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E*TRADE Financial Corp. (ETFC)

Q4 2016 Earnings Call

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Chief Executive Officer & Director

Michael A. Pizzi
Chief Financial Officer

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MANAGEMENT DISCUSSION SECTION

[Operator]

FINANCIAL MEASURES

- During the call we will also discuss non-GAAP financial measures
- For a reconciliation of such non-GAAP measures to the comparable GAAP figures, and for a discussion of additional risks and uncertainties that may affect the future result of E*TRADE Financial, please refer to our earnings release, furnished on Form 8-K, and our 10-Ks, 10-Qs and other documents the company has filed with the SEC
  - All of these documents are also available at about.etrade.com
- Note that the company has not reconciled its forward-looking non-GAAP measures, including non-GAAP adjusted operating margin, to the most directly comparable GAAP measures because material items that impact that measure are out of the company's control and cannot be reasonably predicted

Karl A. Roessner

Chief Executive Officer & Director

FY REVIEW

FY Highlights

- Welcome to our fourth quarter and full year results call
- This January call typically provides a natural point to pause and rehash 12 months of accomplishments, while looking forward to what the next 12 may bring
- While I will provide somewhat of a retrospective, this moment in time is defined by executing with intensity and focusing on our charge to grow the business
- So while we may be at a natural reflection point, we are anything but paused
  - After laying out a plan in late Q3 to refocus the company on brokerage growth, this past quarter we marched forward in devising and beginning to implement the many tactics to deliver on that plan, positioning the company for success

FY Recap

- To quickly recap the 2016 highlights, we built solid momentum and closed the year as a leaner, more focused, more agile organization, well positioned from a financial and capital standpoint
- We entered the year lowering the bank's target leverage ratio by 100BPS, reflecting the continued improvement in our risk profile and our regulatory position
- We distributed a significant amount of capital to the parent and seized opportunities to accelerate our share repurchase program, buying in more than $500mm worth of our shares
- After bringing our balance sheet to nearly $50B, we announced our decision to grow through that threshold and began the work of building out the structure to support that growth

- We delivered a commitment to our investors to be responsive to the revenue environment, shifting our investment philosophy to an operating margin framework
- We managed the legacy loan portfolio through the bulk of the loan conversions from interest-only to fully amortizing, effectively removing the largest remaining credit risk overhang
- We completed our first major acquisition in more than a decade, jumpstarting a transition back to our scrappy brokerage roots and realigned our business to be more nimble while achieving meaningful cost savings
    - And finally, we laid out concrete and tangible growth goals for the company

Key Focus Areas

OPTIONSHOUSE INTEGRATION

- To this last point, I will turn to our key areas of focus that we believe will drive our growth, all of which I will subsequently expand on
- First, finalize the OptionsHouse integration and realize the full potential of this combination
- The team, customer base and functionality we acquired are vital to reaching our growth goals
- The integration activities began the day after closing, and we are tracking to plan
    - But this process is about much more than personnel and infrastructure
- At its heart, it's about our customers and ensuring each and every one of them has access to and appreciation of the best of what we have to offer across platforms

MARKETING

- Second, breathe new life into our marketing
- As I've mentioned before, our challenge is not one of brand awareness but one of perception
    - As such, we are hard at work developing a plan to move the needle on our brand identity, better positioning E*TRADE as a home for both active traders and long-term investors and doing so in a thoughtful, effective and typically irreverent way

OPERATIONAL LEVERAGE

- Third, take advantage of our operational leverage
- In no uncertain terms, our commitment to be responsive to the revenue environment in our spending remains the bedrock of our plans, even as we look to accelerate growth
    - We have a powerful, fully scalable model and we continually evaluate opportunities to further optimize our cost structure and investments

CAPITAL DEPLOYMENT

- And fourth, continue to dispassionately assess opportunities for efficient capital deployment, including reviewing inorganic growth prospects
- As our earnings profile strengthens, so too does our capital generation and our prospects for its deployment
- While we are focused on balance sheet growth and plan to resume share buy backs later this year, we will continue to review all value generative paths for our shareholders' capital and adapt as the environment evolves
    - This list is far from exhaustive, and in some ways it's just the tip of the iceberg

Account and Asset Growth Rates

- With a small handful of folks focused on assessing potential opportunities, the majority of my team is working hard to maintain momentum on the charge forward to meet our growth objectives
- And to reiterate those targets in the short to medium term, we aim to improve our account and asset growth rates by 200 to 300BPS which, using Q3 as the starting point, would equate to a brokerage account growth rate of four-and-three-quarters to five-and-three-quarters percent and annual brokerage asset growth about 100BPS higher than that
- We aim to ship the mix of our trades to be 35% in derivatives, predominantly in options but also including a significant increase to our future's volume
    - And we plan to grow our managed assets to $6B
- To review our current state, this quarter we grew brokerage accounts at an annualized rate of 2.8% and brokerage assets at a rate of 4.7%. 29% of our fourth quarter trades were in derivatives, with roughly 27% in options
    - It should go without saying that integrating platforms and expanding our offering to customers is paramount to growing this metric, as is enhancing and fully integrating our futures offering

Managed Assets

- On managed assets, we ended the period with $3.9B, including around $240mm in adaptive portfolio accounts
- We continue to see significant opportunity for growth across these accounts with the right marketing and customer positioning
- Our most immediate and impactful goal is to complete the OptionsHouse integration
- I am pleased with our progress and feel good about our plans for completing this
- The two remaining components, platform integration and clearing conversion, are both slated to occur in Q3
- We aim to deliver superior active trading capabilities to the combined customer base, incorporating the best of both offerings
    - And we have the right folks in technology and product focused on delivering just that
- And while delivering an exceptional digital experience is in our DNA, we must never rest on our laurels and must always seize opportunities to improve
- The integration affords us a unique moment in time to review our entire digital offering with a fresh perspective and a few new sets of eyes to further captivate our customers

New Leadership with Deep Industry Experience

- On marketing, we've restructured the team and installed new leadership with deep industry experience
- We've also aligned the department within the brokerage business and positioned the new team to ensure they are focused on our key success metrics
    - And at the top of a long list of initiatives is the relaunch of our brand
- We've enjoyed phenomenal brand awareness and we intend to build on that to reclaim our challenger position in the industry
- Expect to see more around midyear
    - In the meantime, we are working on updates to our website, including an overhaul to the look and feel along with improved navigation

Operational Efficiency

- Further, we are working to listen, understand and respond to customer feedback in much better ways
- We're off to a solid start and I'm excited for our customers to experience the changes that lie ahead
- With respect to operational efficiency, of the utmost importance to us and to me personally is remaining highly mindful of how we spend our shareholders' money
- Part and parcel of this is our op margin commitment
- During 2017 we will manage to a target of 38%
- This number is adjusted to exclude provision for loan losses, which has been a significant benefit to earnings for the past six quarters
    - But importantly, it includes all planned costs related to balance sheet growth and the OptionsHouse integrations
- Mike Pizzi will provide additional details on this but I cannot stress enough that under my watch we will be steadfast in our expense discipline
    - If we identify areas for investment which expand beyond this target, we will have to fund them through additional savings found within the business

Capital Deployment

- And finally, on capital deployment, we continue to focus on opportunities to drive meaningful value through product stewardship of our shareholders' capital
- We have two very well established capital initiatives for 2017, growing our balance sheet and resuming share repurchases
- We officially commenced the first
    - And as of this morning, we can boast roughly $52B in consolidated assets
- Our plans have us reaching $57B by midyear, slightly higher than our original assumption and ending the year around $62B
    - This avenue has only increased in attractiveness over the past quarter as rates rose and the amount of available deposits grew
- Further, with all the chatter around regulatory requirements and thus costs possibly being eased under the new administration, we are hopeful this path could become even more compelling as the year progresses
- In addition, as a savings and loan holding company, the timing to comply with the enhanced bank holding company requirements has been extended relative to our original assumption
- We now expect we will have until 2019 to become compliant with CCAR, resolution planning and certain other onerous and costly requirements
    - Separately, the fed announced a one-year LCR compliance phase-in period for banks newly crossing $50B

Share Purchases

- And regarding the second initiative, as I previously mentioned, we intend to resume share purchases in H2
- On a separate yet concurrent track, we continue to evaluate opportunities for inorganic growth
- To be certain, I am confident in our company's organic prospects, but vigorously support our responsibility to evaluate inorganic opportunities as our platform offers immense scalability and additional opportunities remain
- To provide some color on the primary areas that warrants our attention, first, brokerage

- Given the scalable nature of the brokerage business, opportunities that afford additional account and asset volumes typically present attractive economics
    - However, there's a noticeable lack of inventory in what I would call the traditional category at present
- We continue to keep our eye on opportunities that can present new capabilities to our customer base

Stock Plan

- Second, stock plan
- We have a top-rated equity compensation platform and could easily add scale to it
    - We continue to look for opportunities that can expand the scale or add scope to what we offer to our corporate clients and their planned participants

Wealth Management

- Third, wealth management
- This could provide a natural extension of our existing cash management and banking capabilities that we offer to our brokerage customers and stock plan participants
- We have an acquisition channel into the high net worth segment of the market but fall short on capabilities to service them following an exercise of stock plan assets
    - Further, the expansion of cash related capabilities could prove valuable, particularly as we've unshackled our balance sheet growth

Advisor Services

- And finally, advisor services
- This space is quite broad but our focus is on RIA platforms as they could further our asset and account growth capabilities and leverage much of our existing infrastructure
- While we would be a late entrant, the RIA channel continues to be a high-growth segment within our industry
- If we deem that the RIA channel is compelling, entering via acquisition would be the only feasible route at this stage
- To be clear, we are not pursuing a transformative transaction and any potential acquisition would be viewed through our capital deployment lens
- My management team and our Board are extremely focused on the appropriate use of and return on capital, and we will hold that focus as we evaluate inorganic growth opportunities
    - Also, as we demonstrated with OptionsHouse, we will be diligent and anything we pursue would support our core business and align with our digital ethos

Net Income

- Turning now to our results
- Net income of $552mm or $1.98 per share represents our best year since 2006
- It also includes a net benefit of $0.33 per share related to provision and income tax benefits, partially offset by executive severance and certain restructuring costs
    - This reflects our commitment to meticulously manage expenses, the wind down of our legacy loan portfolio, which outperformed our expectations greatly, and the strength of our business model even during a period of tepid growth

- As for metrics, 2016 was a curious year as the markets opened in January and February with one of the bigger selloffs in recent memory, regained their footing and then went on a rally following the election, with major indexes reaching all-time highs
- Meanwhile, our customers opportunistically sold during periods of positive market activity, particularly around Brexit and the election, marking the first full year on record they were net sellers

DARTs

- Our DARTs for the year were 164,000, up 6% from 2015 with derivatives representing 26% as compared to 24% in the prior year
    - These increases are related to OptionsHouse, which is fully reflected in our Q4 metrics
- As for January, our DARTs are currently tracking up 8% from December, including a nice bump yesterday as the DOW hit a historic high

Customer Margin Balances

- Customer margin balances ended the year at $7.1B, up from $6.8B at the end of Q3
- After hitting an intra-quarter high just after the election of $7.3B, they trailed off over the last six weeks as we saw additional customer net selling
- For the year, we added 105,000 net new brokerage accounts excluding the OptionsHouse acquisition and the impact of shutting down our Hong Kong and Singapore operations, representing 3.3% growth and a record low attrition rate of 8.4%
    - This is a modest improvement from 2015 levels
- We brought in $9.4B of net new brokerage assets during the year, representing a 3.8% growth rate flat with 2015 levels

SUMMARY

- In closing, it was an important year for E*TRADE
- But as I said earlier, we're very much in the thick of things when it comes to the work we have to do
- As 2016 was a year of refocus and resolve, 2017 will be a year of execution
- We've brought the company back to its core brokerage roots, embraced our digital spirit and have become more nimble
- We've begun to define who we are and we're working to incorporate a strong message in our marketing to connect with and reengage traders and investors alike
- I'm excited to be leading a fantastic team of committed professionals
- When I took over this seat about four months ago, we established an aggressive timeline and the ensuing sense of urgency remained ever present within our walls
    - It's only been a quarter and I won't pretend that our metrics yet reflect our efforts, but I fully expect we will go a great distance in the year to come

Michael A. Pizzi
Chief Financial Officer

FINANCIAL RESULTS

Net Income and Revenues

- For the quarter, we reported net income of $127mm or $0.46 per share
  - That compares to $139mm or $0.51 per share in the prior quarter, and $89mm or $0.30 per share in the year ago quarter
- Revenues for the quarter were $509mm, up $23mm from the prior quarter reflecting the first full quarter impact of our acquisition
- Y-over-y, revenues were up $70mm, primarily related to OptionsHouse, a larger balance sheet, increased customer cash, a better interest rate environment and organic growth in trading activity

Net Interest Income and Margin

- Net interest income was $288mm, flat with the prior quarter as both our balance sheet and net interest margins held relatively steady
- Net interest margin of 260BPS was slightly above our expectations due to a better interest rate environment and an increase in average margin balances
- Rates rose on both the long and short end of the curve
  - And while the benefit wasn't fully reflected in Q4, it's a meaningful positive for us going forward
- Our average re-investment rate is currently in the 225 to 250 basis point range, which is consistent with where it has been following the post-election bond market selloff
- In terms of forecasting full year NIM, if we hold margin rates and interest rates flat with where they ended Q4, grow the balance sheet at our planned pace and assume no rate increases during 2017, we'd expect NIM to land in the range of 250 to 255BPS
  - However, if we project a fed fund increase in June as the market broadly assumes and a corresponding increase in term rates, this forecast would improve by around 10BPS

Commissions Revenue and DARTs

- Commissions revenue of $122mm increased $15mm q-over-q
- DARTs increased 24% sequentially and our commission per trade decreased by $0.55 to $10.42
- The reduction in average commission portrayed reflects the full quarter impact of OptionsHouse and thus provides a good go-forward run rate
- Fees and service charges increased $12mm q-over-q driven by a full quarter of OptionsHouse, as well as additional fees from cash held off-balance sheet
- There are a number of moving parts on this line in 2017
  - First, once we complete the clearing conversion, OptionsHouse margin balances will move on to our balance sheet and begin earning net interest income as opposed to fees and service charges
  - Second, as we move customer cash from third parties onto our own balance sheet throughout the year, the associated revenue will similarly be recognized during net interest income
  - Third, we assume the rate earned on third party cash will increase from around 45BPS during 2016, to around 70BPS for the full year 2017, assuming a sustained better interest rate environment
  - Finally, we will realize a full year run rate associated with OptionsHouse border flow revenue

Securities and Other Gains

- Other revenues increased $1mm sequentially to $11mm
- Securities and other gains were $8mm, down from $14mm in the prior quarter, which spiked as we took advantage of Brexit-driven market volatility
- As we grow the balance sheet this year, we expect fewer opportunities to realize gains and thus expect the 2017 quarterly levels to be roughly $5mm
- We recorded a provision benefit of $18mm in the quarter
- The allowance reduced by $14mm to end at $221mm as net charge-offs were a recovery of $4mm
- With the loan portfolio now just at $3.8B, it is a mere fraction of our total assets
    - HELOC conversions are 85% complete as of yearend, and will be more than 95% complete at the end of Q1

Expenses

- Moving on to expenses
- Non-interest expense for the quarter was $322mm, down $1mm sequentially
    - This quarter included $7mm of restructuring costs primarily related to OptionsHouse and $2mm related to crossing 50
- The prior quarter included $6mm of executive severance and $25mm of restructuring and other acquisition related activities
- Adjusting for the unique items, non-interest expense was increased $21mm primarily from the inclusion of OptionsHouse for the full quarter

Operating Margin

- Our adjusted operating margin for the quarter was above target at 37%
- That number excludes provision benefit of $18mm but includes about $9mm of non-recurring costs primarily related to OptionsHouse and the $50B initiative
- With respect to our operating margin guidance for 2017, as Carl highlighted, we are targeting 38% inclusive of all planned one-time costs related to the acquisition of OptionsHouse and the buildout of our systems and personnel to comply with heightened regulatory standards
- We are not modeling any movement in the federal funds rate, though we recognize that broad market expectations include at least one increase during the year
- If this does occur, it could provide either upside to or operating margin or an opportunity to invest further in the business should the returns be appropriate

Rate Environment

- Looking forward to a sustained better rate environment, we expect our operating margin to settle in the mid-40% range, which reflects our belief that in a stronger rate environment, a rising tide lifts all boats and increased competition and investment needs would likely be a reality to keep up with the business environment
- I'm happy to provide this all-inclusive number but I also recognize the desire for investors to track our progress on the one-time expenses we've laid out
    - So to provide further insight, we announced expected related costs to total $52mm and incurred approximately $15mm in 2016

Balance Sheet Expansion

- Now with more clarity around the integration, we expect the total number to be closer to $46mm with approximately $22mm to come through in 2017
- Similarly, connected to the balance sheet expansion where we initially outlined $50mm in total implementation-related charges over two years, with work well under way, we have refined our estimate
- Our updated assumption is for roughly $20mm in implementation-related costs over the next two years with approximately half of that in 2017
- We continue to expect the recurring component to be $15mm annually
- In terms of timing and trajectory, we expect our first quarter op margin to be in the mid-30% range, pressured by seasonally higher marketing and compensation-related expense along with elevated non-recurring costs
    - However, as we realize the benefit of a larger balance sheet and the integration progress leads to synergy capture, we expect it to improve throughout the year, exiting the year with Q4 in the low 40% range

Capital Generation

- As for capital, during the quarter we distributed $150mm up to the parent, comprising $100mm from the broker and $50mm from the bank
- For the full year, we moved an impressive $858mm up to the parent, including $435mm from the broker
- We expect ongoing distributions from the broker to be in line with excess capital generation, which was $70mm in Q4
    - That's the amount we intend to move in Q1
- The bank distribution was again below its prior quarter earnings of $118mm as we retained capital to fund planned balance sheet growth
- In 2017, we planned to consume a meaningful amount of capital at the bank and grow the balance sheet
- Accordingly, our current plans include a halt to dividends from the bank to the parent until 2018

Cash Balance

- Sticking with our balance sheet, we ended the quarter at $49B, with customer cash held by third parties at approximately $17B
    - And pro forma for the OptionsHouse integration about $13.5B of those balances are readily available to move on to our balance sheet
- We crossed the $50B mark the first week of January
- And as Karl noted, today we are at approximately $52B
- Crossing the $50B threshold has been an important part of our plan since the middle of last year and has grown increasingly more attractive over time
- While the political landscape has infused meaningful uncertainty into the future of regulation, we continue to plan for full compliance under the current framework
    - That said, if the $50B threshold were meaningfully raised and the requirements surrounding CCAR, resolution planning and LCR were eliminated for companies of our size, the associated cost could further reduce
- Hypothetically, if we were to limit our regulatory build-out to only the elements we believe we should address in any case, we believe our current assumptions for roughly $20mm in implementation costs plus $15mm in running costs would reduce to around $15mm upfront and $10mm ongoing

Leverage Ratio

- Now as for the timing of growth, it will be dictated largely by the amount of available capital
- We ended the year with bank Tier 1 leverage ratio at 8.8%, implying about $275mm of capital in excess of 8%
- Our plan remains to lower the bank leverage ratio to a targeted minimum of 7.5% this quarter and we are in active dialogue with our regulators on this topic
- At that point, the parent leverage ratio with a targeted minimum of 7% would become our binding constraint
- So in summary, we have a lot going on
    - I'm excited about where we are, what we have in the works and the opportunities that lay ahead

QUESTION AND ANSWER SECTION

Richard Henry Repetto
Sandler O'Neill & Partners LP **Q**

I guess the first question is for Karl or Mike would be on the 38% pre-provision margin. It seems conservative. It seems like you'd taken out a lot of cost. You had the cost, the $21mm that you already had taken out, and you guys lowered 50 cost now as well, as well as synergies from the OptionsHouse. Is there any – can you give us a little bit more detail on [ph] Walken (28:02) because we have higher margins than that with these changes that you've given us here tonight in regards to 50 and so forth.

Michael A. Pizzi
Chief Financial Officer **A**

Yeah. Rich, if you back out the one-time items that we talked about in the remarks there, specifically the integration costs, which we project over the current year, plus the buildout of the 50 costs in terms of both the one-time at around $10mm and then the recurring building to about $15mm, that's going to drive that margin higher. So we are including them in that margin guidance. We did that largely for simplicity.

Richard Henry Repetto
Sandler O'Neill & Partners LP **Q**

Okay. All right. I guess one follow-up – another question would be can you give us the pro forma DART growth? Because you yourselves have emphasized accounts, assets and trading. So just the pro forma DART growth Q4 over Q3?

Michael A. Pizzi
Chief Financial Officer **A**

Okay. Q3 pro forma DART should be 173,000, Rich.

Richard Henry Repetto
Sandler O'Neill & Partners LP **Q**

Okay. Okay. And then very last question is it looks like the sweep cash, there was a buildup of a couple billion in sweep, off-balance sheet sweep cash. Was that just – I'm just trying to see. Usually, it felt like people were moving more into the markets than coming out as they did the prior quarter.

Michael A. Pizzi
Chief Financial Officer

A

Net selling customers have been very tactical all year. The year opened with the market going down. We saw a lot of net buying off of that. As the year went up, we saw degrees of selling, very tactical around the election, customers really buying and then really sort of taking gains quickly on the market move.

Devin P. Ryan
JMP Securities LLC

Q

So obviously, nice net new assets the past two months, $3B. Just trying to get a sense, if you can, how much of that you thought was maybe an election bump vs. something you could actually point to that you feel like you're doing? And maybe along the same lines, we're talking a lot about increasing kind of the active trader sales effort. So maybe just a little more specifics around what you're doing there. And then just as we see that growth come through, how we should think about the profitability of that, I'm assuming there'll probably be some promotions with that as well?

Karl A. Roessner
Chief Executive Officer & Director

A

Okay. Let me take the second part of the question first around active trader sales. The way we talked about it and the way that we continue to look at it, we have a very solid, active trader group, right, in a group of customers who are at the higher end of our book who we've provided very good services to. And we're building out a team to really make sure that we're getting the best for them in everything that we do.

So more to come in terms of what we're directing at them in terms of platforms, in terms of the OptionsHouse integration, the options platform that will go out. So that team is under construction, but that's a very important avenue for us and a very big part of our revenue.

Mike, you want to go into the…

Michael A. Pizzi
Chief Financial Officer

A

Yeah. I mean, specifically in the first part around the quarter, I would say that the election had a lot to do with some of the volumes and re-engagement of the retail customer. Obviously, we've seen a pretty good sort of sector rotation in the market from various sectors that have been lagging prior in the indexes. Customers engaged on that, the higher volatility, the movements in the market, all were very beneficial during the period.

We've got a lot of things in play around growth. I'd like to say that some of that was just some of what we immediately put in place, but I have to give credit to the market environment as really supporting the overall effect in the quarter.

Devin P. Ryan
JMP Securities LLC

Q

Got it, that's a great color. And then just with respect to the balance sheet growth, the $57B that's targeted by the middle of the year, is that just an illustration kind of based on your estimate of capital build? Just trying to think if capital's building faster and that's the best use of capital, could you actually add a portion of that $5.5B of additional deposits faster?

Michael A. Pizzi
Chief Financial Officer

A

There's a number of considerations. We're taking the money back from external third party banks, we have a capital plan that we are going to present with our regulators that we've been in dialogue up until this point. So yes, we could go faster if capital is available, but it is really an estimate based around capital build and capital availability to do this in a fairly thoughtful way over the course of the year.

Devin P. Ryan
JMP Securities LLC

Q

Got it. Okay. Just a last quick one here. Sec lending, how are you thinking about rates there and the outlook for that part of the business?

Michael A. Pizzi
Chief Financial Officer

A

Look, it's obviously a business that ebbs and flows with the degree of hard-to-borrows in the market and the degree of market activity. Q4 had a bit of volatility to it, but overall pretty healthy levels and expecting really that to continue as the market environment continues throughout this year. Overall, I think the best way to think about that is about how it should scale overall with the size of the margin book. A bigger margin book should scale directly into the more loanable collateral. The only thing I would add to that is if we see any significant change in the IPO market or any significant amount of hard-to-borrows increasing in the market, then we should be able to do a little bit better out of that book.

Devin P. Ryan
JMP Securities LLC

Q

Yeah. But the NIM guidance essentially reflects kind of what it's been at, not some big change?

Michael A. Pizzi
Chief Financial Officer

A

I think that Q4 is a pretty good overall run rate for right now.

Conor Fitzgerald
Goldman Sachs & Co.

Q

Just want to talk on the operating margin target of 46% with the rate uplift. Obviously, quite a good deal better than you're doing today. Just wanted to understand your confidence of being able to drop the better revenue to the bottom line. And then just on a technical aspect, does the $144mm expense number, sorry the [ph] $1,444mm (34:32) number, include the $70mm of expense synergies from OptionsHouse?

Karl A. Roessner
Chief Executive Officer & Director

A

Yeah. So just in terms of our sort of confidence level to drop it to the bottom line, Mike's prepared remarks had a statement in there about this impacting sort of all boats equally in terms of a rising tide. So what we looked at there when we sort of look forward in an increasing-rate environment, in all likelihood there will be competitive pressures around pricing, around going after active traders and we'll still be in the hand-to-hand combat that we are, so fairly confident that we'll be able to drop quite a bit of it down. But we also know that we're going to be in quite a bit of pricing pressure and other changes as interest rates rise. Mike, you want to cover the last piece?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. Look, the slide really is a pro forma of long-term earnings power, so the expense base is directly taken from the operating margin target. So in that sense, yes, it should include everything, but this is not guidance for 2017 in terms of what the exact expenses should be running through. So I just want to clarify, when we talk about the synergy target what we're showing on sort of the long-term slide vs. the evolution.

And then just to reiterate Karl's point, we do think the market will grow more competitive. There is an increase in both columns on that chart about the amount of expenses there. But we have to respond to the competitive environment. We feel it's going to get more competitive, but we feel it's very competitive today. And so while there is an increase in the overall expense base to maintain that competition and get to those operating margin levels, the market can change and competition can increase beyond what we're expecting.

Conor Fitzgerald
Goldman Sachs & Co.

Q

That's helpful. And I won't build the 46% into my 2017 numbers just yet. And then, Karl, just wanted to get an update on the interest level and M&A in the RIA space. I know you touched on that in your prepared remarks. Just wanted to hear how you were thinking through how you would consider acquisitions in that space just given the uncertainty around the DOL. And then just given your comments about being focused on the returns to shareholders, on my math I think it's a 12% return on equity on the incremental balance sheet growth. So should shareholders expect that any M&A you would pursue would have to have a return on invested capital above that level?

Michael A. Pizzi
Chief Financial Officer

A

Well, there's a little bit of overall lift, I think, in the rate environment that's giving us a pretty good overall return in the current environment. So I think your math is on par correct. It's going to be in the 12% range overall and that's really the best use of capital. From a pure cost of equity standpoint, we're probably a little bit below it so we're probably achieving a spread to that. But I think right now in the current environment the best use of capital is to grow the balance sheet and that's what we're doing.

Karl A. Roessner
Chief Executive Officer & Director

A

And just to get to your point about appetite and sort of where we are, we are looking opportunistically in that space. And it is the only logical way to get into it is through an acquisition. So if I had to look into my cards and sort of see where we were, it would make sense to go look at a platform that we could use to build, right? We're not looking at transformative transactions or a big, messy transaction, but rather one that would provide us additional sort of green shoots for growth. But the return would have to be there, right, as we've shown. And as we'll continue to say to you all, we are stewards of our shareholders' capital and our shareholders' dollars and we will put it through the capital lens each and every time.

Christian Bolu
Credit Suisse Securities (USA) LLC

Q

Just on the – good evening. So on the growth prospect here, just putting aside inorganic opportunities. Just bigger picture, curious how you think about where the growth will come from. Are you expecting to expand the pie here and bringing new customers into the brokerage industry or is this a play for market share from your competitors?

Karl A. Roessner
Chief Executive Officer & Director
A

So Christian, it's a bit of both, right? When you look at what we've done around OptionsHouse and bringing in those capabilities and what we have and the number one rated options platform coming across, that's a new offering. When you package that with education and the right active traders sales team and sales program that we're putting together now, we think that that'll be a nice area of growth for us. There's also some dislocation, as everyone knows, going on in the marketplace so there are active traders out there who are interested in looking for and finding new homes and then getting better at the services we offer and trying to mine into our stock plan participant population that we have who are already customers on us who don't use us for anything else other than executing their stock plan trades. So there are a number of areas of focus that we believe that we can get into quite quickly and in quite a meaningful way that will help us drive this growth. And both of your points, we are hitting very hard.

Christian Bolu
Credit Suisse Securities (USA) LLC
Q

Okay. Got it. And then just a question on liquidity management and the balance sheet. I guess if you put – if you get to $2.5B target, just correct me if I'm wrong, but it will mean effectively all your client cash will be on the balance sheet in securities with duration around three to four years. I mean, there's a bit of cash but most of it will be in securities.

To the extent that we see a massive upturn and resell engagement and there's a significant move away from cash, just help me understand how you manage liquidity just given – best I can tell that would be the – relative to other retail brokers you would have as indeed most of your cash in fairly long dated securities.

Karl A. Roessner
Chief Executive Officer & Director
A

Yeah. I think the best way to think about that is the composition of the portfolio. The portfolio has a significant amount of really fairly short duration securities or floating right securities in it. All of the securities in the portfolio at this point are agency backed with many of them being full safe and credit guaranteed securities. They're incredibly liquid and allow us to reposition the balance sheet quite readily.

Steven Chubak
Nomura Securities Co., Ltd.
Q

So wanted to dig into slide 21 for a moment. It looks like the majority of the balance sheet and business growth targets that are laid out here are actually within reach or within grasp at this point. And I'm just wondering whether you believe that most of these targets are actually achievable on – within a reasonable timetable, call it by 2018. And for the forward curve, if that materializes and we get four rate hikes or 100BPS, I just want to gauge whether that $273mm, if that's an aspirational target or if you think it's readily achievable within the next two years?

Michael A. Pizzi
Chief Financial Officer
A

I think the scenarios we are outlining on the slide are readily achievable. Getting back to one of the prior questions, you have to take out the investment items in the $50B regulatory buildout, the integration cost. But assuming we execute on all of that and deliver our growth targets, we should be able to achieve the economics that are shown in the slide.

Steven Chubak
Nomura Securities Co., Ltd.

Q

Got it. And just switching over to the expense side, Mike, it's very encouraging to see the progress that you guys have made. And you laid out a lot of the different changes in terms of the guidance components that you had laid out previously. I'm just wondering how we should be thinking about the jumping off point for expenses in 2017 after adjusting for all the new guidance. Or maybe said differently, what expense base is actually contemplated in that 38% margin goal?

Michael A. Pizzi
Chief Financial Officer

A

I think we – in terms of a jumping off point, I think we gave clarity around sort of the early part of the year. Keep in mind, Q1 has certain FICA resets and other things that roll through the comp and ben line. We are hiring people for the $50B initiative. There's some consulting spend going through that is going up a little bit early in terms of where the balance sheet's going to be. So operating margin in the early part of the year is going to be a little bit pressured but probably in that mid-30%s range. But we are going to be exiting, hopefully, right around 40% to just above 40%.

Chris M. Harris
Wells Fargo Securities LLC

Q

Regarding OptionsHouse integration, I mean there's some pretty big things to happen in Q3. You talked about that, one of those being clearing conversion. Are there no more synergies coming out until that occurs and then when those things occur, we'll get synergies kind of in the back half of 2017?

Michael A. Pizzi
Chief Financial Officer

A

To this point we've been very faithfully executing on a lot of the expense synergies well on our way. But you're right, the amount of synergies coming out over the next period of time will slow until the conversion is complete. The conversion is really necessary to bring all of the revenue synergies online. That's going to be the cash portion, the investment of the cash as well as the margin economics. And then following that, that will be where there'll be additional costs.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. But we're not providing any specific guidance around what the synergies might be for 2017, the dollar number?

Michael A. Pizzi
Chief Financial Officer

A

No. Not at this time.

Chris M. Harris
Wells Fargo Securities LLC

Q

Okay. All right.

Michael A. Pizzi
Chief Financial Officer

A

We're on track to deliver the synergies as we originally outlined them.

Chris M. Harris
Wells Fargo Securities LLC

Q

Got you. Okay. And then just to get clarity on one item, if we do get another set rate hike in 2017 or maybe actually even two, how should we be thinking about the incremental margin from that?

Michael A. Pizzi
Chief Financial Officer

A

I think the additional rate hike should drive if it comes in mid-year. And I think if you look at the fed fund futures curve, I think right now it's probably looking around June is sort of where it's priced in at, that would give us about 10BPS of expansion in the net interest margin for the full year. You could do the math on what that means around dollars. In terms of what that means for us is where we are in building out for growth is there are opportunities to invest that additional and to continue growth or accelerate growth, we're certainly going to take it if the returns are appropriate. If not, we're going to have the discipline to let it roll through. And I think that's the way, I think, you should think about it. If the opportunities are there, we'll make the investment.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

Just want to drill down again on the NIM for this year. Mike, if you could maybe talk about margin loan pricing, if you expect to be able to get all of that for each fed hike and then your assumption of the yield curve that is banked in the NIM guidance. And then also, if you can talk about any kind of sweep deposit beta when you would expect to be passing that through to customers.

Michael A. Pizzi
Chief Financial Officer

A

I think we are – in terms of overall margin I think we did pretty good this quarter. You can see we were able to push through some of the margin from the late rate hike and some of that just in terms of the mix. Composition of the book also helped us out this quarter as customers more at the higher rack rates re-engaged a bit. We will continue to price the margin book effectively with movements and fed funds, but we're well aware that much of the market is negotiated pricing and we'll continue to negotiate against the competitive backdrop.

Looking at the cash side of the balance sheet, we haven't really taken any actions yet. We're looking at the overall landscape in the competitive market where money fund rates are and looking to see when we will have to do it, but at this point we've not really taken any action into effect.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

And the sensitivity to the – well I guess what yield curve assumptions do you have in [indiscernible] (47:16)...

Michael A. Pizzi
Chief Financial Officer

A

Yeah. The NIM guidance we gave assumes no additional fed rate hikes, so the way we do that is we essentially have just grown the balance sheet according to our plan, effectively re-investing at the marginal re-investment rate and not increasing the federal funds rate. If we get one increase in midyear, you can add 10BPS to that range.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

I meant in the longer part of the curve. So let's say we got another 50 basis point on the 10-year, how would your sensitivity change?

Michael A. Pizzi
Chief Financial Officer

A

Yeah. We are essentially allowing the longer term rates to evolve according to the forward curve. So modeling some degree of upward drift is in that additional 10BPS. But in our base NIM guidance we are holding rates constant.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

Okay. Okay. That's good. And then just on price competition, I guess how are you thinking about – with the industry consolidation going on, are you looking at that as an opportunity to get customers from emerging entities? And how aggressive, I guess, would you be on that? And would that change depending on the environment? Obviously, if the macro backdrop is more supportive for revenue growth in your margins, would you tend to get more aggressive on that for customer acquisition?

Karl A. Roessner
Chief Executive Officer & Director

A

Yeah. We're actually pretty aggressive on customer acquisition now. It's one of the first things that we turn our focus to. As I said before, there's a lot of dislocation including the recently announced merger. And there're a lot of folks who might be willing to look at new homes. So we're definitely focused on that. It's something we're driving at.

Brian Bedell
Deutsche Bank Securities, Inc.

Q

You ramped it up right now basically?

Karl A. Roessner
Chief Executive Officer & Director

A

Yeah. Yeah, we have.

Chris Allen
The Buckingham Research Group, Inc.

Q

I was just curious, and I apologize if I missed this. The balance sheet guidance of $57B. I think it was maybe $62B at the end of the year. How much of that stream is coming from the transfer of third-party deposits and how much is assumed from organic growth?

Michael A. Pizzi
Chief Financial Officer

A

Well, if you look at the amount we have, it's the $13.5B you have. But we have enough third-party cash today to achieve those balance sheet targets. We're not really disclosing what our internal growth estimates are for cash for the year, but we have the capability, really, of delivering on the balance sheet forecast out of the $13.5B pool that's available today.

Michael Roger Carrier
Bank of America Merrill Lynch

Q

Maybe just on the commission rate, you guys mentioned most of it just with OptionsHouse. Just curious, as you're bringing on clients and as there's some movement in the industry, like do you see much pressure there whether it's on margin or whether it's on your commissions? I know you guys mentioned longer term as rates are rising you might see more competition, I think that's expected but in this current environment are you seeing much yet?

Karl A. Roessner
Chief Executive Officer & Director

A

We don't – when we deal with customers and sort of get into moving customer balances or talking about people finding a new home and coming to trade with us, it's almost always hand-to-hand combat, right? So there's pricing pressures around bringing folks in on negotiated pricing, folks who come in on our rack rate pressure or others in the industry we haven't seen a lot of downward pressure on.

But for the larger accounts, the active traders and the folks who really make a difference in terms of what they deliver for us and for our shareholders, there's absolutely pressure and that increases every day. The dislocation is driving a lot of that. There's a lot of competition for that pool of individuals because there's definitely a finite pool of active traders out there.

Michael Roger Carrier
Bank of America Merrill Lynch

Q

Okay. And then just as a follow-up. You mentioned in the prepared remarks just a focus on the marketing, the strategy and a shift vs. maybe the past year. Just wanted to get a sense on where is the time or where is the money being spent and what are the expected returns or the goals if you look over the next 12, 24 months from that shift?

Karl A. Roessner
Chief Executive Officer & Director

A

Look, we're looking and sort of devising the entire marketing plan right now. Right now we're spending a lot of our time and efforts going after customers, whether it be through website, e-mail campaigns or others, developing an entire new approach to our brand that we hope to launch by the middle of 2017, so I would expect a lot more on that.

In terms of the returns, we're going to look at marketing to drive a significant amount of our customer and account acquisition and asset acquisition that we've talked about. So looking at that to be quite a bit of it. We have increased our marketing spend in the numbers that we have, but we'll stay within our op margins on that spend.

Doug R. Mewhirter
SunTrust Robinson Humphrey, Inc.

Q

I had a question about the stock buyback or the potential stock buyback. You talked about how you're going to be holding more capital in the bank this year, but you're still going to see what you can do on maybe H2 for the stock buyback. I would assume that you would buy back approximately what you could dividend up from the broker plus maybe some surplus cash you already have? Is that sort of the way to think about it?

Michael A. Pizzi
Chief Financial Officer

A

I would think about it this way. We have an amount of capital and we're generating capital through earnings that's going to keep our Tier 1 leverage – allow us to grow the balance sheet, keep our Tier 1 leverage ratio at the binding constraint of seven. As we look at sort of that balance sheet evolution in a sort of thoughtful way over the course of the year, as we get into the latter half of the year, we think we're going to have enough capital to return it to buybacks. Now if the best use of capital is to accelerate the balance sheet growth or we have more cash available, that's going to leave us sort of with a high-quality decision to make as to whether we want to get back to buybacks or whether we want to continue to pursue the balance sheet.

But when we look at our capital plan today, when we look at how we're bringing money over, when we look at the expectation of our forecasts, we feel pretty good that we'll be able to return to buybacks in the back half of the year.

Michael J. Cyprys
Morgan Stanley & Co. LLC

Q

Just on the stock plan business, it looks like the un-exercised stock plan assets are down about two years in a row now, $118mm down that's about $103mm. So can you just talk a little bit about the competitive dynamics within the stock plan business? What sort of growth rate do you see for the industry and what your sort of thoughts are in terms of what you'd do differently now in terms of gaining share?

Karl A. Roessner
Chief Executive Officer & Director

A

Yeah. I mean, look, the stock plan business is really the B2B component of it that you're talking about. There's a pretty long lead time on getting new clients over and converting them on to our system. I mean, pretty happy with our Equity Edge Online platform that we have, right? It's an industry leader and we continue to add new clients, but that business is extremely lumpy in terms of where the markets are, in terms of where the particular stock is.

You get folks who get stock for the first time and it's in, it's loaded, it's gone the next day because they've earmarked that for a personal spending goal or for a car or house. So it gets a little lumpy and it's hard to sort of dig into where we are or what we think on that front. I am very happy with the pipeline that we have out there right now, and I'm very happy with the team that services that business.

Michael J. Cyprys
Morgan Stanley & Co. LLC

Q

Any thoughts on M&A for that business?

Karl A. Roessner
Chief Executive Officer & Director

A

Absolutely one of the things that we're thinking about, as I said a little bit earlier on the stock plan side. Looking both at scale, because a lot of participants in that business are really looking to get out or sort of looking to move around and we're quite happy with it because it's a natural extension and a natural feeder to our channels here. So we like that. And also looking at other opportunities to deliver additional products on that line as long as it makes sense. And anything, even in that space we'll look through the capital lens to see if it makes sense for our shareholders. But yes, it's absolutely one of the areas we're looking at.

Michael J. Cyprys
Morgan Stanley & Co. LLC
Q

Okay. Great. Just as a quick follow-up here, just on retirement. Just curious how you are planning to grow your retirement related assets and how you think about prioritizing that vs. the investment spend that you have going on with the active trader side of the business? And then maybe you can just talk to sort of gaps you have on the retirement side today, if any, how you want to close that?

Karl A. Roessner
Chief Executive Officer & Director
A

Yeah. Look, to me it goes hand in hand, right? We need the active traders and we also need investors. As I said earlier, with us, with E*TRADE it's about perception. Are we the home for people's longer term money? Do they look to us as the company that they want to keep their dollars with? So a big part of our marketing push and our marketing campaign we'll be developing will be to generate additional awareness around that, and also to take a good, hard look at our offering. I mean, our Adaptive is a very nice product, it's pretty seamless. It's got a nice customer interface. But we really haven't marketed it, haven't gotten out there. And we've been sort of languishing in the $1B to $3B range over the past seven or eight years in terms of assets under management or longer term money. So it's really about perception and we intend to focus on it quite a bit. So it's both sides that we're investing in at this point.

Kyle Voigt
Keefe, Bruyette & Woods, Inc.
Q

Just one on the OptionsHouse. I'm just wondering now that you've had the acquisition closed for a full quarter, can you just give an update on any attrition that you're seeing? And I know it's still very early days, but also if you can give an update on if you have a better line of sight on the cross-selling or revenue synergy opportunities and the timing of how that will unfold? Thanks.

Karl A. Roessner
Chief Executive Officer & Director
A

Sure. So look, the acquisition went pretty smoothly. The integration is going similarly smoothly, very happy with the team that we acquired, love the capabilities that they bring to the table and I love the energy that they bring to the table. They've definitely helped us move to a more sort of agile environment and gotten a lot more lean in our execution. So that's been working very well. In terms of delivering the cross-sell and the products out to our customers, it's why Q3 finish on both the conversion of the clearers and getting the tools up and running in terms of getting that over to E*TRADE are extremely important to us, so more to come in late third quarter. And hopefully by our third quarter's earnings call we'll be able to give you some more info on that.

Rob Rutschow
CLSA Americas LLC
Q

I was wondering if you might be willing to share the level of payment for order flow revenues and what the impact of the OptionsHouse clearing conversion might mean for that? And then longer term, what, if any, impact moving from 30% to 35% derivative might have on that revenue line item?

Michael A. Pizzi
Chief Financial Officer

A

Order flow for the quarter was about $29mm overall. We don't really break out the full quarter effective OptionsHouse on that number. Now I think you're right that Options have a bit of a higher overall payment and so improving option mix has a lot to do with it, but the real win in improving the option mix is just the regularity of the trading that goes on in the book. It really comes from the commission side. It's not really a desire around the order flow but the order flow is definitely part of the economics there.

Rob Rutschow
CLSA Americas LLC

Q

Okay. And if I could just shift gears. Are there a couple of key things that you're looking to do better in converting the stock plan clients into brokerage or, more importantly, managed-asset clients? So in other words, what are you looking to do better or differently to get more of those clients to convert?

Karl A. Roessner
Chief Executive Officer & Director

A

So one of the biggest things that we – a challenge that we have on that front is showing stock plan participants that we're more than their stock plan provider. They use us, they look at us on the E*TRADE Corporate Services side as the folks who do the plumbing for their stock plan accounts. So getting in front of them earlier, providing education and seminars, dealing with the corporate client up front when we execute the B2B agreement, to make sure that we can get on and become a provider of choice for when those individuals have an event in their stock plan and they have additional cash to invest, helping them understand that we have a rule book, that we're in the space, that we do have the tools that they need. Raising general awareness, as I talked about before, of our longer-term investing solutions.

So it's – to me, a lot of it is around that. We also talked a little bit in the prepared remarks around some wealth management that could be nice bolt-ons or partnerships that help you provide additional asset-management tools or capabilities to our stock-plan clients who have the resources and a lot of times trade off of us to go use others when we have the same tools and products available.