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Ally Financial may be thinking creatively with TradeKing

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It is not a game-changer given its size, but I think one of the more interesting acquisitions announced this year is Ally Financial Inc.'s planned acquisition of TradeKing Group Inc. for $275 million of cash. TradeKing includes a broker/dealer that offers low-cost trading and an SEC registered investment adviser. The PE-backed company was formed in 2005 and has made a couple of acquisitions since then. Its owners presumably were looking for an exit and deeper pockets to compete as technology and regulatory costs climb.

TradeKing is not an obvious acquisition for Ally — auto lending meets online brokerage — though it is not as odd as the 1981 announcement that Sears Roebuck & Co. would acquire retail broker Dean Witter Reynolds for $600 million. Sears' goal then was to become the largest consumer-oriented financial service entity in the U.S. Wall Street summarized the non-obvious merger synergies as "stocks and socks." It was an epic failure that many probably predicted.

I have offered my views on Ally a few times before in this column. My premise is that it is tough to make good money when the core asset is a prime and near-prime auto loan that has a low-single-digit yield. The company's first quarter ROTCE was 7.3% (9.8% core). Management is working on what they can by shifting assets to the bank to be funded with lower-cost deposits and redeeming higher-cost capital instruments; however, by the time those benefits are fully realized, higher loss rates as a result of an economic slowdown may offset or overwhelm the benefits. That seems to be the message investors are signaling in the shares, which have fallen 24.3% over the year ended May 20, and a valuation that is deeply discounted (7.4x consensus 2016 EPS; 62% of tangible book value). It is not a surprise (to me) that some institutional shareholders are restless even though Lion Point Capital LP has backed away from its proposal for Ally to add more/new independent directors and to form a board committee to consider strategic alternatives.

TradeKing is not going to meaningfully improve the company's ROE if for no other reason than it is small. As an online broker, its primary revenue sources are customer trading and net investment income from investable client cash. The company's annual commissions of $25 million are derived from just 20,000 daily average revenue trades (DARTs). Client assets approximate $4.5 billion, of which $1.1 billion consist of cash and deposits.

To get a sense of comparison E*TRADE Financial Corp. reported DARTs of more than 157,000 in March and $299 billion of client assets. Charles Schwab Corp. and TD Ameritrade Holding Corp. reported much higher metrics on both counts. Interactive Brokers Group Inc. reported DARTs of 658,000 and client assets of $61 billion. TradeKing is a minnow compared to these companies.

Nevertheless, the pending acquisition reflects creative thinking on the part of Ally executives and/or its investment bankers. Bank M&A is primarily about cost savings and secondarily about expansion into new markets. Occasionally, revenue synergies are trumpeted, but investors tend to discount or dismiss revenue synergies.

TradeKing is a bet on revenue synergies. While that may be pie-in-the-sky, Ally's executives have created a leading online bank with a high degree of consumer recognition. Maybe they can do the same with TradeKing. According to management, Ally is the largest bank among the top 25 that does not have wealth management. TradeKing is a start. Ally's depositors and borrowers will be a source of growth both for the broker/dealer and the RIA, but who knows how much. The online brokerage industry, which traces its roots to the discount brokerage industry, is mature. So too is the RIA business. Both are huge in terms of customer assets, however.

Management is betting that it can move an incremental amount of market share. It has projected brokerage assets will increase by more than 3x to $12 billion to $16 billion by year-end 2018 through a combination of account growth and average funds per account. DARTs are expected to increase more than 50% to 30,000. Digital advisory AUM is projected to increase from a miniscule amount to $3 billion to $4 billion. And on it goes.

Growth in DARTs and the RIA's AUM will boost fee income — provided industry pricing does not fall to offset volume growth — but the one metric that probably will be the arbiter of success (or lack thereof) is brokerage assets. The greater the balances, the more customer cash that can be swept into Ally Bank and thereby provide incremental deposit funding because most accounts are never fully invested. That matters because Ally's first-quarter cost of funds for $140 billion of borrowings and deposits was 1.82%. The daily credit rate paid to brokerage customers if the sweep was in place today would be much lower, in my view.

This potentially is a big-time synergy. It is so big, one might argue that pricing is very reasonable based upon projected year-end 2018 run rate pretax earnings of $80 million. If realized, the purchase price would equate to 3.4x 2019 pretax earnings. But it still is a small acquisition for Ally. Even if projections follow the script, wealth management would represent just 4% to 5% of core pretax earnings given the current run rate around $1.7 billion.

Maybe questions about whether $275 million is too much to pay for TradeKing and whether the targeted 20+% IRR is enough given the risks are beside the point. Execution is what matters now. TradeKing is an interesting platform acquisition for Ally. Management may fall on its face, or they may meet or even exceed the targets. If they are successful in creating what amounts to a digital wealth management unit, perhaps the company will be awarded a better valuation. E*Trade, which has a poor record as a lender, was trading for 16.1x consensus 2016 estimates and 198% of tangible book value as of May 20.

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