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NASHVILLE NOTES

Robinhood will have to grow assets to make money, too

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By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence or Mercer Capital, where he is the managing director of the financial institutions group.

Over the years, there are two things I have come to believe that Wall Street equity investors intensely love: growth and accelerating growth.

If so, a potential IPO for Robinhood Markets Inc., the parent company of digital broker Robinhood Financial LLC and Robinhood Securities LLC, probably would be well-received, provided the company is not generating Tesla-like red ink. The company was founded in 2012; six years later it has 4 million accounts.

Robinhood provides an app to trade stocks, ETFs, cryptocurrencies and options commission-free with no minimums to open an account. Although there are some fees for certain activities, the revenue model is old-line brokerage x-fees to execute trades according to its website: interest earned on client cash, margin lending, and a monthly fee that starts at $6 for Robinhood Gold. I assume the company lends securities and sells order flow to the Street to generate revenues, too.

Robinhood is yet another example of fintech companies that leverage technology without the baggage of massive legacy cost structures to drive prices lower and deliver more value to consumers. Robinhood's mission is to "democratize access to the American financial system." Millennials have embraced Robinhood. The average customer (or is it client?) is 28.

Ironically, old-line JPMorgan Chase & Co. got a lot more press than Robinhood has garnered when it recently rolled-out You Invest that provides free or nearly free trading depending upon the amount of business conducted with the bank. As noted in my previous post, I see that effort about protecting its vast consumer deposit franchise that is becoming more valuable as short-term interest rates rise and a recognition that execution commissions are headed to zero sooner or later.

Venture capital investors like growth, too. In May 2018 Robinhood raised $363 million in a Series D fund raising that valued the company at $5.6 billion. The company only crossed the unicorn threshold in April 2017 when it raised $110 million in a Series C round that valued the company at $1.3 billion. Rapid growth likely accounts for the 4x increase in value over 13 months.

I am not sure what is driving the IPO planning process that co-CEO Baiju Bhatt recently disclosed other than VC funds require an eventual exit via an IPO, sale of the company to a strategic acquirer or sale to other private equity funds. Wall Street coined the phrase "no one goes broke taking a profit."

The acquisition of TradeKing Group Inc. by Ally Financial Inc. in 2016 offers a word of caution about extrapolating historical growth, however. Ally paid $298 million in cash for TradeKing in 2016, which offered low cost trade execution and no-account minimums. Setting aside the issue of price, I thought then and now the move made sense to bolt-on a digital broker onto Ally’s digital bank in which a broader product offering is available to customers, while Ally Bank would benefit from client cash that could be swept into the bank as a new source of low-cost deposits.

When the deal with Ally was announced TradeKing generated $25 million of annual trade commissions from 20,000 average daily revenue trades (DARTs) and had 260,000 funded customer accounts with $4.5 billion of assets, or an average of $17,000 per account. Uninvested funds totaled $1.1 billion.

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Two years later, the unit's metrics have fallen short of what was then projected by year-end 2018. As of June 30, there were 271,000 funded accounts with $6.0 billion of customer assets — compared to a year-end 2018 target of 400,000 to 450,000 accounts with $12 billion to $16 billion of assets, of which $2 billion to $3 billion would be cash that could be swept into the bank. DARTs declined to 18,000 in the second quarter.

My point is not to rag Ally about projections that thus far have proven to be wildly optimistic. Maybe cross-selling online brokerage to Ally Bank customers has been much tougher than management anticipated, or maybe the execution runway is much longer than anticipated absent a once-hot product like cryptocurrencies that Robinhood offers. Like Robinhood, TradeKing did not have a legacy cost issue because it was founded in 2005 and had fewer than 200 employees when it was acquired.

If the IPO occurs, Wall Street will be intensely focused on growth in client assets in addition to accounts. I do not believe client assets have been disclosed. Presumably it is a modest amount per account because the customer base skews to millennials. Assets matter because that is where the money is made, especially given rising rates and the spread at which idle cash can be invested vis-à-vis the credit rate paid to account holders. Jamie Dimon can confirm that math.

E*TRADE Financial Corp. may be the 1990s version of Robinhood, and today it is one of the online broker incumbents. Its trading commission revenues are at risk. Still it is notable that as of June 30 it had $390 billion in 3.9 million brokerage accounts and $441 billion of total customer assets including its bank. The market cap as of Sept. 21 was more than $14 billion.

If Robinhood is challenging the incumbents in a landgrab for customers, it has covered an amazing amount of ground in a few years. Nonetheless, I think Wall Street will require a meaningful amount of assets in the accounts when an IPO occurs to validate the private market value.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.

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