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E*TRADE Financial Corp. (ETFC)

Q1 2017 Earnings Call

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Chief Financial Officer

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MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP FINANCIAL MEASURES

- During the call, the company will also discuss non-GAAP financial measures
- For 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 results of E*TRADE Financial, please refer to the company's earnings release furnished on Form 8-K along with Form 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

BUSINESS HIGHLIGHTS

Opening Remarks

- It's a pleasure to expand on the quarter's results, and to update you on our progress
- This quarter was one for the history books as our industry attacked published commission pricing for the first time in many years
- Meanwhile, we made progress on our path to deliver meaningful value to our shareholder, efficiently deploying capital and continuing in an undaunted fashion to position ourselves for improved growth

Balance Sheet

- Specifically, we on-boarded deposits to grow our balance sheet by \$7B during the quarter, just shy of our mid-year goal
- We lowered our bank Tier 1 leverage threshold to 7.5%, reflective of the regulatory progress we've made over the years
- We returned to our full-year operating margin target of 38%, despite reducing commission pricing
 - We began to see early benefits from several initiatives we put in play over the last six months in the form of strong brokerage metrics

OptionsHouse Integration

- We delivered on much of the necessary work around the OptionsHouse integration to ensure a Q3 completion

- We concluded an exhaustive process to partner with the right creative agency as we reinvigorate our iconic brand
- We made significant headway in energizing our HR efforts to better support internal business partners, while improving talent acquisition
- And finally, we laid more legacy issues to rest with the effective completion of HELOC conversions from interest-only to fully amortizing loans

Commission Pricing

- Let's start with the elephant in the room; commission pricing
- The moves within the industry this quarter served as a stark reminder of how fiercely competitive our business is, and has been for quite some time
- After three of our closest competitors lowered commission pricing within a relatively short window, we reacted swiftly and accordingly by lowering our own rates
 - This is not a decision we took lightly because we truly obsess about shareholder value

Long-Term Growth Prospects

- But throughout our history, we've never rested in our quest to deliver an exceptional experience to our customers at a compelling value
- And in an industry where pricing is the most transparent variable for customers choosing a platform, we didn't like our long-term growth prospects at a premium price point, especially while the perceived disparity in value among competitors widened in a very public fashion
 - So we took the necessary steps to defend our customer franchise, which is far and away, the most valuable asset we have

Integration Pricing

- Our new structure includes a standard rate of \$6.95 plus \$0.75 per options contract, and an active trader rate of \$4.95 plus \$0.50 per options contract
- Lowering our standard rate was the necessary response to the industry moves, while the changes we made for active traders was the effective pull-forward of a planned post-OH integration pricing tier
- We put significant thought into the right cut-off for our more active tier, and ultimately set the threshold at 30 trades per quarter, down from our previous 150 trades
 - This was born from customer insight
- At this level, we capture customers who actively engage with the markets, as well as those who could be compelled to execute more trades, particularly in derivatives, at a more favorable price point

Target Segment

- Beyond price, we're working to package a differentiated service and product experience for those who qualify for this tier, which we plan to deliver post-integration
- As we make a concerted push to reclaim our spot as the top home for derivatives traders, we believe this structure will prove compelling and competitive for this target segment
- To summarize, this recent price battle and our response presents a temporary bump on our road from a revenue standpoint
 - But we are undeterred in our objectives as we continue to charge full steam ahead, focused on accelerating the growth of our franchise

Brokerage Asset and Account Growth

- Now, to update you on how we're positioning ourselves to do just that
- To reiterate, our targets are to increase our brokerage asset and account growth rates by 2 percentage points to 3 percentage points from Q3 2016 levels; grow derivatives to 35% of our trades; and grow our managed assets to \$6B
- The things we're doing to achieve those goals are progressing as planned

Integration of OptionsHouse

- First, the integration of OptionsHouse
- With the corporate integration largely complete and the clearing conversion on track for Q3, we'll deliver our synergy targets on schedule
- Beyond that, there's more value for us to capture here as we fully capitalize on the acquisition to help us reclaim our space as the premier, undisputed home for options traders

Customer Segment

- We believe that delivering an integrated platform that combines the best of OptionsHouse's derivatives capabilities with the best of our existing technology will move us forward with this valuable customer segment
- The vision we're working hard to deliver puts additional capabilities in the hands of our customers, and also addresses the growing demands for advanced trading capabilities on the go
- And it bears repeating that this integration is about much more than producing a top-notch combined platform
 - It's also about adopting a mindset of efficiency in product development
- The notion is simple; we're relatively small, and we must remain nimble, more agile, and be able to respond to customers' evolving demands faster than the competition

Marketing

- Second is marketing
- This is an initiative we must absolutely nail
- We must revitalize the brand the way our offerings are understood and how they resonate with our customers and prospects
- We took a major step in this direction earlier this month when we tapped a new creative agency, MullenLowe
 - We went through an exhaustive process to select the right partner, and I'm confident in the direction we're headed
- Together with – we are developing brand messaging that will elevate our value proposition in the eyes of our current and prospective customers, while speaking to who we are as a company
- Stay tuned as we look to make a splash in the next few months

CUSTOMER PAIN

- The final initiative we have in place is a bit more comprehensive
- We're working to address all of our customer pain points, which is no small task for any company
 - While we talk a lot about new assets and accounts, keep in mind these are net numbers

- We must be equally conscious about making sure that once a customer chooses E*TRADE, they never have a reason to leave

Integration Process

- While phenomenal customer service will always be core to our offering, we're taking the approach of addressing the most common frustrations of our customers before they ever reach a service rep
- Some changes will occur through the integration process, but we've also rolled out a host of news, features and offerings on our current platforms, including simplified navigation, better organizing our pages and bringing tools and products to the forefront of our site, continued enhancements to our most heavily traffic pages such as the portfolios page, a redesign of the E*TRADE mobile app to provide stock plan participants access to popular benefits and tools; and significant enhancements to the OptionsHouse mobile app to improve fast-paced usability and execution for options traders

Net New Brokerage Assets

- Amid all this hard work, I'm very pleased to say that we're starting to see early returns reflected in our Q1 metrics, which represent a tremendous start to the year
- We brought in a record \$4.2B in net new brokerage assets during the period
- These strong flows continued in March following the industry price changes, giving us confidence that we are doing what is right in the eyes of our customers and that we are still very competitive in our industry

ANNUALIZED GROWTH RATE

- Further, the annualized growth rate of 6.1% is comfortably within the goal we set six months ago for this metric of 5.8% to 6.8%
- Managed product also continued to grow steadily, ending the quarter at \$4.3B, up 10% sequentially
 - We feel good about reaching our target of \$6B

Equity Markets

- Part and parcel with our asset success is our account growth
- We posted a multi-year high in net new brokerage accounts at 58,000, more than half of our full year 2016 total in just one quarter
- The annualized growth rate of 6.7% is far in excess of the goal we set forth, which is 4.8% to 5.8%
- We're not claiming victory after just one quarter, especially as Q1 is a seasonally strong period, but I think these levels demonstrate just how achievable our growth goals are
- The strength of the equity markets undoubtedly boosted our metrics as strong performance instilled confidence in our customers that compelled them to meaningfully engage

DARTs

- DARTs of 207,000 were up 10% sequentially as broad market indices reached all-time highs
- Derivatives represented a steady 29% of total DARTs, which is consistent with our expectations ahead of the launch of our fully-integrated platform
- In April to-date, DARTs are tracking down 5% from March levels
- Our customers were net buyers of \$1.6B of securities during the quarter
 - This follows the prior two quarters' heavy net selling during which customers reduced their securities positions by \$3.2B, underlining the shift in customer confidence

Customer Margin

- This was further supported by an increase in customer margin balances, to \$7.3B from \$7.1B at the end of Q4
- Beyond the metrics, we recently received additional validation of our efforts, having just emerged from our industry's awards season
- Both OptionsHouse and E*TRADE received high marks and an assortment of accolades from Barron's and StockBrokers.com, further substantiating our offering as among the best in the business

OptionsHouse

- Barron's awarded E*TRADE and OptionsHouse each four out of five stars overall, earning a combined four, best of, distinctions
- StockBrokers.com also acknowledged our products and services with nine best-in-class distinctions across the two platforms
- And for the second straight year, StockBrokers.com named OptionsHouse the top overall options platform in the industry
 - While it is nice to receive third-party validation, the true proof of our success will come after we deliver a fully-integrated platform

Q1 RESULTS

Net Income

- Turning now to our results
- We reported net income of \$145mm or \$0.48 per diluted common share in Q1
- Our results include a provision benefit of \$14mm and one-time costs of \$6mm related to the OptionsHouse integration and crossing \$50B.

Capital Deployment Strategy

- Our results also reflect the power of our capital deployment strategy as net interest income was the strongest we've posted in 6 years
- After lowering our bank Tier 1 leverage ratio threshold to 7.5% during the quarter, we took advantage of available capital plus a favorable interest rate environment, and moved deposits on balance sheet
- We ended the quarter just shy of \$56B in consolidated assets, \$7B increase during the quarter, outpacing our growth goals
- I'll let Mike Pizzi provide more details, but suffice it to say, we're pleased with where we stand on this measure

SUMMARY

- In summary, we had a great quarter
- There was some unexpected turbulence in the industry, but we combatted it with fortitude, and we continue to take steps to reinvigorate the growth of our customer franchise
- I believe, our progress here reflects something I feel on a personal level, which is a singular source of strength: that we are a company that can be counted on to achieve the goals we communicate
 - We're a company that delivers on its promises

- I'm excited about what we have in store for the remainder of this year, and look forward to executing on our commitments to both our customers, and our shareholders

Michael A. Pizzi

Chief Financial Officer

FINANCIAL HIGHLIGHTS

Net Income

- For the quarter, we reported net income of \$145mm or \$0.48 per diluted common share
- Note that this includes \$14mm provision benefit and \$6mm of one-time costs related to the OptionsHouse integration, and crossing \$50B
- The bottom line also reflects our first semi-annual preferred stock dividend, which equates to \$0.05 per common share
- Our results compare to \$127mm or \$0.46 per share in the prior quarter, and \$153mm or \$0.53 per share in the year-ago quarter, which included an income tax benefit related to the release of a valuation allowance against state deferred tax assets

Revenue

- Revenues for the quarter were \$553mm, up \$44mm from the prior quarter, reflecting balance sheet growth, a better interest rate environment, and stronger customer trading activity
- Y-over-y, revenues were up \$81mm, primarily on balance sheet growth, and the addition of OptionsHouse

Net Interest Income

- Net interest income increased 11% to \$319mm during the quarter as we grew average interest-earning assets by \$4.4B
- With a significant amount of capital available after lowering the Tier 1 leverage ratio threshold at the bank, against a backdrop of a more favorable interest rate environment, we grew the balance sheet in a purposeful manner
- Net interest margin increased slightly to 263BPS, reflecting the full impact of the December Fed rate hike, as well as a slight benefit from the March hike
- I'll expand on interest rate impact in a moment

Commissions Revenue and New Pricing

- Commissions revenue of \$127mm increased 4% q-over-q, driven by a 10% increase in DARTs, but partially offset by the impact of our commission reductions
- While the new pricing schedule was only effective for the last three weeks of the quarter, it was the primary driver of the decline in average commission per trade, which was down \$0.55 to \$9.87
- As a point of reference for you, pro forma for our new pricing, our Q1 commission per trade would have been \$8.10
- Keep in mind, this includes a sequential increase related to corporate services, for which Q1 is typically the strongest quarter

Fees and Service Charge

- Fees and service charges increased \$6mm q-over-q to \$86mm, driven by a higher rate on off-balance sheet deposits, reflecting the December increase in short-term rates
- This was partially offset by a reduction in the amount of these off-balance sheet deposits as we grew our balance sheet, a dynamic that should continue over the course of the year

OptionsHouse Margin

- As a reminder, OptionsHouse margin balances will no longer run through this line after conversion in Q3, as they will be reflected on our balance sheet and accordingly generate NII.
- Gains increased to \$10mm from \$8mm last quarter, and included approximately \$3mm of non-securities gains
 - We expect this line to return to the \$5mm range next quarter
- Other revenue was unchanged at \$11mm for the quarter

HELOC Portfolio

- Provision benefit was \$14mm, compared to \$18mm in Q4
- The allowance reduced by \$8mm to end the quarter at \$213mm, as net charge-offs were a recovery of \$6mm
- The loan portfolio now stands at \$3.5B, or just 6% of total assets
- Importantly, we've put the last remaining credit risk overhang behind us as 96% of our HELOC portfolio is now amortizing
- Given the dwindling size, complexity and risk of this portfolio, we have eliminated much of the associated supplementary information in this release, particularly that related to the performance of modified loans or TDRs and the breakout of reserves for that population
- Further detail will be available in our 10-Q

Non-Interest Expense

- Non-interest expense for the quarter was \$342mm, up \$20mm sequentially, which primarily reflects seasonality in marketing spend and compensation
- It also includes one-time expenses of approximately \$6mm, primarily related to the OptionsHouse integration
- Our operating margin was 41%
- Excluding provision benefit, our adjusted operating margin was 38%, up slightly from the prior quarter and ahead of our expectations as a result of strong customer activity, a faster pace of balance sheet growth, and higher interest rates

Operating Margin

- As for our full year operating margin, during our last call, we outlined a 38% target, which we subsequently revised down to 36% when we announced our commission reductions in late March
- Now, in the wake of the Fed's March hike, our revenue forecast supports our initial 38% level
- And for clarity in your modeling, achieving this target for the full year does not require targeting expenses beyond our ongoing commitment to be disciplined in our spending

- Our operating margin in Q2 will be down from Q1 as a result of the commission price reduction, elevated expense related to the OH integration, and the costs of crossing \$50B.

Tax Rate

- As for tax, this quarter we posted an effective tax rate of 35.6%, which includes a benefit related to the adoption of amended accounting guidance for employee share-based compensation
- This item will likely have the greatest impact in Q1 each year; however there could be additional tax impact as shares vest throughout the year
 - We expect our full year tax rate to approximate 38%, assuming no further unique items

Interest Rate

- And finally, on the P&L, I'll give an update on the impact of rising interest rates on our expectations for the remainder of this year
- First on net interest margin; we benefitted from higher short-term rates following the Fed's rate hike in March
- And while the long end of the curve did not show the same degree of upward movement, our average reinvestment rate was firmly in the 230 basis point to 250 basis point range
- This, coupled with accelerated timing of balance sheet growth, raises our expectations for full year NIM to the low-260s
 - This expectation assumes no change in the rate environment, and that margin receivables are held constant

Fed

- However, we acknowledge the broad market expectations for at least one Fed hike, if not more
- If the Fed does raise rates in June, and there's a corresponding increase in term rates, holding all else equal, our NIM expectations would increase by approximately 10BPS
- However, considering the intense nature of the competitive environment, we remain conscious of the potential need to amend deposit pricing following future hikes, which would obviously temper some of the NIM benefit
- As for the yield on off-balance sheet deposits, in Q1 we averaged a gross yield of 58BPS, up from 45BPS in Q4
 - Today, that yield is around 80BPS, and we expect it to average approximately 90BPS for the full year

Operating Margin Target

- There are a lot of moving pieces with respect to interest rates, and I want to be clear on how we think about op margin in this context
- Shareholders bore the brunt of the extended and unprecedented low-rate environment, and so our intent is to allow as much of this upside to reach the bottom line as possible
- We believe that an additional hike in June of this year could add up to 100BPS to our full year operating margin target
 - But as I mentioned a moment ago, competition remains intense within our industry
- And should competitive dynamics shift again, we will do what it takes to defend our franchise

Capital

- Moving on to capital, we generated and put a significant amount to work for our shareholders during the quarter
- We moved \$70mm from the broker to the parent during the quarter, and plan to move another \$50mm this quarter related to excess capital generation during Q1
 - We continued to utilize excess bank capital directly at that entity to fund balance sheet growth
- After crossing \$50B in the first days of January, the interest rate environment presented an opportunity to accelerate our growth plans, and with plenty of available capital, we took full advantage
- We ended Q1 just shy of our mid-year target at \$56B, representing an increase of \$7B during the quarter
 - This growth utilized the majority of our capital buffer, which widened after lowering the bank leverage ratio threshold during the quarter
- Since we began managing to this ratio in 2012, we have been able to lower the threshold by a full 200BPS to 7.5%, creating a substantial amount of capital for deployment, and putting us at a level we consider appropriate

Leverage Ratio

- However, the bank ended the quarter well-above that at 8.1%
- This compares to our parent leverage ratio of 7.2%, vs. our internal minimum of 7%
- So clearly, the parent has become the binding constraint
- Given that we conservatively maintain a slight buffer to these capital thresholds, we expect the pace of balance sheet growth to be more measured from here, and to be fully supported by organic capital generation

Assets

- We now expect to be at \$58B in consolidated assets by the end of this quarter, and \$63B by the end of this year, which is just shy of our fully-deployed balance sheet size of \$65B, assuming all available deposits were brought on balance sheet today
- Beyond that, our broad expectations are to direct all growth in customer deposits to our balance sheet, barring any abnormal patterns or net selling activity

Capital

- I want to reiterate that we are focused on putting capital to work in the ways that we believe will generate the most value
- Share repurchases serve as our baseline return on capital when we consider a range of deployment strategies
 - We feel that in conjunction with balance sheet growth, repurchases are our best path for long-term value generation for our shareholders
- Accordingly, we continue to plan to resume share repurchases in H2, with the size dependent on the amount of capital in excess of the consolidated leverage ratio

Commission Pricing

- To close, overall this quarter, we posted solid results and we put a lot of capital to work for our shareholders

- Despite the turbulence in commission pricing, our franchise didn't skip a beat, and we remain positioned to deliver on the commitments we made with respect to operating margin and capital deployment

QUESTION AND ANSWER SECTION

Steven Chubak

Nomura Instinet

Q

So want to just kick things off with a question on the competitive environment. You alluded to this a little bit in some of your prepared remarks, but just given the strong growth in net new assets and accounts that we saw, it certainly appears like the latest round of price cuts had a little impact in terms of franchise performance.

Mike, you noted that you guys really didn't skip a beat, and didn't really hinder your ability to make progress towards those growth targets that you guys have outlined. I'm just wondering, if you could just speak a little bit more in terms of how the competitive environment actually evolved over the course of the quarter, following those actions, whether you saw any impact if at all?

And if we do, in fact, see another round of meaningful price cuts, you did note that you would look to defend the franchise. I'm hoping you can give some additional context in terms of what specific actions you might have to take?

Karl A. Roessner

Chief Executive Officer & Director

A

Sure. Looking at what went on during the quarter around the price cuts, initially, it was a lot of calls from our customers, and a lot of interested parties trying to figure out what was going on in the space. There was certainly no large demand for lower pricing, and there was no calls before that coming into us. So there were a lot of offers and asks in the marketplace to match pricing, and see if we would sort of lower down to where they were.

So like I said before, it's sort of a hand-to-hand combat on the higher-end of the book to make sure that we are providing pricing. But keep in mind that, what we always say and it holds true today. The higher end of our book is on negotiated pricing, and they provide a lot more to us than just commission per trade. They've large cash balances with us, they have large margin receivables sit with us.

So it was some pretty heavy flooding for our customer service reps and for our FCs on the ground, working with customers. And our pricing changes, I think, resolved a lot of that, bringing it down to \$6.95, because our offering overall provides a significant amount of value to our customers. That was true before the price cuts, and it remains true after the price cuts.

What they gave us the opportunity to do, in the price cuts was really pull forward what we were thinking about and looking at internally for post-integration on the OptionsHouse side. It also allowed us to redefine what we look at as an active account, and looking at 30 trades per quarter as a opposed to the 150 trades that we used to use, which we believe is the right customer and the right type to go after with our improved options capabilities and derivatives trading capabilities, our client services team that we've put in place on the active trader side, our derivative services guys.

So we think, we're in the right place now. In terms of positioning the franchise for additional cuts, just to take a step back, when I look at what went on, and Mike hit it head-on in his prepared remarks. In 2010, we went

through this, all right, and we saw those price cut, and matching and we collapsed some tiers and there was really no reallocation among the larger players.

There was lot of – a lot of lower pricing, a lot of revenue foregone, and a lot of shareholder value, because that went out the door, but we didn't really see a lot of reallocation among. So in my view, I don't really want to see additional price cuts come through.

But Mike's right, we'll do everything we can to defend the franchise. And in terms of – if we would have to go down lower, if we have to match, if we have to do what we need to do, to keep our customers in our book, the most valuable asset we have.

So it's really more of the same, should that happen. I don't think it is rational to think about additional price cuts at this point in time, particularly given what we're seeing in the early days, but we'll see how it ends up, and it's not always necessarily within our control, but we'll absolutely defend our franchise.

Steven Chubak

Nomura Instinet

Q

Thanks, Karl. It's certainly a very helpful detail. And just switching over to the deposit growth side of the equation. The balance sheet growth itself has actually come in stronger than expected. You guys touched on some of the factors driving that faster growth. What do you believe is a reasonable pace of organic deposit growth that you can achieve once the on-boarding is completed?

And what do you believe is a reasonable expectation in terms of deposit beta? Has your thinking there evolved a bit, given some increased competition we've already seen from one of your competitors actually passing on some of the benefits to clients this early on in terms of the rate tightening cycle?

Michael A. Pizzi

Chief Financial Officer

A

Yeah, I'll start with that. I mean, we did see pretty growth in the quarter. If you measure it in terms of what we sort of size as the fully-deployed balance sheet; last quarter, we were at \$62.5B, this quarter we're showing \$65B.

From a pace of balance sheet growth, I think at this point, the pacing will be really in line with capital generation as we go forward, as we've really deployed the buffer that we had at the start of the year. From an organic growth perspective, I think, you can expect deposit growth or cash growth really to scale with the underlying account growth and asset growth that's within the business.

And so, from a cash perspective, we would expect cash to grow in line with accounts and assets once we reach sort of that fully-deployed state. So you can mirror that directly to the underlying business forecast. But the only really caveat is that our Corporate Services business does generate some cash, and that is a little bit more heavy around the seasonal vesting patterns that are in that business.

Steven Chubak

Nomura Instinet

Q

Got it. And then, just one more in terms of the efficiency targets that you guys have outlined. As you think about the long-term profitability of your business, just given your heavier gearing on NII or spread revenue relative to some of your peers, it's about 60% of your revenue, less than 50% for some of the peer set. There is a case to be

made that the operating margins that, your model support should in fact be greater than that 46% that you've outlined in the earnings walk slide.

And in the environment where commission cuts aren't accelerating, and we continue to see some healthy growth in terms of balance sheet and some additional rate help, what do you believe is at least an achievable margin target longer-term? And is it reasonable to expect that, it could in fact grow beyond 46%?

Karl A. Roessner

Chief Executive Officer & Director

A

So, let me start by saying, I'll hand over to, Mike, for some specific guidance, but look, I couldn't agree with you more. This business can absolutely generate higher margins, and we can absolutely get there. But I think, what you described would be the perfect utopian state, right, where there's no additional pricing pressure, maybe there's no additional competition coming in for our accounts, because – remember if we're in that type of an environment, our competitors are benefiting just as much as we are, and it's probably extremely difficult out there to maintain and defend your book.

So you have to look at continuing to defend, and continuing to invest in the best technology you can to provide to your customers. You need to look at marketing, how do we make sure that we keep out there and keep in the customer mindset, and attract our fair share of new customers that come into the pipeline, right. And what else do we need to do to continue to maintain, defend and then grow our book.

So, that's why, when you start getting out, then you can come up with some pretty big numbers based on the current scheme we have. If you hold everything constant, sure, we can do better. Mike, I don't know if you...

Michael A. Pizzi

Chief Financial Officer

A

Sure. I mean, look, we've put out really a long-term target with 100 basis point normalization, and achieving of our growth goals of about 46%. But if you do the math on what we're putting out, that's going to give you a pretty high operating margin on both our additional growth, as well as the additional moves in rates. Obviously, if you extend the rate move or you accelerate the growth even further, and keep applying that, you'll get higher and higher op margins.

When we look at a model and we do that math, we have to use an element of judgment as to how much we think the competitive environment is going to intensify, and how much are we going to be able to pass through of the rate hikes.

So for today, we think sort of that mid-40s, 46% as we're showing in our long-term earnings slide, is the appropriate target for how we're thinking about the business, today. But if the competitive environment warrants, if there's no reason why those operating margins could not be higher.

Conor Fitzgerald

Goldman Sachs & Co.

Q

Karl, want to get your latest thoughts about the target of 200BPS to 300BPS of fast organic growth, and just how that feeds into the firm strategy. The pricing cuts we saw this quarter highlight that, the pickup in organic growth improvement can be pretty quickly overwhelmed by pricing pressure. Just given what you saw in Q1, is it still your view that, executing on your growth targets is still the best interest of shareholders, kind of even with maybe more elevated risk of future pricing cuts?

Karl A. Roessner

Chief Executive Officer & Director

A

Yeah, look. I absolutely stand by the growth goals we put out and they are absolutely achievable within the timeframes that we've set forth. I've been through this with, Mike, a number of times in terms of where we are on the interest rate front, where we are on the balance sheet, and where we are just as a franchise.

I really like what I'm seeing around here. I like the initiatives that we've taken. I like the way that we've gone through and restructure the company around the goals that we've set. So we have real ownership and real accountability throughout the organization to deliver on these. And the teams have really stepped up, so I'm excited about it. And absolutely no change in timeframe, and the scope of the goals or in what we've promised to deliver.

Conor Fitzgerald

Goldman Sachs & Co.

Q

And maybe just building on that from a broader strategy perspective. You're still confident that the improving growth is kind of in the best interest of shareholders. If you just think about as a risk reward equation of faster growth vs. maybe the risk of intensing pressure, it's still your view that the reward of faster growth is the best path for shareholders.

Karl A. Roessner

Chief Executive Officer & Director

A

It is absolutely my view, Conor. That's absolutely what I think.

Michael A. Pizzi

Chief Financial Officer

A

Conor, when we look at sort of the revenue drivers in terms of how we generate P&L from a net interest perspective, from a commission perspective, from fees and service charges, from our margin book, from our stock lending position; as we look at all those revenue drivers, commission is one element of it. While there's certainly sensitivity to commissions and certainly we've seen what happened this quarter, you could see right in the quarterly results, the power of all of the other drivers coming together, and then just look at how we illustrate the earnings power of that growth, it's pretty clear to us that growth remains the right objective for the firm.

Conor Fitzgerald

Goldman Sachs & Co.

Q

Thanks. That's helpful. Just wanted to get, both the updated thoughts. And then, Mike, just one for you. You mentioned, you were bumping up against the 7% Tier 1 leverage target. I interpreted your comments about operating with the buffer above the 7% target as meaning you wouldn't drop below that number even for a temporary period of time? But just want to confirm that. And then second, do you have any appetite for additional pref issuance to help accelerate the balance sheet growth?

Michael A. Pizzi

Chief Financial Officer

A

The 7% is the floor, so we have no intention to drop below it. We are aware of where things are in the preferred market. But right now, we think the best course of action is to continue the build out from an organic capital generation standpoint.

Richard Henry Repetto

Sandler O'Neill & Partners LP

Q

I guess, the first question is just, maybe an obvious one, but I don't know what happened on the cash and cash equivalents, it went down by \$1B, could you just explain that?

Michael A. Pizzi

Chief Financial Officer

A

It's the cash position at the bank, Rich. If you look at the yield table, you'll see it's a little bit higher. It's just, investing in securities really over the last few weeks, and just positioning of the balance sheet in terms of what was settling and what was unsettled.

You can see on average for the quarter, it was higher. We continue to just sort of sweep cash over. It's the movements that are coming on and off the balance sheet as we deploy them. It's the record date really vs. just the ongoing average.

Richard Henry Repetto

Sandler O'Neill & Partners LP

Q

Got it. Okay. And then the next question is, a peer, their average commission will drop, they gave guidance by around the low-double-digit percentage. If you take your \$8.10, it's going to be over – and you said, it could be less than \$8.10, in coming quarters, it's going to be more like in the low-20% compared to Q4's average commission.

So, I'm just trying to understand, what do you think the impact, is it – they're doing more price discounting than you do? Is it derivatives or is it the idea that you brought the active trader tier down, but why is it as big a difference vs. your peer, the drop in commission?

Michael A. Pizzi

Chief Financial Officer

A

Well, I think one, Rich, we did bring the active trader tier down at a lower price point than I think the peer you're referring to. In terms of where we are, that's a significant portion of our book, but then keep in mind, we have a – the book of business we bought, and OptionsHouse is already at that pricing tier. So it's really not affected by that move in any way.

So I mean, it's just a dynamic. Every book of business has evolved differently through past acquisitions, grandfathered at acquisition rates, through negotiated schedules that have been applied over time, in terms of what the decision we made, in terms of how we're going to offer pricing in the market vs. theirs.

Devin P. Ryan

JMP Securities LLC

Q

Would love to, maybe just drill down a little bit more into the drivers of the strength in NNA, this quarter. Maybe just at a little more granular level, if you can, how much is from the active trader sales effort vs. how much do you think is coming from marketing, branding or if you can attribute anything specifically to OptionsHouse momentum?

And then, just in your opinion, how much do you feel like is really, truly a direct result of the things that you're doing vs. how much is seasonality as you mentioned or the Trump bump? Just looking to see if we can get a little more granular there.

Karl A. Roessner

Chief Executive Officer & Director

A

Yeah. Sure. So when I look at how we proceeded, and what we've done over the past couple of months, there is quite a bit of more directed marketing and more thoughtful marketing going in to our campaign. So a lot more on the digital side, and we're being really different in the way that we approach things around here.

So there's a little bit of marketing, has to do with some of the active trader sales. And as I said, in the prepared remarks, we're not declaring victory, and there was absolutely, some of the environment behind some of the strength in our results.

But we're just getting started, right. So Q1 to me is extremely encouraging in terms of what we were able to produce, but we haven't rolled out our new brand campaign. We haven't put ourselves back on the map in terms of the irreverent challenger brand that we are.

We haven't gone through, and fully integrated OptionsHouse, and rolled out some of the top derivatives capabilities into our entire E*TRADE book. So Q1 results are extremely encouraging, given what we've been able to roll out to-date and where we're headed.

Devin P. Ryan

JMP Securities LLC

Q

Yeah. Absolutely. Great result there. And then, just maybe a follow-up on some of the prior questions on some of the thinking after the price cuts. I mean, obviously one way to defend is to match on pricing, and other ways are to add more value for clients or shift the mix of your business.

So I'm just curious, after that, are there any specific investments that have, maybe been moved to the front burner for the firm or changes just within the priority list? I'm sure, that this cut wasn't in the budget at the start of the year, and it doesn't seem like, obviously, the aggregate expense commentary is all that different. But just curious kind of the mix of how you're thinking about spending and opportunities might be shifting a little bit.

Michael A. Pizzi

Chief Financial Officer

A

Look, when we set out our plan for the year, and we worked on the budget and really the corresponding strategic and capital plan, we identified initiatives that really tie in very closely to the growth goals.

Obviously, getting to the \$6B in managed assets or fee-based assets as we would say, managed products, is an important goal, the derivative amounts are an important goal. Those projects remain high priorities of the company. And so really, we don't feel that we needed to really reprioritize much overall from the project standpoint.

On the expense side, yeah, the environment forces us to be disciplined, but that's a culture that we're trying to instill and put in place every day, is to remain disciplined and focused on how we look at expenses.

Chris M. Harris

Wells Fargo Securities LLC

Q

So, clearly the commission cuts show the vulnerability of that revenue source. Can you guys give us an update about your longer-term plans to diversify the business away from that? And then, how quickly do you think you can do that?

Karl A. Roessner

Chief Executive Officer & Director

A

When I look at the way we're setup now, right, we have our stock plan business on one side. And we've just acquired and sort of finished the acquisition on the OptionsHouse side. So it's really growing the derivative traders and growing the percentage of our customers that exercise those trades and use the functionality and the tools that we've taken in.

And so that's one piece is moving upstream in that area, where it will help us bring in the higher end of the book, and help us bring in more value added customers. So it's not about reaching out and trying to find additional streams of revenue. We'd like to be able to roll out additional managed product, right?

That's one of the goals and one of the sets of people we have focused on moving up to \$6B, to make sure that we can provide the best possible robo capabilities, the best possible managed investment products to roll them out to our customers. And it's more investment on that side. So that's really a part of our organic growth strategic, Chris, and those are right in line with the goals that we've set out before any of these price cuts took place.

Chris M. Harris

Wells Fargo Securities LLC

Q

Got you. Okay. And then just unrelated question on branding. You guys had mentioned that you're really focused on that, and really, I'm just kind of wondering, how do you guys want E*TRADE to be viewed by the marketplace, vs. perhaps how you're being viewed today?

Karl A. Roessner

Chief Executive Officer & Director

A

So what I'd like to do, and I believe what our new marketing agency, MullenLowe and the fantastic marketing people we have here will be able to put out into campaign that puts us back on the map, in terms of the irreverent challenger brand that we are. And we'll roll out additional branding and advertising around our products and capability sets following the completion of the integration on the OptionsHouse side.

So it's really getting back to the roots that we came from, irreverent challenger brand with fantastic tools, products and services to be offered to our customers looking particularly on the active trader side, and on the derivatives and options capabilities.

Chris Allen

The Buckingham Research Group, Inc.

Q

Just wanted to touch a little bit on the NIM guidance. I'm just trying to reconcile that with the guidance you gave after fourth quarter, which if I recall correctly, for the full year was 250BPS to 255BPS with 10BPS higher, with the June hike. You've obviously got a hike sooner than expected, you're able to put on a lot assets into securities at pretty decent yields, it looks like. So I'm just wondering why there wouldn't be a little bit more upside relative to that guidance than you're currently providing?

Michael A. Pizzi

Chief Financial Officer

A

Yeah. Chris, we said 250BPS to 255BPS. We said, a June hike would be – a mid-June hike would be worth about 10BPS. We've got that hike looking at sort of, what that hike did is, it flattened the curve a little bit, spreads are a little bit tighter overall.

So, while we're still optimistic low-260s basis points, it's really sort of midpoint-to-midpoint. We're getting to almost to the same place of getting that 10BPS. But we didn't see that 25 basis point yield near completely across the curve with spreads held constant. So we had to back a little bit off of that level, but we still think that there's a pretty strong NIM expansion with each hike.

Michael J. Cyprys
Morgan Stanley & Co. LLC

Q

You spoke a lot about the active trader customer. Just curious how you're prioritizing growing the longer-term retirement investor, and what's the opportunity set to pursue that more aggressively here, and how is that aspect of your business, can look in, say, 5 years?

Michael A. Pizzi
Chief Financial Officer

A

Sure. I mean, look, growing the active trader is really about reclaiming the roots of our business in terms of the evolution of the company, of the brand and where we are today and really, really closing the gap that emerged in the past few years in that market. And that you can see is very much tied in with the OptionsHouse acquisition.

But right along with that, our initiatives to improve in the managed investment product space, and to continue to try and be one of the best providers at offering digitally-centric financial services. And that goes directly into the retirement space. We've been doing pretty well in growing retirement assets even though we were a bit late to get started.

But as you can see, we're really at the beginnings of a revolution in the digital distribution of financial services. And so, it's a key priority for us over the next few years, especially at the lower asset size customer, where digital distribution is going probably be the mainstay of the market.

Michael J. Cyprys
Morgan Stanley & Co. LLC

Q

And you mentioned buybacks and also margins – margin targets generally thinking longer-term where you can operate. I guess, why not just kind of put some of that aside and just invest more aggressively going after the retirement investors out there? How do you think about kind of balancing the margin, the capital management vs. investing more aggressively at the business itself?

Michael A. Pizzi
Chief Financial Officer

A

Well, when we lay out our plan, we look at sort of what the capacity is from a product development, from an advertising standpoint, from a positioning. We think this is the right plan that allows us to deliver and achieve on those objectives, while delivering enough for those results to the bottom line.

I mean, certainly, if there's more an investment opportunity, and the value is there, we certainly have that option. But how we sort of think about that balance is really, sort of the value of the investments we're making and the value of the next marginal investment vs. letting it go, letting the additional earnings flow through to the bottom and become part of capital.

Patrick J. O'Shaughnessy
Raymond James & Associates, Inc.

Q

A question for you on deposit beta. So prior to financial crisis, was the rate paid on customer brokerage cash ever used as a competitive lever? And if not, why is that the general assumption that the deposit beta on those assets is not something close to zero?

Michael A. Pizzi
Chief Financial Officer

A

We've always taken the position that the deposit beta is a fairly low number. As you've heard me say many times, the best evidence of that is, when LIBOR rates were around 5%, we were paying about 1% on sweep and growing the underlying sweep balance, if you want to go back that far in time.

When we look at what customers are most sensitive to, obviously, they're sensitive to commission level, they're sensitive to margin rates, they're sensitive to a lot of things, but really the – but the bottom of that list really is sort of the cash level overall, in terms of these being relatively small transaction accounts. That may differ across the industry depending on the size of the account, and the amount of cash. But when you look on average for our average account size and average cash holdings, the betas are pretty low as you're suggesting. And therefore, it's not necessarily the most efficient place from a competitive differentiation. That said, there are customers who care deeply, and you have to have the right product mix to address that need.

Patrick J. O'Shaughnessy
Raymond James & Associates, Inc.

Q

Got it. Thanks. And then, follow-up question. So we obviously saw very strong net new asset and account growth at E*TRADE. And to be honest, we saw a strong account and asset growth at your publicly-traded competitors as well. So, if your strong growth wasn't coming from market share gains and same thing for your competitors, can you maybe provide us some color on where you think that was coming from? Was it from the full service channel? Was it from your existing customers, at least the net new assets? What was really driving those flows in the new accounts that you saw during the quarter?

Karl A. Roessner
Chief Executive Officer & Director

A

Yeah. I don't have the information on that front coming in or where they came from. But a lot of work going into what we're doing on the marketing side, what we're doing on the products side and what we're doing to move forward. They continue to grow accounts. So, I can't speak to our competitors. I can't speak to sort of exactly where our accounts came from on the call.

Brennan Hawken
UBS Securities LLC

Q

So, one, you made reference earlier to the new pricing tier that you guys have rolled out. I know it's only been a few weeks, but curious whether or not you're actually noting any adjustments in client behavior with this new lowered tier and obviously adjusting for any calendar issues such as option expiration or the like. Are you seeing some of your clients actually try to reach for this aspirational level like you've designed it?

Karl A. Roessner
Chief Executive Officer & Director

A

It's early days in terms of what we've rolled out, and I think we'll start to see some more of this and we'll have some better data when we get through the integration on the OptionsHouse side and we start offering their tools into the complete E*TRADE population. But little bit early to make a judgment call on that one, given where the pricing changes took place in the quarter.

Brennan Hawken

UBS Securities LLC

Q

All right. Maybe I'll give it a shot next quarter. And then, apologies if you walked through this when you were running through the NIM outlook, Mike. But on the recent hike with March, did you guys change your margin rates and was there any difference in the adjustment in margin depending on negotiated rate vs. rack?

Michael A. Pizzi

Chief Financial Officer

A

We did change our rates that included both negotiated and rack rates. And so, the book is essentially reset. There's still an ongoing movement of growth in negotiated vs. rack, and so that that does cause a little bit of deterioration that you can see on the period vs. the full sort of 25BPS that you would see coming out of that December hike, but we move all account.

Michael Roger Carrier

Bank of America Merrill Lynch

Q

Just a question on capital allocation. You mentioned the balance sheet and – I guess, once you're through the steady state and then you're growing organically from inflows. Just wanted to get your sense, when you think about that vs. the buybacks, is there a certain rate environment that makes the buyback option a bit more attractive, as you get into H2?

Michael A. Pizzi

Chief Financial Officer

A

Well, I think right now when you look at sort of the differential between the on-balance sheet and off-balance sheet rates, it still makes sense to continue to pursue the strategy of balance sheet growth. And I think more importantly and that is, if we try to place the large quantum of deposit that we have off-balance sheet, we would actually see some dilution in the rate as we would move through – we would move from more aggressive banks to less aggressive banks in terms of what they would be willing to pay, to take those deposits overall in our [ph] suite Waterfall (54:08) program.

So from a balance standpoint, this remains the best use of capital and strategy. Sure, we can come up with yield curve environments where that may not be the case, and we're going to adjust accordingly to do the right thing for shareholders and the get best return on capital possible.

Michael Roger Carrier

Bank of America Merrill Lynch

Q

Okay. Thanks. And then just quick follow up on the fees or services line. Just wanted to get a sense, when you're basically done with the strategy on the off-balance sheet cash, is there a base level for that revenue line? I know there's a lot of other items in there, so maybe that's tough, but just wanted to get a sense.

Michael A. Pizzi

Chief Financial Officer

A

Yeah, I mean it is literally fees and service charges. So there's a lot of things that are in there other than just the off-balance sheet revenue that's running through there. So you have any fee that a customer might pay, other service charges, wire fees, all things like that, and then including payment for order flow.

So overall, we haven't broken it out in terms of what percentage of it is from each area, but we can probably think about giving a little bit more color on that as that gets down and is replaced by net interest income. I think you can get all that data in the queue.

Kyle Voigt

Keefe, Bruyette & Woods, Inc.

Q

Most of my questions have been answered, but I guess a few housekeeping questions. Mike, sorry if I missed this, but I think you said the average reinvestment rates in Q1 were 230 to 250BPS. Can you just give us an update on the current reinvestment rates? Are you still in that range?

Michael A. Pizzi

Chief Financial Officer

A

We are still in that range.

Kyle Voigt

Keefe, Bruyette & Woods, Inc.

Q

Okay.

Michael A. Pizzi

Chief Financial Officer

A

We've been moving about – spreads have been getting a little bit tighter, rates came down, but we're seeing rates move back up a little bit. We are still in the 230 to 250 basis point range.

Kyle Voigt

Keefe, Bruyette & Woods, Inc.

Q

Okay. Thank you. And then, Karl, just a follow up on the question earlier. I think you said there was a bit of spike in the renegotiations [ph] and/or (56:10) call volume with those active traders right after they cut by one of your large competitors before you made your cut. Can you just give us a sense of what you're seeing today in terms of renegotiations vs. what you're seeing prior to the cuts in the beginning of February? Just trying to get a sense if it's more intense now still.

Karl A. Roessner

Chief Executive Officer & Director

A

No. For the top end of the book, there's always competition, right? People are always trying to go after those folks with large balances, large margin, large margin balances and active traders in that front. So you always see that kind of competition. The call volume has subsided. We're back down to sort of normal levels, if you will, but there is a lot of competition out in the marketplace and a lot of offers unlike things that we've seen in the past. We continue to do what we're doing to make sure we keep our customers and defend the book, but this call volume is definitely down from where we started [ph] pre our move (57:02).

Brian Bedell

Deutsche Bank Securities, Inc.

Q

Just a little bit more on the timing, Karl. You were talking about obviously the roll out of the marketing campaign and that – and the branding along with technology enhancements with option tests that you're saying you'll close that in Q3. Is it possible to be a little bit more precise about the exact timing of the close? And then, sort of the roll out, I assume that would be in the fall.

Karl A. Roessner

Chief Executive Officer & Director

A

So in terms of what we're looking at, first of all, on the marketing campaign. We hope to, by the end of June, beginning of July, roll out our new marketing campaign. So that will be focused primarily around our rebranding and sort of some hard hitting advertising to pull out with. The integration itself is still planned for Q3, mid-to-end third quarter. I mean it's sort of a safe assumption on where we are.

And in connection with that, you'll see some additional advertising, some additional product rolls that'll come out afterwards. But the integration for us is the start of everything that we're doing. So, innovating and bringing the OH platforms that we acquired to the next level is something we're already working on and hope to rollout following the integration. So I think you'll see a lot more from us over time. I'm pretty excited about what the future looks like. So I'd just – if you would, just stay tuned and we'll be there as soon as we can.

Brian Bedell

Deutsche Bank Securities, Inc.

Q

It sounds like there could be a little bit of a soft touch in the organic growth in the spring depending, I guess, on the environment then obviously you would expect that to reaccelerate upon all the – working through these plans. Maybe just one last one on the commission rate of \$8.10. Any sense of what that would be pro forma for the seasonality? I think you mentioned the corporate stock plan trades were affecting that rate. So, if you sort of...

Michael A. Pizzi

Chief Financial Officer

A

Yeah. If you go back and look, you'll see our Q1 is always strong due to corporate services. If you think around – right around \$8 is going to be a really good – is a good run rate going forward.

Vincent Hung

Autonomous Research US LP

Q

I just want to touch upon again on the strength of new account growth. Is there any sense for the mix between the number of accounts you're getting for competitors vs. customers of opened accounts, who've never had brokerage accounts before and how that compares historically?

Karl A. Roessner

Chief Executive Officer & Director

A

I mean, look, we get accounts from lots of different places and we've done a lot to revamp the way that we go after accounts. And in particular, some of the reach out and call out campaigns we've had around, our new active traders sales group and some of the other activities have been taking place. And it's not a breakdown that I have in front of me. But our accounts come from lots of different places and we're just happy with the growth we had in the quarter and we expect to see more.

Vincent Hung

Autonomous Research US LP

Q

Okay. And you noted that you're going to be addressing the main customer pain points. Can you touch upon what these are?

Karl A. Roessner

Chief Executive Officer & Director

A

Look, the way we look at the pain points and the list of dissatisfiers as you will, changes on pretty much a daily basis. There are always five or six things that our call reps are getting calls from our customers on. And it's really trying to identify those before they hit that level and before they become a pain point for customers. So the minute you see that somebody in the call center needs to do a work around or deal with an issue on a repeated basis, you step in and fix and you raise your hand, right?

So, it's really about changing culture and changing the way we think and the way that we act in the call centers with our reps. If you see something, you raise your hand, you tell someone, goes on the list and you knock it out. It's a change in focus is really what's driving that. I'm not getting into the specific list of dissatisfiers, because it's constantly changing and we're doing everything we can to make sure our customers have the best experience possible and they'll never have the reason to leave E*TRADE.

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