

Merrill Lynch First-Quarter 2008 Earnings Call

Good morning and welcome to Merrill Lynch's conference call to review our first quarter 2008 results. The following live broadcast is copyrighted to Merrill Lynch. Statements made today may contain forward-looking information. While this information reflects management's current expectations or beliefs, you should not place undue reliance on such statements as our future results may be affected by a variety of factors that we cannot control.

You should read the forward-looking disclaimer in our quarterly earnings release as it contains additional important disclosures on this topic. You should also consult our reports filed with the SEC for any additional information including risk factors specific to our business and the information on calculation of non-GAAP financial measures that is posted on our Investor Relations website, www.ir.ml.com, where an online rebroadcast of this conference call will be available later today at approximately 11 am Eastern time.

And with that I'll turn the call over to John Thain, Merrill Lynch's Chairman and Chief Executive Officer.

John Thain:

Thank you Sara, good morning everyone.

I would characterize our first quarter results as good operating results in a very difficult environment. The widening of credit spreads, forced liquidations, high volatility, the lack of market liquidity for many credit products is probably as difficult a quarter as I've seen in my 30 years on Wall Street. And in that context we generated \$7.4 billion of revenues before our marks and their fair value gains. And a number of our businesses did very well.

We had record Global Wealth Management revenues with an industry leading proportion of fee-based revenues. We added \$9 billion to our annuitized products and we added \$4 billion in spite of the market environment in net new money, \$1.3 billion of which came from First Republic, so that acquisition is starting to bear fruit.

In our trading businesses we had record revenues in rates and currencies, almost double from the year ago quarter. We had 20% year-over-year revenue growth in our equity financing and services businesses. And we had the highest revenues in cash equities in the Americas and EMEA since our 2000 record levels.

Investment banking we did well - we were in the top 5 of debt and equity lead tables. We were the # 1 in EMEA mergers on a completed basis. We were # 3 in the Pac Rim. And although our investment banking revenues were down significantly for the first quarter, what's interesting and good is that our pipeline was down only 5% from the fourth quarter and down 6% from the first quarter of '07. Which means that although the deals were delayed, they're still there and so we would hope to realize those over the course of the rest of the year.

Internationally our revenues were strong. Japan was up 87%, Latin America was up 67%, EMEA also had good growth. We are focusing on the rapidly growing parts of the world. In Brazil you saw we hired a senior investment banking team. In India we're building on our equities trading platform and our wealth management business. In Korea we've just obtained our banking license. And recently, last week, I was in Japan and China, where we also see great opportunities to grow our businesses.

And then our investment in BlackRock has experienced exceptional growth, and just on a market value basis the current market value of BlackRock is over \$13 billion versus about \$8 billion that's on our balance sheet. So I think that our operating businesses in this environment have done well.

The second focus for us has been on our balance sheet. We've been very actively managing our balance sheet and our liquidity positions. As you've seen already from the release, our liquidity is up from the fourth quarter of last year. We were very concerned about the market environment at the end of last year. We had \$79 billion of cash available at that time, and we've increased that to \$82 billion at the end of the first quarter. This gives us tremendous flexibility in this difficult market environment. I would also say that our bank deposits, we had \$100 billion of bank deposits, is a very stable source of funding for us.

On the capital side we've increased our saved capital from \$36.7 billion at the end of the fourth quarter to \$41 billion. We are well capitalized under the risk rated asset test. And for those of you who like to blog, we do not

have any plans to raise any additional common equity and Nelson actually agrees with that.

In terms of leverage, we had been reducing our balance sheet. Our risk related assets are down 7%. Our leveraged loan book - this is a good example of places where we have been able to make some progress reducing our balance sheet - our leveraged loan book was down from \$18 billion at the end of the fourth quarter to \$14 billion. And that reduction was actually a \$5 billion reduction with a \$1 billion increase. Those were done through cash sales right around our marks. So that actually is a good sign that we're getting some liquidity into the market place.

On the sub-prime, except for CDOs our sub-prime position is down from \$2.7 billion to \$1.4 billion. And we're bringing our risk down, our VaR down from 65 to 59. We have also been successful in what we said at the beginning of the year we would do in terms of our principal investing. So we said we would start to move our principal investing into third party funds. The first piece of that was completed this quarter where we raised the third party commercial real estate fund in the PacRim and we moved \$723 million of assets from our balance sheet into that fund. That fund ultimately we expect to be between \$2.5 billion and \$3 billion. So our balance sheet's in good shape, our operating businesses are good.

There's no question that the credit spread widening that occurred in this quarter impacted our inventories, particularly our ABS CDO inventory. You saw from the press release we had \$1.5 billion of net write-downs on ABS CDOs, obviously much, much lower than the fourth quarter of last year. Just to give you an idea of how we were pricing those, we moved our cumulative loss assumptions on sub-prime mortgages from what was a range of 16% to 21% at the end of the fourth quarter, to a range of 19% to 24% at the end of the first quarter. And remember, at 24% that would mean that if half of the mortgages defaulted you would lose 48% of the value of the home. So very, very significant price declines. And just in terms of the average over the U.S. so far, year-over-year home prices are down about 11%. Although sub-prime in certain areas are down more than that.

We did increase our credit reserves on monoline hedges against the ABS CDOs by \$2.2 billion. And I think what's important there is that if you look at the total gain that we have on our shorts that are protected by the monolines it was \$7.8 billion. We have reserved \$4.8 billion of that which is over 60%. But unlike the CDOs where I think that it's not very likely we will recover value on, we do expect in many cases to recover a significant

amount of the reserves and at least some of those monoline insurers continue to be rated AAA. So we're much more comfortable that we're being conservative on the monoline reserves and we would expect to recover that over time.

On the expense side, we have announced that we are going to reduce our headcount approximately 10% from the beginning of the year levels, excluding our financial advisors and the support to the financial advisors. That should generate about an \$800million a year run rate savings. It's a very targeted headcount reduction. We are not in any way pulling back from our fundamental strategy, we are not changing our view that we need to invest in the faster growing parts of the world. And so the headcount reduction will be made in those slower growing areas that are not the focus of our global strategic growth.

And then lastly, I'll just comment a moment on the economic environment, then I'll turn it over to Nelson to give you some more details. I think that we are seeing some improvement in the credit markets, the leverage loan markets probably a good example of that. We are seeing some improvement in spreads. And I think the real risk going forward here is how much do all of the problems in the financials and credit markets seep into the real economy? What is the impact of higher energy prices, higher food prices, higher unemployment and falling home prices on the consumer and what's the impact on that in terms of the U.S. economy and ultimately the global economy? We are planning for a slower and more difficult next couple of months and probably next couple of quarters. But we're also optimistic for our results for the full year of 2008. And so with that I will turn it over to Nelson.

Nelson Chai:

Thanks John.

Let me take a moment to review our major segments.

In our **Global Markets** business first quarter revenues of negative \$690 million were up substantially from the fourth quarter, but lower than the prior year period as a result of the weaker capital markets environment. GMI's pretax loss for the quarter was \$4 billion.

Turning to the revenue detail by business line,

FICC revenues were a negative \$3.4 billion as the business continued to face significant headwinds due to our CDO monoline-related exposures which I'll detail in a minute. However the positive trading environment drove FICC revenues of \$1.9 billion which exclude marks of \$6.6 billion in fair value debt gains of \$1.4 billion.

In fact the vast majority of the FICC businesses demonstrated sequential growth from the fourth quarter including rates and currencies, credit trading, commodities and municipals. Rates and currencies in particular generated record revenues this quarter benefiting from the combination of increased capital allocations, favorable market positioning and strong client flows.

As I'm sure you've all seen, we've disclosed our key exposures in attachments five and six in this morning's release. With that in hand, let me walk you through each of our major exposures.

The majority of the write-downs this quarter were related to the ABS CDOs and related monoline exposures, as John mentioned earlier.

On the super-senior ABS CDO front, at quarter end our gross exposure was \$26 billion, down from \$30 billion at the end of the year. And the net exposure related to these positions was \$6.7 billion. As you can see in our release write-downs in this area were offset by an increase in our net exposure due to the reduction of certain hedges. Namely at quarter end we made a decision to consider notional hedges of \$1.1 billion with MBIA ineffective as we are working to expedite the resolution of a potential conflict related to hedges we have with SCA. This is a decision that was made-- made clear economic sense as the carrying value on the MBIA hedges that we have considered ineffective was less than \$50 million.

We remain prudent in our approach. During the quarter we increased our average cumulative loss assumptions for this portfolio across all underlying collateral types. And we are taking into consideration incremental remittance and other data which was negative during the quarter, although for which the velocity of the downward trend has slowed.

As a result of the losses in our underlying super-senior ABS CDO positions the corresponding value of our related hedges of the monolines increased during the quarter. For these hedges our credit valuation adjustment was negative \$2.2 billion during the quarter which are largely driven by gains on hedges and a number of rating downgrades for the monolines we have exposure to. As John mentioned again, on average we have written down

the value of these hedges to \$0.40 on the \$1 at quarter end, levels that while appropriate are conservative relative to fundamental cash flow expectations for most of the monolines.

Away from the \$10.9 billion of hedges we have with the monolines on the super-senior ABS CDOs, as you can see in the bottom of attachment five, we have \$9 billion of CDO hedges with other financial counter parties such as insurance companies and hedge funds. We remain confident in the strength of these hedges as the ratings outlooks for these counter parties are stable and they continue to post collateral as required.

With respect to residential mortgages within the FICC business our exposure has increased slightly. Although approximately 70% of this figure reflects prime mortgages, almost all of which are from our GWM private clients, which in their history of experience virtually zero defaults. During the quarter the most significant drivers of change were \$3 billion of prime mortgage originations and the net purchases of \$900 million of Alt-A securities which are partially offset by sale securitization and other changes in hedging activity.

On our leveraged finance front our write-downs were slightly more than \$900 million driven by significant spread widening and market illiquidity. We reduced our exposure by approximately \$4 billion in the quarter and sales were completed at levels consistent with our marks at the time of the execution. In commercial real estate our exposures were also impacted by the weaker market environment. However gains on commercial real estate loan sales more than offset our marks. We remain comfortable with the quality of both of these portfolios and will selectively reduce our net exposures to these asset classes consistent with our overall strategy to reduce less liquid assets.

Finally within our U.S. Bank investment securities portfolio, we recognized approximately \$3 billion of pretax net write-downs through other comprehensive income or OCI, and approximately \$400 million of net write-downs through the income statement. The largest contributor to these write-downs was our exposure to Alt-A securities which we have written down to an average of less than \$0.70 on the \$1.

Turning to **Equity Markets**, first quarter net revenues of \$1.9 billion were down 13% sequentially. The solid growth in financing and services, equity length and approximately \$700 million in fair value adjustments related to

certain long-term debt liabilities were more than offset by declines in our principal-related businesses.

Within our financing and services business we reported double-digit sequential and year-on-year revenue percentage increases. Our client balances are up 27% year-over-year and down only modestly from record levels in the 2007 fourth quarter despite significant industry wide de-leveraging during the period. Our prime brokerage business continues to gain momentum as we are currently ranked No. 2 Prime Broker by the Global Custodian survey and have added new clients during the quarter.

Net revenues from our private equity business this quarter were negative \$207 million, down almost \$100 million sequentially and \$650 million versus the year ago period primarily due to price declines for our publicly traded investments. Net revenues for our proprietary trading and hedge fund related businesses were also negatively impacted by the adverse market conditions this quarter, declining \$300 million sequentially. However we believe we are well positioned for the remainder of the year.

Investment banking revenues declined by 30% sequentially as industry volumes were materially lower and we faced challenging comparisons to last quarter which included significant revenues from our role as an adviser to a consortium's acquisition of ABN AMRO. While revenue and strategic advisory declined slightly from the year ago quarter the business showed strength outperforming the decline in industry transaction volumes from the year ago levels.

Our investment banking fee pipeline remains strong. Although execution of course is market dependent as our client dialogue is active despite the continued volatility in the capital markets. We ended the quarter down 5% from 2007 year end, but saw increased levels in the Pac Rim.

Turning to our **Global Wealth Management** business--

GWM continues to deliver record performance with quarterly revenues of \$3.6 billion, up 8% on a year ago basis, even in this challenging period which included significant asset depreciation and market volatility. Pretax earnings of \$720 million were down 8% year-over-year as we continue to invest in the business and fully reserved for an \$80 million client receivable. Excluding the impact of this reserve, GWM's margin was 22.2%, comparable to year ago levels but down sequentially reflecting the

seasonal impact of payroll taxes and the generally tougher market conditions.

During the quarter we achieved:

- Positive net new money and more than \$9 billion in net new annuitized inflows
- Client assets of more than \$1.6 trillion down less significantly than the approximate 10% decline in the S&P 500
- Success in retaining our industry leading team of financial advisors was net positive recruiting in our top two quintiles
- Annualized revenue per FA of \$862,000
- Overall FA growth of 5% year-over-year including 18% outside the Americas

GPC net revenues in the first quarter were \$3.3 billion, up 7% from the year ago period. Revenue growth was driven by increased fee-based revenues and record net interest revenues reflecting the inclusion of First Republic and greater client inflows into deposit programs.

Transaction and origination revenues remained relatively strong up slightly from the prior year quarter but down sequentially from the fourth quarter in 2007 due to continued market weakness. March marked the fifth consecutive month of declining market indices and persistent volatility coupled with the downward bias typically causes the retail investor to sit on the sidelines.

Furthermore we're still identifying new opportunities to enhance our market leading position. During the quarter we effected enhancements to our FA training program a result of a year long study to improve our return on investment. Specifically we have tightened a timeframe to make decisions on continuing our investment in trainees, which reduced our FA census this quarter, but we expect to increase our returns from the program.

We are also continuing to invest in our platforms and planned initiatives to:

- Deliver a new online platform for all ML clients

- Upgrade our advisor work stations
- Support international growth by adding local products and platforms outside the U.S.

Lastly in **GIM**, net revenues were \$299 million for the quarter year-over-year growth at 15%, was driven primarily by an increase in earnings from our investment at BlackRock, which John touched upon earlier.

That concludes my discussion of the segments. Now we will turn briefly to the firm as a whole and discuss expenses. I'll start with the compensation expenses for the quarter which were \$4.2 billion, and reflect increased headcount levels and productivity for FAs from a year ago partially due to acquisition. Comp expenses also include approximately \$180 million related to the accelerated vesting of restricted stock we effected last quarter.

As John mentioned, we intend to reduce our headcount by about 4,000 employees or 10% of our work force excluding the financial advisors and investment associates. These headcount reductions will occur predominantly in GMI and support areas but they will not impact the FA or investment associate population. We estimate the cost savings from this reduction will be approximately \$800 million of compensation expense on an annualized basis which includes approximately \$600 million for the remainder of 2008. As a result we expect to record a restructuring charge of approximately \$350 million in the second quarter of this year.

On a non-comp cost they increase 10% year-over-year to \$2 billion largely related to acquisitions, increased headcount and growth in brokerage clearing and other expenses during the quarter. As I mentioned, managing the firm's expenses to be better in line with the business activity our key focus for 2008.

At year end and adjusting for our convertible preferred securities on an if converted basis, total equity capital was \$41.3 billion and our adjusted book value per share was \$28.93 reflecting the impact of our net loss and increased negative balance at OCI.

And our effective tax rate was 40% for the quarter, a significant increase reflecting changes in the geographic mix of our earnings.

Finally as John mentioned in terms of outlook we remain cautious in the near term and continue to monitor the U.S. economic environment. Merrill Lynch is truly a global firm and we continue to be optimistic regarding our long-term growth opportunities in each of our major business lines, particularly outside the U.S.

And with that we will open it up to questions, thank you.