

St. John's University Undergraduate
Student Managed Investment Fund
Presents:
Merrill Lynch & Co., Inc. (MER)



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Recommendation: **HOLD**

Share Data:

Price (5/5/06): \$76.48

Shares outstanding: 988.1 million

Market Cap.: \$72.16 billion

Beta: 1.65

52-week high: \$81.25 (4/20/06)

52-week low: \$52.16 (5/13/05)

Corporate credit rating S&P: A+

P/E (5/5/06): 13.66

Forward P/E, 2006e: 14.471

Diluted EPS, 2005: \$5.26

Diluted EPS, 2006e: \$5.27

Dividend yield: 1.31

Last dividend: \$0.25 – 5/4/06 (Ex Date)



Sector: Financials

Industry: Investment Banking & Brokerage

I. EXECUTIVE SUMMARY

After evaluating the numbers, facts and circumstances surrounding Merrill Lynch & Co., Inc. (NYSE: MER), we conclude that the stock is fairly-valued and should not be added to the SMIF portfolio.

MER's financial ratios indicate that it is performing similar to its competitors and does not stand out as more or less favorable, comparatively. Similarly, the relative valuation deems the stock to be overvalued as a standalone company. It is only when the forthcoming merger of BlackRock, Inc. (NYSE: BLK) is taken into consideration that the stock is considered fairly valued; this intuitively signifies that the market price has already adjusted to incorporate the effects of the merger. Additionally, MER's forward-looking P/E ratio is also substantially higher in comparison to those of its competitors and the industry, yet another indicator that the market price has already adjusted for the anticipated contribution that the BLK merger will have on MER. Oppositely, the absolute valuation model contradicts the ratio analysis and the relative valuation. Since MER's dividend per share (DPS) has an average annual growth rate between the range of 8.589% and 10.193%, the estimated 9% DPS concludes that the stock is currently undervalued relative to the benchmark of 8.064%.

Due to inconsistencies between the ratio analysis and relative and absolute valuations, it is our overall investment recommendation to take a "hold" position.

II. COMPANY OVERVIEW

A. General

Merrill Lynch & Co., Inc. (NYSE: MER) was founded in 1911 and became a publicly traded company on June 23, 1971.

History and Development

Charles E. Merrill and co-founder Edmund C. Lynch met each other in 1907 at the former 23rd Street YMCA and a great partnership emerged. In 1915 Charles E. Merrill and Co. changed its name to Merrill Lynch and Co. In 1973, MER established the holding company, ML & Co., a Delaware corporation. Its services and related products include subsidiaries, providing broker-dealer, investment banking, financing, wealth management, advisory, asset management, insurance, and lending on a global basis. MER presently has operations in 36 countries and territories. Its major geographic regions of operations include the U.S., Europe, the Middle East and Africa (EMEA), the Pacific Rim, Canada and Latin America. MER's world headquarters is located in the World Financial Center in New York City. The U.S. represents 68% of its net revenues, Europe, Middle East and Africa accounts for 19%, the Pacific Rim rounds off at about 10%, and others represents approximately 3%.

Business Segments

Merrill Lynch's activities are performed through three business segments: Global Markets and Investment Banking Group (GMI), Global Private Client (GPC), and Merrill Lynch Investment Managers (MLIM).

A. Global Markets and Investment Banking Group (GMI)

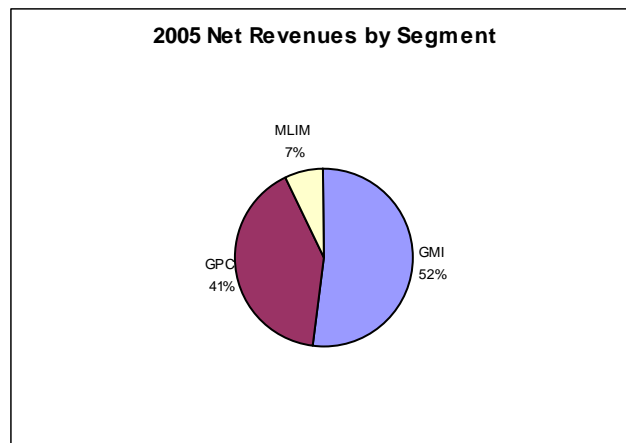
This segment provides equity, debt and commodities trading, capital market services, investment banking and advisory services to financial institutions, governments and corporations. GMI's debt market deals with sales and trading securities for interest rates, credit and foreign exchange products and also principal investing, secured financing and real estate. The commodities section of the debt market deals with natural gas, electricity, and other energy-related products. The equity market specializes in cash equity trading, equity product trading, equity financing and services, and private equity investing. GMI's global markets division offers worldwide sales and trading services for new and secondary market instruments. GMI's Global Markets division transfers transactions of clients. This division is a market maker in securities, derivatives, currencies, and commodities. GMI's investment banking division offers financing and strategic advisory services to clients including advising clients on valuation, mergers, acquisitions and restructuring. GMI generates 52% of Merrill Lynch net revenues and 65% of Merrill Lynch pre-tax earnings. GMI's highlights consist of helping Merrill Lynch as being ranked the number one trader of U.S. Stocks (NYSE) since 1989, a member of approximately 70 exchanges in over 30 countries, and being one of the top global underwriters of debt and equity securities. In 2005 GMI's total net revenues from total global markets net revenues and total investment banking net revenues of \$13,869 million.

B. Global Private Client (GPC)

GPC provides expertise on wealth management services and products in over 700 offices. They provide services to their clients based on their level of assets that can be invested. One client would be the ultra high net worth investors with \$10 million or more served by Private Wealth Advisors. Then there is high net worth investors with \$100,000 to \$10 million served by the Financial Advisor Network. Individual investors with less than \$100,000 are primarily serviced by the Financial Advisory Center. Some of the products and services provided include: comprehensive, customized financial planning, investment advisory services, mutual funds, deposit and cash management products, retirements products, trust funds, consumer and small business lending and insurance and annuity products. GPC is focused on remaining a market leader in terms of earnings, productivity, and services. It has improved financial advisor (FA) productivity, enhanced its FA department by over 1000, and expanded non-U.S. businesses. In 2005 GPC's results of operations total net revenue was \$10,764 millions. Outside the U.S., GPC achieved a strong profitability for its third consecutive year.

C. Merrill Lynch Investment Manager (MLIM)

MLIM is one of the largest investment managers in the world, managing around \$539 billion of client assets in 2005. This business segment offers many investment management capabilities including equity, taxable and tax-exempt fixed income, money market, and index products. Their expertise is navigated through a variety of investments: mutual funds, retail separate accounts, and institutional separate accounts. These are distributed through five channels: proprietary retail, U.S. non-proprietary, U.S. institutional, EMEA pacific third-party retail, and EMEA pacific institutional. MLIM focuses on long term investment performance. MLIM's main focus in 2005 was to enhance distribution across its channels. Another goal was strong investment performance with more than 70% of MLIM's global assets under management. The last goal was acquiring the pension business from Royal Philips Electronics in the Netherlands. On February 15, 2006, Merrill Lynch announced that it entered into an agreement with Blackrock, Inc. in exchange for 49.8% of the combined investment management firm. This brings together two strong firms with under \$1 trillion in assets under management. For 2005 the total net revenue for MLIM's operations was \$1807 million.



Executive Leaders

- Stanley O'Neal – Chairman of the Board; Chief Executive Officer; President; and, Chief Operating Officer.
- Rosemary T. Berkery – Executive Vice President and General Counsel.
- Robert C. Doll – Senior Vice President; Chief Investment Officer; and, President of Merrill Lynch Investment Managers (MLIM).
- Jeffery N. Edwards – Senior Vice President and Chief Financial Officer.
- Ahmass L. Fakahany – Executive Vice President; Executive Vice Chairman; and Chief Administrative Officer.
- Gregory J. Fleming – Executive Vice President and President of Global Markets and Investment Banking (GMI).
- Dow Kim – Executive Vice President and President of Global Markets and Investment Banking (GMI).
- Robert J. McCann – Executive Vice President and Vice Chairman and President of Global Private Client (GPC).

B. Recent News Events

1. BlackRock, Inc. (NYSE: BLK)

During the first quarter of 2006, MER entered into an agreement to combine its Merrill Lynch Investment Management (MLIM) operation segment with BlackRock, Inc. (BLK) in exchange for an approximate 49.8% stake of ownership and 45% voting interest in the combined firm. BLK is one of the largest, publicly-traded investment management firms in the United States that manages assets internationally for institutional and individual investors.

The combined company will operate under the BLK name and hold a board of directors composed of a majority of independent directors. The combined firm, among other things, will have nearly \$1 trillion in assets under management (of which the MLIM division and BLK will contribute \$544 and \$452.7, respectively) will be a top-ten asset manager worldwide, and will rank top as fixed income manager in the United States. The combined firm will provide a plethora of U.S. and non-U.S. investments in every major asset class, inclusive of equity, fixed income, liquidity, cash management, real estate and alternatives, with various products available as separate accounts, and open- and closed-end funds. In addition, BLK will continue to provide risk management and advisory services to institutional clients.

Under the terms of the agreement, MER will have restrictions on the sale or acquisition of shares in the newly-formed company, but will have the right to maintain its stake percentage if further stock is issued. The transaction, subject to regulatory and BLK shareholder approval, is expected to close in the third quarter of 2006.

2. First-Quarter Results (2006)

MER reported its highest quarterly net revenues ever for first-quarter 2006 at \$7.96 billion, compared to an expected \$7.4 billion. Net revenue was up 28% from first-quarter 2005 and up 17% from fourth quarter 2005. MER incurred a \$1.8 billion (or \$1.2 billion after taxes) one-time, non-cash acceleration of compensation expenses arising from modifications to the retirement eligibility requirements of existing stock-based employee compensation awards and the adoption of Statement of Financial Accounting Standards No. 123 for first-quarter 2006. This resulted in a 2006 net earnings of \$475 million, or \$0.44 per diluted share. Analysts polled by Thomson First Call had, on average, expected the company to earn 32 cents a share, including the accounting charge.¹ Excluding these one-time charges, 2006 net earnings was \$1.7 billion (up 36% from first-quarter 2005 and 19% from fourth-quarter 2005) and earnings per share was \$1.65 (up 36% from first-quarter 2005 and 17% from fourth-quarter 2005), 9 cents better per share than expected by analysts polled by Reuters Estimates.²

3. Share Repurchases (February 2006)

In the first quarter of 2006, MER announced the repurchase of \$6 billion of the company's outstanding common shares to maintain capital management flexibility for the third consecutive

¹ Morcroft, Greg. Merrill Net Slips On Charge; Revenue at Record \$8 billion. 18 April 2006. MarketWatch.

² Wilchins, Dan. Merrill Lynch Beats Estimates, Shares Rise. 18 April 2006. Reuters

year. A repurchase program was also announced in February of 2004 for \$2 billion, July of 2004 for \$2 billion and April of 2005 for \$4 billion.

The February 2006 announcement does not specify the time period in which the authorization should be completed, but instead conveys that it will be exercised from time to time, subject to market conditions, the relative attractiveness of other capital deployment opportunities, and regulatory considerations.³ MER categorizes the repurchases as an intention to make appropriate alterations to its capital structure and are for general corporate purposes.

For the fiscal year ended December 31, 2004, MER repurchased 54 million shares of common stock totaling \$3 billion, completing the February 2004 repurchase program and utilizing \$968 million of the July 2004 repurchase program.

For the fiscal year ended December 30, 2005, MER repurchased 63.1 million shares of common stock totaling \$3.7 billion, completing the July 2004 repurchase program and utilizing \$2.7 billion of the April, 2005 repurchase program.

To date in 2006, MER repurchased 25.8 million shares of its common stock for \$2 billion during the first quarter, completing the remaining \$1.356 billion of the \$4 billion repurchase program authorized in April 2005 and using \$644 million of the \$6 billion repurchase program authorized in February 2006.

Major Components of the Changes in Equity Capital for 2005 and 2004⁴:

(dollar in millions)	2004	2005
Beginning of Year	\$31,523	\$33,914
Net Earnings	4,436	5,116
Issuance of preferred stock, net of redemptions and repurchases	205	2,043
Common and preferred stock dividends	(643)	(777)
Common stock repurchases	(2,968)	(3,700)
Net effect of employee stock transactions and other	1,361	1,548
End of Year	\$33,914	\$38,144

III. INDUSTRY ANALYSIS

A. Overview

Industry Life Cycle

The location of the investment service/securities industry in its life cycle process follows the overall state of the economy. The economy dictates investors' confidence which will determine the life cycle of the industry. When the economy is in a recession, investors are

³ Press Release: Merrill Lynch Announces \$6 Billion Share Repurchase Authorization. 27 February 2006. Merrill Lynch. 2 May 2006. http://www.ml.com/?id=7695_7696_8149_63464_64119_64708

⁴ Merrill Lynch. Annual Report 2005. Page 46.

reluctant to spend their money which causes business profits to decline. This uncertainty of the future causes individuals and businesses to be conservative with their spending. The main source of revenue for many of the securities firms is their clientele which include businesses and individuals. For the past couple of years, the economy of the U.S., as well as other developed countries, have seen growth and increased levels of economic activity. With this in mind, the securities industry has seen substantial growth as a major player in a healthy economy. Besides the positive outlook of the economy, consumer spending has been a steady force in keeping the market stable. To describe the life cycle of the securities industry, one has to access if the current market is a bull market, or a bear market.

Bull Market – market characterized by optimism that prices are either rising or on an upward trend. During a bull market, several business lines such as trading, investment banking, and asset management tend to expand in tandem. At these times, the headcount of employees are at the highest with continuing efforts to expand.

Bear Market – market characterized by falling prices of securities or expected falling prices. Many companies in the investment service industry tend to contract and layoff employees. According to the Standard and Poor's Industry Survey, layoffs for the securities industry during a bear market may accumulate anywhere from 5 - 10%.

Although, many firms have the capabilities through highly complex financial strategies to make profits in both markets, many prefer the bull market over the bear market.

Trends

One of the major trends in the financial industry is globalization. In order to grow profits and respond to the high competitiveness, corporations across many industries have expanded into international markets. However, this need for expansion requires access to capital and other financial means that help corporations manage currency and interest rate risk. Investment banks can profit by helping companies meet these needs. The managers have to find ways to cope with this new reality. They need to create options to encourage international investments. Moreover, the sale of government-owned businesses to the private sector has increased the supply of equity and the demand for capital, creating further opportunities for investment banks. Examples of the sale of government-owned businesses are such as the sale of Sourcefire Columbia, which is a government-owned network security company, also the sell of port management businesses in six major seaports of United States to Dubai Ports World.

Another trend is the structural change that corporations may need to lower the cost of transactions and to increase operating efficiency toward reaching goals and dealing with the market needs. Technology advances and the innovation of new financial tools in the recent years have created opportunities for new services and new ways of management to respond to the growing demand of clients for these services, which require structural changes. Then, the demographic changes such as the aging of the baby boom generation is expected to bring reforms in social security, which will shift the flow of client assets towards large management companies, ongoing growth in assets under management, changes in distribution channels and declines in funds expense ratios.

Concerns

The healthy performance of the financial industry should not overlook the industry's issues that raise some concerns about the future outcomes in this industry. One of those concerns is the increase of interest rates. This will make borrowing more expensive and may slow down the trend of investment. Also, a flattening yield curve is problematic to investors. The return on long-term investments becomes equal or almost equal to the return on short term investment. This situation will make the investors to run off from long term investments since the investors do not gain any excess compensation for the risk associated with the hold of long term investment. This can cause a slowdown of the economy. However, there are experts that argue that the flat yield curve is no more an important tool under the new reality in finance industry. Another issue concerning the financial industry is the sensitive regulatory scrutiny and ongoing litigation, which creates uncertainty among the investors about the future of the industry.

Finally, the extremely high oil prices may not directly affect the financial industry, but it may result in increased inflation. It causes means of production to be more expensive, then it generates reduction of tax revenues and increase of budget deficit, decline in wages, higher unemployment, lower GDP, and then, currency will adjust to the changes in the trade balances. All these factors create a new environment for investor which will influence their behavior toward the market and the financial industry. Many analysts argue that the tightening monetary policy that follows the rise of oil prices has much more severe impacts than the rise of oil prices themselves.

B. Analysis of Competitive Forces

1. Rivalry among Existing Competitors

Many of the larger companies have adapted to the competitiveness of the Investment Services Industry and has made it part of its culture. These companies have unique as well as uniform characteristics in their operations of business which makes the industry lucrative but also extremely competitive. With the securities industry having a diverse array of companies, rivalries are clearly classified by size, market capitalization of industry, monetary value of assets under management and other company characteristics. As the major companies continue to use capital to invest in growth and globalization, it will be hard for small and new companies to maintain and capture any type of market share. One of the main and popular strategies for growth across the Investment Services Industry is for many of the larger companies to merge or acquire other profitable businesses such as the Merrill Lynch/BlackRock deal and the Citigroup/Legg Mason deal. In both of these deals, the larger company swapped one of its businesses in exchange for some portion of the smaller business for the opportunity of growth. The Investment Services Industry is dominated, but not limited to, the following major financial firms:

- Merrill Lynch
- Goldman Sachs
- Morgan Stanley

- Bear Stearns
- Lehman Brothers

2. Threat of New Entrants

Across the Investment Services Industry, it is generally hard for new companies to enter the industry and stay competitive. As the major companies maintain their reputation worldwide by growing profits and successful operations, it is difficult for small companies to obtain the talent and resources to be successful and profitable. Many of the requirements for entry into the securities industry is very costly and time consuming which will work against many of the new startup firms. With entry and substantial growth being so hard to obtain by a small company, Merrill Lynch can focus on being competitive with the major players in the industry. Many of the larger firms may also try to achieve a competitive advantage by merging or acquiring smaller profitable firms. This is one the easiest ways for smaller companies to stay profitable and obtain growth rather than seeking ways to grow independently through investing and capital spending. This can either have a positive or negative impact on Merrill Lynch depending on what company is completing a merger or acquisition. For example, if a competitor of Merrill Lynch acquires a small profitable company and plans to heavily invest in its operations, the competitor may capture some of Merrill Lynch's market share. For many of the small individual firms and new entrants, competing against the full service brokerage companies and banks is very difficult and nearly impossible. The main option for the new entrants is to compete against separate individual business units of investment services.

3. Threat of Substitutes

The Investment Services Industry is profitable as a whole due to the various and complex finance products and services that are offered by the companies. These products and services are normally structured to fit one's financial goals or needs, which makes them unique. With this in mind, it is hard to create substitute products and services that will offer the same benefits at the same or lower cost. One major service that is already considered a threat to the investment services industry is the discount brokers that offer a considerably lower stock transaction fee relative to the full service brokers in the Investment Services Industry. These discount brokers include the following:

- Charles Schwab
- E*Trade
- Ameritrade Holding Corp.
- Scottrade
- Fidelity
- Vanguard

Many people use these discount brokerages for their trading accounts rather than the larger company brokers since they can enjoy low fees per trade which in turn can give them the opportunity for more capital gains and the incentive to trade more often with the online capabilities. There are many pros and cons with using the discount brokerage accounts. First, many of the brokerage accounts offered by the large firms offer their client financial advice on

their trades and accounts. Clients, who are considered uneducated about the market and their investments, rely on their financial advisors' expertise and recommendations to construct their portfolio and do not mind paying the large transactions fees. The discount brokerages only give the investor the capability to trade and offer no sort of financial advice. Preference on brokerage account may be based on the classification and experience of the investor. Inexperienced investors are willing to pay the extra transactions fees to a full service broker due to their needs of the full service broker benefits. The experience investor who is an active trader, seeks capital gains, and is market savvy, will view the discount brokers as a valuable tool for generating income. Besides the lack of financial advice, many of the discount brokers lack the reputation and trust of the general public relative to the most of the companies in the securities industry. Many instances of fraud have occurred with discount brokerages either stealing money from their customers or violating SEC regulations which contributed to some of negative reputation of discount brokerages. Examples of scandal and fraud include:

- Charles Schwab's settlement of a civil fine based on SEC allegations that the company allowed certain clients to change their mutual fund trade orders after the stock market's close.
- Access Brokerage, a New Zealand based discount broker, used its client funds to pay the company's bills.
- Identity Theft cases that have occurred throughout the online discount brokerage business. This has caused many of the discount brokers to implement more security features to their business to restore investors' confidence.

This proves that the most valuable asset for most of the firms in the securities industry is the positive reputation and reliability that they obtained over the years by investing their clients' money. This solid reputation will help companies, like Merrill Lynch, withstand any threat of substitute products and services in the long run especially since investing is a very sensitive task that cannot be duplicated easily and cheaply to achieve similar or better results. This is the main reason why there is such a premium to pay for a financial company's services.

Many of the discount brokers have merged with other companies in hoping to diversify their business and gain market share. According to Standard and Poor's Net Advantage, E*Trade made the three significant deals to gain large economies of scale and diversification of services:

- Acquired Kobren Insight Management. This enables E*Trade to be diversified by allowing it be more involved in the advisory services and wealth management.
- Acquired Harrisdirect form BMO Financial Group for \$700 million
- Acquired the BrownCo online brokerage business form JPMorgan Chase & Co. for 1.6 billion

AmeriTrade Holding Corporation had also made a significant acquisition by acquiring TD Waterhouse USA which resulted in a \$2.9 billion merger. Another acquisition included Bank of America merging its broker/dealer business, Banc of America Investment Services, Inc with the discount brokerage, Quick and Reilly in 2004. With these mergers and acquisitions, the discount brokers hope to gain market share and the diversification of services offered by many of the big firms in the financial sector.

4. Bargaining Power of Suppliers

The Investment Service Industry is unique compared to other industries because their suppliers or providers of capital are the company's workers and not the usual outside companies. Since their employees are the companies' suppliers, the compensation expense is one of the most closely-watch indicators in the industry rather the cost of good sold expense in many other industries. This presents a positive and a negative to Merrill Lynch. The negative impact of their suppliers is that the company is too reliant on its employees and does not have another source of suppliers. This heavy reliance is unhealthy for the business because if the employees leave or quit, so does the company. The benefit for having employees as the providers of your capital eliminates the need for the company to rely on outside sources and gives the company better control over their supplies. By giving employees compensation and benefits based on an industry or competitor standards, Merrill Lynch will have control over their capital and expense structure. Overall, bargaining power of the employees mainly is based on the skills, qualifications and value that the employees possess. If the employees' skills are limited, then the employee deemed to be replaceable and their bargaining power is limited. On the other, many firms are reluctant to lose a valuable employee to a competitor due to the time and money spent on training as well as the skills and potential of that employee. This gives the high skilled employee a large amount of bargaining power with its present employer, its main competitors, and other companies in the industry.

5. Bargaining Power of Buyers

Customers have limited influence on obtaining any discounts in pricing. Many of the financial services offered by Merrill Lynch and its competitors offer premium based services due to differentiation and complexity of the financial strategies. Since these services are delivered by experienced and qualified professionals, customers tend to agree with the prices offered by these companies. The types of customers that do have some sort of bargaining power or influence are high net worth clients and long time customers and institutional clients. These customers are considered sensitive since the monetary value of their investment is high and the long time relationship with the company. As these sensitive clients become more demanding, the company must seek ways to satisfy them and prevent them from switching to a competitor. This leads the company into giving these sensitive clients special attention to their needs as well as discount financial packages.

C. Analysis of Strategies

The competitive strategy that Merrill Lynch employs is to build on its distinct reputation of industry leadership and performance. With this reputation, Merrill Lynch creates a foundation that can be used for investing in continual growth. Basically, the competitive strategy of Merrill Lynch is to implement various strategies or actions that will provide the best growth opportunities for the company, maintaining the competitive nature of the firm, and building on their client relationships.

For the year of 2005, management has sought ways to modify and improve various businesses within Merrill Lynch such as prime brokerage, real estate, commodities, foreign exchanges, and other. These businesses received additional capital in structural changes to better meet client needs and goals. Merrill Lynch also extended their geographic presence internationally through partnerships, business ventures and increased ownership. These geographic extensions are a perfect example of Merrill Lynch's efforts of achieving growth since they are occurring in the world's fastest growing economies such as China and India. Merrill Lynch took a 10% stake in the Bank of China as well as increasing its ownership in DSP Merrill Lynch which is India's leading investment bank.

As the competitive strategy focuses on investing in internal growth, Merrill Lynch has continued to attract the top talent to help deliver unique financial products and strategies to their clients. For the past two years, management has added significant number of employees to contribute to the talent of its three business divisions' workforce. In the GMI division, more than 1,600 people, which included over 200 Directors and 160 Managing Director, were hired. The non-proprietary sales distribution team was expanded and several new management and investment professionals were added to the Merrill Lynch Investment Managers division. One of the most important moves was the addition of 1,800 financial advisors and the increased financial advisor productivity to its Global Private Client Group. The fact that this occurred when many of the financial advisor forces of Merrill's competitors have either down sized or grown at a smaller rate displays the huge strides that management is making. This also shows managements' focus on internal growth as it gains new clientele and attract the talent that can deliver the financial services to them.

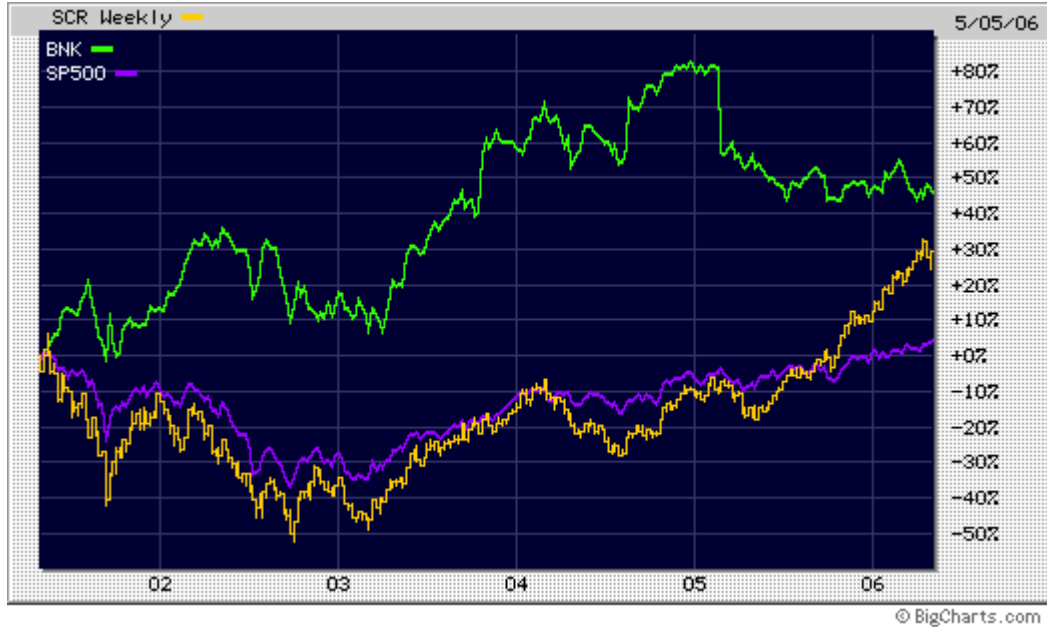
Merrill Lynch has made several small acquisitions and investments to promote growth and strengthen its lines of business. Many of the acquisitions and improvements include:

- Added servicing to the mortgage finance platform
- Added capabilities in equities improving electronic trading and clearing
- Acquired the regional broker-dealer, Advest.

Although these small investments and acquisitions may seem irrelevant, their equivalent worth can be compared to a billion dollar acquisition of a large company.

In analyzing Merrill's competitive strategies and their effects, the mindset and skill level of their management can be assessed. Overall, the skills and the mindset of their management is mainly focused on long term goals and growth which is good for the company's culture, employees, clients and shareholder. With this in mind, each strategic move and action undertaken by management, must be planned and done carefully to ensure long term growth.

D. Relative Industry Valuation



The above chart compares the Dow Jones Investment Services Industry (SCR – yellow line) and the Dow Jones U.S. Bank Industry (BNK – green line) to the S&P500 (purple line) for a five-year period on a weekly basis.

The chart indicates that the financial industry is currently trading at a premium to the market, and has been since mid-2005. During mid-2002, the investment services and banking industry mirrored the S&P500. In 2002, the investment services industry generally traded at a discount to the S&P500 except for in 2004 when the investment services industry mirrored the S&P500, while the banking industry traded at a steep premium. The relationship between the S&P500 and the investment services industry persisted until mid-2005, when the investment services industry began trading at a premium to the S&P500. As evidenced by the graph, the gap between the diversified investment services industry and the banking industry is tightening, and all three indexes are moving closer together to reflect their relationships in 2002.

Conclusively, the finance industry has historically been undervalued, but is currently overvalued relative to the S&P500.



This graph compares the following indexes to the S&P500 (brown line) for a five-year period on a weekly basis:

- Financial Select Sector SPDR Fund (XLF) – tracks the total return of the financial sector of the S&P500 (pink line);
- Vanguard Financials (VFH) – tracks the performance of the Morgan Stanley Capital International (MSCI) U.S. Investable Market Financials Index, an index of stocks of large, medium-size and small United States companies in the financials sector (blue line); and,
- iShares S&P Global Financials Sector (IXG) -- measures the performance of companies that are part of the S&P financial sector and invests in a representative sample of securities with similar investment profiles of those in the S&P Global Financial Sector.

The graph indicates that the financial sector, demonstrated by the above indexes, is currently trading at a premium to the market. From 2002 through early 2005, IXG and XLF have generally traded at a premium to the S&P500 and have mirrored each other, but since early 2005, the IXG has traded at a premium to the XLF. Before 2002, the financial sector mirrored the S&P500. Throughout its existence, VFH has mirrored the S&P500. Overall, the financial sector has in its recent history been and currently is overvalued relative to the S&P500.

IV. FUNDAMENTAL ANALYSIS

A. Ratio Analysis (in millions)

It is important to bear in mind when interpreting the ratio analysis that MER was dramatically adversely affected by the terrorist attacks of September 11th and also announced a restructuring of the company during the same year.

I. Operating/Profitability Margins. Profitability ratios offer several different measures of the success of the firm at generating profits while operating ratios measure a company's operating efficiency.

Earnings before Taxes (EBT)

Merrill Lynch's EBT (earnings before taxes) experienced a positive growth from 2000-2001. Merrill Lynch's EBT in 2005 was third to Goldman Sachs, and in 2004, it was third again to Goldman Sachs and behind Morgan Stanley's EBT. During the 2001-2005 period Merrill Lynch has looked comparable to its competition. Morgan Stanley throughout this period has been Merrill Lynch's closest competitor. In 2005 both companies almost had identical EBT's.

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>Avg Annual Growth</u>
Merrill Lynch	\$2083	\$2312	\$5220	\$5836	\$7231	4.81%
Bear Stearns	\$935	\$1311	\$1772	\$2022	\$2207	13.51%
Morgan Stanley	\$5809	\$4859	\$6160	\$6818	\$7361	7.11%
Goldman Sachs	\$3696	\$3253	\$4445	\$6676	\$8273	10.51%
Industry Avg.	\$16017	\$12,092	\$24,054	\$20719		

Net Income

MER's net income compares favorably with its competitors. In 2005, MER was slightly behind Goldman Sachs in net income. Merrill Lynch had \$5,116 while Goldman Sachs had \$5,609. In 2004, the difference between the top three firms were narrow. MER came in a close third behind Morgan Stanley. MER's asset management revenue and investment banking revenue generated a combined \$9,625 million. The growth rates from 2001 to 2005 for asset

management were -8.1%, 4.5%, 15.8%, and 10.9%, respectively. The investment banking division took a major lapse after 2001 but gradually bounced back in 2004 and 2005. Its growth rates from 2001-2005 were -32%, -8.7%, 23.6% and 10%, respectively.

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	Avg Annual Growth
Merrill Lynch	\$1443	\$1708	\$3836	\$4436	\$5116	6.44%
Bear Stearns	\$618	\$878	\$1156	\$1344	\$1462	14.78%
Morgan Stanley	\$3610	\$2988	\$3787	\$4486	\$4939	5.45%
Goldman Sachs	\$2310	\$2114	\$3005	\$4553	\$5609	12.90%
Industry Avg.	\$13164	\$8753	\$19,264	\$12524		

Net Revenue Margin

The information below suggests that Merrill Lynch had declining net revenues from 2001-2002, and 2004-2005. Their industry competitors experienced the same decline. From 2003-2005 Merrill Lynch has seen a positive growth in net revenue. Their numbers show in 2003 with 26%, to 26.45% in 2004 and 27.8% in 2005. Merrill Lynch's closest competitor is Morgan Stanley.

	2001	2002	2003	2004	2005
Merrill Lynch	9.667%	12.585%	26.231%	26.456%	27.802%
Bear Stearns	19.054%	25.566%	29.563%	29.683%	29.784%
Morgan Stanley	26.39%	25.47%	29.59%	28.76%	27.49%
Goldman Sachs	23.376%	23.259%	27.760%	32.487%	33.383%

Cash Flows from Operations

The Cash flows from Operations includes net earnings and changes in operating assets and liabilities. During the 2001-2005 period the leading firms all experienced negative growth rates.

	2001	2002	2003	2004	2005	Avg. Annual Growth
Merrill Lynch	(\$130)	\$825	\$8,656	(\$14,941)	(\$25,658)	-18.61%
Bear Stearns	\$7066	(\$1211)	(\$5217)	(\$2177)	(\$14,011)	97.22%
Morgan Stanley	(\$25,175)	(\$5013)	\$2355	\$6349	\$4681	174.54%
Goldman Sachs	\$2,865	(\$10,077)	(\$16,739)	(\$33,391)	(\$12,413)	-54.14%

ROA ratios

The return on assets is net income divided by the average total assets. The ROA numbers after 2002 are consistently matched with their competitors. Before 2002 ML's ROA ratios were half of Goldman Sachs. During 2001 Merrill Lynch was affected by the 9/11 attack and announced that they will be restructuring the company. This caused lack luster performances among their financial ratios.

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Merrill Lynch	.344%	.392%	.833%	.801%	.782%
Bear Stearns	.347%	.474%	.582%	.574%	.533%
Morgan Stanley	.774%	.590%	.669%	.665%	.601%
Goldman Sachs	.767%	.633%	.791%	.974%	.909%
Industry Avg.	.85%	.980%	1.14%	1.16%	4.45%

Interest Revenue Margin

Interest Revenue minus interest expense divided by interest revenue and that will give you the margin. Merrill Lynch's interest revenue margin averages from 2003 to 2005 has increased. Their average annual growth rate is 4.62% second behind Morgan Stanley. From 2004-2005 Merrill Lynch experienced their largest growth from year to year.

	2001	2002	2003	2004	2005	Avg. Annual Growth
Merrill Lynch	-4.97%	-34.58%	-11.38%	28.22%	77.46%	4.62%
Bear Stearns	-23.09%	-48.56%	-12.41%	18.52%	120.41%	-1.97%
Morgan Stanley	13.62%	-34.24%	-0.77%	18.08%	51.56%	9.65%
Goldman Sachs	-4.46%	-32.20%	109.63%	-49.57%	78.36%	4.08%

Interest and Dividend Expense Efficiency

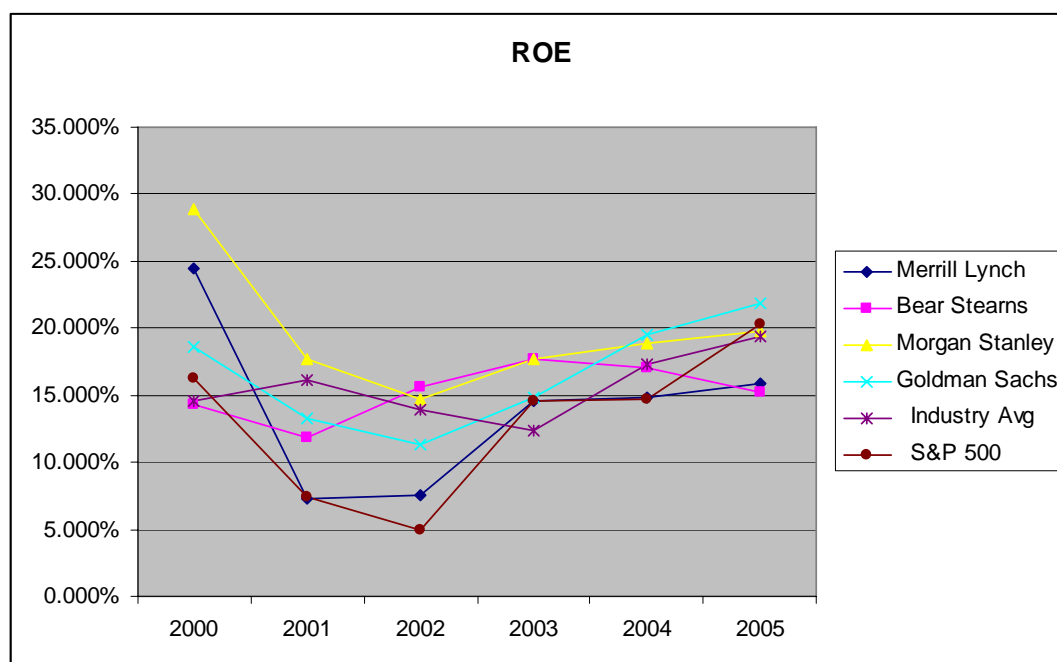
Interest Efficiency tells us how efficiently \$1 in interest expense generated Net Interest and Dividend Revenue. Merrill Lynch's average growth rate was the leader among their competitors at .29%. From 2004 to 2005 all four corporate giants suffered declining interest efficiency rates. Bear Stearns had the highest in 2005 with 23% followed closely by Merrill Lynch.

	2001	2002	2003	2004	2005	2000-2005
Merrill Lynch	15.294%	31.912%	45.538%	41.790%	22.031%	.29%
Bear Stearns	14.395%	26.674%	39.643%	44.002%	23.328%	.276%
Morgan Stanley	17.671%	26.784%	23.990%	26.362%	15.353%	.212%
Goldman Sachs	8.436%	27.075%	41.461%	34.046%	17.061%	.2234%

Return on Equity (ROE) is an indicator of profitability and potential growth of the company. The higher the return, the better it is for the company. A company with high return on equity is more likely of being able to generate cash internally. Return on equity is determined by dividing the net income – preferred dividends occurred during the time period, with the common shareholders equity.

	<u>2001</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>
Merrill Lynch	7.35%	7.58%	14.57%	14.85%	15.85%
Bear Stearns	11.8%	16.65%	17.65%	17%	15.18%
Morgan Stanley	17.76%	14.64%	17.63%	18.92%	19.79%
Goldman Sachs	13.29%	11.35%	14.79%	19.49%	21.85%
Industry Avg.	16.15%	13.87%	12.3%	17.27%	19.34%

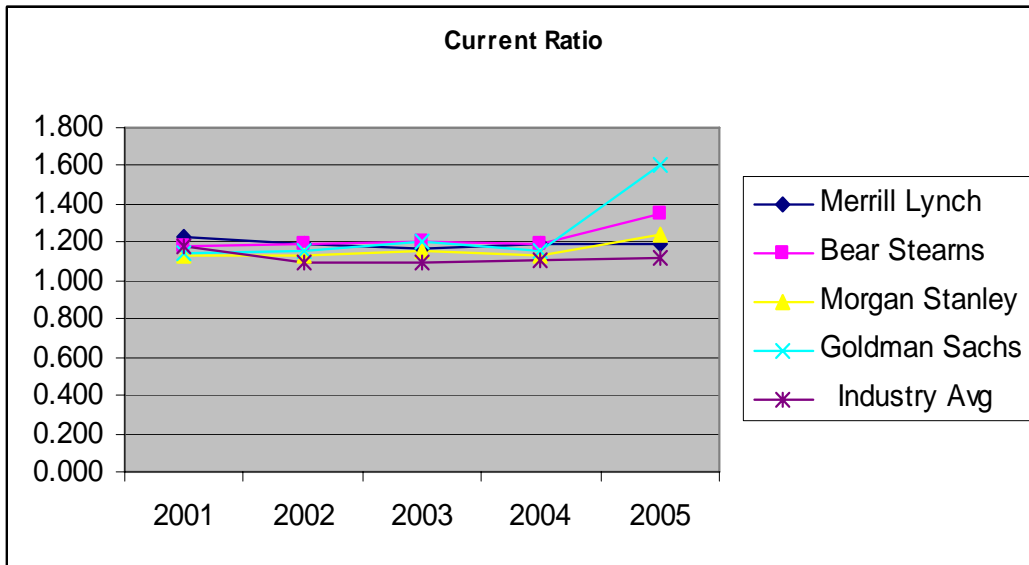
As seen from the graph below, Merrill Lynch has a similar trend of performance with that of S&P 500. Still, Merrill Lynch has underperformed when comparing to its industrial average and its competitors in regard to this ratio. However, it is clear that its profitability is improving because there has been a significant change in the return of equity of the firm from year 2001 when it had its lowest value of 7.348%. Since then, the increase of the return on equity has been stable improving every year. In 2005 the return on equity was 15.851%.



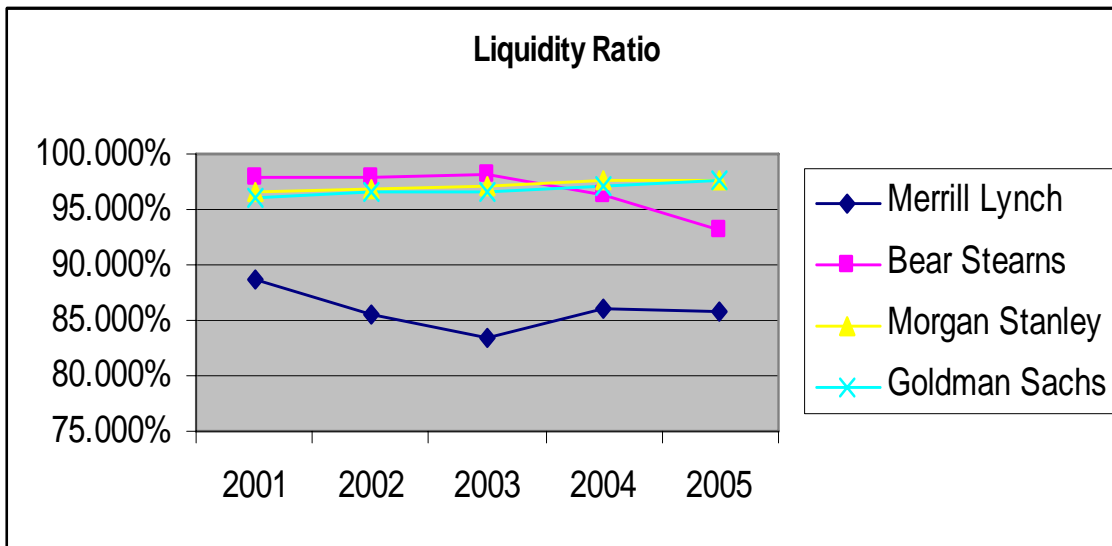
II. Short term solvency ratios. These are ratios that measure the liquidity of the firm, which means the ability of the firm to convert its assets quickly into cash.

Current Ratio is an indicator of short-term debt-paying ability. It is determined by dividing current assets by current liabilities. The higher is this ratio then the more liquid is the company.

In regards to this ratio Merrill Lynch is performing close enough with its competitors and industrial average. So there are no concerns about its liquidity.

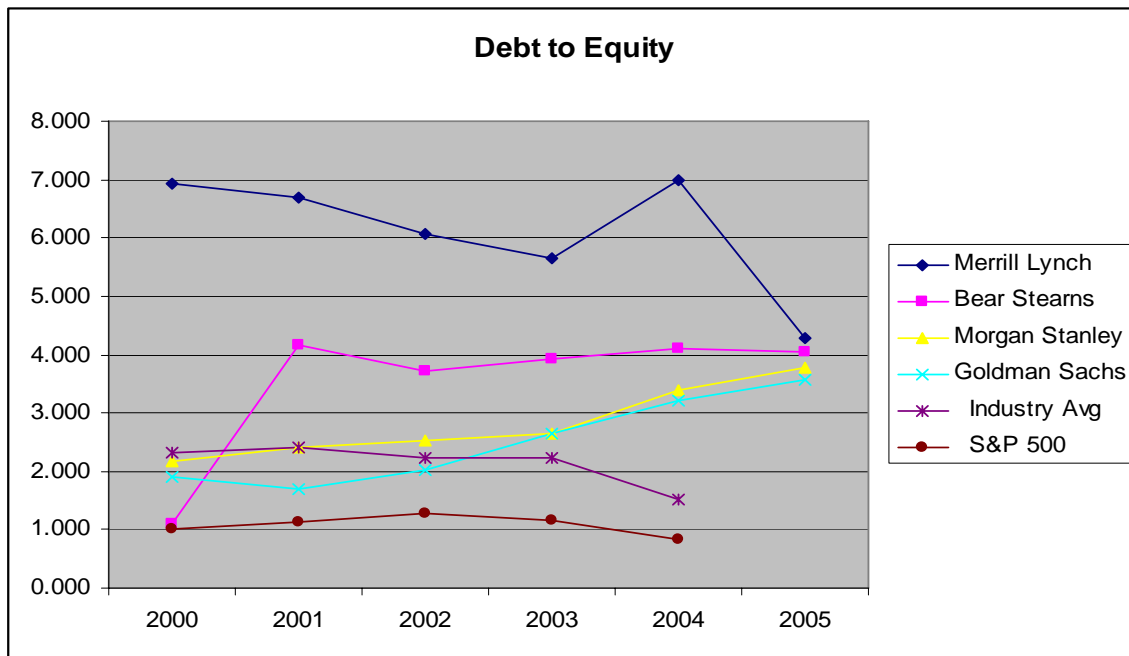


Liquidity Ratio is another short term ratio that is determined by comparing current assets against total assets. We are using this ratio to determine the liquidity of Merrill Lynch's assets by exposing how much of total assets allocation is concentrated in current assets, which we know are very liquid assets. The chart below helps us to see how Merrill Lynch compares with its competitors on this ratio. The all period of time from 2001 to 2005 Merrill Lynch stands below its competitors. In 2003 it seems that the other competitors had the best management of this ratio, while Merrill Lynch had it lowest value of 83.328%. This means that Merrill Lynch underperformed its competitors by about 14%-15%. Nevertheless, by year 2005 this gap seems to have been diminished, and the difference is in a range of 8% - 12%. Still, it remains uncertain how the trend of this ratio is going to progress in the future in comparison to these competitors.

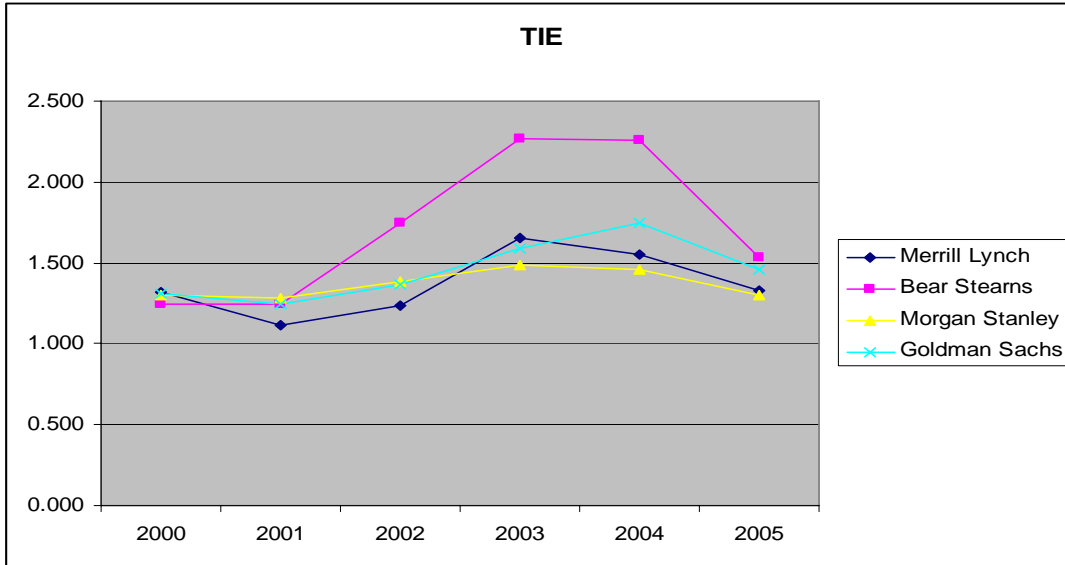


III. Long term solvency ratios. These are ratios that tackle firm’s long run ability to respond to its obligations.

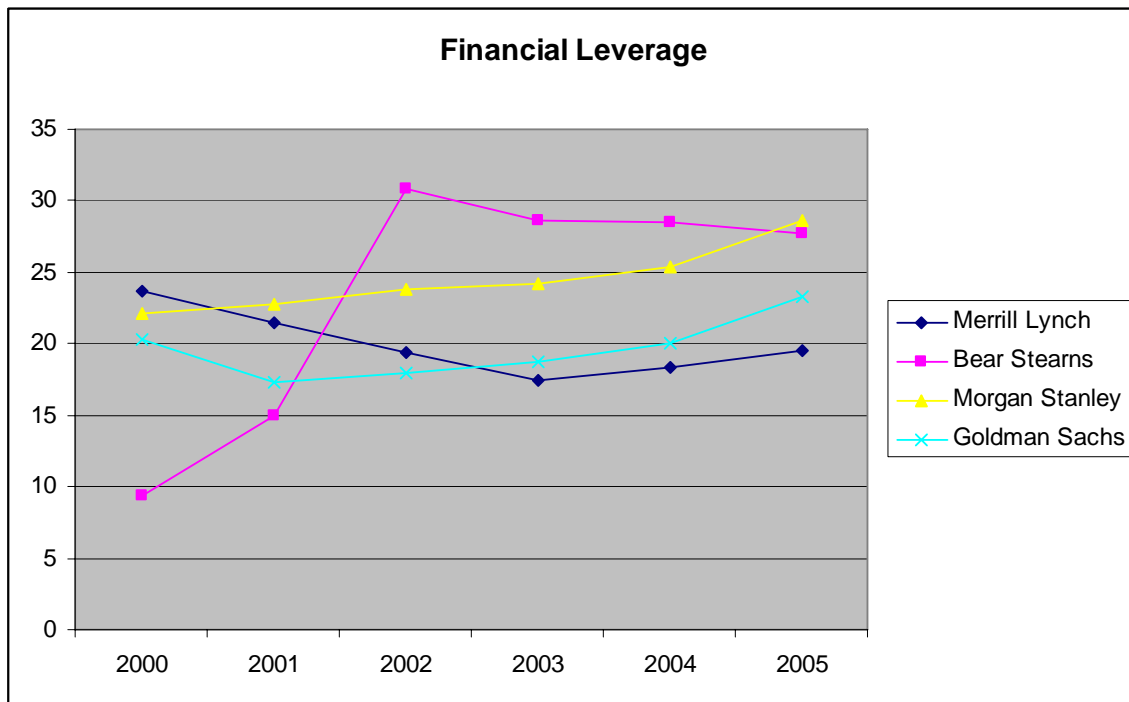
Debt/equity ratio is one of the long term ratios. It is an indicator of the total debt a company owes compare to the equity of shareholders. It is determined by dividing long-term debt by shareholders equity. It shows how risky the company is. The lower is this ratio then the less risky is the company. Looking at the chart below it seems that in the past Merrill Lynch has been riskier than its competitors. Nevertheless, it also shows that this aspect is improving, especially during 2005 when its debt to equity ratio is 4.278, almost the same as its main competitors.



Times Interest Earned ratio (TIE) is another ratio that take under consideration the long term performance of the firm. TIE is an indicator of how well the company can cover its interest on the debt it has financed, and it can tell if the company is experiencing financial trouble. It compares operating profits to the interest earned $[(EBT + IntExp) / IntExp]$. The larger is this ratio then the greater are the abilities of the company at paying the interest on its debt. An overview of the performance of Merrill Lynch and its competitors it seems that industry in general had its peak during 2003 and 2004 in regard to TIE Ratio. Merrill Lynch does not look to perform badly in aspect of this ratio even though it does not stand on top of the list. It has picked up from its lowest 1.119 during 2001 to 1.651 in 2003, and during 2005 was reported to be 1.332.



Financial Leverage is also a long term ratio. It indicates how the company is using its debt by comparing total assets against total shareholders' equity. The higher this ratio, the more debt the firm has used to finance its assets. Merrill Lynch has performed well in comparison with its competitors, and in year 2003 its financial leverage was 17.379, which is its lowest level in a period of six years from year 2000 to 2005. Then during 2004 and 2005 Merrill Lynch's financial leverage has slightly increased indicating an enlarged need for debt to finance its assets.



IV. The DuPont Analysis is a method employed to show the effect of asset turnover, net profit margin and financial leverage on return on equity, since the multiplication of those three ratios

equals to return on equity. By analyzing each of them we can determine the sources of return on equity for the company and compare it with its previous years or with its other competitors.

In 2005 the return on equity for Merrill Lynch is 15.851%. This year is the highest in a period of time from 2002 to 2005. Year 2005 has a higher return on equity compared to year 2002, which has a 7.588% return on equity. In 2002, the company has approximately the same financial leverage, which means almost the same use of debt in 2005. Also, the asset turnover in 2002 is 4.22% compare to 3.97% in 2005; still its return on equity is almost half of what is in 2005. This increase derives from the higher net profit margin in 2005 (19.67% in 2005 vs. 9.30% in 2002), which is due to the improved profitability and ability to control its cost. Moreover, if we compare the return on equity in 2005 with 2004 we see that this ratio is again higher in 2005, although in 2004 the asset turnover and the net profit margin are slightly higher compare to 2005 (3.98% and 20.11% in 2004 vs. 3.97% and 19.67% in 2005). Still, return on equity in 2005 appears to have been increased artificially by the increase in the use of debt in this year compare to 2004 indicated by the increase of financial leverage (19.547 in 2005 vs. 18.393 in 2004).

DuPont Analysis	2002	2003	2004	2005
ROE	7.588%	14.572%	14.848%	15.851%
Asset Turnover	4.22%	4.32%	3.98%	3.97%
Net Profit Margin	9.30%	19.28%	20.11%	19.67%
Financial Leverage	19.421	17.379	18.393	19.547

B. Valuation Models

1. Relative Valuation (P/E Ratio)

Relative valuation models specify an asset's value relative to that of another asset because conceptually, all else equal, similar assets should sell at similar prices. This model utilizes price multiples to evaluate this similarity. Of these price multiples, the most prominent is the P/E ratio, calculated as the relationship between the price of an asset at a given time and the asset's earnings per share (EPS) (or net income divided by the number of diluted shares outstanding). P/E ratios are useful in signaling prospective growth or can be interpreted as the number of years it will take to earn back the stock's price in terms of earnings or the amount the market is willing to pay for \$1 of the firm's earnings. As the equation suggests, an estimated EPS must first be forecasted before proceeding with a valuation. Such forecast involves developing a pro forma income statement; the forecasted revenue drives the pro forma income statement.

The industry is expected to grow at a median of approximately 9%⁵ from the 2005 total net revenue of \$182,600.61 million⁶, forecasting the industry's total net revenue for 2006 as

⁵ 2006 Brokerage Profits Seen at \$26 Billion. 20 December 2005. FX News Limited. <www.lexisnexis.com>

\$199,034.7 million. MER's market share has remained relatively constant throughout the past five years either remaining stable or slightly increasing, and there is no anticipated change. Accordingly, MER's estimated market share for 2006 will remain stable at 14%.

To proceed with the valuation, a pro forma statement was constructed, as follows:

Total Net Revenue (2006):

MER's total net revenue assessment for 2006 is \$27,865, derived by multiplying its projected market share by the estimated future revenue of the industry it operates in. To account for an expected stock repurchase of approximately \$5 billion during 2006, revenue was adjusted to account for interest and dividend revenue that will be lost under the assumption that future investments or interest earnings will be foregone. To compute the repurchase effect, the approximate \$5 billion share repurchase reduced from total assets are removed from the projected interest and dividend revenue for 2006 (approximately \$24,514). Total net revenue reduces by \$180 million, making 2006 total net revenue an estimated \$27,685 million.

Total non-interest expenses (2006):

To determine total non-interest expenses, the 2006 total net revenue of \$27,685 million was multiplied by a 3-year historical line average between revenue and non-interest expense of 72.95%. The total non-interest expense for 2006 is \$20,197 million.

Earnings before income taxes (EBT) (2006):

EBT represents the difference between total net revenue and total non-interest expense, totaling \$7,488 million.

Tax rate (2006):

A tax rate of 29.8% was used since that was the effective tax rate for MER's first quarter of 2006. Income tax expense totaled \$2,231 million.

Net Earnings (2006):

Net earnings are determined by taking the difference between earnings before taxes and the income tax expense. Net Earnings for 2006 are forecasted to be \$5,257 million.

Preferred stock dividends (2006):

⁶ Industry values were obtained from www.sia.com and represent financial data of all broker-dealers doing a public business. The figures were provided quarterly and a 2005 fourth-quarter "Total Net Revenue" number was not provided. Instead, to compute the fourth-quarter "Total Net Revenue," an average was taken of the "Total Net Revenue" numbers for the first three quarters of 2005, since the fourth-quarter "Total Net Revenue" figures of the last four years (2001 through 2004) demonstrated this trend.

Preferred stock dividends for 2006 were estimated to be \$170. This was determined by maintaining MER's first quarter preferred stock dividends constant over each quarter and rounding ($\$43 \times 4 = 172$, rounded to \$170).

Net earnings available to shareholders (2006):

Net earnings available to shareholders are computed as the difference between net earnings and preferred stock dividends. Net earnings available to shareholders for 2006 are estimated to be \$5,087 million. This amount is used as the earnings figure when determining EPS.

The relative valuation piece is driven by the forecasted EPS figure. Once earnings are determined, outstanding shares must be computed to determine the final EPS estimate. The weighted average of diluted outstanding shares as of April 2006 was 981.1 million, but this number was reduced to approximately 966.01 for the EPS estimate to account for the expected stock repurchases that will occur in 2006. MER's 2006 EPS estimate is \$5.27 (\$5,087 million/966.1 million).

Relative valuation means just that: valuing a company by comparing it to similar benchmarks. Those benchmarks being utilized for purposes of this valuation are three competitors (Goldman Sachs, Morgan Stanley, and Bear Stearns), the industry, the four-year industry average and the S&P500. To determine MER's price estimates using the P/E multiple, three main factors must be multiplied: MER's forecasted EPS for 2006, the forecasted P/E ratios of various benchmarks, and the corresponding average historical proportion relationships between MER and the various benchmarks. Each of these factors is represented below:

MER's E(EPS 2006): \$5.27

BENCHMARK	E(P/E 2006)
4-Year Industry Avg.	13.738
Merrill Lynch	14.512
Bear Stearns	11.800
Morgan Stanley	11.300
Goldman Sachs	10.600
Industry Avg.	12.300
S&P 500	15.260

Historical Relative Proportion Between MER and Benchmark P/E Ratios	
MER/INDUSTRY	1.149
MER/SP500	0.7704
MER/BEAR STEARNS	1.119
MER/MORGAN	1.139
MER/GOLDMAN	1.081

The first table lists each benchmark and their corresponding forecasted 2006 P/E ratio. The comparison between the P/E ratios of MER to its competitors shows that MER's expected P/E is

higher than that of its competitors. This is an indicator that MER is expected to experience high growth, likely attributable to MER and BLK's merger, is overvalued, had earnings that are considered attractive at a particular point in time, or just became profitable.

The second table lists each benchmark and its corresponding estimated historical proportion between MER and its own P/E ratio. This is determined by comparing the trailing P/E ratios of each benchmark to that of MER over a five-year period and forecasting a future relationship between the trailing P/E ratios based on these historical figures. As the table indicates, MER trades at a premium in comparison to its competitors and the industry, as follows: 14.9% to industry, 11.9% to Bear Stearns, 13.9% to Morgan Stanley and 8.1% to Goldman Sachs. Oppositely, MER has on average traded at a 33% discount to the S&P500.

The first step in computing price estimates for MER is to multiply each benchmark's projected P/E ratio by its corresponding historical relative proportion between MER and the benchmark P/E ratio, which will, in essence, give an estimated P/E ratio for MER. That figure is then multiplied by the estimated EPS for 2006. These calculations result in the following price estimates:

2006 PRICE ESTIMATES	
BEAR STEARNS	\$69.604
MORGAN STANLEY	\$67.801
GOLDMAN SACHS	\$60.392
INDUSTRY	\$74.486
S&P500	\$61.955
INDUSTRY AVERAGE (4-YEAR)	\$75.745

The final step is to average the individual 2006 price estimates to come up with a final price estimate to compare to MER's current stock price. The averages were computed, as follows.

FINAL RELATIVE VALUATION	
AVG. OF MS, GS, BEAR, INDUSTRY & SP500	\$66.85
AVG. OF MS, GS, BEAR, IND. AVG & SP500	\$67.10
AVG. OF BEAR, MS, GS, & INDUSTRY	\$68.07
AVG. OF BEAR, MS, & GS	\$65.93

Various averages of the mix of price estimates indicate that MER should be trading at a price between \$65.93 and \$68.07. As of May 5, 2006, MER closing stock price was \$76.48. Conclusively, these price estimates would make the stock overvalued.

With the anticipation of MER and BLK forming a combined new firm, these estimates should be increased to represent the expected growth that BLK will have on MER's P/E ratio. The P/E boost that would make MER undervalued must be determined and then evaluated to see whether it is a reasonable expectation or not. The price that makes MER undervalued is \$84.13, a 10% price increase, which represents the necessary capital gain to compensate for the risk of the stock

and mitigates any divergence that may occur from our forecasted price estimates. The minimum percentage impact that BLK must have on MER's P/E ratio to make it undervalued is 26%:

FINAL RELATIVE VALUATION		
BLK Percentage Impact	0%	26%
AVG. OF MS, GS, BEAR, INDUSTRY & SP500	\$66.85	\$84.23
AVG. OF MS, GS, BEAR, IND. AVG & SP500	\$67.10	\$84.55
AVG. OF BEAR, MS, GS, & INDUSTRY	\$68.07	\$85.77
AVG. OF BEAR, MS, & GS	\$65.93	\$83.07

The second issue that must be addressed is whether or not the percentage P/E boost that BLK must contribute to MER's P/E to make the stock undervalued is reasonable. Since the MLIM division of MER only accounts for 7% of its revenue, it is unlikely that the merger will have a 26% impact on MER's P/E ratio.

A review of the relationship between MER's P/E ratio to that of BLK depicts that BLK has generally had a P/E ratio double that of MER. Accordingly, the portion of MER's P/E ratio attributable to the MLIM operating segment is anticipated to double, thereby increasing MER's P/E ratio by approximately 14%:

FINAL RELATIVE VALUATION		
BLK Percentage Impact	0%	14%
AVG. OF MS, GS, BEAR, INDUSTRY & SP500	\$66.85	\$76.21
AVG. OF MS, GS, BEAR, IND. AVG & SP500	\$67.10	\$76.49
AVG. OF BEAR, MS, GS, & INDUSTRY	\$68.07	\$77.60
AVG. OF BEAR, MS, & GS	\$65.93	\$75.16

An analysis of these averaged price estimates indicates that the stock is fairly valued and does not justify an investment recommendation.

Relative Valuation Recommendation: HOLD.

2. Absolute Valuation (Dividend Discount Model – DDM)

The Dividend Discount Model was used in the Absolute Valuation to develop estimates of the intrinsic value of Merrill Lynch's stock. The first step of this valuation is to obtain the cost of capital or k. In many occasions, using one k can be misleading thus making it very unreliable. In our absolute valuation, we used three different costs of capital.

The first cost of capital was obtained by using the CAPM with the following variables:

Risk-free rate	5.03%
Beta	1.65%
Risk premium	6.00%

We used the yield on a 10-year Treasury STRIP from the Wall Street Journal expiring on May 2016 as the risk-free rate and the historical market premium of 6% as the risk premium. The beta was calculated using Merrill's monthly rate of return from the time period of 2001 to 2005 relative to the S&P 500. These variables were inserted into the following CAPM formula:

$$K = \text{Risk-free rate} + \text{Beta (risk premium)}$$

CAPM gives us our first k to of 14.93%.

Our second and third costs of capital was calculated by taking the equity premiums of 3.5% and 3.0% and adding it to Merrill's Yield To Maturity of 5.92 on a bond expiring in July 2018. This technique gave us our second and third costs of capital as 9.42% and 8.92% respectively.

From our forecast of Merrill Lynch and its industry, we expect 2006 EPS to be around \$5.27. Merrill Lynch has already paid a dividend of \$.25 for the first quarter so we will assume that dividend for the year will be \$1.00. Our EPS (2006e) along with the expected \$1.00 dividend will give Merrill Lynch an estimated payout ratio of 18.587.

We then gathered the dividends per share for the past eight years so that we can calculate the average annual growth rate from 1998-2006, 1999-2006, 2000 -2006, and 2001-2006. We noticed a steady trend where the DPS growth rates were in the range of 10.193% and 8.589%.

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006
DPS	\$0.46	\$0.53	\$0.61	\$0.64	\$0.64	\$0.64	\$0.64	\$0.76	\$1.00

Avg. annual DPS growth	
1998-2006	10.193%
1999-2006	9.504%
2000-2006	8.589%
2001-2006	9.336%

Estimated Dividends 2006-2010	
DPS (2006e)	\$1.00
DPS (2007e)	\$1.09
DPS (2008e)	\$1.19
DPS (2009e)	\$1.30
DPS (2010e)	\$1.41

From those growth rates, we concluded that 9% would be the suitable number to use as our growth rate to calculate estimated dividends out to 2010. With the estimated dividends from 2006-2010, we calculated the present value of each dividends streams at the end of 2005 for each cost of capital using the following formula:

$$\frac{E(DPS_1)}{(1+K)} + \frac{E(DPS_2)}{(1+K)^2} + \frac{E(DPS_3)}{(1+K)^3} + \dots$$

PV of dividend streams at the end of 2005		
PV using K1	PV using K2	PV using K3
\$3.92	\$4.53	\$4.60

The most challenging part of the DDM is forecasting the post-2010 annual growth. We approached this problem by using different growth rates in a sensitivity analysis. The first step in our sensitivity analysis is to calculate an estimate of 2011 dividends by multiplying the various growth rates by DPS (2010e): \$1.41. We then took this estimated 2011 dividend and divided it by the difference between each cost of capital and the growth rate used. This gave us the present value of all post 2010 dividends. This present value was then discounted back to the end of 2005. This terminal value was added to the present value of dividend streams to give us the stock's intrinsic value.

Benchmark used to match stock intrinsic value to closing stock price of MER at \$76.48 as of 5/5/2006					
Growth Rate	DPS 2011e	K's	PV post div	PVs calc back	Stock intrinsic value
13.822%	\$1.607	K1 = 14.930%	\$145.01	\$72.31	\$76.24
8.064%	\$1.525	K2 = 9.42%	\$112.49	\$71.72	\$76.26
7.538%	\$1.518	K3 = 8.92%	\$109.84	\$71.65	\$76.25

Different growth rates were then used for the different costs of capital to match the stock's intrinsic value with Merrill Lynch's closing stock price of \$76.26 as of April 28, 2006. The second cost of capital was selected as the appropriate selection due to the following reasons:

The first cost of capital obtained from CAPM, presents unreasonably high equity premium when it was subtracted from Merrill's YTM of 5.92% bond. As you can see, the high growth rate of 13.822% was needed to match the stock's intrinsic value to the current stock price is very high and unlikely.

The third cost of capital used the historical equity premium of 3% and was also used in the Utendahl's analysis of General Mills. Although, this cost of capital could have been used since it represents the historical equity premium, it was not large enough to take into account the uncertainty of future periods for a company operating in the Securities Industry.

By using the second cost of capital of 9.42%, the 8.064% dividend per share growth rate can be used as a benchmark for the analysis of the value of the stock. If Merrill Lynch's DPS growth rate exceeds the benchmark of 8.064%, the stock is currently undervalued but if it grows at a smaller rate then the stock is overvalued. With the Merrill Lynch's DPS having an average annual growth rate between the range of 8.589% and 10.193%, the estimated 9% DPS growth is suitable enough to conclude that the stock is currently undervalued relative to the benchmark of 8.064%.

C. Risk Factors

1. Market Risk

MER's operation segments can be negatively affected by the global market and economic conditions, such as changes in monetary and fiscal policies, the liquidity of global markets, availability and cost of capital, international and regional political events, acts of war or terrorism and investor habits, that can cause volatility in interest rates, exchange rates, equity and commodity prices and credit spreads. The valuation of MER's trading positions in fixed income, currency, commodities, equity securities, real estate and private equity may be hurt by market volatility. On the other hand, a MER's trading businesses depend on the volatility, so if the market would become more stable, this part of MER would be negatively affected. MER seeks to mitigate market risk associated with trading inventories by utilizing hedging strategies that correlate rate, price and spread movements of trading inventories and related financing and hedging activities. MER uses a combination of cash and derivatives to hedge this market exposure.

2. Credit Risk

MER is susceptible to credit exposure within lending relationships, commitments, letters of credit, derivatives, foreign exchange, and other transactions if individuals, counterparties, or issuers are unable or unwilling to honor their contractual obligations. An increase in MER's credit exposure could hurt its profitability if credit losses exceed credit provisions.

3. Operational Risk

MER is vulnerable to losses due to inadequate or failed internal processes, people or systems or from external events. The inadequacies and/or failures could cause MER to suffer financial loss, disruption of its business, liability to clients, regulatory intervention or reputable damage.

4. Liquidity Risk

MER is exposed to liquidity risk which is the inability to repay short-term borrowings with new borrowings or assets that can be quickly converted into cash while meeting other obligations and continuing to operate normally. This risk can be due to uncontrollable circumstances, such as general markets disruptions. MER's inability to meet maturing obligations can bring down its credit rating thereby constraining its ability to borrow funds or may cause regulatory capital restrictions imposed on the free flows of funds between MER and its affiliates.

5. Litigation Risk

MER has been named defendant in a number of legal proceedings and has been under high government scrutiny through investigations and proceedings by governmental and self-regulatory agencies. The monetary damages that will have to be paid out by MER is indeterminable at this time since, in some cases, the first-name defendants are bankrupt or in financial distress. These litigations are likely to conclude in adverse judgments, penalties,

injunctions, or fines that may be material to its operating results or cash flows for any particular period and may impact its credit ratings.

6. Regulatory and Legislative Risks

Many of MER's operational segments are highly regulated and may be impacted by further regulatory and legislative initiatives imposed globally. These changes have already impacted corporate governance, anti-money laundering, privacy, research analyst conflicts of interest and qualifications, practices related to the issuance of securities, mutual fund trading, disclosure practices and auditor independence. Such further regulation cannot be forecasted, but can be expected and can have a strong impact on the how MER operates.

7. Competitive Environment

MER competes globally for individual and institutional clients on the basis of price, the range of products that it offers, the quality of its services, its financial resources, and product and service innovation. The financial industry is highly competitive and the demand for full-service brokerage firms seems to be diminishing. The industry is highly affected by an intensified competitive environment due to new technologies, mergers, and diminishing margins in many mature products and services. Particularly, there is strong competition in brokerage because of the ability to execute trades electronically, through the internet and through other trading systems. This has put pressure on trading commissions and spreads.

D. Investment Drivers

1. Prominent Player in a Growing Industry

There are many favorable conditions that makes purchasing Merrill Lynch's stock a good buy. One of the conditions is the positive outlook for the Securities Industry. According to Standard and Poor's, it is forecasted that in 2006, Investment Services Industry will continue to see growth in profits in all areas of business except for the financial activities involving fixed income due to the flattening yield curve. This flattening yield curve decreases level of fixed income security underwriting due to the low demand of long term bonds. Merrill Lynch, being a prominent player in its industry, will only capitalize from this industry growth in all areas of business. Merrill Lynch has an estimated market share of 14% and will be able to either maintain or increase their market share due to several growth initiatives.

2. Retirement of Baby Boomers

Another favorable condition or opportunity for Merrill Lynch is the retirement of baby boomers. Baby boomers represent individuals born between the years of 1946 and 1964 in a time where birth rates rose dramatically. Today, baby boomers still represent a significant amount of the U.S. population. Many of the baby boomers heading into retirement and will not be able to generate income from employment. With this in mind, baby boomers must adjust their current portfolio to meet their financial obligation and needs of their post employment lifestyle. Generally, since no employment income is being generated due to retirement, people will rely on

their portfolios for income which means adjustment towards a more conservative portfolio must be made. The baby boomers will look to financial advisor for financial expertise and advice on reconstructing their portfolios. The financial advisor will reduce the risk of the portfolio by investing less money into stock and more into fixed income securities and marketable securities. Merrill Lynch's Global Private Client Group has a good reputation of meeting clients' financial goals with its financial strategies and performance. Their past performance and reputation will help Merrill Lynch attract large clientele from the baby boomers who are in need of their service. As Merrill Lynch continues to invest and hire more financial advisors into GPCG, an array of clientele, experience and innovative solutions will be brought into Merrill Lynch to initiate growth in revenue and all aspect of the business.

3. Merger with BlackRock

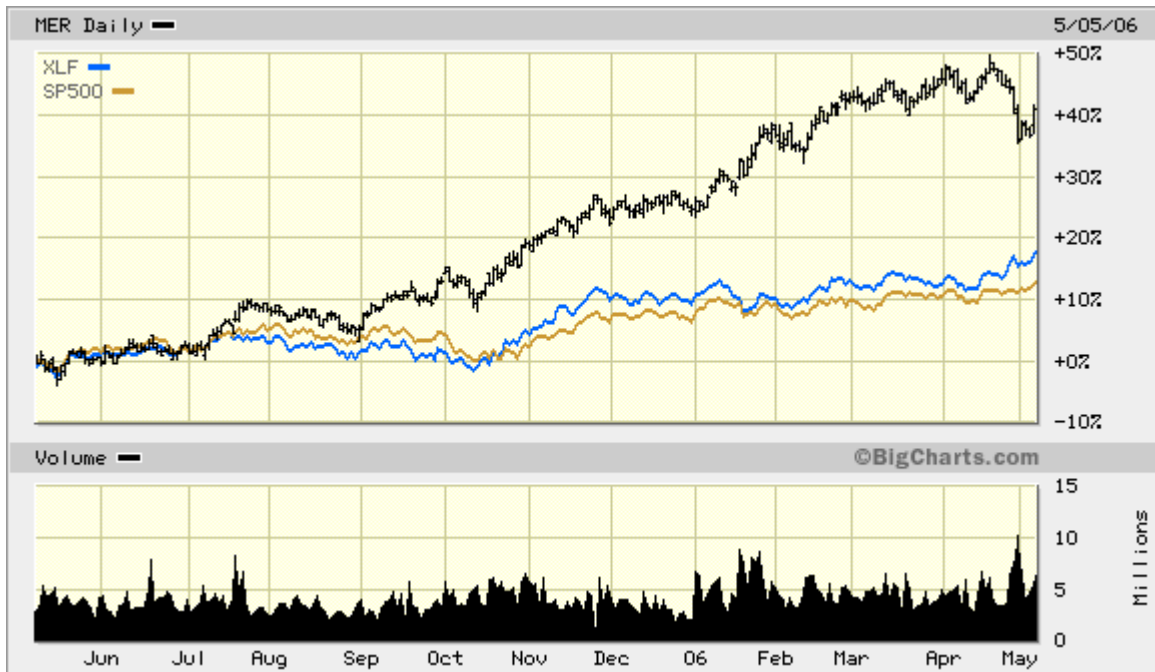
In February 2006, it was announced that Merrill Lynch will merge its MLIM division with BlackRock to form a newly independent company operating under BlackRock. This merger gives Merrill Lynch an estimated 49.5 stake in the company as well as 45% in voting rights. This merger presents two favorable opportunities for Merrill Lynch:

- **Growth** – This merger enables Merrill Lynch to combine its MLIM division with a unit twice its size. BlackRock is the premier asset management firm servicing a global institutional client base. By giving up its MLIM division, Merrill Lynch was able to free up capital cost of operating the division which now can be used for investment in growth and share buybacks.
- **Diversification** - Merrill Lynch will diversify their business as a result of this merger. Merrill Lynch has been very successful in operating through the retail channel while BlackRock has operated through the institutional channel of clients. By merging the retail and institutional channels together, Merrill Lynch and BlackRock will become the world's most diversified asset management firm which will give Merrill Lynch and BlackRock a competitive advantage.

V. TECHNICAL ANALYSIS

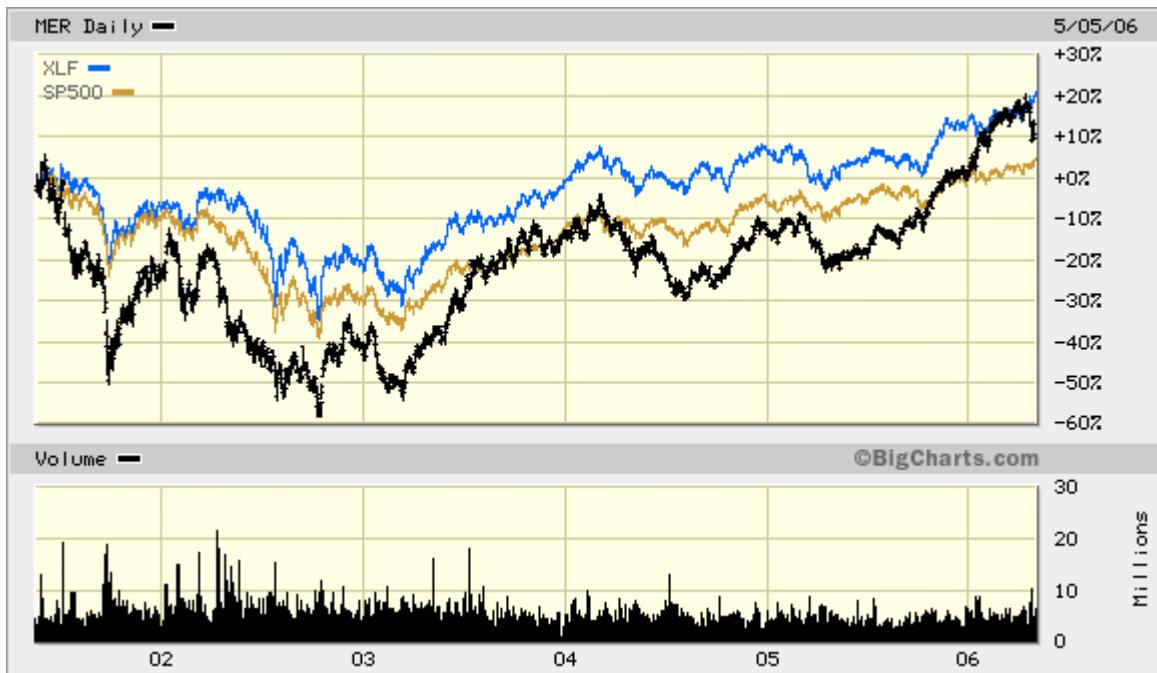
A. One Year Chart: MER vs. S&P 500 vs. XLF (Financial Select Sector SPDR)

The chart below displays the rate of return for the S&P 500, Merrill Lynch's stock, and the Financial Select Sector SPDR for the period of one year. Overall, the Financial Select Sector SPDR and the S&P 500, has almost similar rates of return. Between the months of June and August, Merrill Lynch, S&P 500, and the XLF had similar rate of returns. Starting in September 2005, Merrill Lynch began gaining huge returns relative to the S&P 500 and the Financial Select Sector. While the S&P 500 and XLF had made modest gains, Merrill Lynch has continued to widen the spread of performance relative to both indexes.



B. 5 Year Chart: MER vs. S&P 500 vs. XLF (Financial Select Sector SPDR)

This five-year chart shows the 5 year performance of the S&P 500, Merrill Lynch, and the Financial Select SPDR. Overall, the XLF has performed better than the S&P 500 and Merrill Lynch between 2002 though the end of 2005. Between late 2001 through mid 2003, the S&P 500 performed better than Merrill Lynch which can be contributed to the economy in the post 9/11 era even though the XLF out performed both the S&P 500 and Merrill Lynch. This stretch came to an end in mid 2003 where Merrill performed better than the S&P 500 but not the XLF. By mid-2004, the S&P 500 had outperformed the Merrill Lynch until the end of 2005. By the beginning of 2006, Merrill Lynch began and continued gained similar return to the XLF but has continued to outperform the S&P 500.



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