Online Brokers Don't Exist Any Longer…

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How We Got Here:

For the last decade or so, E*Trade was considered the most likely firm to be acquired, by Schwab or Ameritrade. On February 20th, 2020, Morgan Stanley surprised the market and announced its intention to acquire E*Trade. This all stock, $13 billion deal equates to a 31% premium for E*Trade, at $58.74 per share. Using 2021 estimates, Morgan Stanley is paying 14.7x earnings, but 10.9x if one properly factors in the $400 million of expense synergies. This $13 billion price isn't anywhere near what E*Trade was hoping for, especially the value believed the business was worth following the October 2017 "strategic review". This wasn't the first online brokerage transactions, just the latest in a string of very successful consolidations.

Back in November 2019, Schwab announced its intention to acquire Ameritrade for $28 billion. Ameritrade had to follow Interactive Brokers and Schwab's "free trading" lead and analysts materially lowered their 2020 and 2021 revenue and earnings expectations. Schwab swooped in and acquired Ameritrade for 16.5x 2021 earnings, but only 8.9x if one adjusts for the $1.9 billion in expense synergies. This much larger percentage represents roughly 2/3rds of Ameritrade's total expense base. The operational overlap between Schwab and Ameritrade is significant, while the same cannot be said for Morgan Stanley and E*Trade. The new Schwab will be a powerhouse, with $5 trillion in client assets over nearly 25 million brokerage accounts.

Following the Schwab and Ameritrade announcement, E*Trade was desperately looking for a dance partner. Many were thinking Interactive Brokers or Fidelity would consider buying E*Trade, as the synergies are much larger with both of those online brokers, versus Morgan Stanley. We still think both parties would be foolish to not at least consider E*Trade at this price (only $13 billion). Before we dive deeper into this transaction, let's take a step back and do a "State of the Union" on the online brokerage business. OK?

The State of the Online Brokerage Business:

The online brokerage business is vastly different today, than in year's past. The advent of "free trading" has turned these brokerages from transaction processors into asset managers. These firms no longer compete on execution and low-priced trading. Instead, they are looking to garner as much wallet share as possible and earn profits from predictable fees on ETF's and most importantly, cash balances.

For decades, many online brokers wanted to become a customer's primary financial supermarket. With "free trading", it seems like financial firms are rushing to be your broker and your bank. Decades ago, insurance providers like Prudential attempted to migrate towards brokerage to increase their cross-selling opportunity. American Express wanted to leverage its position in credit cards to move into brokerage as well. Citigroup was a dominant bank and looked towards both insurance and brokerage as opportunities to grow their franchise. Most of these ventures failed, as client's look for a "separation of church and state". Unlike Amazon in retail, where customers can essentially buy anything they desire, there is not an immediate need to get all of your financial services from one company. The concept of one-stop shopping in financial land is just not that critical.

A key takeaway from the free trading initiative is that if you keep your clients engaged, you can keep your clients happy. A happy client stays (i.e. lowers churn) and becomes more and more profitable over time.

It's All About the Cash:

Once your account is on-board with one brokerage firm, there will naturally be 10% to 20% in residual cash. That cash earns next to nothing for clients. This becomes obvious when one does an analysis of Schwab's current business model.

Looking at last year's Schwab revenue mix, one can see that net interest income represented over 60% of total revenue. Since trading revenue was adjusted to "free" last year, this actually understates interest revenue. Looking at the model going forward, we would expect trading revenues to continue to fall and net interest to begin to approach 3/4rds of total revenue.

Now, let's look at the composition of that revenue. Schwab has $269.8 billion in interest earning assets compared to $245.6 billion of funding costs. The +$24 billion difference are assets that Schwab doesn't have to pay any interest on. Now, look at the mix of those interest earning assets. $136 billion or over 50% of the assets are considered "held to maturity", yielding Schwab 2.53% in the 4th quarter and 2.65% in 2019. Another $56 billion or 21% is considered "available for sale", yielding 2.51% in the 4th quarter and 2.67% in 2019. Only $17.4 billion or 6% of total interest assets are in "bank loans". While they yield a handsome 3.22% in the 4th quarter, they come with a modest amount of client risk. Nothing too dramatic, but this is very "bank like" revenue.

The more interesting piece of this puzzle is on the funding side of the equation. Overall, Schwab's funding costs (for this large cash balance) was a modest 26 basis points in the 4th quarter. The largest component of this was "bank deposits", which was $211 billion or 86% of the total. Schwab paid these clients 16 basis points in the 4th quarter.

This isn't just the case with Schwab, as it was a key contributor as to why Ameritrade bought Scottrade and why all online brokerage deals are profitable. If clients aren't focused on how much interest their cash generates for them, why should any firm pay a significant interest rate, right? Clients just aren't terribly focused on generating interest income on their cash; they are much more intent on earning sizeable returns on their ownership of Facebook, Amazon, Apple, Netflix and Google.

The cash conclusion should be fairly obvious. Banks love to have large cash balances that cost little to get and then they can either invest those assets or lend it out to clients. Either way, online brokers have essentially become spread-based banks, from our perspective.

As Brokers Become Banks:

Following the Financial Crisis, many brokers were forced to become banks. For example, Morgan Stanley and Goldman Sachs are now classified as banks and come under the regulatory scrutiny and oversight of various banking bodies. Brokers are getting squeezed, as to what they are permitted to invest in and how they put money to work. For example, the Volcker Rule advocates that brokers cannot proprietarily trade, but only make markets on their client's behalf. This is impossible to enforce and has led to some of the flaws in getting this rule implemented.

While brokerage firms are restricted from doing what they want with their cash, banks do not have the same issue. Banks can take that cash and can do multiple things. They can lend out the money and earn a banking spread, accepting the underlying risk of the loan. However, most firms take the cash and invest in super safe

US Treasuries, earning another 100 to 200 basis points. While this process does not generate a huge spread, it can be very profitable when there is billions and trillions of dollars held in-house.

This is the general state of the current online brokerage industry. They are looking to migrate from trading revenue to ultimately managing more of your financial assets. Instead of charging you a trading fee, these firms are looking to make spread-like revenue on minimal funding costs. This isn't a surprise, but the long-term multiple should also be considered. Instead of garnering a decent transaction-based P/E valuation, many of these firms will begin to receive a bank like multiple. One just has to look at the modest forward multiples Morgan Stanley and Schwab just paid (see above). Banking is not a terribly sexy business…

Conspiracy Theories:

We have a subtle twist on last year's Schwab deal for Ameritrade. We will never know, but it wouldn't surprise us if there was some truth and merit to our thoughts. In September and October, the entire online brokerage community lowered their online trading fees to $0. Schwab followed Interactive Brokers, which was pretty much immediately followed by Ameritrade, E*Trade and then Fidelity. Which firms had the most to lose, from this "race to zero"? Well, Ameritrade generated the most commission revenue out of this group (over 20%), followed closely by E*Trade (over 15% of revenue). Some Wall Street analysts lowered their earnings estimates for Ameritrade by nearly 30%.

Since Schwab generated the lowest percent of its revenues (under 10%), it would hurt them the least. While it did inflict some damage to Schwab's share price, it was significantly less damaging that the market's harsh take-down of both Ameritrade and E*Trade. Did Schwab make the move to $0 trading just to buy Ameritrade at a much cheaper price? Both firms (Ameritrade and E*Trade) were also in the midst of management turnover, making an offer even more tempting. We believe Schwab pounced on Ameritrade, only after it lowered the price it had to pay. We will never know, but this scenario seems very plausible, considering we have followed Schwab for over 2 decades.

Accretion:

Why are synergies and operational overlap important? Well, if another online broker were to buy E*Trade, there is tremendous overlap and duplicate costs. The platforms can be consolidated, and these networks have essentially unlimited capacity. We believe the biggest factor is labor. Following prior online brokerage deals, the largest area for cost cutting is employee headcount. We know it is horrible to say, but that's just the honest truth in what these businesses look to accomplish. The goal is to keep as many of the acquired clients and assets as possible and push them quietly onto your leverageable platform.

Expense synergies should always be extremely high and make these online broker deals almost immediately accretive. For example, Ameritrade's deal to acquire Scottrade was a "total homerun", in the eyes of their management team. This Morgan Stanley deal is fairly light on the cost savings opportunity, as there isn't a ton of similarities and overlap. We believe the initial cost saves are light and MS will look to increase these as the deal progresses. Also, Morgan Stanley might be slow-walking these costs, in case anybody else arises to purchase E*Trade.

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Other Suitors:

Other online brokers need to "sharpen their pencils" on this transaction. We imagine that Schwab is pre-occupied with other deals. It made a $1.8 billion deal with USAA in July of 2019, that just closed. This added 1 million brokerage accounts and $90 billion of client assets. Also, Schwab is still getting approval for its acquisition of Ameritrade. This will add 12 million brokerage accounts and $1.3 trillion of assets. If Schwab targeted E*Trade too, it would likely garner governmental concentration questions.

Interactive Brokers has already stated that it isn't interested in E*Trade, but I have to believe they are crunching the numbers today, now that Morgan Stanley has become an official offer. While Morgan Stanley will make E*Trade accretive, another online broker would be a much better partner. The E*Trade price isn't yet at MS's offer, but we won't be surprised to see it close that $2 to $3 spread.

Not Terribly Surprising:

This wasn't surprising to many, as E*Trade filed a document with the SEC on January 16,2020 which essentially guaranteed its senior management team a healthy compensation payout, in the event of a transaction. Reading that filing, "*if (the named executives) incurs an involuntary termination following a change in control, then the executive would receive an amount equal to 2.99 times the sum of the executive's (a) annual base salary and (b) annual target cash bonus".* That's not too shabby for a few months of work, right?

Following the Schwab and Ameritrade marriage, E*Trade was looking to aggressively poach unhappy clients, that weren't getting the "white glove" treatment. There are always dissatisfied clients, that typically can be appeased with 10 to 20 to 50 free trades. However, now that trading is "free" across the industry, that freebie won't work.

Lastly, as the industry changed, there was absolutely no way that E*Trade would ever reach its target of $7/share in EPS by 2023. From our perspective, E*Trade was pretty desperate to do a deal and there were limited interested parties.

What is MS Thinking?

The combined Morgan Stanley and E*Trade franchise will have an impressive $3.1 trillion in client assets, $580 billion of stock plan balances and over 8 million accounts. However, not every account is equal, in terms of size and profitability, right? E*Trade has over 5.2 million client accounts and over $360 billion of retail assets, which equates to an average account of only $70,000. Compare that to the high net worth clients that Morgan Stanley has, over its $2.7 trillion in client assets and 3 million client relationships (an average closer to $1 million per account).

The Street is expecting the Morgan Stanley transaction to be accretive over a 2-year window, once it is able to fully phased-in its estimated run-rate cost synergies of $400 million. At only 25% of E*Trade's cost base, we believe an online broker would be able to squeeze out significantly more synergies. Morgan Stanley is also including $800 million of restructuring and integration costs, over a 3-year timeframe.

It appears that Morgan Stanley will keep the E*Trade brand, which is somewhat surprising to us. We consider the Morgan Stanley brand to be materially higher in quality, than the 4th to 5th best online retail broker. The main asset Morgan Stanley wanted (from our perspective) is E*Trade corporate stock plan business. E*Trade

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manages $300 billion of stock plans for larger public companies and then gets first crack at keeping those assets, if the employee ever leaves the firm. These IRA rollovers can be very profitable and are some low hanging fruit, in the brokerage business.

E*Trade has never had a strong branch network and it is hoping to leverage Morgan Stanley's locations for retail or corporate services. However, we don't believe Morgan Stanley financial advisors will be terribly happy about seeing their branches turn into retail coffee shops. Morgan Stanley might have to think about having its offices turn into retail branches catering to the much smaller E*Trade clientele. Have you seen the last 10 years of E*Trade's TV advertisements? They clearly have a customer base vastly different from Morgan Stanley's "white shoe" history.

Conclusion:

This deal surprises us and just doesn't seem like a great fit for either party. Morgan Stanley went down roughly 4%, which isn't terribly surprising since it was the acquiror. However, we have to think some Morgan Stanley shareholders are wondering about the fit between Morgan Stanley's culture and that of E*Trade.

Just like Goldman Sachs is struggling with its migration towards retail banking (i.e. Marcus), it is not easy for a traditional Wall Street investment bank to change its stripes. Morgan Stanley has a very powerful Wealth Management / financial advisory business. It also has a good stock plan administration business (called Solium), which it acquired last year. James Gorman is clearly betting on this overlap, but we just don't think this is perfect fit. This isn't as bad as Schwab buying US Trust in 1999 for a $2.7 billion, but is a bit of a head scratcher.

The industry has changed, from transactions and volumes to cash balances. No longer do these firms care if you want to trade like your "hair is on fire". They simply want to be your financial supermarket, earning a healthy spread on your lingering cash balances. These businesses will be monumentally profitable, just not sexy. As this becomes more obvious, the entire industry will reap an ugly forward multiple / valuation.

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