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CHARLES SCHWAB – TD AMERITRADE: A DEAL FOR A NEW ERA OF BROKERAGE

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INDUSTRY OVERVIEW

The securities brokerage industry in the United States generates more than $150 billion in revenues per year and it is one of the backbone of the American (and global) economy. Back in the 2008 financial crisis, the industry has witnessed an unprecedented shrinkage of stock trading volume, which it has not yet recovered. The shrinkage of demand is a result of lower high-frequency trading activity, rising investment in passive investment funds and new regulations on banks' trading activity. Hence, for the brokerage industry, on of the major consequences has been a more intense price competition in order to capture the lower demand, a competition led by new discount brokers offering electronic trading at very low commissions.

These discount brokers benefit from one of the key trends disrupting the industry in recent years: technology innovation. Commission-free online securities broker Robinhood Financial, for example, is able to maintain low operating costs, thanks to a mobile-only trading service. Profits are generated from interest on uninvested cash balances of its customer base, a business model which would have been unthinkable without the cost-efficient technologies of today.

Figure 1 – Factors Driving Threat of Change: Innovation Concentration
Source: IBIS World

COMPETITIVE LANDSCAPE

The four major players, Bank of America, Wells Fargo, Charles Schwab, and Morgan Stanley, have adopted two strategies to stay competitive in the changing industry: consolidation through M&A to benefit from scale or move into the realm of advisory and investment management. Since 2014, they have managed to hold the industry leadership pretty well, totaling a combined 28% market share in 2019. A clear example of success in the recent years has been The Charles Schwab Corporation, which has grown its market share from 4.3% in 2014 to 7.1% in 2019. Specifically, in 2019, the company has announced the acquisition of TD Ameritrade, a leading deep discount brokerage firm that opened its doors as a first-mover back in 1994.

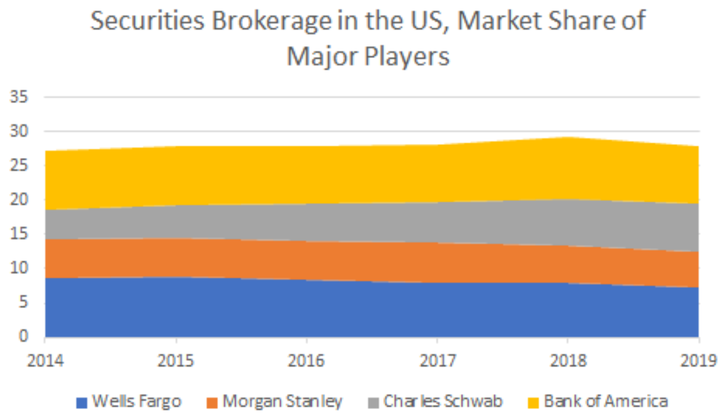


Figure 2 – Securities Brokerage Market Competition
Source: IBIS World

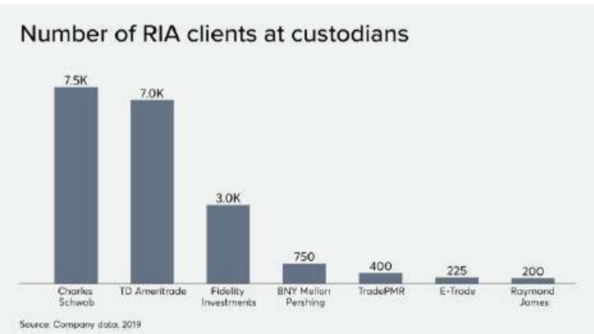
CHARLES SCHWAB

The Charles Schwab Corporation is an American multinational financial services company founded and based in San Francisco, California. The vigorous growth the firm has experienced since its foundation in 1971,- the broker-dealer was able, in fact, to capitalize on the financial deregulation of the 1970s to pioneer discount sales of equity securities- has led Charles Schwab, as it is commonly addressed, to become the 14th largest banking institution in the United States with over $3.3 trillion in client assets (as of 2019).

After few years it was acquired by Bank of America in 1983 for $55 million, but only three years later its performances persuaded Charles Schwab himself and the management to present an offer of $280 million, buying the company back and becoming once again the principal shareholder. The technological development in the following years was absolutely fundamental for the profitability of the company and of the industry as a whole. In 1994, online trading was introduced and offered by Charles Schwab, which represented an incredible breakthrough in the financial sector and which made it possible to reduce even more and eventually eliminate accounts fees and later on to offer commission fees-free funds (2011).

The subsequent years have seen a consolidation of the firm position characterized by the introduction of services such as commercial banking, stock brokerage, and wealth management advisory services. Afterwards, the firm presented a more complex structure, allowing itself to evolve from a specific discount brokerage company to an effective commercial bank.

In 2019, by means of a process of mergers and acquisitions, aimed at reducing costs and at implementing an even more effective and complete service, the company announced the billionaire agreements with TD Ameritrade ($26 billion, all-stock deal) and with USAA ($1.8 billion).



(*A Registered Investment Advisor (RIA) is a person or firm who advises high-net-worth individuals on investments and manages their portfolios)*

Figure 3 – RIA
Source: TD Ameritrade Institutional, 2019

TD AMERITRADE

TD Ameritrade is a discount broker that offers an electronic trading platform for financial assets such as common and preferred stocks, futures contracts, ETF (exchange-traded funds), options and other derivatives, mutual funds, fixed income investments and, which later introduced also cryptocurrencies.

Founded by Joe Ricketts in 1971 in Omaha, Nebraska, TD Ameritrade has been a pioneer in the deep-discount brokerage sector. Not only, in-fact, did the firm help create the discount market, but it was the first to offer new services such as automated touch-tone phone trading (1988), online internet trading (1994), a personal digital assistant to access trades (1995), and online program investing for individual investors (1996) that changed the way individual investors managed their portfolios.

The firm, which, as of the end of 2018, presented client assets for a total of $1,297 billions, has been investing in the development and in the growth of its technological and financial services since its foundation and in the recent years has been able to provide many new services among which margin lending and cash management ones.

As of 2019, TD Ameritrade represented one of the most important and structured companies in the industry.

Figure 4 – Percentage of firms that adopt technology
Source: TD Ameritrade Institutional, 2019

ACQUISITION FUNDAMENTALS AND RATIONALE

On November 25th 2019, The Charles Schwab Corporation and TD Ameritrade Holding Corporation announced the definitive agreement for Schwab to acquire Ameritrade in an all-stock acquisition totaling around $26 billions. Ameritrade stockholders would receive 1.0837 Schwab shares for each of their own shares. The total would imply a premium of 17% over the 30-day price exchange ratio as of November 20th 2020.

The transaction has been approved unanimously by the two boards of directors, as well as the Strategic Development Committee of TD Ameritrade. TD Ameritrade major stockholder, the Toronto-Dominion bank, would exchange a 43% share of TD Ameritrade common stock with approximately 13% in the combined company. As of November 2019, the companies expected the deal to close in the second half of 2020. In the following few days, both stocks rallied (10% and 25% for Schwab and Ameritrade respectively).

The strategic value of this acquisition builds upon the industry trends introduced at the beginning of this report. The deal is part of the consolidation efforts that brokerage industry players are making in order to stay profitable in a low-to-no-commissions environment. Schwab president and CEO Walt Bettinger stated "Together, we share a passion for breaking down barriers for investors and advisors through a combination of low cost, great service and technology".

The statement sums up the rationale behind the deal: the companies expect up to $2 billion in cost synergies (around 20% of the combined cost base), which would help supporting the low-cost offering; they also calculate $1 billion in revenue synergies, a result of cross-selling across two huge customer bases (TD Ameritrade alone is going to bring in 12 million customer accounts) and of improved services and technology capabilities. The overall impact is an expected 10-15% growth in EPS in three years.

REGULATIONS, COVID-19 IMPACT AND FORESEEABLE FUTURE

Unsurprisingly, antitrust and legals jumped on the train and, in the period December 2019 - March 2020 different suits were filed and withdrawn. In January 2020, the Justice Department asked for additional information and more time in order to approve the deal. Spokesmen for Schwab have assured that that is common practice for such big acquisitions. The most recent suit claims that the merger registration statement "omits material information about projected earnings and cash flows of the combined firm" and aims to halt the deal.

There is also another factor that puts pressure on the deal: Schwab's acquisition plan is an all-stock deal, and its stock is now trading at $ 33.60, instead of the $49.31 seen in November, when the deal was agreed upon. However, TD Ameritrade's stock has also dropped significantly, trading at a 32% discount (as of April 6th 2020) compared to November 2019 prices.

Will the deal still happen? Most likely, yes. Schwab does not comment on the pending litigations but confirms that it expects the deal to happen in mid-late 2020, as originally announced.

Furthermore, halting an acquisition does not happen overnight. Particularly because the market turmoil has been caused by external causes (COVID-19 outbreak), and none of the two stakeholders has any responsibility, it would be even more difficult to break the deal. The termination agreement is not upended by the recent news, and either side may have to pay up to $950 million if the deal is not successful.

"I think Joe Ricketts and I agree that our fierce competitiveness nearly 30 years ago is proof that market competition can be a source of miraculous innovation."

– Charles Schwab

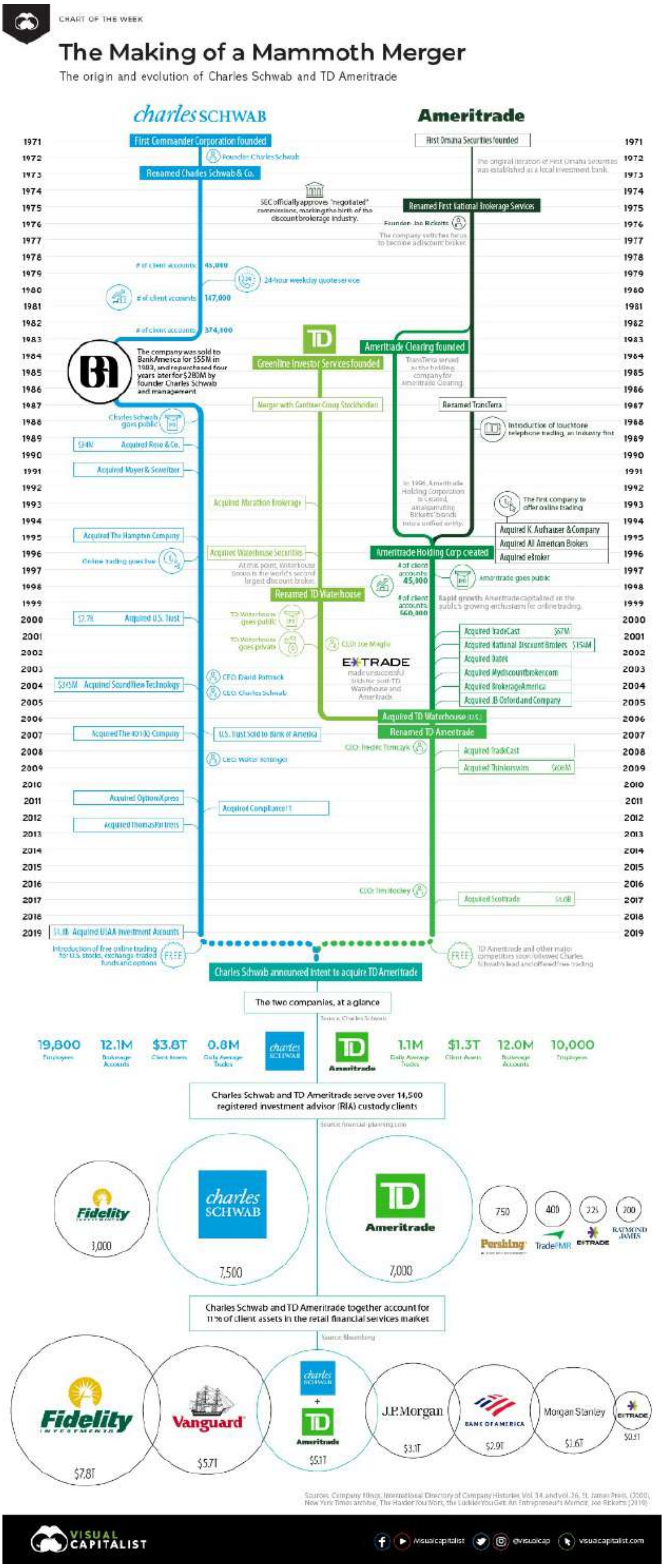


CHART OF THE WEEK
The Making of a Mammoth Merger
The origin and evolution of Charles Schwab and TD Ameritrade
charles SCHWAB
Ameritrade
First Commander Corporation founded
First Omaha Securities founded
Renamed Charles Schwab & Co.
SEC officially approves "negotiated" commissions, marking the birth of the discount brokerage industry.
Renamed First National Brokerage Services
# of client accounts 45,000
24-hour weekday quote service
# of client accounts 147,000
# of client accounts 374,000
Ameritrade Clearing founded
Greenline Investor Services founded
The company was sold to BankAmerica for $55M in 1983, and repurchased four years later for $280M by founder Charles Schwab and management
Merger with Gardiner Group Stockholders
Renamed TransTerra
Charles Schwab goes public
Acquired Rose & Co.
Acquired Mayer & Schweitzer
Acquired Marathon Brokerage
Acquired The Hampton Company
Online trading goes live
Acquired Waterhouse Securities
Ameritrade Holding Corp created
Acquired K. Aufhauser & Company
Acquired All American Brokers
Acquired eBroker
Ameritrade goes public
Renamed TD Waterhouse
Acquired U.S. Trust
TD Waterhouse goes public
TD Waterhouse goes private
Acquired TradeCast
Acquired National Discount Brokers
Acquired Datek
Acquired Mydiscountbroker.com
Acquired BrokerageAmerica
Acquired JB Oxford and Company
Acquired SoundView Technology
Acquired TD Waterhouse (U.S.)
Renamed TD Ameritrade
Acquired The 401(k) Company
U.S. Trust sold to Bank of America
Acquired TradeCast
Acquired Thinkorswim
Acquired OptionsXpress
Acquired Compliance11
Acquired ThomasPartners
Acquired Scottrade
Acquired USAA Investment Accounts
Charles Schwab announced intent to acquire TD Ameritrade
The two companies, at a glance
19,800 Employees
12.1M Brokerage Accounts
$3.8T Client Assets
0.8M Daily Average Trades
1.1M Daily Average Trades
$1.3T Client Assets
12.0M Brokerage Accounts
10,000 Employees
Charles Schwab and TD Ameritrade serve over 14,500 registered investment advisor (RIA) custody clients
Fidelity 3,000
7,500
7,000
750
400
225
200
Charles Schwab and TD Ameritrade together account for 11% of client assets in the retail financial services market
$7.8T
$5.7T
$5.1T
$3.1T
$2.9T
$1.6T
$0.5T
VISUAL CAPITALIST

DISCLAIMER