Holders Hungry for Profit Will Find Slim Pickings at Merrill Lynch

By DENNIS K. BERMAN

What if you woke up one morning and had 615 million more mouths to feed? And your fridge? It's half-empty.

This is the dilemma for Merrill Lynch Chairman and Chief Executive John Thain, who last week unveiled an $8.55 billion sale of new Merrill common stock. Coupled with other share offerings, previous Merrill holders will be diluted by 615 million shares, or roughly 38%.

The market seemed to overlook this dilutive donnybrook, instead focusing on Merrill's other plan, to dump $30.6 billion in crummy derivatives. Mr. Thain tinkered with the timing of his problems: trading today's derivatives-pricing mess for tomorrow's earnings shortfalls.

Let's look at how Merrill is going to scamper out of this mess. For it is here where one finally understands just how this credit crunch has split Wall Street's past and future.

Start by rolling the clock back to 2004, a period just before the excesses of the mortgage and lending booms engulfed Merrill and its Wall Street brethren. Back then Merrill was reliably grinding out brokerage sales, IPO issues and investment-banking fees. The company posted net income of $4.4 billion for the year. Spread over roughly one billion shares, that produced annual earnings per share of $4.40. Merrill's shares traded at about $55 in 2004. Monday they traded at $26.39.

We need not dwell on Merrill's troubles since then. The company has been desperate for cash, most recently culminating in the new-share sale.

All this wheeling and dealing will soon leave Merrill with 1.6 billion shares outstanding. To return to an earnings-per-share level of $4.40 each, Merrill will have to produce annual net income of a little more than $7 billion. Right now, Street analysts are predicting median per-share earnings of $2.65 for 2009, or net earnings of $4.2 billion, according to Thomson Reuters.

In other words, Merrill needs to come up with $2.8 billion in new profit -- not sales -- to get back to its 2004 per-share earnings levels. That's $43,000 in new profit for each of Merrill's 65,000 employees. Oh, and don't forget Merrill's dividend. Merrill continues to pay out 35 cents a share per quarter. Layer on 615 million more shares, and that's an additional $861 million out the door each year.

"It's extremely difficult to get to the earnings-per-share number of 2004 anytime soon," says Brad Hintz, Sanford Bernstein's brokerage analyst. "The denominator has gone up so much."
Merrill did produce $7 billion in net income -- in 2006. That was at the height of the debt-market bubble, when structured finance, leveraged lending and mortgage originations were gushing cash for shareholders.

That's precisely the problem. All those businesses have largely disappeared. That puts most of the earnings burden on Merrill's old-line businesses -- brokerage, asset management and investment banking. Mr. Thain embraces these units as Merrill's future, as well he should. But those new mouths are hungry. And the fridge is indeed sparse.

Amid a flagging general economy, that leaves few options for Mr. Thain: Cut costs even deeper, hoping that the franchise can stay intact with ever-fewer employees. Somehow grab market share from other Street houses. Or, gradually, start to take on more risk on Merrill's trading desks, which produced the bulk of the $30 billion in losses over the past 12 months.

In the meantime, there is the Wall Street Way. Set expectations, low, low, low. Remind, as Mr. Thain did, that "these losses are coming from legacy positions that the current management team...had nothing to do with." And don't dwell on any comparisons of yore. Yes, life's only getting better. Just not better than it used to be.

Email dennis.berman@wsj.com