

# [Financial statement analysis for bank of america merrill lynch](https://assignbuster.com/financial-statement-analysis-for-bank-of-america-merrill-lynch/)

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Objective This objective of this report is to analyse and evaluate the financial data of Merrill Lynch through 2006, 2007 and 2008. It also looks at the developments in the financial markets during these years and its impact on Merrill Lynch, a what-if analysis of the possible financial performance that might have existed had the economic downturn not occurred and in the end summary and conclusions based on the findings. Introduction to Merrill Lynch Merrill Lynch is one of the world’s premier providers of wealth management, securities trading and sales, corporate finance and investment banking services.

With over 15, 000 financial advisors and $2. 2 trillion in client assets it is the world’s largest brokerage. Formerly known as Merrill Lynch ; Co. , Inc. , prior to 2009 the firm was publicly owned and traded on the New York Stock Exchange under the ticker symbol MER.

Merrill agreed to a purchase by Bank of America on September 14, 2008, at the height of the 2008 Financial Crisis. It ceased to exist as a separate entity in January 2009. The company was founded on January 6, 1914, when Charles E. Merrill opened his Charles E. Merrill ; Co.

for business at 7 Wall Street in New York City. A few months later, Merrill’s friend, Edmund C. Lynch, joined him, and in 1915 the name was officially changed to Merrill, Lynch ; Co In the succeeding years, Merrill Lynch became one of America’s top firms in terms of securities and investment profits as well as brokerage network strength. By 1971, the company went public. We begin by taking a look at the company’s performance for 2006, 2007 and 2008. Performance in 2006 The financial statements, annual report, CEO’s statement and CFO’s report all indicate a very strong performance by the company for the year 2006.

In fact the last quarter of 2006 and the entire year of 2006 were reported to be the strongest quarter and year for Merrill Lynch ever with record revenues and earnings. Some of the highlights of the company’s consolidated financial statement for the year 2006 are as follows: \* Total Net revenues for the year 2006 were $34. 7 billion as against $26 billion in 2005 which indicates an increase of 33%. \* Net earnings were $7. 5 billion against $5 billion in 2005 and $4.

4 billion in 2004 marking an increase of 47% and 69% respectively. \* Earnings per diluted share were $7. 59. Earnings before Income Taxes rose from $7. 2 billion to $10. 4 billion, a rise of 44.

4% \* Pre-tax profit margin rose to 30. 1% \* Return on Equity is defined as the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation’s profitability by revealing how much profit a company generates with the money shareholders have invested. For Merrill Lynch this value increased to 21. 3% for the year 2006. (Its calculated as Net Income/Shareholder’s Equity) \* Book value per common share increased to $41.

35. \* 2006 dividends on common stock increased by 32% from 0. 6 to $1. 00 per share. Performance in 2007 As per the Balance sheet of the company on Dec 26 2007, the total assets had gone up from $841. 3 billion in 2006 to $1020.

05 billion in 2007. The important point to note however is that $70. 7 billion worth of doubtful account is has been accounted for as ‘ Other Receivables’ by the company. Doubtful accounts are receivables that may go uncollected. Thus, even though the Balance sheet shows a rise in the company’s Total Assets from 2006, it did not exactly mean that the company had had better performance as compared to the previous year. Net revenue was down to $11.

25 billion, a huge drop of 66. 7% from the previous year. Dividends on common share increased from $1. 00 per share to $1. 40 per share and although this may seemingly look like a good thing, there are many ways in which this figure can be manipulated to show a better picture than the one that actually exists. It’s a well-known fact that the stock markets were going crazy during that time and hence companies were resorting to such methods to gain investor confidence and to prove to the market that they have a good amount of cash flow to stay put in the market.

Dividend per share (DPS) is the total dividends paid out over an entire year (including interim dividends but not including special dividends) divided by the number of outstanding ordinary shares issued. As per a Reuter’s article in April 2007, Merrill Lynch had announced that it would buy back as much as $6 billion of its common stock over time, as it looked to return capital building up on its balance sheet to investors. This meant less shares outstanding or in other words lower denominator in the calculation of Dividends per share thus increasing the overall value of the raction which meant a higher amount in Dividends per share. The company suffered the worst performance in its history as per the annual report of 2007. They reported a net loss from continuing operations for the full year of $8.

6 billion, or $10. 73 per fully diluted share, following write-downs resulting from their exposures to the U. S. mortgage market in U. S. ABS (Asset Backed Securities) CDOs (Collateralized Debt Obligations) and sub-prime residential mortgages and securities.

Out of the reported losses, $7. 9 billion were solely those resulting from Collateralized Debt Obligations. Performance in 2008 The balance sheet of Merrill Lynch for Dec 2008 shows the Interest income under Mortgage backed securities and Asset backed securities as $ 107. 8 billion. The net earnings before taxes show a loss of $633.

03 billion and the final net loss from continued operations after taxes was $387. 6244 billion. This was the worst year in the history of Merrill Lynch. Mounting losses and the difficult market situation had pushed it to the brink of a collapse. Its actual losses were turning out to be significantly more than what had been anticipated earlier in the year. Its own losses combined with the Wall Street crisis had made its stock price plummet to a closing price of $17.

05 on Sept 12th 2008 at which point the company’s existence appeared to be in danger. Developments in the financial markets during the years 2006, 2007 and 2008 The global recession of the late 2000s was a mix of economic and legal factors which brought about turmoil in the investment banking industry. The entire world’s economy was hit by a severe global recession in the late 2000s which came to be called as The Great Recession. This financial crisis is linked to the irresponsible and risky lending practices by the financial institutions. The US mortgage backed securities which had risks that were hard to assess were marketed around the world. What exactly was the credit crisis? It was a world-wide financial debacle involving sub-prime mortgages, Collateralized Debt Obligations (CDOs), Frozen Credit Markets and Credit Default Swaps.

Everyone was affected by this crisis. Here’s how it began; The credit crisis brought two groups of people together; Home-owners and investors. Home owners represented their mortgages and investors represented their money. These mortgages represented houses and this money represented large institutions like Pension funds, Insurance companies, Sovereign funds, Mutual funds etc. These groups were brought together through the financial systems which are nothing but investment banks usually referred to as the “ Wall Street”. Due to a very low interest rate on borrowing money from the Federal Bureau and an abundance of cheap credit, borrowing money was made very easy for banks causing them to go crazy with leverage.

Banks were thus making a lot of money and growing tremendously rich. The investors saw this and wanted a piece of the action. This gave the banks an idea to connect the investors to the home owners through mortgages. When a family wanted to buy a house, they got in touch with a mortgage broker who in turn connected them to a lender who gave them a mortgage. The family bought the house and became home owners. This was a good deal for everyone because housing prices are rising constantly.

The investment banker would then call the lender and offer to buy the mortgage. The lender would sell this mortgage to the investment banker for a fee. The investment banker would then borrow millions of dollars, buys thousands of mortgages and package them into a neat little security. This means that every month he would get the payments of all the mortgages in this security. The investment banker would then do his work on this security and in simple words, cut it into three slices; Safe, Okay and Risky. These slices were then packed into one security and called as Collateralized Debt Obligation or CDO.

To compensate for the higher risk, the Risky slice received higher return, the Okay slice received slightly less return than the risky slice and the Safe slice received the lowest yet sufficiently good returns. To make the Safe slice even safer, banks would offer to insure it for a small fee called Credit Default Swap. The banks do all of this work so the credit rating agency would rank the Safe slice as “ AAA” rated investment which is the safest possible rating for any investment. The Okay slice is “ BBB” which was still pretty good and the Risky slice remained unrated. The investment bankers could now sell the Safe slice to those investors who only wanted safe investment.

The Okay slice was sold to other bankers and the Risky slice was sold to Hedge funds and other risk takers. The investment banker would thus make millions. He would then repay his loans and the investors had found good investment for their money. They were so pleased they wanted more CDOs so the investment banker calls the mortgage lender who then calls the broker but the broker couldn’t find anyone as everyone who qualified for mortgage already had one. Now since lenders were covered if the home-owners defaulted on their mortgages(as they get the house in such a case), they started adding more risk to new mortgages; not requiring down-payments, no proof of income, no documents at all and that’s just what they did. So instead of lending to responsible owners called Prime mortgages, they started to lend to some less responsible owners and these were called as Sub-prime mortgages.

The same cycle would follow again and the investment banker would turn it into a CDO and sell slices to the investors and others. Not surprisingly the home owners default on their mortgage which at this point was owned by the banker. This meant he forecloses and one of his monthly payments got turned into a house. This was fine and he would put it up for sale but slowly more and more of his monthly payments started turning into houses. Now there were so many houses for sale on the market creating a supply that was more than the demand and housing prices weren’t rising anymore.

In fact they plummeted. This created a new problem for those home owners who were paying their mortgages regularly. As all the houses in their neighbourhood go up for sale, the price of their own house went down making them wonder why they were paying back a mortgage for a certain amount when the actual value of their house was much lesser. So they started walking out. Default rates swept the country and prices plummeted. Now the investment banker was basically holding a box full of worthless houses.

The banker tried to sell this CDO to everyone but nobody wanted it anymore. The banker was now in a tough spot because he had borrowed millions or even billions of dollars to buy these CDOs and he can’t pay it back. Whatever he tried he couldn’t get rid of it. But he was not the only one. The investors already held these CDOs worth millions of dollars. The mortgage lender tried to sell his mortgage to the banker but the banker wouldn’t buy it and the broker was out of work.

The whole financial system was frozen. Everybody started going bankrupt. Thus occurred what came to be called as “ The crisis of credit” The precarious financial situation was made more difficult by a sharp increase in oil and food prices. It wouldn’t be wrong to say that the financial institutions themselves were responsible for bringing this upon themselves. The regulatory bodies and the credit rating agencies were also to be blamed to some extent for lavishing good credit ratings upon securities for which risks were difficult to assess in the first place.

Constant deregulation of the securities created by investment banks was also to be blamed. The mortgage-based collateralized Debt Obligation became the cause of Merrill Lynch’s downfall eventually. The financial condition of Merrill Lynch had deteriorated to the extent where it was impossible to salvage it independently. On 15th Sept 2008, the same day that Lehman brothers, one of the top US investment banks filed for bankruptcy, it was announced that Merrill Lynch would be acquired by Bank of America in a $50 billion deal. Merrill Lynch was sold to Bank of America for 0.

8595 shares of Bank of America common stock for each Merrill Lynch common share, or about US $50 billion or $29 per share. After the merger the company came to be known as BofAML(Bank of America Merrill Lynch). Merrill’s performance in vis-a-vis its competitors in the industry during the financial crisis Merrill’s overall performance in the investment banking industry was no better than the worst performing companies like Lehman Brothers and Bear Stearns. Just like these two, Merrill too could not withstand the economic crisis and was brought to its feet forcing the company to the point of sale. Its other close competitor Morgan Stanley did substantially better delivering three straight quarters of profitability for the first nine months of the year and being profitable for the full year with net income of $1.

7 billion and net revenues of $24. billion. Morgan Stanley had substantially reduced its leverage and adjusted leverage ratios to 11. 4x and 8. 0x, respectively, from 32.

6x and 17. 6x at the end of fiscal 2007 thus taking the right steps as early as 2007 to avoid a complete catastrophe. Merrill Lynch failed to take such steps to deal with the forthcoming crisis and kept going deeper and deeper into the mess it had created for itself. ‘ What if’ analysis of the financial performance that might have existed had the downturn not occurred The entire cycle of economic downturn originated with the Wall Street banks like Merrill Lynch, Morgan Stanley etc. Therefore it’s hard to imagine what would have happened in case this economic downturn hadn’t occurred.

First of all the only way the credit crisis could have been avoided is if the investment bankers had the foresight to see the risk associated with sub-prime lendings and CDOs. Assuming they did so and avoided sub-prime CDOs, they could have avoided write-downs resulting from their exposures in Mortgage Backed Securities and Asset Backed Securities. A look at Merrill Lynch’s performance in 2005 and 2006 indicate that it was performing at par with its competitors like Morgan Stanley and Goldman Sachs. It would be helpful to look at the financial figures of the company across the years 2002-2006 to analyse at what rate the company was growing before it was hit by the economic meltdown. Here’s looking at some of the important ratios of the company across the 5 years up until 2006. Earnings before Interest And Taxes (EBIT) EBIT is a measure of a firm’s profitability that excludes interest and income tax expenses.

Merrill’s EBIT was growing positively from 2002 to 2006 as shown in the table below (All values are in millions)Year| 2002| 2003| 2004| 2005| 2006| Average Annual Rate of Growth| EBIT| $2312| $5220| $5836| $7231| $10426| | Percentage Growth| 11% (EBIT for the year 2001 was $2083)| 126%| 12%| 24%| 44%| 43. 4%| During this period Merrill Lynch was doing extremely well as per the industry standards and also comparing well to its close competitors like Bear Stearns and Morgan Stanley. Their EBIT made a very high leap from $2. 3 billion in 2002 to $5. 2 billion in 2003, a whopping 126%.

Overall the average annual rate of growth in EBIT during this period was 43. 4% which is significantly high. A look at other important figures and ratios during the period 2002-2006 Net Earnings These are the earnings of a company after all expenses, depreciation and taxes have been deducted from the gross income. Year| 2002| 2003| 2004| 2005| 2006| Avg Annual Rate of Growth| Net Income| $1708| $3836| $4436| $5116| $7499| | Percentage Growth| 18% (Net Earnings for the year 2001 was $1443)| 124%| 16%| 15%| 46. 5%| 43.

9%| Net Earnings displayed a steady rate of increase throughout the period of 5 years before the effects of economic downturn started showing on the balance sheets of the company. The average annual Net Earnings for the period 2002-2006 was almost 44% Return on Equity (ROE) The ROE is useful for comparing the profitability of a company to that of other firms in the same industry. Higher the return of Equity better it is for the company. Year| 2002| 2003| 2004| 2005| 2006| Avg Annual Rate of Growth| Return on Equity| 7. 58%| 14. 57%| 14.

85%| 15. 85%| 21. 3%| | Percentage Growth| 0. 23% (ROE in 2001 was 7. 35%)| 7%| 0. 28%| 1%| 5.

45%| 2. 8%| Current Ratio Current ratio is a liquidity ratio that measures a company’s ability to pay its short term obligations. The formula for Current Ratio is: Current Ratio = Current Assets/Current Liabilities Also known as “ liquidity ratio”, “ cash asset ratio” and “ cash ratio”. This ratio is mainly used to give an idea of the company’s ability to pay back its short-term liabilities (debt and payables) with its short-term assets (cash, inventory, receivables). The higher the current ratio, the more capable the company is of paying its obligations.

A ratio under 1 suggests that the company would be unable to pay off its obligations if they came due at that point. The current ratio for Merrill Lynch during 2002-2006 was maintained at a steady 1. 2% making its performance competitive in the industry and at par with its close rivals. In order to analyse the financial performance of Merrill Lynch that might have existed had the economic downturn not occurred, we shall consider all the values calculated for 2002-2006 above and extrapolate them to arrive at the probable figures for 2007, 2008 and 2009 which might have been the figures for this company in the hypothetical situation that the credit crunch had not occurred at all. It should be noted that these figures have been calculated purely using mathematical formulae for linear trendline equation and hence are only a theoretical evaluation of what could have been the financial situation of the company if it kept going at the same rate that it was going before the financial meltdown occurred. Forecasting EBIT values If we extrapolate the EBIT values using data from 2002-2006, we arrive at the following figures for the next three years (using the trendline equation) Predicted EBIT for the year 2007 = $11677 million Predicted EBIT for the year 2008 =$13500 millionPredicted EBIT for the year 2009 = $15324 million Forecasting Net Earnings If we extrapolate the Net Earnings values using data from 2002-2006, we arrive at the following figures for the next three years (using the trendline equation) Predicted Net Earnings for the year 2007 = $8378 million Predicted Net Earnings for the year 2008 =$9664 million Predicted Net Earnings for the year 2009 = $10950 million Forecasting Return on Equity (ROE) If we extrapolate the ROE values using data from 2002-2006, we arrive at the following figures for the next three years (using the trendline equation) Predicted ROE for the year 2007 = 23.

% Predicted ROE for the year 2008 = 26. 2% Predicted ROE for the year 2009 = 29% Thus by looking at the above predicted figures it is very clear that Merrill Lynch would have been doing a lot better today had the economic downturn not occurred. This financial crisis not just weakened the company; it pushed it to the verge of complete collapse. In all likelihood, there would have been no acquisition of the company by Bank of America and it would have continued to function as a strong, independent company in the financial services sector. The extrapolated values above are only notional indication of how the figures might have looked like and there is a very high possibility that the company could have had even better figures on its financial statements had it avoided involving itself with CDOs, ABS and MBS securities and kept going at the same momentum at which it was going before the onset of the credit crunch in the financial services industry.

Summary and conclusions: The global economic crisis costs tens of millions of people their homes, their jobs and their savings. In Sept 2008, the bankruptcy of Lehman Brothers and the collapse of AIG triggered this financial crisis. This crisis was caused by a financial services industry gone out of control. Merrill Lynch was a part of this industry along with others like Lehman Brothers, Goldman Sachs and Morgan Stanley. The company was doing well for itself until it decided to borrow millions and millions of dollars to buy sub-prime mortgages without having a backup plan or reserves set aside in the case these mortgages went bust. Bloomberg reported in September 2008 that Merrill Lynch had lost $51.

8 billion in mortgage-backed securities as part of the subprime mortgage crisis. As expected the company totally collapsed in the wake of the financial meltdown, its survival threatened and had to be sold to Bank of America in a $50 billion deal. At regular intervals it also faced various allegations of corruption, inflated bonuses and cooking of books from different groups of the society. On Jan. 1, 2009, Merrill Lynch & Co. Inc.

(“ Merrill”) merged with Bank of America Corporation (“ BofA”). At the end of 2008, prior to the close of the merger, Merrill awarded approximately $3. 6 billion in bonuses to its employees. This amount was one-third of the money they received from the Feds’ TARP (Troubled Asset Relief Programme) bailout. The payment of these bonuses has been the subject of numerous investigations and lawsuits. Why Merrill had to rush with paying billions of dollars in bonuses right before it went through with the merger and in a time of such severe economic crisis was the subject of worldwide speculation.

The company is still only recuperating from its losses under the flagship of Bank of America and though the financial statements of Bank of America for the year 2010 still show losses, these losses have come down significantly. The Global Wealth and Investment Management segment has been performing well and making quicker progress. It can be expected to show profits in 2 years’ time. The Global Banking and Markets division generated a Net loss of $6319 million in the year 2010 as compared to $10, 058 million in the year 2009 showing a drop of 37%. Similarly the Net loss for Global Wealth and Investment Management division reduced by 21. 5% from $1716 million in 2009 to $1347 million in the year 2010.

According to a very recent fund manager survey by BofAML, Investor confidence has returned to the equity markets which is definitely good news for the company. Bibliography and References Websites: http://www. globalissues. org/article/768/global-financial-crisis http://blogs. law. Harvard. edu/corpgov/2009/11/07/merrill-bonuses-raised-issues-in-merger-with-bank-of-america/#more-5123 http://phx. corporate-ir. et/phoenix. zhtml? c= 71595&p= irol-reportsannual Morgan Stanley business highlights for the year 2008 from http://www.

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