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MER | Stan O'Neal Leaves, but CDO Exposure Remains; What's Next for the Firm?

			10/29/2007		YTD	EPS			P/E			
Ticker	Rating	CUR	Closing Price	Target Price	Rel. Perf.	2006A	2007E	2008E	2006A	2007E	2008E	Yield
MER	M	USD	67.42	78.00	-33.4%	6.44	3.58	7.28	10.5	18.8	9.3	2.1%
SPX			1540.98			86.75	91.05	97.00	17.8	16.9	15.9	1.8%

O – Outperform, M – Market-Perform, U – Underperform

Highlights

- Last Wednesday, Stan O'Neal, took personal responsibility for the $8 billion in losses that Merrill Lynch incurred in the CDO and sub-prime mortgage markets. Today, it was announced that Mr. O'Neal is stepping down from the CEO position at Merrill Lynch.
- The company announced that Alberto Cribiore, founder of Brera Capital Partner and current Board member, will serve as interim non-executive chairman during the search for a new CEO. Cribiore will head the search committee.
- Does management change solve the MER CDO-overhang problem? Unfortunately the answer is no. With $15.2 billion of "net exposures" to ABS CDO securities and $5.7 billion of sub-prime mortgage related exposures remaining on Merrill's balance sheet, we remain concerned about the potential for further write-downs.
- CDO sales are not available – there are no bids in the market – and hedges are too cost-prohibitive to be executed in sufficient volume to quickly neutralize the portfolio problem – so only time will solve the MER CDO exposure problem. We estimate a fixed income retrenchment of MER will cost about $1.4 billion in net income and $1.50 in EPS in terms of an annual 2008 run-rate.
- Merrill is trading in the bottom decile of its historic price-to-book trading range. But despite the attractive valuation of Merrill Lynch, and the likelihood that revenue will recover in 2008, until we are convinced that the firm has re-established a disciplined risk management function we rate the stock Market-Perform, with a price target of $78 per share.

Investment Conclusion

Last Wednesday Stan O'Neal took responsibility for the $8 billion in losses that Merrill Lynch incurred in the CDO market. Today, it was announced that Mr. O'Neal is stepping down as CEO of Merrill Lynch.

The company said that Alberto Cribiore, founder of Brera Capital Partner, will serve as interim non-executive chairman during the search for a new CEO. Cribiore will head the search committee. Ahmass Fakahany and Gregory Fleming will continue as Merrill Lynch co-presidents. We hope that re-establishing discipline in MER's risk management function is a top priority of new management.

But does this change of management solve the MER CDO-overhang problem? Unfortunately the answer is no. With $15.2 billion of "net exposures" to ABS CDO securities and $5.7 billion of sub-prime mortgage

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related exposures remaining on Merrill's balance sheet, we remain concerned about the potential for further write-downs.

Currently, SIVs hold large amounts of CDOs and their liabilities are running off. And the actions of the credit rating agencies to rapidly downgrade certain CDO issues, continues to lead apprehensive holders to attempt to sell their CDO positions. As a result of this uncertainty, the vulture funds have not landed yet to feed on the carcass of the CDO market and market conditions remain very challenging.

So MER's only choice appears to be to work the CDO problem out over time. Unfortunately, during this period, the mark-to-model cost of unhedged CDOs on MER's balance sheet could be painful. MER's net write-downs in Q3 2007 equated to roughly 30% of its pre-writedown CDO exposure and 15% of its sub-prime mortgage exposure.

Based on one scenario of worsening market conditions, we note that a further 50% writedown of MER's CDO positions and 25% of sub-prime mortgage exposure would result in a charge of $6.70 per share (or 16% of year-end expected book value). In addition, we estimate that a fixed income 'retrenchment' of MER will cost about $1.4 billion in net income and $1.50 in EPS in terms of an annual 2008 run-rate.

Merrill is trading in the bottom decile of its historic price-to-book trading range. But despite the attractive valuation of Merrill Lynch, and the likelihood that revenue will recover in 2008 until we are convinced that the firm has re-established a disciplined risk management function we rate the stock Market-Perform.

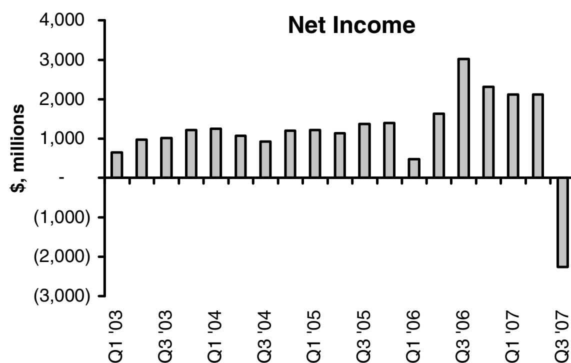
Details

"The Buck Stops Here"

– Harry Truman

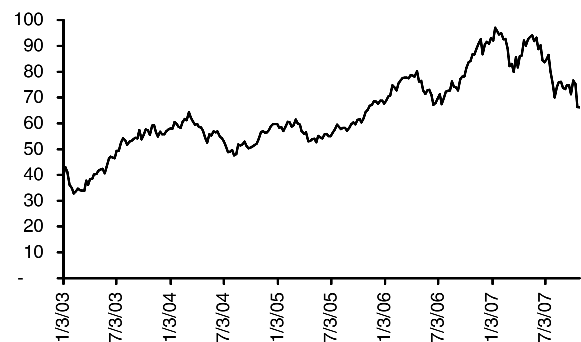
Last Wednesday Stan O'Neal took personal responsibility for the $8 billion in losses that Merrill Lynch incurred in the CDO and sub-prime mortgage markets. Since that point, the business media have been running story after story about Mr. O'Neal, the firm's massive CDO losses and the search for new executive leadership by the Merrill Lynch Board. Today it was announced that Mr. O'Neal is stepping down.

Exhibit 1
MER Net Income During the O'Neal Years



Source: Company Disclosure

Exhibit 2
MER Stock Price During the O'Neal Years



Source: Company Disclosure

But before we consign Mr. O'Neal's regime to the history books, let's remember how unusual it is for a Chief Executive Officer of any company to stand up and publicly say "I'm responsible". And how plausible it would have been, for Mr. O'Neal, whose background is in investment banking and finance, to place the blame for this unfortunate event on 'rogue' traders. Too his great credit, he didn't take the easy way out.

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Perhaps we have become used to seeing politicians who refuse to accept the outcomes of their policy actions, corporate executives who fire subordinates and proudly announce that the problem is fixed and those Wall Street managers who pathetically cling to power after the market has lost confidence in their leadership.

Mr. O'Neal displayed none of these characteristics. During Bernstein's first meeting with Mr. O'Neal, years before he had been named CEO of Merrill, he confessed his love of the firm. And when he stood up and said "I'm responsible" last week, he knew that, in the sharp elbowed world of Wall Street, he was sealing his fate and ending his career at his much-loved Merrill. If only all Wall Street executives recognized that with authority comes responsibility.

The New Team

The company announced that Alberto Cribiore, founder of Brera Capital Partner, will serve as interim non-executive chairman during the search for a new CEO. Cribiore will head the search committee. Ahmass Fakahany and Gregory Fleming will continue as Merrill Lynch co-presidents.

Does this change of management solve the MER CDO-overhang problem? Unfortunately the answer is no. The situation that MER is in is much like that of a bank with a problem lending portfolio – only time will solve the problem. Exhibit 3 highlights the breakdown MER provided of its net exposures to ABS CDO and sub-prime mortgage-related assets.

Exhibit 3
A Breakdown of MER's $7.9 billion Q3 2007 Write-down

$, billions

	Initial Exposure	Net Writedown	Net Exposure on 9/30/2007	% Writedown
High Grade	10.2	(1.9)	8.3	-19%
Mezzanine	8.4	(3.1)	5.3	-37%
CDO-squared	1.4	(0.8)	0.6	-57%
Other Exposures	2.1	(1.1)	1.0	-52%
Total ABS CDO	**22.1**	**(6.9)**	**15.2**	**-31%**
Total U.S. sub-prime mortgage related	**6.7**	(1.0)	5.7	**-15%**
TOTAL CDO & Sub-prime	**28.8**	**(7.9)**	**20.9**	**-27%**

Sources: Corporate Reports, Bernstein Analysis

With $15.2 billion of "net exposures" to ABS CDO securities and $5.7 billion of sub-prime mortgage related exposures remaining on Merrill's balance sheet, we remain concerned about the potential for further write-downs. But CDO sales are not available – there are no bids in the market – and hedges are too cost-prohibitive to be executed in sufficient volume to quickly neutralize these exposures. SIVs hold large amounts of CDOs and their liabilities are running off. And the actions of the rating agencies to rapidly downgrade certain CDO issues continue to lead apprehensive holders to try to sell. As a result of this uncertainty, the vulture funds have not landed yet to feed on the carcasses of the CDO market. So MER's only choice will be to work the CDO problem out over time and unfortunately, the mark to model cost of the CDOs on MER's balance sheet could be painful during this period.

Exhibit 4 shows the affect of incremental write-downs to MER's exposure on its CDO and sub-prime MBS exposure assuming differing degrees of deterioration in these troubled areas of the fixed income markets.

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As we showed earlier, MER's net write-downs in Q3 2007 equated to roughly 30% of its pre-writedown CDO exposure and 15% of its sub-prime mortgage exposure.

Exhibit 4
Affect to MER's Forward Book Value Assuming Incremental Write-downs

$, billions		Assumed Writedown Scenarios			
	Null Case	**Case 1**	**Case 2**	**Case 3**	**Case 4**
% Writedown on CDOs	0%	25%	50%	75%	100%
MER's CDO Holdings	15.2	11.4	7.6	3.8	-
Potential CDO Writedown		**(3.8)**	**(7.6)**	**(11.4)**	**(15.2)**
% Writedown on Sub-prime	0%	13%	25%	38%	50%
MER's Sub-prime Holdings	5.7	5.0	4.3	3.6	2.9
Potential Sub-prime Writedown		**(0.7)**	**(1.4)**	**(2.1)**	**(2.9)**
Total Potential Writedown	-	**(4.5)**	**(9.0)**	**(13.5)**	**(18.1)**
Taxes at 35%	-	(1.6)	(3.2)	(4.7)	(6.3)
After-tax Writedown	-	**(2.9)**	**(5.9)**	**(8.8)**	**(11.7)**
After-tax Writedown (per Share)		$ (3.35)	$ (6.70)	$ (10.06)	$ (13.41)
Q4 '07E Book Value/Share	40.72	37.36	34.01	30.66	27.31
Book Value Decline vs. Null Case		-8%	-16%	-25%	-33%
Q4 '08E Book Value/Share	44.76	41.41	38.06	34.70	31.35
Book Value Decline vs. Null Case		-7%	-15%	-22%	-30%
Price-to-Current Book (using Q4 '07E BV)	1.66	1.80	1.98	2.20	2.47
Price-to-Forward Book (using Q4 '08E BV)	1.51	1.63	1.77	1.94	2.15

Sources: Corporate Reports, Bernstein Analysis

We recently published our expectations of what it would cost for Merrill to tighten its fixed income sales and trading business (please see our 10/23/07 report, *"MER| What Does it Cost to Tighten Fixed Income Performance?"*). In that research piece which analyzed the performance of MER's fixed income business, we concluded a 'back to basics' retrenchment of the business will cost approximately $1.0 billion in net income and about $1.10 in 2008 EPS. Since then, we have updated this analysis of MER's fixed income earnings power going forward assuming that new management at MER reduces the balance sheet allocation to the business by 15% (see **Exhibit 5**). We now believe that the fixed income retrenchment of MER will cost about $1.4 billion in net income and $1.50 in EPS in terms of an annual 2008 run-rate.

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Exhibit 5
Scenario Analysis of MER Fixed Income Performance

$, millions	2006-Q1 '07 Performance Data	**Scenario 1** Average '02-'05 Performance Data	**Secanario 2** 15% Reduction in Fixed Income Balance Sheet
Trading Assets (Q2 2007)	$164,009	$164,009	$139,408
Revenue Return on Trading Assets (RROTA)	5.7%	4.1%	4.1%
Fixed Income Net Revenues (based on RROTA)	$9,283	$6,771	$5,755
Fixed Income Trading Margin	44.2%	36.9%	34.0%
Pre Tax Income	$4,100	$2,500	$1,957
Tax	$1,435	$875	$685
Net Income	$2,665	$1,625	$1,272
Equity Usage	$8,200	$8,200	$6,970
ROE	32.5%	19.8%	18.2%
Contribution to EPS	$2.90	$1.77	$1.38

Sources: Corporate Reports, Bernstein Analysis

The Bottom Line on MER

We have just been through a challenging period highlighted by the problems in the domestic sub-prime mortgage industry, illiquidity in the fixed income market and the re-pricing of the credit markets. Much of the fixed income market is recovering but certain pockets of the MBS market and the CDO market are likely to remain under pressure. Despite this uncertainty we remain optimistic about overall market conditions for the brokers. We expect U.S. economic growth, which has supported the strong revenue performance posted by the industry in 2005 and 2006, will continue, albeit at slower rate, through H2 '07-2008. Unemployment should remain low, job growth should continue at a reasonable rate and, as a result, consumer confidence should remain favorable.

The demand for investment banking products and services remains strong; economic conditions in North America, Europe and Japan are favorable. The IPO market in the United States is still open, U.S. M&A activity backlog is strong, the consolidation of European economies is sustaining cross-border M&A revenues, retail investors' net inflows are healthy and, despite the turmoil of the last few months, they have not been frightened away from the equity market.

We anticipate that slowing economic growth in North America implies that certain businesses, such as domestic M&A, will likely post another year of reasonable performance and equity capital markets will continue to contribute to investment banking earnings albeit with lower contribution from the financial sponsor segment.

Other businesses, such as retail brokerage, will likely experience improving performance as low unemployment levels and continued economic growth supports positive investor confidence, encouraging small investor participation in the equity markets, and the high operating leverage of this business works its magic.

Wider credit spreads will limit fixed income underwriting and a fixed income client base that has become more cautious about opaque securities will limit the profitability coming of the structured product areas.

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As equity analysts covering a high risk industry with relatively opaque disclosure, we have to assume that a company is practicing prudent risk management and its management team has ensured that conservative inventory valuation and control procedures are in place. Losses occur in any trading business, especially in an environment like the one in Q3 2007. But we have lost confidence in MER's risk management and in the independence of the business unit controller's function of GMI. We hope that the new Merrill CEO will immediately address the failure of risk management within the GMI business that led to this problem and reassure shareholders that risk is being tightly controlled at the firm, that accounting is independent of the business units and that financial disclosure is appropriate.

Merrill is trading in the bottom decile of its historic price-to-book trading range. But despite the attractive valuation of Merrill Lynch, and the likelihood that revenue will recover in 2008 until we are convinced that the firm has re-established a disciplined risk management function we rate the stock Market-Perform

Valuation Methodology

We have found that the major brokerage firms' common stocks trade on a price-to-tangible book basis. Bernstein believes that the tangible book value of a securities firm is a "hard number" for these companies reflecting the industry's mark-to-market accounting discipline and the rapid turnover of brokerage firm balance-sheets. By comparison, forecasting the highly cyclical earnings is problematic and therefore price-to-earnings valuation ratios are not accurate or stable.

We derive our price targets based upon a valuation model that takes into account Return on Equity (ROE) versus K_e (the CAPM-based cost of equity), credit rating and a variable that differentiates between the 1999-2000 internet bubble period and all other periods of history. The formula is:

- **Target Price-to-Tangible Book Value = 5.33 + .77 * (Conditional Tangible ROE/Ke) – .62 * Credit Ratings + 0.90 * Internet Dummy Variable**

We are reducing our 12-month share price target for MER to $78 from $100 to mainly reflect the credit rating downgrades yesterday as all 3 major credit rating agencies (S&P, Moody's and Fitch) downgraded MER's debt by one notch.

We expect Merrill Lynch performance to recover in 2008 and to report an 18% tangible ROE over the next 4 quarters. Based on our valuation model, this results in a target 1.95x price-to-tangible book value, leading us to our $78 share price target.

On a cautionary note, we should emphasize that our industry price-to-book valuation regression only explains 73% of the quarterly change in the price-to-book – very good but not perfect.

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Exhibit 6
MER: Price to Book Ratio Deciles (ex-TMT Years)

MER

1995 to Present (Excl. TMT Years)*			
Deciles	**From**	**-**	**To**
1st	3.39	-	2.69
2nd	2.64	-	2.20
3rd	2.19	-	2.14
4th	2.13	-	2.02
5th	2.02	-	1.94
6th	1.92	-	1.82
7th	1.82	-	1.76
8th	1.76	-	1.70
9th	1.69	-	1.60
10th	1.58	-	1.31

Current P-to-B Value	1.53
Current Decile	10th
Average Price-Book	2.00

*TMT years include 1998, 1999 & 2000

Sources: FactSet, Corporate Reports, Bernstein Analysis

Exhibit 7
MER: Price to Book Ratio Deciles

MER

1995 - Present			
Deciles	**From**	**-**	**To**
1st	3.70	-	3.09
2nd	3.08	-	2.78
3rd	2.72	-	2.47
4th	2.47	-	2.18
5th	2.17	-	2.09
6th	2.07	-	1.95
7th	1.94	-	1.82
8th	1.82	-	1.73
9th	1.73	-	1.64
10th	1.63	-	1.31

Current P-to-B Value	1.53
Decile	10th
Average	2.21

Sources: FactSet, Corporate Reports, Bernstein Analysis

Risks

The most significant risk to our 12-month price target for Merrill Lynch of $78 per share is if the fixed income correction we are currently experiencing evolves into a long-term credit crunch and leads to an economic slowdown or a recession in the U.S. Given MER's industry-high revenue exposure to domestic retail brokerage and asset management, weakness to the retail customer base resulting from an economic slowdown would probably lead MER to report a lower 2008 ROE than we currently forecast. We would not expect the stock to achieve our 12-month target price if this scenario plays out.

In addition, there is a risk that MER's $15.2 billion in net exposures to ABS CDOs and $5.7 billion in net exposures to sub-prime mortgages and mortgage-related securities could face another writedown in the future. Given that the CDO market is virtually frozen and that these asset classes are difficult to value, let alone hedge effectively, if the market for these products continues to deteriorate, MER will likely have to take additional write-downs on these exposures. This would result in a lower book value for the firm and we would not expect the stock to achieve our 12-month target price if this occurs.

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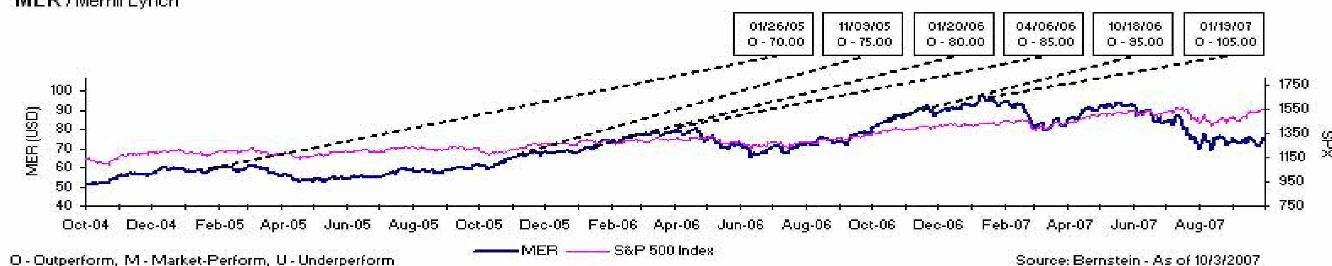

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