Moving Closer to the Masses : Morgan Stanley to Purchase E*Trade for $13bn in all-stock deal

Morgan Stanley [MS:NYSE] – Market Cap as of 06/3/2020: $64.116bn

E*Trade [ETFC:NASDAQ] – Market Cap as of 06/3/2020 $9.33bn

Introduction

On Feb 20th 2020, Morgan Stanley announced it was looking to buy E*Trade in a $13bn deal, all stock deal—the largest acquisition by a U.S. bank since the 2008 financial crisis. The deal itself is a bet on smaller customers and Morgan Stanley's impressive wealth management division, as it shifts even further away from a number of its struggling trading divisions. The acquisition comes on the heels of recent consolidation in the discount brokerage industry—such as the Charles Schwab-TD Ameritrade merger—as margins are pressured by the shift towards a zero commission based fee structure for brokerage accounts. The purchase will also bring Morgan Stanley an invaluable online bank with cheap deposits, which the firm can further use to create loans for smaller customers such as small to medium sized enterprises.

About Morgan Stanley

Morgan Stanley, one of the world's largest providers of global financial services, is present in 42 countries and employs over 55,000 people. While it was originally spun off from J.P. Morgan in 1935 due to the Glass-Steagall Act, the firm has grown to become a leading provider of investment banking, investment management, and wealth management services. Its clientele vary from large private financial institutions to corporations, and even individuals through their wealth management arm. While Morgan Stanley is infamous for many of its investment banking deals, its largest business division remains its wealth management arm. Following the financial crisis of 2008, Morgan Stanley shifted an even greater focus into money management, as it was perceived as more dependable than many of its former trading operations. This plays a stark contrast to many of their peers, such as Goldman Sachs, which invested heavily into divisions such as trading, lending and corporate investing. The firms full service, advisor driven model boasts nearly 3m clietns with $2.7tn in client assets.

In recent years Morgan Stanley's performance has been steadily growing in particular segments, but less dependable in others. Overall, net income for the financial year ended December 31, 2019 was $8.5bn, a 3.53% increase YoY, whereas EPS increased from $4.73 to $5.19, a 9.73% increase. Much of this financial growth was driven by divisions such as investment management, which experienced a 98% growth over the past year. As its largest division, and the division with the greatest potential for market expansion, the wealth and investment management lines are essential in terms of growth and stable future performance.

*About E*Trade*

Originally founded in 1982 in Palo Alto, California, E*Trade Financial Corporation is an electronic trading platform that allow individuals and companies to trade a variety of different financial assets, as well as offer other services such as employee stock ownership plans, advisor, and cash management services. Account types vary from brokerage to retirement to accounts specifically tailored for small businesses. E*Trade serves 5 million retail customers, and boasts nearly $360bn in assets.

It is often considered alongside other large discount brokerage giants, such as Charles Schwab, TD Ameritrade (soon to be merged with Charles Schwab pending regulatory approval), and Vanguard as one of the 4 major players of the brokerage industry. Like many of its competitors, E*Trade was heavily affected by new developments occurring in the brokerage industry, such as the push for a zero fee based commission structure on brokerage accounts and more personalized services for individuals. While this led to innovation in terms of new accounts and services, the industry shift to zero fees on brokerage accounts proved a heavy toll on margins. The move by Morgan Stanley is welcomed by E*Trade executives as they look to improve their margins through the cost synergies of a closed transaction. Additionally, while many discount brokerage firms offer similar services, there are a number of aspects that make E*Trade fundamentally unique—the most important of which is its powerful E*Trade platform. Fixed costs for technology investment in new platforms is an important cost that could be reduced through a potential merger, and E*Trade's existing, strong platform is a tantalizing opportunity for any potential buyer. E*Trade's third party research offerings, a common offering of many online brokerage firms, are also of particularly high quality on E*Trade, a factor that only slightly offsets the fact that its margin interest rates are some of the more expensive in the industry.

In the years following the financial crisis many brokerage firms struggled; however since 2012, E*Trade's financial performance has experienced choppy, on and off growth. For instance, net income in 2017 ($0.589bn) experienced a 6.7% YoY increase from 2016, but in 2018 it increased by 72.5% to $1.016bn. Due to the industry shift to zero fees on brokerage accounts in October, E*Trade experienced a 9.94% decline, reducing net income to $0.915bn. Whether or not margins can be improved in future years will be dependent on the future merger being able to execute an impressive amount of cost reductions.

Industry Overview

FinTech has enabled unique and brand-new horizons to traders. Thanks to the era of digitalization, people can execute trades and manage trading accounts as simply as sending money transfers, and the best part of it is having no need to rely on a financial intermediary. Combined with the widespread availability of real-time information, this ease of accessibility accredits traders to develop solid strategies based on their goals. As FinTech continues to enlarge, its influence on trading will grow too. Experts expect trading volumes to increase even more and further spread to online platforms. In the long run, this will also create new business models and, contrary to popular belief, digitization will not lead to fewer jobs in finance, but rather to a shift in the allocation of human talent.

Online trading is a platform based on a computer software program that is utilized to place orders for financial products. Through this self-directed platform, users can invest in employing online services and trading platforms offered by brokers. A brokerage offering online investing will provide individuals with the opportunity to buy or sell foreign exchange, mutual funds, options, and both fixed income and equity securities. The market leaders of the industry are Fidelity, E*TRADE, Charles Schwab Corp. and TD Ameritrade. The United States being the top region to produce online trading platforms, is followed by Europe, China, and Japan.

Contrary to traditional trading services, online investing has certain cost advantages, such as lower fees. In addition, the convenience of trading online increases the accessibility of trading for a younger customer base, such as millennials and Generation Z. Fee compression and ease of online platforms poses a challenge to online brokers, as they are forced to pull their customers back into the market.

The landscape of online brokerage firms has changed dramatically in 2017, with massive price cuts implemented by most of the big brokers. However, 2018 marked a tough year with its numerous large selloffs in the market's history, in terms of points lost. Volatility had returned even after years of a slow and steady bull market, triggering an international "fight or flight" response. The number of brokers that do not charge commission has risen since 2018, especially when JP Morgan's You Invest App was launched. It is becoming an increasingly difficult industry for all but the biggest discount brokers. Commissions for trading stocks have been declining for decades, driven partly by the technical advances. Noticable changes over the past year have occurred with online brokerage firms improving their platforms to be more stable and responsive to surges in trading activity. In order to get users to engage in greater trading volumes, brokers charging commission focused on addressing their infrastructure shortcomings, as well as becoming more resilient and rapid. Likewise, brokers that don't charge commissions were forced to align to the new industry standard, since most of them earn compensation from selling order flows to market makers.

It is no shock that the online trading industry is in a constant state of change and development. Markets are ever-changing, so it is crucial that platforms adapt and change accordingly. The majority of the innovations in the early years of online trading platforms have specialized on the mechanisms of trading itself, from shaping new analytical tools to the production of bots that could help with trades. Now, platforms have mastered the art of online trading, delivering comprehensive services and easy-to-use interfaces. The innovations and developments to the industry are based on the aim to supplement the core trading experience, classified as such: social and security. Social innovations consist of community building and trading academies, while security infers to trade protection features and regulatory changes to ensure security online. Though it is still an ongoing debate how much regulation is optimal, there exists evidence that illustrate the industry trend as moving towards higher levels of regulation and lower leverage on trades.

Deal Rationale

Morgan Stanley and E*Trade Financial Corp. used to be Wall Street rivals: One being an investment banking firm with a historic pedigree that served corporations and the wealthy, while the other a discount brokerage that had pioneered inexpensive online trading. These two firms are now merging, for reasons that show a lot about the changes in the U.S. financial landscape. After a decade where Wall Street giants mostly remained cautious, partly due to the fallout from the "too big to fail" bailouts of 2008, the desire to get even bigger has returned.

Perhaps, it would sound too simplistic to say money is the biggest rationale behind this merger. More specifically, the $56bn deposit base E*Trade is presenting to the table. Despite most of the biggest U.S. banks, deposits matter to Morgan Stanley significantly. Unlike JPMorgan Chase, Bank of America, Citigroup or Wells Fargo, Morgan's history as solely an investment bank until the 2008 financial crisis pushed the firm to branch out. Post-crisis regulations that discourage reliance on short-term borrowing and the low-interest rate environment is partially what slashed what banks pay savers since then have made deposits the most coveted form of funding for all banks.

Another tempting reason for this deal is the young customer base. As expected from a brand that made itself a household name through commercials featuring stock-trading babies, the foundation of E*Trade's customer base are millennials. Some of them will grow up to become the rich individuals that Morgan Stanley traditionally caters to, and the bank is counting on them to stick with the firm. Morgan Stanley Chief Executive Officer James Gorman described the purchase as an investment in technology and the future, considering that millennials demand everything online or mobile, through easy-to-use interfaces. E*Trade has a well-built internet-based platform that Morgan Stanley can leverage to utilise for alternative financial products. The top four U.S. banks spend $38bn annually in what consists of a giant technological arms race, and this step—to acquire a discount brokerage known for its online platform—will only help Morgan Stanley win the war.

From the perspective of E*Trade, the market became increasingly tough to compete in considering the shrinkage in fees and powerful competitors. The big hit came in October when the largest discount broker, Charles Schwab Corp., cut its fees to zero. A month later, the second biggest in the industry, TD Ameritrade Holding Corp., agreed to be acquired by Schwab, its largest rival. With zero commissions and its two bigger peers joining forces, E*Trade would certainly benefit from becoming part of a bigger franchise to survive in this cut-throat, ever-changing industry.

The deal — largest by a global bank since the 2008 financial crisis and the second biggest by Morgan Stanley — comes as rival Goldman Sachs chases American consumers with its mass market wealth management business and online bank. Following the deal, Morgan Stanley will gain 57% of its pre-tax profits from wealth management and investment management — less cyclical businesses that, since the financial crisis, investors have been valuing more highly than investment banking.

Deal Structure

Morgan Stanley will acquire E*Trade in a $13bn all stock deal—an offering that will dilute the firm's existing shareholders and reduce the firm's tangible book value per share by 10%. E*Trade shareholders will receive 1.0432 Morgan Stanley shares for every share that they own in E*Trade. The deal values E*Trade at about $58.74 per share, a 30% premium to the firm's share price.

Market Reaction

The day the deal was announced MS shares fell 4%, lagging behind the 4.5% jump in the Dow Jones Industrial Average and the 2.3% pop in the KBW Nasdaq Bank Index (BKX). E*Trade (ETFC) stocks surged 24% after disclosure. Morgan Stanley investors, Barron's expressed disapproval of the transaction, since the merger doesn't seem to be accretive to the bank's earnings until 2023 and will dilute tangible book value per share. The $13bn deal has also been called "value destroying" by analysts monitoring the industry, such as Wells Fargo analyst Mike Mayo.

Advisors

JP Morgan acted as the sole financial advisor to E*Trade, while Morgan Stanley advisors were not disclosed.

TAGS: Wealth management, discount brokerage, Charles Schwab, TD Ameritrade, roboadvisors, fintech, trading, securities, investment management, Morgan Stanley, Solium Capital, E*Trade, investment banking