total client assets.

Investment Rationale

SCHW operates industry leading businesses in two secular growth verticals which support positive annualized organic growth over the next five years. However, we also expect client cash sorting and lower net new assets to cause downside to long-term EPS expectations. Additionally, if organic growth is weaker than expected, the SCHW stock may trade at a lower valuation.

Quarterly Earnings Estimates

	2022	2023
Q1	0.77A	0.93A
Q2	0.97A	0.75E
Q3	1.10A	0.77E
Q4	1.07A	0.68E

Maintain Underperform

Maintain Underperform: Deposit & Organic growth driven

We look for cash sorting to improve but linger in 2024 which impacts the size of SCHW's balance sheet and the time it will take to repay its expensive liability sources (FHLB + CDs) and reinvest its securities portfolio at higher yields. However, a smaller balance sheet and no share buybacks for 1-2 years should allow SCHW to start repurchasing stock again in 2025 after its Tier 1 + AOCI ratio reaches its 6.5-7% target. Additionally, despite lower interest rates, SCHW has an upward sloping NIM trajectory as it repays its expensive funding sources and eventually is able to reinvest its low yielding securities portfolio. However, a higher stock valuation (relative to peers) combined with lower organic growth supports our Underperform rating despite SCHW's lower rate sensitivity.

Expect cash sorting to improve but linger in 2024

We believe RIAs are upgrading their liquidity and liability models which will improve their returns. Specifically, our channel checks have revealed that RIAs are looking to run with much lower cash levels by using more dynamic models. This is also driving product innovation in cash alternatives which include products like PIMCO's BILZ ETF. This product offers a 4.5% improvement to SCHW's cash sweep rate and can enhance a client's total return by 10-15bps if they lower deposit allocations to 2% from 5%. Additionally, we look for retail investors to continue "waking up" to the >4.5% cash yield delta and look to re-risk into both fixed income and equities. There are also three NT seasonal headwinds for SCHW's deposit balances (early year re-risking, RIA advisory payments and tax-related outflows).

Update on Thinkorswim May integration

Background on Ameritrade and Thinkorswim

In November 2019, SCHW announced its acquisition of TD Ameritrade (AMTD) following its October 2019 decision to cut equity commission rates to zero which severely impacted its two major public competitors (including E*TRADE which also then decided to sell to Morgan Stanley). AMTD had 12M accounts at the time of announcement but we estimate they have grown to 17M as of December 2023. AMTD's business was similar to SCHW with a large retail and RIA offering.

Active trader was key difference between SCHW & AMTD

Unlike SCHW, AMTD's retail offering contained a high mix of active traders through AMTD's ToS (Thinkorswim) platform which it initially acquired in 2009. SCHW's retail offering is more geared towards less active, buy-and-hold main street investors that own ETFs, seek low cost advisory solutions, value the brick-and-mortar branches but aren't actively trading stock/index options and futures. While they represent a small percentage of total AuC, we believe the active trader base, which includes having the highest margin loan usage and options volumes, are significantly more lucrative than the more passive retail cohort which have already been onboarded by SCHW.

Details on the May Thinkorswim integration

We estimate 10% or 1.7M AMTD customer accounts have not been integrated with SCHW to date and SCHW targets May 2024 as the final integration (which targets all 1.7M). We believe 100% of these accounts are active trader clients that reside in ToS. SCHW also already integrated a smaller group of active trader ToS clients in November 2023 and experience no major issues that we heard of. We believe SCHW saved the riskiest integrations (active trader) for last while SCHW did experience a pick-up in AMTD attrition in the RIA segment in 2H23. In the RIA segment, SCHW did remove some capabilities as its RIA offering is more streamlined than AMTD's Veo One. Veo One offered an open architecture platform for 3rd parties to offer products and technology to advisors. With ToS, we don't believe SCHW is removing any capabilities but will move ToS clients onto the SCHW app.

No issues in November; Positive indicator for May

To our knowledge, SCHW had no major issues with its November 2023 active trader clearing conversions. We believe this is a good indication that May 2024 should go smoothly too. Clearing conversions for active traders are more difficult given all of the complex securities that they own and are managed by different clearinghouses (options, futures, non-US securities). The real risk would be if there are technology issues that create trading gaps or prevent clients from accessing their accounts and funds.

Less concerned with May NNA headwind from ToS

Most active traders have multiple accounts. For example, they may have open self-directed accounts at ToS, IBKR, TastyTrade or E*TRADE at the same time. When they have a bad experience, they may not close the account or ACAT (automated customer account transfer) securities out. Instead, they may pivot their activity to another account and could eventually transfer cash out. While the process of moving money is faster and easier in the retail segment than in the RIA segment (4-7 days versus 2-3 months), historical investor behavior and channel checks reduces our concerns with NT attrition. Specifically, we think it is less likely that we are going to see a decline in accounts or a large headwind to net new assets around the May 2024 integration date.

Perspective on competition: TastyTrade & IBKR

TastyTrade and IBKR are in the best-position to win unhappy ToS customers. Tom Sosnoff, who was a co-founder of ToS is also a co-founder of TastyTrade. And he created TastyTrade partially to offer improvements to ToS and he also knows the ToS customers well. We view TastyTrade's frontend technology as easier to use and faster while its customer service is best-in-class too. Alternatively, we view IBKR's pricing including its cash sweep and margin rates as more attractive than most while its technology may be harder to use (given all of its capabilities) and its customer service may not be as robust. Given that HOOD is focused on younger, less experienced investors, we don't see them as a real competitor for ToS to date.

App migration & cross-sell could create negative feedback

Negative feedback from the integration could come from the need to move onto the SCHW app and any future experience with advisory solution cross-sells. Specifically, we believe active traders enjoy being highly active and may not be a good fit for SCHW's buy-and-hold and low cost advisory solutions (even if they demonstrate a stronger track record). The cross-sell of SCHW's low cost investment products and solutions were listed as one of its four sources of revenue synergy in the November 2019 merger deck.

ToS clients will not lose capabilities through conversion

It is our understanding that while ToS customers may have to download the SCHW app and use this to access their accounts after May, that once signed in and on the app, they will not lose any capabilities. This is very different to the AMTD RIA integrations where they lost access to Veo One's open architecture platform and were migrated to SCHW's more simplified offering.

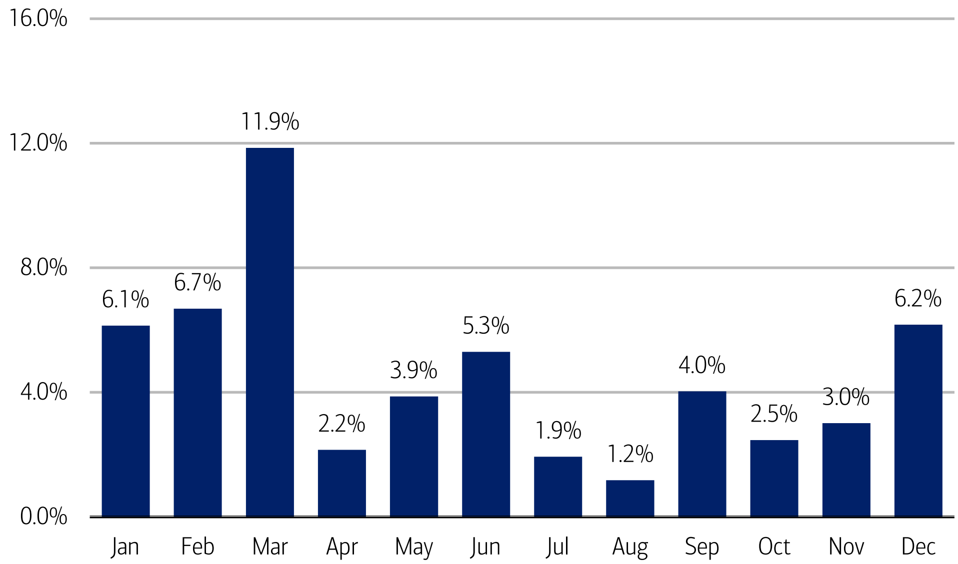
Update on SCHW's overall organic growth

NNA strength in December not sustainable in our view

While SCHW's NNAs (net new assets) came in below its LT target (5-7%) in three consecutive quarters (2Q23-4Q23), its organic growth rate did improve in 4Q23 and December flows were strong (partially due to seasonality). Specifically, SCHW's core NNAs improved from $11B in October 2023 to $22B in November and then further to

$43B in December. By channel, SCHW's NNAs were $25B in retail and $41B in RIA which did indicate that the improvement was driven by the RIA channel. In the prior quarter, retail was $19B versus RIA at $29B so the retail NNA composition did decline through the November 2023 conversion which we estimate at 10% of AMTD's total accounts and had some active traders in there too.

Exhibit 1: Core NNA annualized excluding AMTD attrition
SCHW's core NNA have decelerated through 2023 to below its target +5-7% rate



Source: BofA Global Research, company filings

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AMTD attrition was key driver for 2023 weakness

The weakness in 2023 was partially driven by Ameritrade merger-related attrition, especially in the months of July and August before its Labor Day weekend conversion of RIA accounts. We also estimate that there was a residual headwind in September – December that could continue (but should improve) and SCHW called out $5B of AMTD attrition in October.

4 reasons NNAs could miss AMTD's 5-7% target

Going forward, we forecast SCHW's net new assets to remain below the low end of its 5-7% in 2024, 2025 and 2026. However, a strong bull market that accelerates retail engagement could provide a strong tailwind if we see a significant increase in interest rates. Here are four drivers of our below target forecast at 3% (2024) and 4-5% in 2025:

1. **In 1H24 there will be negative seasonality (taxes)**

2. **Potential outflows relating to the Thinkorswim integration in May**: Although we are less worried with ToS now.

3. **Residual Ameritrade RIA attrition:** In the RIA segment, SCHW's offering is more limited vs. Ameritrade's Veo One and its low yielding client cash sweep rates are another factor. SCHW also faces more competition from new and differentiated offerings that attempt to compete on more than just price including white-glove services or a larger suite of integrated third-party vendors and customizable technology stack.

4. **Law of large numbers and maturing businesses:** SCHW AuA base is approaching $9Tn with the law of large numbers making future growth more difficult than when it was just $3-4Tn a few years ago.

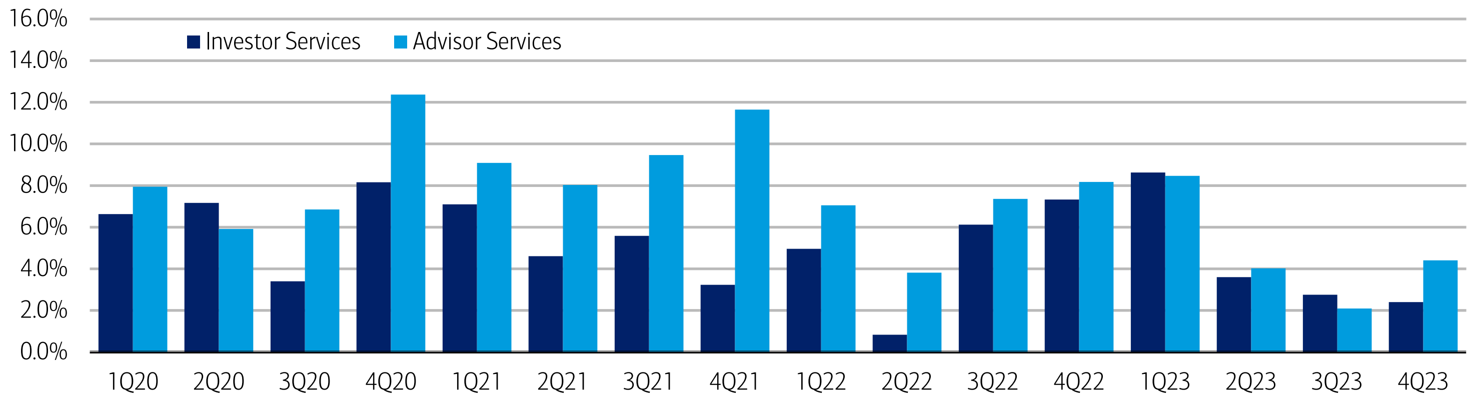
5. **Covid backdrop in 2020-21 juiced results at an unsustainable level:** The pandemic provided an optimal scenario for organic growth in the wealth management industry.

Perspective on the composition of SCHW's 5-7% target

SCHW's 5-7% net new asset target is comprised of 3-5% from existing clients and 2-3% from new clients. SCHW's 2023 accounts growth of 3% compared to 20% at IBKR. Accordingly, SCHW is more challenged to generate new clients than peers, and this is partially due to its size and demographic focus. However, SCHW has a powerful reoccurring inflow generator from existing clients as they accumulate more wealth and SCHW cross-sells them additional products. Alternatively, HOOD and IBKR could experience "graduation risk" or underperformer headwinds as clients age, lose money or change preferences.

Exhibit 2: SCHW NNA annualized by segment

We think it will be harder for SCHW to hit its +5-7% NNA target after growth has decelerated in recent quarters



Source: BofA Global Research

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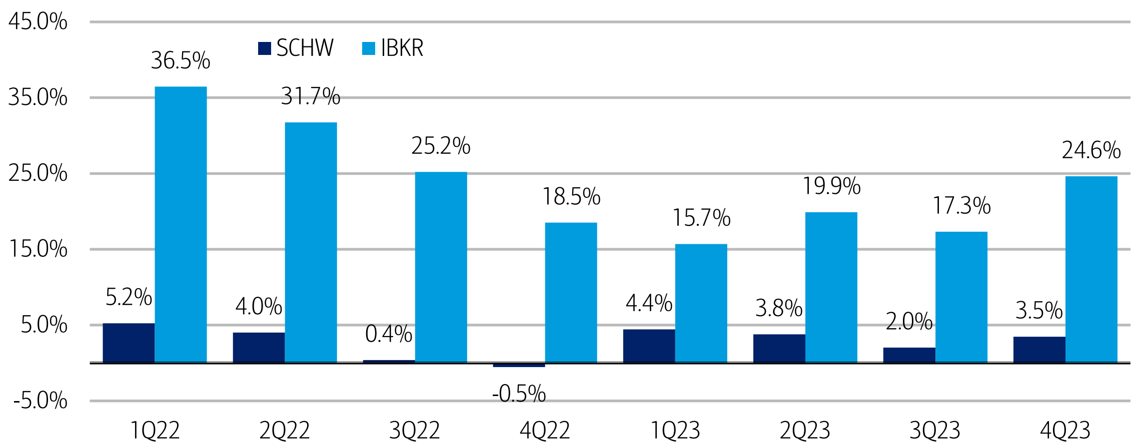
Exhibit 3: Account growth (q/q, annualized)

IBKR is growing new accounts at a faster pace than SCHW



Source: BofA Global Research, company filings

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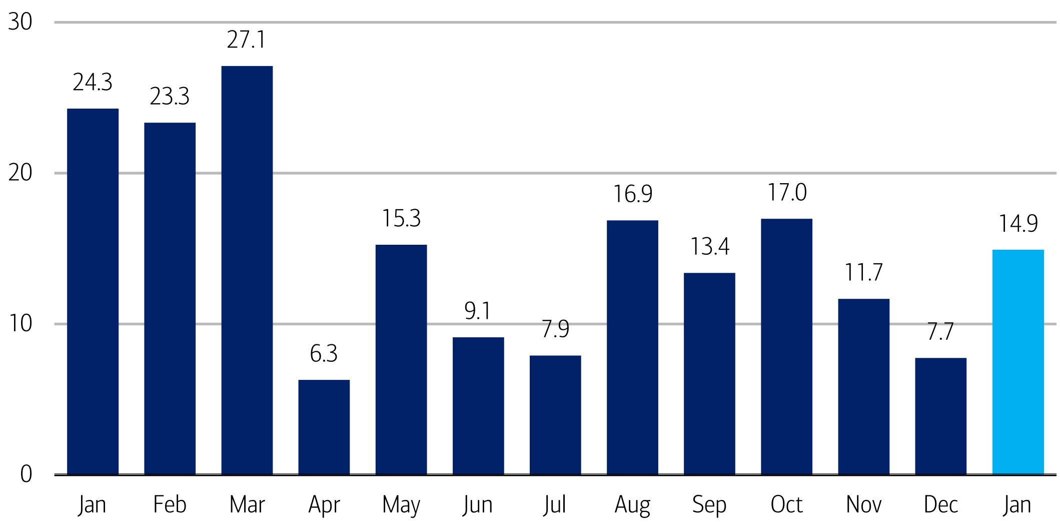
Sorting update after December strength

Cash sorting to improve but linger in 2024

We expect client cash sorting to improve but linger in 2024. The improvement will be driven by the lower cash balances per account and the amount of sorting that has already occurred (especially in the RIA channel). However, it will linger as retail clients continue to "wake up" to the cash sweep differential or look to re-risk their portfolios. Re-risking can include both investors that lock-in higher rates in fixed income or chase equity returns in the bull market.

Exhibit 4: Money market fund net inflows in 2023 ($B)
Net flows have remained elevated with a pickup in January ($14.9B MTD 1/22/24)



Source: BofA Global Research, company filings

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RIAs are upgrading their liquidity management models

More RIAs are figuring out how to live with lower cash sweep balances which includes a more active liquidity management effort and the usage of new cash alternatives. We are finding more product innovation with cash alternatives including PIMCO's BILZ which offers a 5.23% yield vs. SCHW's cash at 45bps. You can also trade BILZ and other cash alternative ETFs for free on SCHW (commission-free). While RIAs used to hold 5% of their client assets in cash sweep, they can actually run with much lower balances (2.0%) but will need to more actively manage their liquidity and liability models. This will enhance their total returns for clients by 10-15bps (4.5% x 3% = 13.5bps).

Three NT seasonal client cash headwinds for SCHW:

- seasonal deployment of yearend cash builds in January/February
- RIA advisory payments in January (and April)
- Tax-related outflows in March/April.

Quantifying the seasonal redeployment risk

SCHW's bank sweep deposits (and broker-dealer free credits) declined in October but then increased in November and were up big in December ($18B). Its BDA (bank deposit account) balances from AMTD also saw a similar increase in December ($4B). This implies that we could see most or all of the December increase ($18B + $4B = $22B) decline in January/February and we estimate the January RIA advisory payment at $7.5B (75bps on advisory services AuC).

Perspective on sorting from SCHW's 2024 revenue targets

In SCHW's revenue/scenario targets, it included a -10% q/q transaction cash assumption as the low end of its expected range which we interpret as a worst-case scenario.

Abbreviations:

FHLB: Federal Home Loan Bank
AOCI: Accumulated Other Comprehensive Income
RIA: Registered Investment Advisor
HOOD: Robinhood ticker
AMTD: Ameritrade
ToS: Thinkorswim
NNA: Net new assets
AuA: assets under administration
AuC: assets under custody
IBKR: Interactive Brokers
NIM: net interest margin

Price objective basis & risk

Charles Schwab Corp. (SCHW)

Our price objective (PO) for SCHW is $58 and is derived from a price to earnings method. We apply a 12.5x multiple on our 2026E EPS to obtain our PO. We use 12.5x given (1) elevated sorting will continue through mid-2023, (2) "bank" risks would weigh on SCHW's multiple and (3) forecast net new assets to slow over the near-term.

Risks to our PO are an extension of the Fed hiking cycle positively affecting SCHW's securities portfolio reinvestment opportunity and muted sorting activity.

Analyst Certification

I, Craig Siegenthaler, CFA, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Brokers, Asset Managers, & Exchanges Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	AllianceBernstein	AB	AB US	Craig Siegenthaler, CFA
	Ameriprise Financial	AMP	AMP US	Craig Siegenthaler, CFA
	Ares Management Corp	ARES	ARES US	Craig Siegenthaler, CFA
	BlackRock, Inc.	BLK	BLK US	Craig Siegenthaler, CFA
	Blackstone	BX	BX US	Craig Siegenthaler, CFA
	Blue Owl Capital	OWL	OWL US	Craig Siegenthaler, CFA
	Cboe Global Markets	CBOE	CBOE US	Craig Siegenthaler, CFA
	Interactive Brokers	IBKR	IBKR US	Craig Siegenthaler, CFA
	Intercontinental Exchange	ICE	ICE US	Craig Siegenthaler, CFA
	KKR & Co. Inc.	KKR	KKR US	Craig Siegenthaler, CFA
	Raymond James Financial	RJF	RJF US	Mark McLaughlin, CFA
	TPG Inc	TPG	TPG US	Craig Siegenthaler, CFA
	Tradeweb Markets Inc.	TW	TW US	Craig Siegenthaler, CFA
	Victory Capital Holdings, Inc.	VCTR	VCTR US	Craig Siegenthaler, CFA
	Virtu Financial	VIRT	VIRT US	Craig Siegenthaler, CFA
NEUTRAL				
	Affiliated Managers Group	AMG	AMG US	Craig Siegenthaler, CFA
	Apollo Global Management	APO	APO US	Craig Siegenthaler, CFA
	Brookfield Asset Management	BAM	BAM US	Craig Siegenthaler, CFA
	CME Group Inc	CME	CME US	Craig Siegenthaler, CFA
	Invesco	IVZ	IVZ US	Craig Siegenthaler, CFA
	Janus Henderson Group	JHG	JHG US	Craig Siegenthaler, CFA
	LPL Financial Holdings	LPLA	LPLA US	Craig Siegenthaler, CFA
	Patria	PAX	PAX US	Craig Siegenthaler, CFA
UNDERPERFORM				
	Charles Schwab Corp.	SCHW	SCHW US	Craig Siegenthaler, CFA
	Franklin Resources	BEN	BEN US	Craig Siegenthaler, CFA
	Nasdaq	NDAQ	NDAQ US	Craig Siegenthaler, CFA
	Robinhood Markets	HOOD	HOOD US	Craig Siegenthaler, CFA
	T. Rowe Price	TROW	TROW US	Craig Siegenthaler, CFA
	The Carlyle Group	CG	CG US	Craig Siegenthaler, CFA

iQmethod℠ Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A

Quality of Earnings	Numerator	Denominator
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense

Valuation Toolkit	Numerator	Denominator
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

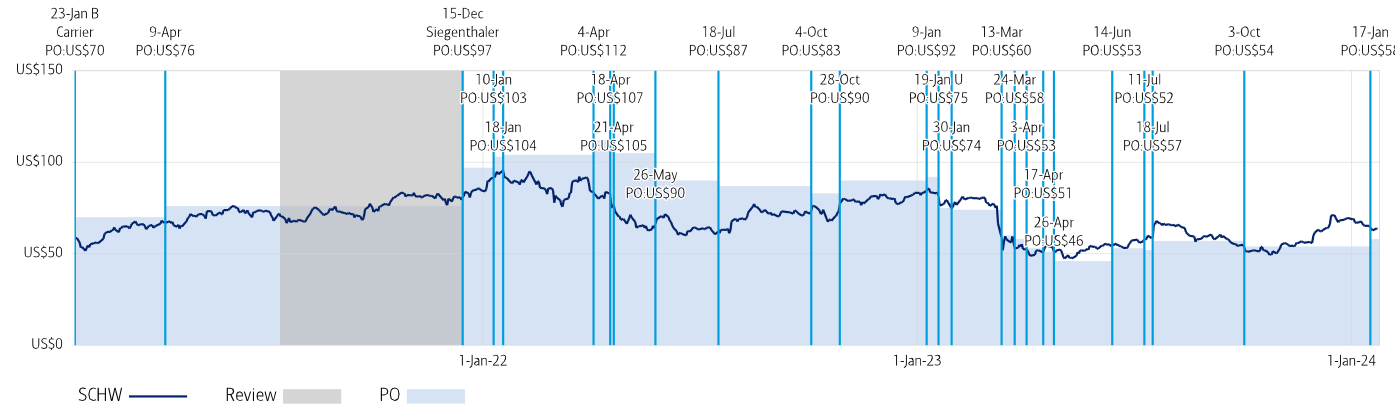
iQmethod℠ is the set of BofA Global Research standard measures that serve to maintain global consistency under three broad headings: Business Performance, Quality of Earnings, and validations. The key features of iQmethod are: A consistently structured, detailed, and transparent methodology. Guidelines to maximize the effectiveness of the comparative valuation process, and to identify some common pitfalls.

iQdatabase® is our real-time global research database that is sourced directly from our equity analysts' earnings models and includes forecasted as well as historical data for income statements, balance sheets, and cash flow statements for companies covered by BofA Global Research.

Disclosures

Important Disclosures

Charles Schwab (SCHW) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
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Underperform	N/A	≥ 20%

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