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Collapse of the Auction Rate Market

Minimal Earnings Impact (But Only If It's Cleaned Up Quickly)

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- **The auction rate market will cease to exist, in our view (similar to the SIV marketplace).** Both of these structures existed to satisfy a thirst for yield by clients who wanted the yield generated by longer duration securities but the liquidity of short dated securities. In both cases, the liquidity providers were unwilling to provide liquidity during a time of market distress.
- **We estimate that the earnings impact will be less than 1-2% for brokers & asset managers as a result of this marketplace disappearing over time.** The near-term impact will be driven by a lack of new issuance of closed-end funds. Over the long-term, the impact may be driven by a higher cost of leverage or the inability to structure leverage in muni closed-end funds. In both cases, the impact would still be relatively small.
- **However, potential reputational impact could be material if issues are not quickly resolved (stressing broker & asset mgr relationship).** There is potential for more severe impact from reputational damage to extent that clients don't get liquidity in the near-term. Basically, clients could stop using the services of their brokerage and/or asset management firms as a result of a loss of trust.
- **We estimate that full-service brokerage clients hold about $100-150b of ARS & the major closed-end funds have issued about $40b in ARS.** We estimate that brokerage clients who hold this $100b to $150b in ARS control in excess of $750b of total assets. While the ARS holdings are currently illiquid, the ability to borrow against them has been introduced at most firms. The major asset managers manage 246 funds with about $40b in ARS outstanding.
- **A combination of steps will likely be used to alleviate the illiquidity.** We detail the pros & cons of several potential solutions to the issue including: 1) taxable funds using traditional debt to repurchase ARS; 2) muni funds issuing new securities with a put feature (e.g. 12-month put); 3) creating a secondary marketplace; 4) putting securities on brokers balance sheets (client potentially absorbing some discount); 5) reducing leverage by funds repurchasing ARS.
- **The biggest potential beneficiaries include Federated, BlackRock, and Schwab.** Plain and simple, the money fund turned out to be a superior product and as the ARS crisis is resolved we expect inflows into money funds. Federated, BlackRock and Schwab manage $242b, $234b & $183b of money funds, respectively. Furthermore, Schwab's clients have virtually no ARS within its $1.4 trillion client asset base so it is positioned to take mkt share from peers.

See Appendix A-1 for Analyst Certification and important disclosures.

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Brokers & Asset Mgrs Intertwined In ARS

The Auction Rate Securities ("ARS") market is estimated to be about $340b in size... We estimate that roughly 80% of the outstanding auction rate securities are debt instruments and the remaining 20% (or $72b) are preferred securities (essentially a form of equity, largely used by closed-end funds). In Figure 1 below, we show an excerpt from the *Citi Bond Market Roundup* that details the different instruments that make up the auction rate marketplace. Almost 60% of the auction rate securities are tax-exempt instruments.

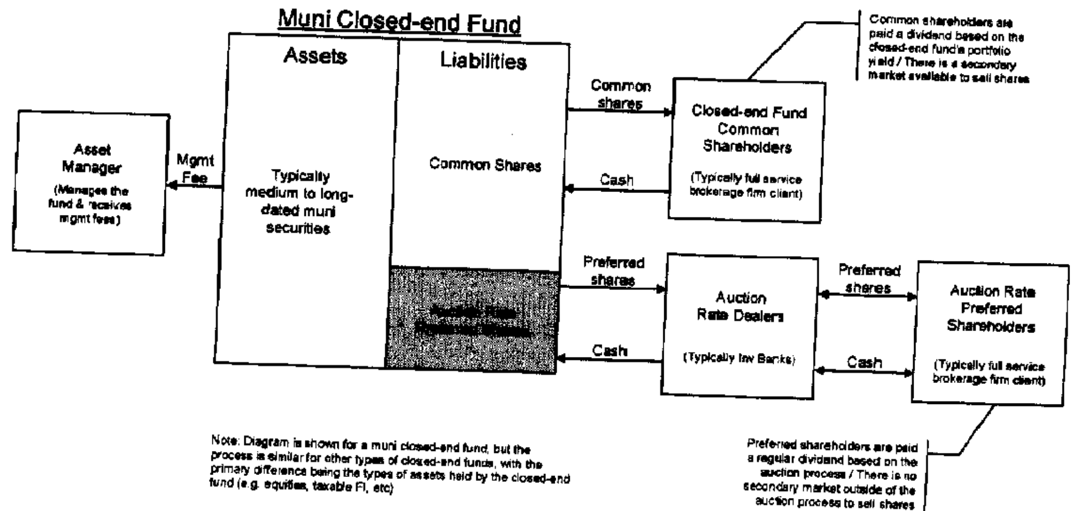
Figure 1. $340m of Auction Rate Securities Outstanding

Type	ARS ($b)	Issuers
Tax-exempt debt	175	Municipalities, state authorities, nonprofit orgs
Taxable debt	95	Asset-backed, nonprofit orgs, state authorities, CDOs, closed-end funds
Muni preferred	30	Closed-end muni funds
Taxable preferred	35	Closed-end funds
Par value preferred	7	Corporations, closed-end funds
Total	**342**	

Source: Citi Bond Market Roundup report (SDC & Citi) as of 2/21/08

...and brokers and asset managers are intertwined in the ARS market... In Figure 2 below, we diagram out how a closed-end muni fund uses auction rate preferred securities (ARPS). Historically, ARPS were viewed as near-cash instruments because they could be sold at par at regularly scheduled auctions (generally held weekly or monthly) and auction failures were very rare. The dividend rate received on these securities generally produced a yield that was slightly higher than other cash alternatives. In essence, the securities backing the ARPS were long-dated and near-term liquidity was provided by auction agents (typically investment banks). The auction process was generally run by investment banks and these securities were generally sold to full-services brokerage clients. These auctions started failing in February 2008, when firms with constrained balance sheets / capital stopped bidding on ARPS, resulting in auction failures (the equivalent of breaking-the-buck in our view).

Figure 2. Brokers & Asset Managers Intertwined In Auction Rate Preferred Securities Marketplace



Source: Citi Investment Research Estimates

...with about $40b of Auction Rate Securities issued by funds of the large asset managers... In Figure 3 below, we show our estimates of ARS exposure broken out by asset manager. We estimate that the exposure shown for the ten firms below represents over 70% of the total ARS market from closed-end funds. We estimate that the two biggest players in this market are Nuveen and BlackRock with over $25b of ARS outstanding between them. An important distinction to keep in mind is that the closed-end funds issue ARS, not the asset manager / advisor. We also note that several closed-end fund managers, including Nuveen and Eaton Vance, have already started to redeem ARS shares totaling $3-4b as they refinance their leverage.

Figure 3. $40b of ARS Outstanding Across 250 Closed-end Funds

	# of Funds Using ARS			ARS AUM ($b)		
Firm	Munis	Taxable	Total	Muni	Taxable	Total
Nuveen	87	13	100	11.1	4.3	15.4
BlackRock	61	5	66	8.0	1.8	9.8
Eaton Vance	21	8	29	N/A	N/A	5.0
Morgan Stanley	24	2	26	4.1	0.5	4.6
Calamos	0	5	5	0.0	2.3	2.3
Lehman	4	3	7	0.4	0.4	0.8
AllianceBernstein	3	0	3	0.4	0.0	0.4
Legg Mason	3	4	7	0.3	0.3	0.6
Franklin	0	1	1	0.0	0.1	0.1
Federated	2	0	2	0.1	0.0	0.1
Total	**205**	**41**	**246**	**24.4**	**9.7**	**38.2**

Source: Company Reports & CIR Estimates (as of 3/31/08)

...and we estimate that about $100-150b of Auction Rate Securities are held by clients of full service brokers. Based on Morgan Stanley's disclosure that their clients have about $20b of exposure to auction rate securities (or 2-3% of total client assets), we have estimated exposure at several of the major full service brokerage firms. Furthermore, we estimate that brokerage clients that have exposure to ARS have in excess of $750 billion of total assets.

Revenue / Earnings Impact Appears Limited

We believe the revenue / earnings impact of the ARS marketplace disappearing is relatively limited for brokers... In Figure 4 below, we show the closed end fund underwriting league tables and underwriting revenue estimates of about $600m (source: Dealogic). With the recent disruption in the ARS market, there will likely be fewer new closed-end fund launches in 2008 for strategies that utilize leverage. In our view, the impact from lower issuance will be fairly small relative to their overall revenue at the investment banks. Furthermore, the investment banks may even be able to partially offset some of the lost income as they help the closed-end funds restructure their leverage by issuing other forms of debt and buying back ARS. Additionally, some of the fees associated with managing the auction process could go away over time ($500m to $1b of revenue for the industry).

Figure 4. 2007 Closed-end Underwriting League Table ($m)

Rank	Bookrunner	Deal Value ($m)	Net Rev ($m)
1	Wachovia	15,538	194
2	Merrill Lynch	6,624	116
3	Morgan Stanley	3,315	98
4	Citi	2,825	49
5	UBS	2,263	29
6	CIBC World Markets	961	34
7	RBC Capital Markets	790	17
8	HSBC	476	13
9	LCF Rothschild	402	7
10	National Bank Financial	268	14
11	BMO Capital Markets	187	3
12	Scotia Capital	172	3
13	Wellington West Capital Inc	164	3
14	Credit Suisse	154	3
15	Raymond James	138	3
16	TD Securities Inc	122	7
17	ANZ	108	1
18	ABN AMRO	108	1
19	Dundee Securities Corp	46	2
	Total	32,302	597

Source: Dealogic; Full deal credit allocated to each bookrunner

...and the revenue and earnings impact of the ARS marketplace disappearing is also relatively limited for most asset managers, in our view. In Figure 5 below, we estimate the EPS impact in a worst case and unlikely scenario for asset managers if their funds were to repurchase all of their outstanding ARS and de-lever completely (we assume management fees of 20bps to 86bps and 80% incremental margin). While this scenario is fairly extreme (and unlikely, in our view), it highlights that in general the direct EPS impact for most asset managers will be fairly small. The biggest impact will be a slowing of new closed-end fund issuance which impacts the growth rate for firms that depend heavily on the closed-end fund market. We estimate that 16% of Calamos's AUM & 3% of BlackRock's AUM is in closed-end funds. Additionally, given that none of Calamos's closed-end funds are muni funds (i.e. all taxable), Calamos's worst case EPS impact of 8% is significantly overstated in our view. Calamos funds will be able to refinance the majority of its leverage using debt securities which means the closed-end funds will not need to de-lever.

Figure 5. Assuming 100% De-levering (Worst Case Scenario), The EPS Impact Is Minimal At Most Firms

Firm	ARS Outstanding	EPS Impact	As A % of '07 EPS
Eaton Vance	5.0	$0.12	11%
Nuveen	15.4	N/A	11%
Calamos	2.3	$0.10	8%
Blackrock	9.8	$0.21	3%
Morgan Stanley	4.6	$0.01	0%
Federated	0.1	$0.00	0%
Franklin	0.1	$0.00	0%
Legg Mason	0.6	$0.02	0%
Lehman	0.8	$0.00	0%
AllianceBernstein	0.4	$0.01	0%
Total	39.2		3%

Most firms derive less than 3% of earnings from using leverage in closed-end funds

Source: Company Reports & CIR Estimates (JNC impact vs '07 is shown based on revenue not EPS)

But The Reputational Impact Looms Large

The reputational impact on both the brokers and asset managers could be meaningful the longer it takes to create liquidity in the ARS marketplace... While the EPS impact seems very manageable at both brokers & asset managers, the reputational impact for both industries could be meaningful. In our view, full-service brokerage firm clients who are unhappy with their investments in ARS may react by moving their accounts to another firm. For example, Schwab has a robust advice offering and virtually no ARS impact.

...and how the mess is eventually solved is also important... In our view, brokerage clients not only want to be able to exit their investment as soon as possible, but they also want to exit at par value (i.e. no loss on "cash"). In clients' minds a solution that either restores liquidity to the auction rate process or one in which their ARS securities are called by the closed-end fund at par are both workable. However, any solution that results in a meaningful loss on the part of a client may be viewed poorly by some clients and as a catalyst to move assets away from a firm / broker.

...and, in our view, the real challenge will be what to do with the outstanding ARPS issued by the closed-end muni funds. In our view, ARPS issued by closed-end muni funds presents the biggest challenge. Muni funds can't use traditional forms of debt without losing the tax-exempt status on the interest generated from leverage. One potential solution is to create a new security that has a put feature (i.e. can be put back to the fund at the owners option) which may make this new security eligible for ownership by money market funds. While this would solve the problem there are several hurdles that make this a problematic solution. First, there is a lack of appetite to write put back-stops by investment banks and a lack of appetite for structures within money funds. A potential solution is to have a put structure that becomes active after 12 months of failed auctions (i.e. gives the banks time to clean up balance sheets before having to take on these assets).

Potential Solutions

While the taxable bond related ARS will likely get restructured, in our view, the muni bond related ARPS may take much longer to get restructured.

1. **Closed-end funds issue traditional debt securities to redeem outstanding ARS (high probability for taxable funds / low probability for muni funds).** Closed-end funds have the option to issue new debt securities and use the proceeds from these securities to repurchase outstanding ARS. This has the advantage of allowing the closed-end funds to remain levered which enhances the yield to common shareholders. One potential drawback is that this debt could be issued at a higher cost than the existing ARS, eating into the yield common shareholders earn. Muni closed-end funds on the other hand will likely find this approach more difficult as they would not be able to pass on their tax-exempt status with a debt security. This has the effect of raising the cost of financing significantly and possibly eliminating the benefit from using leverage. This would have a meaningful impact on the yield common shareholders earn and will likely make this option unworkable for most closed-end muni funds.

2. **Closed-end funds issue a new form of preferred securities to redeem outstanding (low to medium probability).** For tax-exempt funds one alternative is to create a new security which includes a put feature allowing the owner to redeem shares at their option for cash. By embedding a put

feature in the security the hope is to make this security eligible for purchase by money market funds while still retaining the ability to pass on the tax-exempt status to the holder of this security. This would allow muni closed-end funds to pay a lower yield on these new products than would be possible with regular debt alone. If asset managers succeed in creating these new products and find new buyers to purchase them, they should be able to use the proceeds from these securities to repurchase outstanding ARPS without impacting the yield to common shareholders significantly. Having said that, we believe that there are significant hurdles to 1) getting banks to provide a liquidity backstop, 2) to getting the required regulatory approvals to sell this product to money funds, 3) finding money funds that are willing to purchase a new type of product. In our view, the probability of this working is higher if the put feature is pushed out 12 months giving I-banks time to clean up their balance sheet before having to deal with these securities.

3. **Closed-end funds redeem outstanding ARS without re-levering (low probability).** An alternative option is for closed-end funds to sell securities and use the proceeds from these sales to redeem outstanding ARS securities. This essentially de-levers the closed-end fund. In our view, this would be very damaging to the common shareholder as it removes the benefit of leverage and is an unlikely option. Additionally, each fund's board of directors has a fiduciary duty to common shareholders which makes this option that much more unlikely.

4. **Closed-end funds can negotiate higher penalty rates to restore liquidity (low probability).** Another option is for the closed-end funds to raise their penalty rates on the preferred shares. Higher penalty rates will eventually attract more buyers to the market and reestablish liquidity to preferred shareholders. The drawback of this option is that the higher yield paid to preferred shareholders will eat into the yield paid to common shareholders. Again, given that each fund's board of directors has a fiduciary duty to protect the interest of common shareholders, we think this option is also unlikely, at least in the near-term.

5. **Development of a secondary market for ARS (medium probability with likely potential client fallout).** Brokers could opt to set up a secondary market for ARS to allow some clients to sell their shares. The issue with this option is these securities are unlikely to sell at par in the secondary market so a sale in the secondary market would in effect crystallize a loss for clients. While this may be an option for some clients who need liquidity immediately and are unwilling to take a loan out. With some brokers already marking down these securities on client statements this may be around the corner.

6. **Brokers take ARS on balance sheet (low probability).** Brokers could opt to purchase ARS out of client accounts and take them on their balance sheet. While this would solve the client's desire to exit the product and allow closed-end funds to maintain the benefit of leverage for common shareholder, it could put additional liquidity strains on broker balance sheets. Additionally, by taking these assets on balance sheet most brokers would be required to mark these assets to market which would negatively impact earnings for their shareholders. In our view, most brokers are unlikely to take these products on balance sheet which is why the auctions started failing to start with.

7. **Some combination of all of the above (high probability).** In our view, the existing problem will eventually be solved by some combination of all of the above. There are many market participants with angry customers or unhappy investors that have a vested interest in arriving at a solution, so we expect a continued effort by these firms to work towards a resolution.

BlackRock, Inc.

Investment strategy

We rate the shares of BlackRock (BLK.N; US$202.85; 1M) Buy / Medium Risk (1M). We see long-term opportunity coupled with near-term momentum that should drive strong earnings growth and a higher stock price at BlackRock. Our view is driven by our analysis that shows roughly 80% of the $1.36 trillion asset base is well-positioned for near-term organic growth. Additionally, BlackRock has several multi-billion dollar AUM growth opportunities including expanding European & US retail asset growth (which alone could add up to 10% incremental EPS growth), cross-selling to existing institutional clients, and broadening the firm's global platform, none of which are fully reflected in our current EPS estimates. Furthermore, we estimate that continued growth in alternatives and European retail equities (some of the fastest growing areas in the firm), could drive revenue yield expansion of up to 5bps over the next 3 years providing about 10% more upside to our out-year estimates. Finally, we believe the acquisition of the Merrill Lynch Investment Management business (MLIM), transforms the new BlackRock from an entity that was relatively insulated from the global economy (since it was largely fixed income oriented) to a franchise that can capitalize on global growth. Key to capitalizing on these opportunities is the fact that management is focused on going forward as one firm, with one platform and one culture, which in our view is critical to maximizing the earnings potential of having a global asset management franchise—a unique and differentiating factor compared to other large asset management firms.

Valuation

We rate the shares of BLK Buy/Medium Risk (1M) with a target price of $240. We derive our target price using a discounted cash flow-based model to derive our target price. Our model uses net income adjusted for non-cash items including amortization expense and LTIP funding and then takes into account net debt on the balance sheet. Our model assumes a cost of equity of 10% using a risk-free rate of 5.0%, a 2-year beta of 1.2 (source: Bloomberg), and an equity market premium of 4.0%. Every 1% higher/lower in the equity risk premium has a roughly 20% impact on our target price. We use a 2-year Beta to appropriately reflect the most recent growth rates of BLK (pre-merger) as well as the stock price movement post announcement of merger. In our view, using a 1-year Beta would inappropriately reflect significant stock price fluctuations related to the merger speculation and announcement. We assume that over the long-term, capital expenditures are roughly equal to depreciation. Our DCF model assumes that about 59% of the firm's present value is derived from its terminal value. We assume a terminal growth rate of 4.0% (consistent within our coverage universe) reflecting our view that the terminal growth rate should be roughly in line with long-term global GDP growth. We estimate that every 25bps (up or down) in the terminal growth rate has a 2-3% impact on valuation. Using these assumptions, our DCF-based valuation model derives a target price of $240.

Risks

We rate BLK shares Medium Risk because a majority of its revenue is derived from recurring management fees (calculated as a % of AUM), and the firm's revenues are diversified across products and geography, with various distribution channels and seller relationships.

Key risks related to BlackRock reaching our target price are primarily related to the macro environment, including the strength of the economy and the capital markets operating environment, and overall levels of market engagement by retail and institutional investors. Industry-specific risks include a prolonged equity or fixed income downturn, regulatory & legislation issues, downward fee pressure, increasing distribution expense, and competition from industry participants.

Company-specific risks include poor investment performance which could lead to negative asset flows, a decline in AUM, and lower performance fees. The loss of key employees could lead to a loss of assets and/or declining performance. BlackRock is currently in the process of integrating MLIM and risks include not realizing expected synergies, client & asset attrition, and greater than expected integration costs. Losing access to key distribution channels could negatively impact the firm's ability to gather new assets. Due to their global platform, the firm is exposed to foreign currency fluctuations impacting revenues. Finally, together MER & PNC own about 84% of BlackRock's fully diluted shares outstanding and any sale of these shares may result in sharp declines in the stock or an overhang that depresses the valuation.

Federated Investors, Inc

Investment strategy

We rate Federated Investors (FII.N; US$33.09; 2M) Hold/Medium Risk (2M). We are big believers that the secular growth trend in money market assets will resume as short-term rates rebound from 40-year lows. Furthermore, we believe that Federated is the best positioned asset manager in our universe to capitalize on this trend. Its advantages include size, scale, and long-standing relationships with select customers. However, despite being quite bullish on the outlook for money market funds we are currently recommending investors stay on the sidelines for several reasons including: 1) our view that the market seems to have already factored in earnings upside from higher money market inflows, 2) its equity mutual funds have deteriorating performance relative to peers and may continue to suffer net outflows, 3) a 18-quarter trend of fixed income fund outflows will likely continue for the next several quarters, and 4) limited expense flexibility driven by increasing money market flows, increased workloads due to recent acquisitions, and rebuilding its equity investment process. We would likely be more constructive on FII at a valuation that we believe reflected the fundamentals.

Valuation

We assign the shares of FII a target price of $44. We use a discounted cash flow based model to derive our target price. We use net income as a proxy for cash flow. Our model assumes a cost of capital of 10%. Our cost of capital is about 100bps higher than the 9% cost of capital derived by CAPM formula