

## BLACKROCK (BLK) Memo

Date:	09/24/08	12/02/08		Company:	Blackrock
Price:	\$196.91	\$113.36		Analyst:	Cecil Ang
<b>12/02/08</b>	<b>Price</b>	<b>52 Week Range</b>	<b>Market Cap</b>		
	\$113.36	\$94.78 - \$249.37	\$14,713		
					<b>2004</b>
					<b>2005</b>
					<b>2006</b>
					<b>2007</b>
					<b>2008E</b>
					<b>2009E</b>
					<b>2010E</b>
				Revenue	634
					1018
					1841
					4360
					6414
					4248
					5832
				Growth	60.7%
					80.8%
					136.8%
					47.1%
					-33.8%
					37.3%
Equity Value		\$15,583	EBITDA		201
					383
					596
					2061
					1877
					1729
					2892
Net Debt		\$647	Margin		31.8%
					37.6%
					32.4%
					47.3%
					29.3%
					40.7%
					49.6%
TEV		\$16,229	FCF		118
					82
					535
					1328
					1197
					1176
					1968
Short Interest		3.45%	Growth		-30.3%
					549.6%
					106.4%
					-9.8%
					24.8%
					64.4%
As % of Float			Multiple		NM
					NM
					26.0x
					18.3x
					19.2x
					18.4x
					15.4x

### Investment Thesis:

I believe that Blackrock Inc. is a long because of its **best in class proprietary risk management system, a strong and motivated management team and a valuation that vastly underestimates the company's earnings and growth potential.** I think of Blackrock as the leading risk management and portfolio valuation service provider and the benchmark against which various risk management standards are set. Overall, **Blackrock has a presence in all major markets and is well positioned to grow as major corporations around the world grapple with the aftermath of the credit crisis.**

### Misperception:

- Blackrock is **currently undervalued due to concerns about the composition and growth of its AUM.** For 9mo' 08, base management fees from equity, cash management, fixed income and alternative assets segments contributed 44%, 13%, 17% and 10% respectively (Fig 9). Therefore, it is no surprise that the market reacted adversely when asset depreciation in Blackrock's equity portfolio and net redemption from cash management funds caused its **total AUM to decline by 12% QoQ in 3Q08.** However, its **core fixed income and alternative assets portfolios remain relatively unscathed since their AUMs declined by just 5 and 6% respectively.**
- Despite falling AUMs, Blackrock has two hidden growth platforms that are forgotten by the market. The first is Blackrock's crown jewel - Blackrock Solutions. **This risk advisory arm is at the heart of the financial crisis (Fig 10) and has been growing at a break neck rate of over 200% annually since 2004 to contribute 7% to 9mo' 08's total revenue** despite recent market upheavals. The growth in revenue was so robust that its contribution more than offset declines in other fee revenues, resulting in **an overall revenue growth of 1% QoQ in 3Q08.** The second platform is Blackrock's growing presence in Asia Pacific. From 2006 through to 9mo' 08, revenue from this segment has grown at an annual rate of over 200% (Fig 11) and looks set to continue as Asian clients warm to Blackrock for its growing reputation as a problem fixer.

### Most Compelling VAR point:

**Blackrock's risk management business (Blackrock Solutions) has high barriers to entry and high switching costs for customers.** According to Terrence Keely, a managing director at UBS, *"I think of it [Blackrock] like Ghostbusters: When you have a problem, who you gonna call? Blackrock!"* According to customers, Blackrock Solutions' service model differentiates itself by providing consistent, well-linked analysis for both internal portfolio management teams and institutional clients, emphasizing straight-through trade to risk management processing and preservation of user-defined functions. In the deal between Morgan Stanley and Mitsubishi UFJ, Blackrock's analysis of the risk on Morgan Stanley's book helped keep the deal from falling apart. "It gave us added credibility," says an executive at Morgan Stanley.

### Key Thesis Points

- Unprecedented Growth in Adversity: The financial crisis opens up unprecedented opportunities for Blackrock. **Candice Ong from Barclays mentioned that almost all major banks and mutual funds around the world have engaged Blackrock for valuation projects.** Blackrock now counts among its clients most bulge bracket investment banks such as JP Morgan, Bank of America, Citigroup, Barclays, UBS and Morgan Stanley and mutual fund clients such as Vanguard. Because of its rise to eminence, **Blackrock's bargaining power over customers has increased significantly.** With a strong pipeline of engagements, Blackrock has the liberty to select its clients based on how comfortable it feels about the working relationship while commanding high premiums for its differentiated service. Consequently, **total revenue rose 18% YoY to \$4bn from \$3.4bn for 9mo' 08 and operating margin increased to 38% from 36.9%.**
- Strong Leadership: Laurence Fink and his team of founders are the architects of Blackrock's proprietary risk management technology and systems. **The vision behind Blackrock was to leverage technology and human capital to efficiently evaluate massive amount of fixed income assets overnight.** Under CEO Fink's guidance, Blackrock's business model has grown from strength to strength while its core focus of valuing investment risks remained unchanged. **The firm's main differentiating factor is arguably its ability to value \$30bn of Bear Stearns assets overnight for the Fed.**

## BLACKROCK (BLK) Memo

- High Growth Potential in Asia Pacific: Asia Pacific's revenue contribution has been historically low at around 3%. However, riding on its connection with the Fed, Blackrock was able to **grow this relatively small segment at an annualized rate of over 200% from 2006 to 9mo' 08**. As a result, Asia Pacific's revenue contribution was 4.8% of total revenue or \$192mn for 9mo' 08. Blackrock's success in Asia Pacific can be attributed to its **ability to approach conservative Asian institutional investors from a less intrusive angle so that they feel more comfortable working with Blackrock risk analysts**. According to Trista Cheung from Blackrock Singapore, the company knows that value for money is a top criterion for most Asian clients when hiring service providers and subsequently **scaled back on its premium pricing and service offerings to gradually build long-term relationships with these customers**. VAR contacts mentioned that Blackrock earned high marks from customers and word of mouth advertisement has increased the firm's engagements in the region.

### Valuation:

- **Valuation is very compelling with BLK currently trading at 16x 08E earnings. A DCF analysis reveals that a base case scenario (short recession with S&P 500 rebounding within two years) will value Blackrock at \$176.5, or a 55.7% premium over current price (Fig 13).**
- However, my projection suggests that Blackrock's stock price might slide further in 2009 due to an inevitable decline in AUM that is not offset by revenue growth from Blackrock Solutions. Should the base case scenario come true, Blackrock can trade as low as \$98.9 at 16x 09E earnings. **However, stronger AUM and Blackrock Solutions pipeline growth in 2010 will result in a quick rebound in Blackrock's stock price to \$167.4 per share at 16x 10E earnings which is very close to its intrinsic value implied by the DCF model. This price represents a premium of more than 70% over 2009's estimated price of \$98.9.** Therefore, I would recommend modest buying now before picking up more shares in 2009 in view of a quick valuation rebound in 2010.

### How it Plays Out:

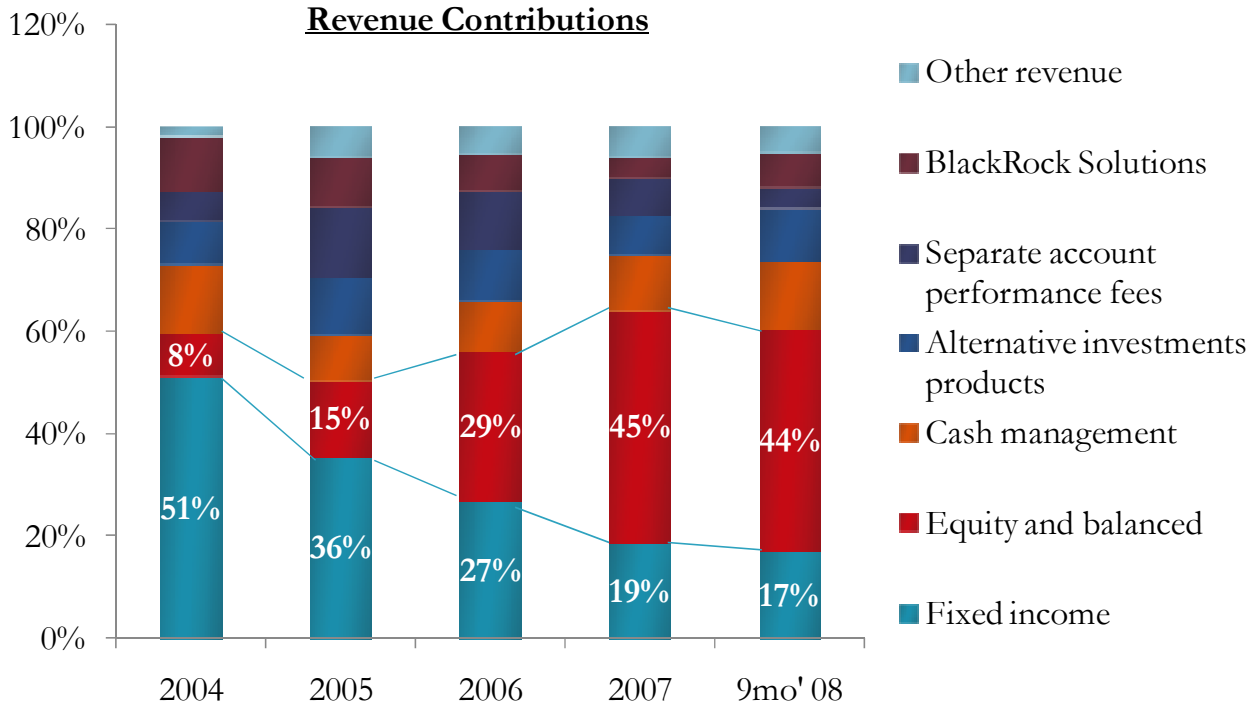
The global economic slowdown is likely to put pressure on Blackrock's AUM growth over the next 1-2yrs. **But Blackrock's two hidden growth platforms will provide the necessary cushions in bad times and add to the company's growth when the market recovers.** Blackrock Solutions, with its high service premium and strong reputation within the financial industry, will continue to benefit from the financial crisis. In the aftermath, this risk advisory arm will continue to generate revenue growth because **customers' valuation models are intricately tied to Blackrock Solution's platforms and switching to a competitor will be prohibitively costly.** Internationally, Blackrock is able to **gain sales momentum because of its strong reputation as the "default" problem fixer well after the financial crisis is over.**

### What Would Make us Wrong (i.e. risks)? Other Considerations?

- Unstable Funding Sources: Based on my work, **Blackrock might face substantial short term funding issues.** As witnessed in 3Q08, "fast money" can pull out of Blackrock's funds overnight, regardless of performance, as a broad and deep market correction takes place. **A worst case scenario of a prolonged global recession can reduce Blackrock's AUM further and lower its share price to \$70 in 2009 and \$90 in 2010.** However, growing revenue contributions from Blackrock Solutions and Asia Pacific will help cushion any decline in performance and anchor Blackrock's growth when the market rebounds.

Figure 9

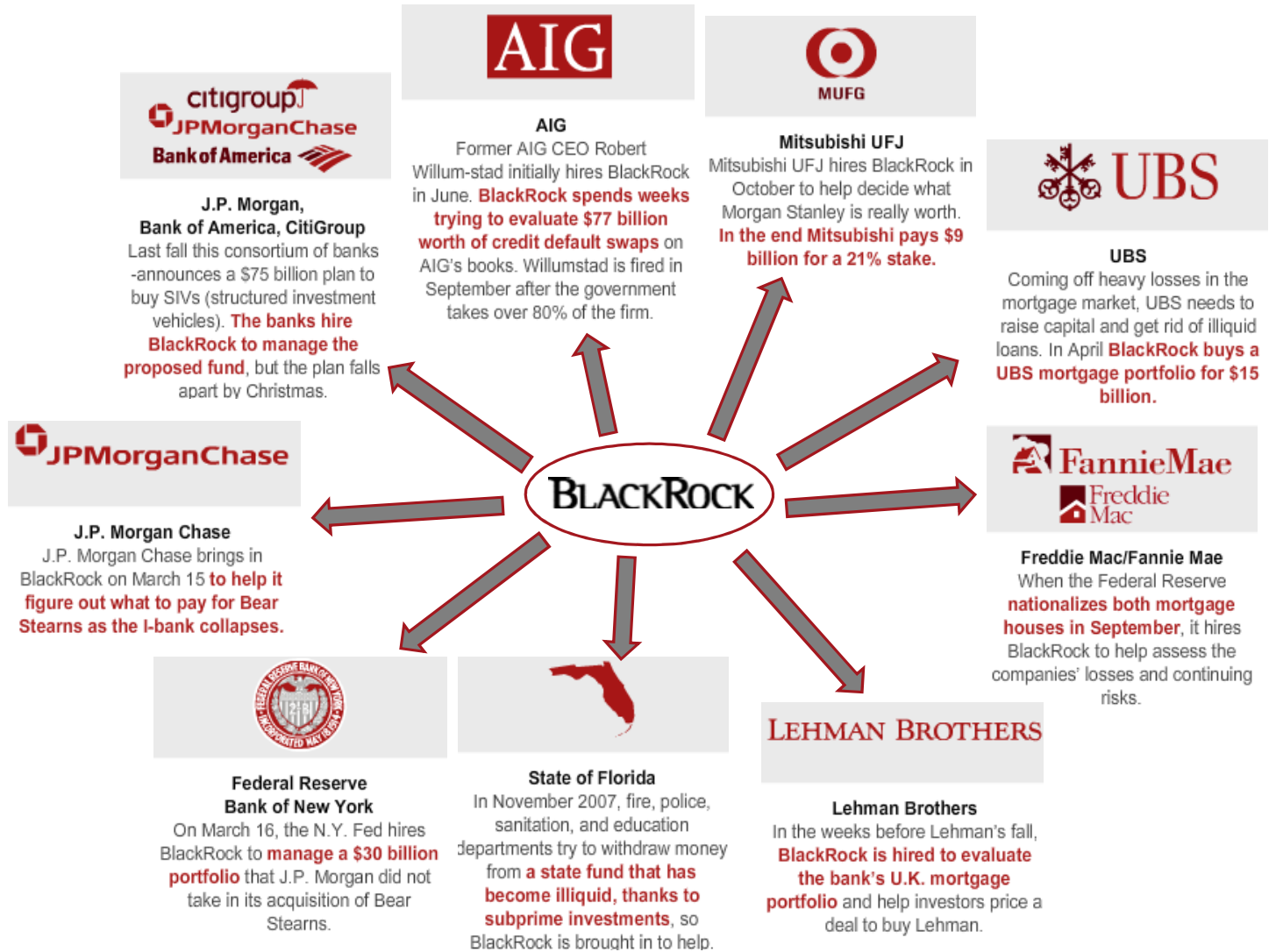
# Equity replaced Fixed Income as Blackrock's core portfolio



Source: Blackrock SEC 10K, 10Q

Figure 10

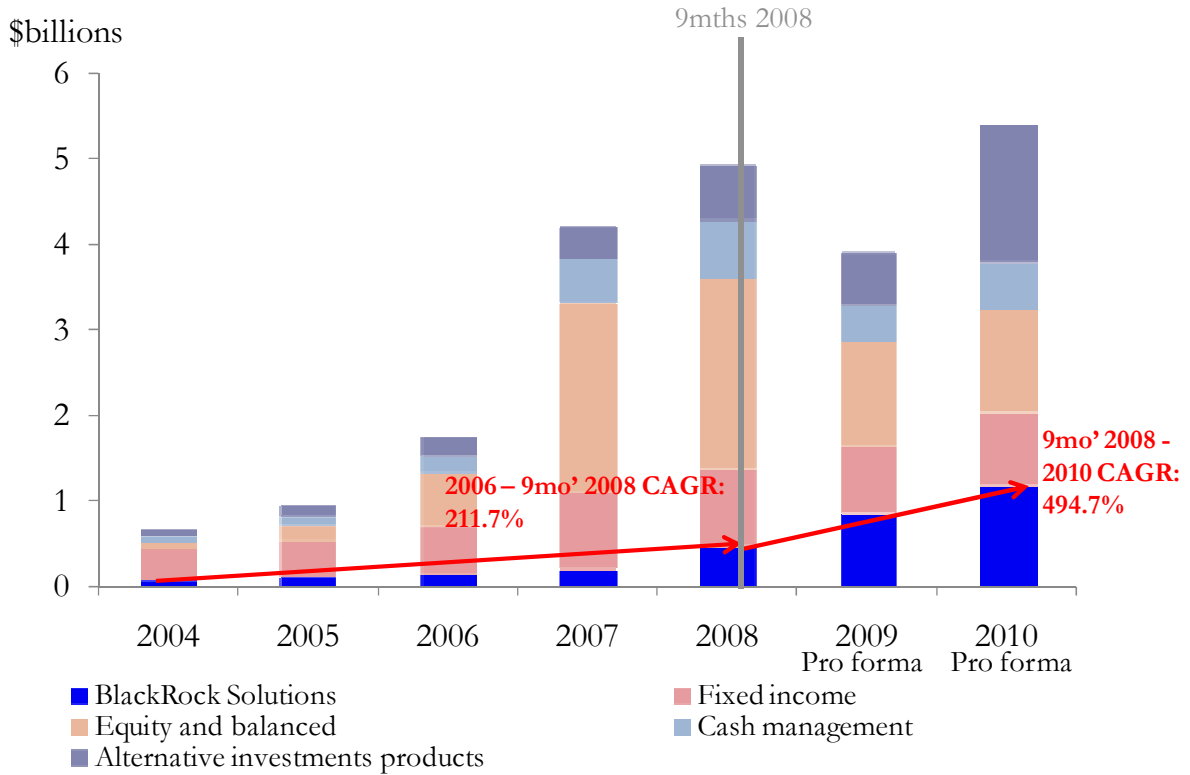
# Blackrock is at the center of the financial crisis



Source: Fortune

Figure 11

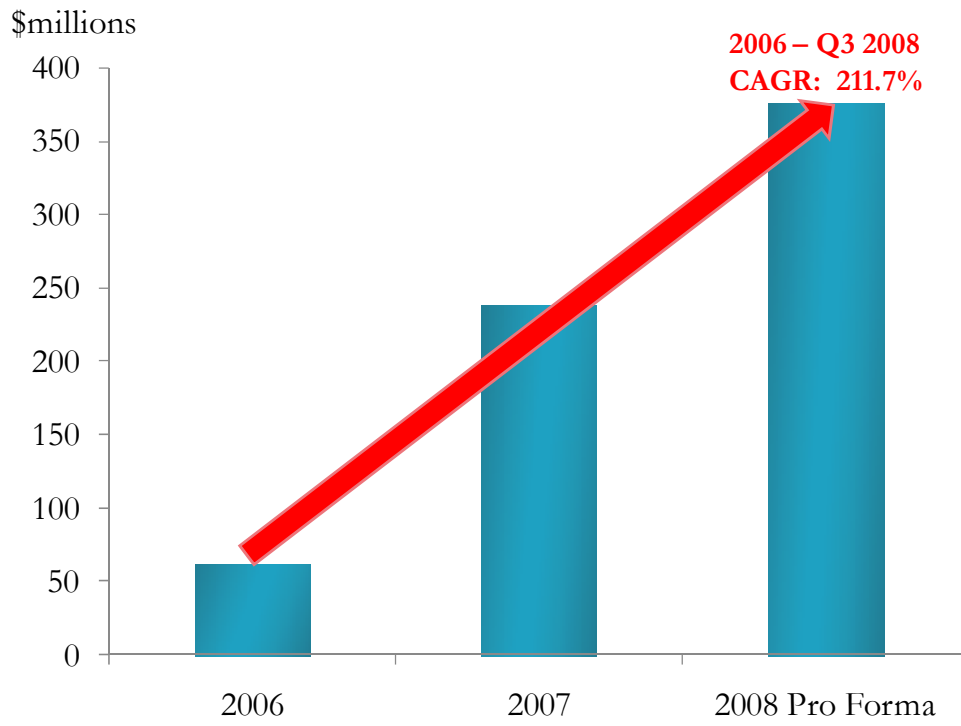
Blackrock Solutions' contribution to revenue will grow during financial crisis



Source: Blackrock SEC 10K, 10Q

Figure 12

## Asia Pacific Sales is taking off



Source: Blackrock SEC 10K, 10Q

## BLACKROCK (BLK) Memo

**Figure 13**

BlackRock's stock price should be more than 40% higher than current price

Key Driver : S&P 500

Base Case:				
Short Recession, AUM Growth				
FY 2008 =	-40%			
FY 2009 =	-20%			
FY 2010 =	5%			
<i>\$ millions</i>	FY 2008	FY 2009	FY 2010	
Revenue	6	4	6	
EBIT	2	2	3	
Net Income	876	828	1,402	
EPS	6.75	6.38	10.80	
Diluted EPS	6.54	6.18	10.46	
<b>P/E Multiples Analysis:</b>				
FY Consensus (Blmberg):	19.16	18.39	15.41	
Implied Price	125.3	113.7	161.3	
<b>Price Per Share @</b>				
12 x	78.4	74.2	125.6	
14 x	91.5	86.5	146.5	
16 x	104.6	98.9	167.4	
18 x	117.7	111.2	188.3	
20 x	130.7	123.6	209.3	

Best Case				
Quick rebound, AUM Growth				
FY 2008 =	-40%			
FY 2009 =	-10%			
FY 2010 =	10%			
<i>\$ millions</i>	FY 2008	FY 2009	FY 2010	
Revenue	6,414	4,298	5,898	
EBIT	1,735	1,671	2,819	
Net Income	876	843	1,423	
EPS	6.75	6.50	10.96	
Diluted EPS	6.54	6.29	10.62	
<b>P/E Multiples Analysis:</b>				
FY Consensus (Blmberg):	19.16	18.39	15.41	
Implied Price	<b>125.3</b>	<b>115.7</b>	<b>163.7</b>	
<b>Price Per Share @</b>				
12 x	78.4	75.5	127.4	
14 x	91.5	88.1	148.7	
16 x	104.6	100.7	169.9	
18 x	117.7	113.3	191.1	
20 x	130.7	125.9	212.4	

Worst Case:				
Prolonged Recession, AUM Growth				
FY 2008 =	-40%			
FY 2009 =	-50%			
FY 2010 =	-30%			
<i>\$ millions</i>	FY 2008	FY 2009	FY 2010	
Revenue	6,414	4,074	4,229	
EBIT	1,735	1,542	1,961	
Net Income	876	779	990	
EPS	6.75	6.00	7.63	
Diluted EPS	6.54	5.81	7.39	
<b>P/E Multiples Analysis:</b>				
FY Consensus (Blmberg):	19.16	18.39	15.41	
Implied Price	<b>125.3</b>	<b>106.8</b>	<b>113.9</b>	
<b>Price Per Share @</b>				
12 x	78.4	69.7	88.6	
14 x	91.5	81.3	103.4	
16 x	104.6	93.0	118.2	
18 x	117.7	104.6	133.0	
20 x	130.7	116.2	147.7	

**DCF Sensitivity Analysis**

Base Case			
WACC	Terminal Growth Rate		
	2%	3%	4%
10%	\$186.7	\$205.9	\$231.5
11%	\$167.7	\$182.1	\$200.5
12%	\$152.8	\$163.8	\$177.6

Best Case			
WACC	Terminal Growth Rate		
	2%	3%	4%
10%	\$190.0	\$209.7	\$236.0
11%	\$170.5	\$185.3	\$204.2
12%	\$155.2	\$166.6	\$180.8

Worst Case			
WACC	Terminal Growth Rate		
	2%	3%	4%
10%	\$94.9	\$103.1	\$114.1
11%	\$86.7	\$92.9	\$100.8
12%	\$80.3	\$85.1	\$91.0

Weighted Average Cost of Capital (Beta = 1, rf = 3.	11.28%
Terminal Growth of Unlevered FCF	3.00%

NPV of Unlevered Free Cash Flow	7,671.8
Terminal Year Unlevered FCF	26,870.3
NPV of Terminal Free Cash Flow	15,331.4
Enterprise Value	23,003.2
Less: Debt	(1,146.7)
Add: Cash	1,793.3
Equity Value	<b>23,649.8</b>
Diluted Shares (millions)	134

Equity Value Per Share	<b>\$176.5</b>
Premium over current price	55.7%

**Key Assumptions:**

- Returns on S&P500 negatively affects AUM growth and positively affects BlackRock Solutions' revenue growth
- Headcount reduction will cut compensation and benefits' growth by 15% per year from 2008-2010
- SGA expenses will be cut by 15% per year by reducing external consulting headcounts that advise on the integration of Merrill Lynch Investment Managers and Quellos
- Terminal Growth rate equals US's long run GDP growth rate

## BLACKROCK (BLK) Memo

High growth, high margin business delivers great value

Discounted Cash Flow Analysis	2004	2005	2006	2007	9mo' 08	2008	2009	2010	2011	2012	2013
<i>\$ amount in millions, except unit data</i>											
Total AUM	341,760	452,682	1,124,627	1,356,644	1,258,598	1,059,669	873,483	1,252,930	1,543,865	1,746,268	1,798,656
% Growth		32.5%	148.4%	20.6%		-21.9%	-17.6%	43.4%	23.2%	13.1%	3.0%
Total Revenue	634	1,018	1,841	4,360	4,000	6,414	4,248	5,832	5,347	6,047	6,229
% AUM	0.2%	0.2%	0.2%	0.3%	0.3%	0.6%	0.5%	0.5%	0.3%	0.3%	0.3%
EBIT	200	376	528	1,823	1,093	1,735	1,640	2,777	2,546	2,880	2,966
Margin	31.6%	36.9%	28.7%	41.8%	27.3%	27.0%	38.6%	47.6%	47.6%	47.6%	47.6%
Tax expense	52	139	189	464		539	510	863	692	783	806
Tax Rate	26.1%	36.9%	35.9%	25.4%	0.0%	31.1%	31.1%	31.1%	27.2%	27.2%	27.2%
D&A	1	8	67	238	21	142	89	115	115	131	89
% AUM	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
EBITDA	201	383	596	2,061	1,113	1,877	1,729	2,892	2,662	3,011	3,055
Margin	31.8%	37.6%	32.4%	47.3%	27.8%	29.3%	40.7%	49.6%	49.8%	49.8%	49.0%
Capex	(26)	(55)	(84)	111	(72)	(52)	(43)	(62)	(76)	(86)	(89)
% AUM	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Working Capital	(5)	(107)	213	(380)	(99)	(89)	-	-	-	-	-
% AUM	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Unlevered FCF</b>	<b>118</b>	<b>82</b>	<b>535</b>	<b>1,328</b>	<b>943</b>	<b>1,197</b>	<b>1,176</b>	<b>1,968</b>	<b>1,893</b>	<b>2,142</b>	<b>2,160</b>
% Growth		-30.3%	549.6%	148.0%		-9.8%	24.8%	64.4%	61.0%	8.9%	14.1%
<b>NPV of FCF</b>						<b>1,165</b>	<b>1,029</b>	<b>1,547</b>	<b>1,338</b>	<b>1,360</b>	<b>1,232</b>

Weighted Average Cost of Capital (Beta = 1, rf = 3.53%)	11.28%
Terminal Growth of Unlevered FCF	3.00%

NPV of Unlevered Free Cash Flow	7,671.8
Terminal Year Unlevered FCF	26,870.3
NPV of Terminal Free Cash Flow	15,331.4
Enterprise Value	23,003.2
Less: Debt	(1,146.7)
Add: Cash	1,793.3
<b>Equity Value</b>	<b>23,649.8</b>
Diluted Shares (millions)	134

**Equity Value Per Share** **\$176.47**

WACC	Terminal Value (PV)		
	Terminal Growth Rate		
	2%	3%	4%
10%	16,698	19,271	22,701
11%	14,154	16,079	18,555
12%	12,153	13,635	15,489

WACC	Stock Price		
	Terminal Growth Rate		
	2%	3%	4%
10%	\$188.58	\$207.78	\$233.37
11%	\$168.10	\$182.46	\$200.94
12%	\$151.72	\$162.79	\$176.62

WACC	Enterprise Value		
	Terminal Growth Rate		
	2%	3%	4%
10%	24,626	27,198	30,628
11%	21,881	23,806	26,281
12%	19,686	21,169	23,022



## BLK and BX VAR Contacts

VAR Contacts	Capacity	Email	Angle
<b><u>BLACKROCK</u></b>			
<b>Insiders:</b>			
Trista Cheung	Blackrock Solutions Asia Associate	trista.cheung@Blackrock.com	Blackrock Solutions' Asia Pacific operations and opportunities
Jason Bennett	Blackrock Solutions Analyst	jason.bennett@Blackrock.com	Blackrock's corporate strategy, competitive advantage, internal culture, and product quality
Eric Stern	Blackrock Solutions VP	eric.stern@Blackrock.com	Blackrock's internal culture and product quality
<b>Customers:</b>			
Ross Cuddeback	Vice President, Deutsche Bank Credit Risk Management / Asset Management Risk Platform	ross.cuddeback@db.com	List of criteria for good risk management systems
Matt Vincent	Freddie Mac Enterprise Risk Manager	matt_vincent@freddiemac.com	Blackrock Solutions' user friendliness
Ben Pollack	Freddie Mac Enterprise Risk Analyst	BRP4H@comm.virginia.edu	Blackrock Solutions' user friendliness
Candice Ong	Convertible Bond Origination Analyst, Barclays Capital	youscandice@gmail.com	Subscription of Blackrock's valuation service by major banks
<b>Related Fields:</b>			
Dmitri Alder	Ex Blackrock PAG Intern	da8s@virginia.edu	Blackrock's internal culture and product quality
Mark Plant	Senior IMF Official	markwplant@gmail.com	Partnership with Fed and new risk management and valuation standards
Prof Whitfield Broome	Accounting Professor	OWB@virgnia.edu	Fees Revenue Accounting