Blackrock (ticker BLK)

September 2018

MANOLE CAPITAL MANAGEMENT

MCM

Introduction:

A decade ago, the US was enduring a brutal financial crisis. Many still have memories are bankruptcies, massive losses, home foreclosures, reckless insurers, CDS (credit default swaps) bets and billion-dollar bank bailouts. With the 10-yr anniversary of Lehman Brothers bankruptcy just occurring, most investors remember the losses and pain of the financial crisis. While we learned much from enduring this time-period, as well as the dot-com bust, we thought we would spend some time reviewing a winner from this environment. There are lessons to be learned, both positive and negative, and we wanted to highlight how a winner took advantage of this situation. This article will attempt to highlight how Blackrock transformed itself during the Financial Crisis and re-positioned itself towards the fastest segment and growth in the asset management business.

Business Description:

Today, Blackrock (ticker BLK) stands as the world's largest asset manager with a massive $6.3 trillion in assets under management. That's right…we said TRILLION. To put that amount into perspective, it is an amount that exceeds the size of Germany's economy.

Blackrock has experienced tremendous growth because it saw where the market was going and decided to be a "fast follower". McDonalds did not invent the hamburger, but it experienced massive growth by taking a great idea and packaging it to meet the needs to US consumers in the 1950s. It was not just Ray Krok that grew McDonald's, but he is widely credited for driving the business to great heights. Blackrock, led by Chairman and CEO Larry Fink, did much of the same. They appreciated the marketplace and embraced the growth expected for index and ETF (exchange-traded). Once again, Blackrock did not invent this category, but it did quickly grasp the opportunity in passive, low-fee investing.

Long-Term Catalyst:

Vanguard's S&P 500 index fund recently turned 42 years old, but it was not an immediate success when it was first launched. At the time, Fidelity Investments was a clear asset management leader and its management team, led by Edward Johnson, publicly stated that investors would never be satisfied with "just average returns." Early on, Vanguard raised just $11 million in assets. It took years to build scale and it did not launch another index fund until the 1980s.

It took patience and several decades, for the passive investment theme to really gain steam. Vanguard was steadfast in its business model, but it did not hit $1 billion of assets until 1990. Now, Vanguard has $5 trillion in passive assets and there are new index funds seemingly created every day.

Market Share:

The *Big 3* of passive investing are Blackrock, Vanguard and State Street. In the US, it is estimated that Blackrock has 39% market share of the passive business, while Vanguard is at 25% and State Street is 17%. Combined, these *Big 3* control over 80% of the US market.

The passive trend is far from over. Some analysts are estimated that the global fund business could double from these levels and reach $12 trillion by 2023. Future growth should come from international markets, which are still significantly underpenetrated. In addition, fixed income passive products are just beginning. In fact, Blackrock believes that the Bond ETF market is "as ripe as equities" was a decade or two ago. This is a scale business, for which much of the rewards from future growth will go towards these three dominant franchises. With fees at a measly 5 basis points, and quickly approaching zero, there seems little room for new competitors.

History:

CEO Fink began his career in 1976 in First Boston's bond department. A decade later, under the umbrella of Blackstone, Fink became the CEO of Blackrock. In 1994, Blackrock was separated from Blackstone and fully independent a few years later. The business was a "one trick pony", primarily considered an institutional, fixed income asset manager.

In 2006, Blackrock merged with Merrill Lynch Investment Managers (known as MLIM), which essentially doubled its assets under management. While this built scale and diversified Blackrock's product mix, the timing was not ideal. Becoming partners with Merrill Lynch, right before the financial crisis, came with long-term issues. As the crisis unfolded, Merrill Lynch was essentially forced to sell itself to Bank of America. The US government, grasping for ideas to stabilize the market, leaned on the stellar reputation of Fink and Blackrock for assistance. Blackrock ultimately bought out its Merrill Lynch partnership and was considered one of the few strong financial companies during this time period.

These efforts, steered by Fink, led a huge shift for Blackrock's business. Instead of just being considered a fixed income manager, Blackrock had a dramatically different look. By the end of 2009, the business would undertake another shift that would cement Blackrock's positioning in the market as a global leader. Times have certainly changed, but nothing with obvious at the time. Blackrock's management team deserves a tremendous amount of credit for positioning the business to succeed.

One of our investment beliefs, is that one must always look forward. Driving (and investing for that matter) constantly looking in the rearview mirror can be dangerous. While Fink would probably deflect credit and highlight the depth of his team, he certainly deserves recognition for dramatically impacting Blackrock's growth and success.

Looking Forward:

When it comes to assets under management, we prefer to look at long-term assets and exclude the money market business. Using this framework, assets at Blackrock were $5.842 trillion as of June 30th. Before we break down Blackrock's business into the same two sub-segments that management does, by client type and by product, we want to address the "elephant in the room".

The market and industry are clearly moving towards passive. There can be no doubt, that all active asset managers are struggling with the trend towards passive management. We certainly feel that active managers, specifically those that are niche-based, can succeed. However, study after study has shown that active managers have struggled to beat their benchmarks. Manole Capital is exclusively focused on the emerging FINTECH industry and prefers to leave generalist (i.e. large cap growth or small cap value, etc) portfolio management to others. We firmly believe that the future of asset management will be focused on specialists, with investors looking for managers with industry expertise. We liken this to the medical profession, where patients with knee problems will visit a knee specialist, not a generalist physician. We have written on this very subject. Our note titled "A Different Take on the Active versus Passive Debate" was published in April 2017 and can be read on the Seeking Alpha site.

Financial Crisis:

Winston Churchill once said that "one should never let a good crisis go to waste." In 2008, with the market in a freefall, Blackrock leapt into action. Anxiety levels were high, and the government was scrambling to stick a finger in a leaky dam. At this difficult point, Blackrock seized an opportunity.

As huge sports fans and Tampa Bay Lightning season ticket holders, we like to make the parallel with one of Wayne Gretzky's best quotes. "You need to skate where the puck will be, not where it has been." Fink understood where the market was going (i.e. towards passive), and he quickly anticipated and capitalized on Blackrock strong balance sheet.

The first step that Blackrock made to transform itself involved Barclays. Barclays was in a desperate position to raise capital. The UK government had already injected it with funds, but it needed more. That is exactly when Blackrock saw its opportunity and pounced.

Barclays owned BGI (Barclays Global Investors), which had a wonderful subsidiary called iShares ETF's. Blackrock paid $13.5 billion for Barclays crown jewel and quickly doubled its assets under management *again*. One can feel bad for Barclays misfortune or can one understand that Blackrock was simply capitalizing on an opportunity.

Balance Sheet:

Having a strong balance sheet was instrumental for Blackrock's success in 2009, but it still holds true today. When, not if, we have another market downturn, the companies with strong balance sheets will survive and thrive. This is true, not just for all companies, but especially within the financial sector. Why? Most financials do not produce tangible goods or manufacture items. There is an old adage that the real assets of any financial firm go up and down the elevators each day (i.e. its people). Most financials are commodity businesses, with the US dollar as their product. Banks, in their simplest form, borrow money from consumers (paying little if any interest) and lend money at a higher rate to earn a spread. Firms with strong balance sheets, sustainable businesses and excellent free cash flow, will be in position to benefit from any market decline. Those that are heavily levered, will not be able to re-invest for future growth and may struggle to payback the interest on their debt.

Financials:

Financials, as a sector, present interesting dynamics for financial analysts. Most financials, especially traditional banks and insurance companies, are terribly complex. Analysts struggle to properly model (in Excel) most financials. It can also take hours to decipher their convoluted earnings, once they are reported.

Just last week, Warren Buffett discussed some of his takeaways from the 10-year anniversary of The Financial Crisis. In his opinion, the crisis occurred because many in the banking system were over-levered and some financials were "awash in toxic subprime mortgages". Instead of diversifying their balance sheets, many banks thought they were safe by packaging these mortgages and then re-selling them into the market. Since no bank could afford to "miss this opportunity", it became a widespread and prevalent Wall Street move.

The ease of valuing these securities was difficult and they were not terribly liquid. When the red-hot housing market turned, the race to the door was swift and painful. We liken it to another Warren Buffett quote, where he said "if you've been playing poker for half an hour and you still don't know who the patsy is"…

When the financial crisis began to erupt, banks and insurance companies, with complicated balance sheets, were facing a serious problem. In order to survive, they needed to present themselves as confident, and well-capitalized. Nobody would trade with a bank that was soon-to-be insolvent. Banks were pleading with counterparties (and the media) that they had a strong balance sheet and were not in those contagious derivative instruments. It was clearly a crisis of confidence.

Investors could not quickly analyze these companies, let alone grasp the declining positions that were on those opaque balance sheets. When in doubt and when times are tough, investors will "shoot first and ask questions

later." The freefall in 2007 and 2008 hit all companies and our type of "fintechy" financials too. However, the relative pain was dramatically less than the dramatic declines suffered by traditional financials.

The Model:

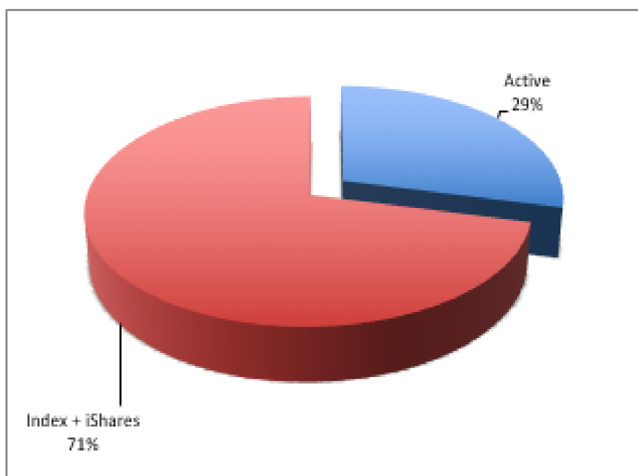
The lesson here is somewhat simple. While many like to over-complicate things, we prefer plain-vanilla and easy to understand businesses. The asset management business is trending towards algorithms and complicated trading strategies. We, on the other hand, adhere to a *KISS* investment mantra - "keep it simple stupid".

Blackrock has a fairly simple model. Analysts multiply assets times a management fee to arrive at revenue. Expenses do not dramatically swing from year to year and earnings and free cash flow can be easy to estimate. We prefer models that have predictable and sustainable business models. For us, Blackrock checks the box.

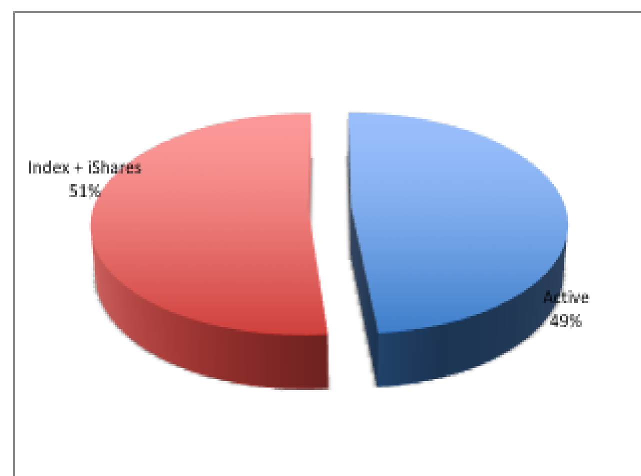
Details:

As the charts below show, the vast majority of Blackrock's assets and over half of fees are now generated from its index and iShares products.

Investment Style AuM

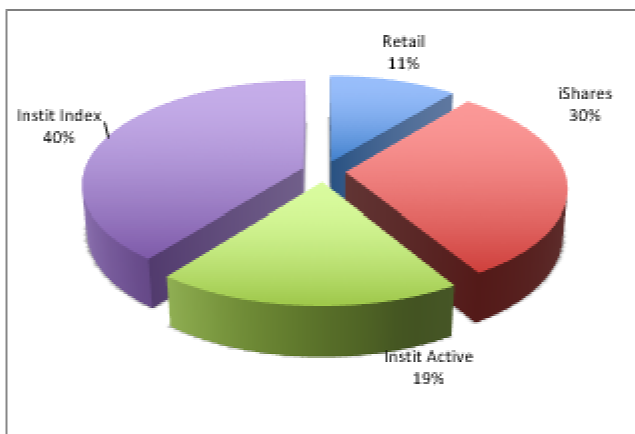


Investment Style Fees

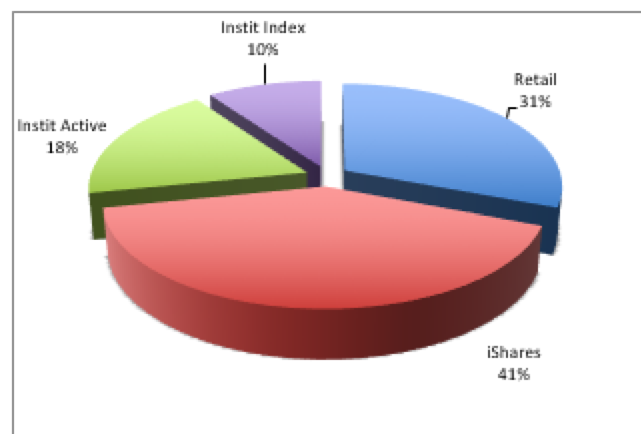


By Client Type:

Client AuM



Client Fees

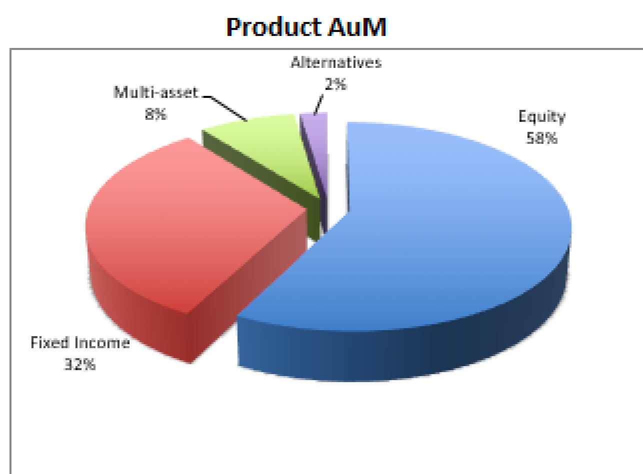


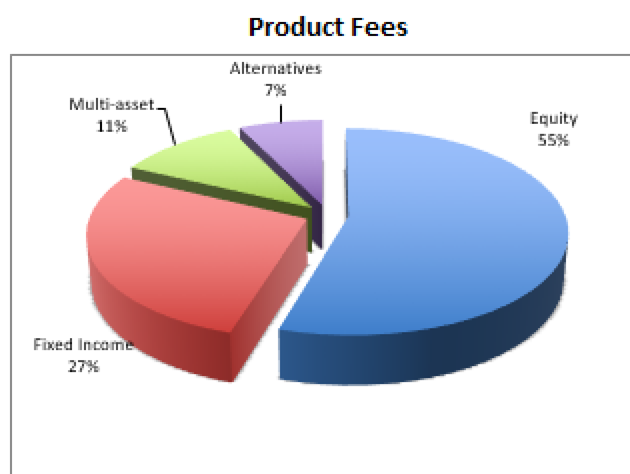
As the chart from the previous page highlights, Blackrock breaks down their client assets into 4 distinct areas. Retail is 11% or $637 billion, iShares is 30% or $1,777 billion, Institutional Active is 19% or $1,123 billion and Institutional Index is 39% or $2,305 billion. Summing up these areas, we can see that Institutional represents 58% of total assets or $3,428 billion and passive (representing iShares and Index) are over 2/3rd's of total assets or $4,082 billion.

In addition, the fees that Blackrock earns vary widely, with institutional clients paying the least, while retail and active management paying higher rates. Lastly, we would point out that asset management is very much a scale game, as evidenced by the "race to zero" the industry is dealing with now. We will address this risk and issue later on.

By Product Type:

As the chart below highlights, Blackrock breaks down their products into 4 distinct classifications. Equity is the largest at 58% of total assets, Fixed Income is second at 32%, and multi-asset and alternatives make up the remaining roughly 10%. Once again, fees that Blackrock can charge are highest for alternatives, which is why it reaches 7% of total fees. Equities are still over half of Blackrock's product fees.





Peers:

We like to break up the asset managers into a few separate and distinct groups. There are roughly 20 publicly traded *Traditional Asset Managers*. There is a group of 10 to 15 names, with a market capitalization above $1 billion consisting of well-known companies like Alliance Bernstein (AB), Affiliated Managers Group (AMG), Franklin Resources (BEN), Blackrock (BLK), Eaton Vance (EV), Federated Investors (FII), Invesco (IVZ), Legg Mason (LM), T Rowe Price (TROW), Waddell & Reed (WDR) and WisdomTree (WETF). There is another group, which we call *Private Equity Managers* that are more complex to analyze, especially from a tax perspective. These are names like Blackstone, KKR, Apollo and Ares. For valuation analysis and peer grouping, we will lump Blackrock in with its *Traditional Asset Managers* group.

Since we are constantly looking forward and not managing money through a lens of the rearview mirror, our valuation will focus on 2019. Not only are we fairly close to the end of 2018, but this year is somewhat skewed and artificially inflated. When looking at growth rates, 2018 is elevated versus 2017 because of the dramatically lower corporate tax rate. This, to us, is a one-time benefit, which will not be recurring. We prefer to look at sustainable growth rates and believe 2018 is a little bit elevated due to this macro change.

MANOLE CAPITAL MANAGEMENT

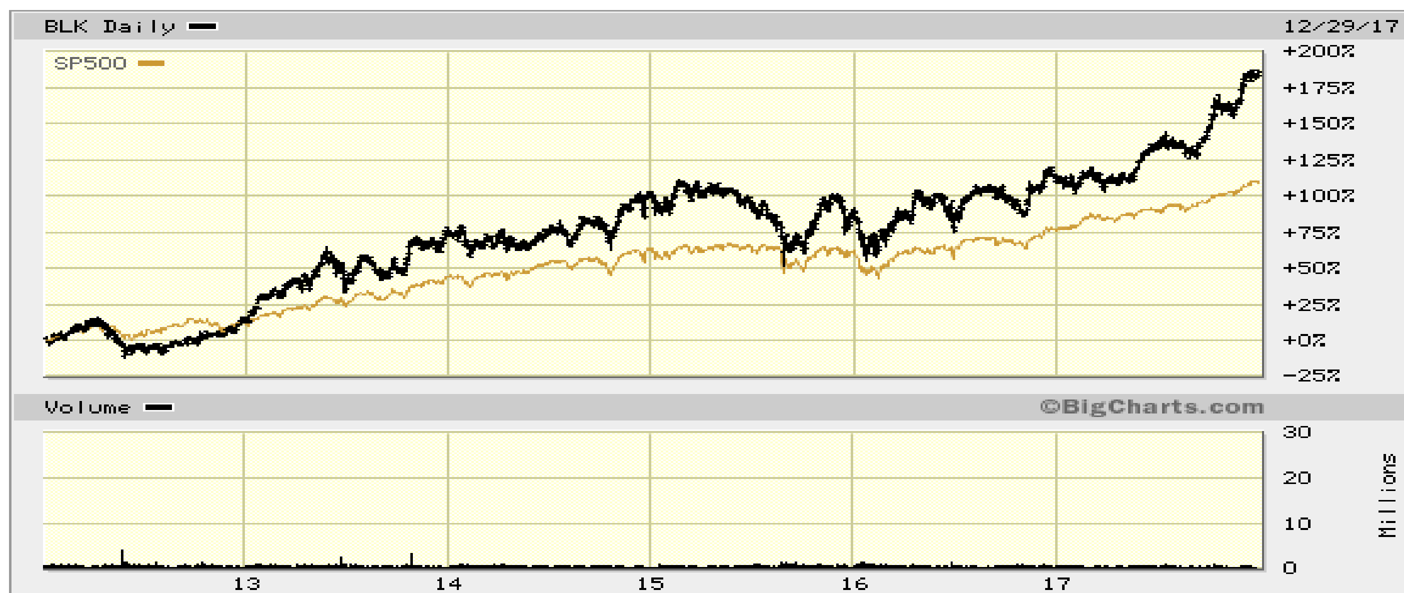
As we mentioned earlier, we like the somewhat simplicity of many asset management business models. As one examines the balance sheets, these companies are not wildly complex. Cash and short-term investments are a decent proxy for cash, while debt is mostly straight debt. There are not a lot of complicated derivative structures sitting on traditional asset management balance sheets (except maybe for AMG's convertible notes). In terms of Blackrock's balance sheet, there is $6.6 billion of cash equivalents plus $1.8 billion of investments versus $5.0 billion of debt. With a stock price of $475 per share and 162 million shares outstanding, Blackrock has a market capitalization of $76 billion and an enterprise value of $73 billion.

Performance: 2012 to 2017

Since most asset managers are dependent on the stock market for driving their results, the S&P 500 return should be our starting point. Over the last 5 to 6 years, the S&P 500 has been quite strong, with annual returns since 2012 through 2017 of +16%, +32%, +13%, +1%, +12%, and +22%. Over the last several years, the market has widely embraced Blackrock as the pre-eminent asset manager. This is reflected in Blackrock's outperformance, especially relative to the overall market. In 5 of the last 6 years, Blackrock has beaten the market. Since 2012, Blackrock is up +20%, +57%, +16%, -2%, +15%, and +38%.

2017 was a great year for Blackrock. The stock was up 38%, well in excess of the overall market. Revenues grew an impressive double-digits (+12% year-over-year) and earnings were up in the high-teens (+17% year-over-year). It generated significant free cash flow, which management used to lift its dividend by 15% to a respectable +2.5% yield. In addition, Blackrock re-purchased $900 million of its own stock.

As the chart below shows, Blackrock has been a wonderful company to own and has beaten the overall market, until this year.



Street Estimates / Valuation:

As we just mentioned, 2018 benefits from a lower US tax rate, but revenues should be up nearly 20% and produce earnings in the low 20% range. Using history as a guide, we know that the stock market has averaged roughly 6% to 8% a year in growth. Most sell-side analysts will use a positive equity market for their inputs for asset approximations and earnings estimates.

In 2019, assuming a similar high-single digit increase in the overall S&P 500, the sell-side is estimating Blackrock's EPS to be close to $30.40 per share. At $475/share, this equates to a 15.6x forward multiple. Considering how dependent Blackrock is to the overall market return, we feel it is appropriate to compare it to the S&P 500 valuation. With the S&P 500 at $2,880 and estimated 2019 earnings of $169.50 per share (per Zacks Research), the market multiple is 17.0x. So, Blackrock is cheaper than the market and pays a better yield. How do its fundamentals look compared to Benjamin Graham's *Mr Market*?

Next year, Blackrock's revenue and earnings growth is estimated to be up 6% and 10% respectively. The market estimate, for S&P 500 2019 revenue and earnings growth, is only 4% and 9% respectively. Back in 2012, Blackrock's adjusted operating margins were just over 40%. At the end of last year, Blackrock posted margins in the 44% range, nearly 400 basis points better. According to Zacks Research, the overall market (represented by the S&P 500) generates pre-tax margins in the 15% range.

Looking at its future growth opportunity, we believe Blackrock should continue to gain market share. In the Americas, Blackrock has 8% market share and should reach 10% over the next few years. In EMEA, Blackrock is only 6% of the market and will absolutely grow that base. Blackrock will leverage its brand and diversified product set to grow its APAC market share from only 3% today.

So, Blackrock is cheaper than the overall market, is growing faster than the overall market and generates better returns than the overall market. Now, we will look at Blackrock's specific characteristics and traits.

We believe Blackrock's business model is much more sustainable than the average US company. It does not have any issues with fluctuating commodity costs or inflationary pressures. It is experiencing positive regulatory change and is one of the few companies actually benefitting from new Washington DC rules. It is a clear market leader and has durable competitive advantages. There are high barriers to entry and a wide moat around its franchise. Management has done a great job of properly allocating capital and does not seem to have any tariff or trade battles to concern itself with. When arriving at a valuation, we would argue that Blackrock has a better than average business model and it generates predictable (albeit boring), recurring revenues. Because of these factors, we believe Blackrock should trade at a premium to the market, not its current discount.

Price Target Scenarios:

In M&A transactions, some asset managers get valued as a percentage of assets. Historically, valuations are in a range of 2% to 5% of assets under management. We do not believe this is the best way to value Blackrock. With its massive size, Blackrock's enterprise value to assets under management is only 1.7%.

Others like to utilize an enterprise value to EBITDA basis for valuing asset managers. This is often utilized, especially for companies that over-levered and for those that have large debt positions. This really is not a great valuation metric, for many asset managers as most are in a net cash position. Blackrock has net cash on the balance sheet and has ample liquidity. When looked at through this lens, Blackrock is not overly expensive at 11.4x EBITDA.

As we highlighted earlier, Blackrock's business model is fairly straight forward. Earnings are a wonderful representation of cash flow. Because of this, for valuation purposes, we tend to believe a simple, but solid P/E estimate is best.

We see 12 sell-side analysts covering Blackrock, with 10 at Buy and 2 at Hold. The sell-side typically makes their future earnings estimates based upon a positive stock market expectation. We look at 2019 and attempt to "bake in" some upside and downside to expectations.

We utilize a scenario valuation technique, applying different weights to different possible outcomes. For example, if the market is strong and inflows are positive at Blackrock, we would anticipate earnings exceeding estimates and approaching $32 per share (5% upside to estimates). In that positive environment, we would expect Blackrock to garner a multiple better than its *Traditional Asset Management* peers and in excess of the overall market multiple. In this bullish scenario, we apply a 19.0x forward multiple on Blackrock's earnings, which is more in-line with its prior average. In this environment, see a stock exceeding $605 per share which equates to over 25% of upside. We apply a 55% chance of this scenario playing out.

On a predictable and "normal" year, we simply roll the current P/E multiple forward and apply it towards next year's earnings estimate. This produces a return of 9%, similar to its earnings growth rate. We apply a 30% chance of this scenario playing out. For a price target reflecting downside in earnings and the overall market, we think a bearish EPS estimate for 2019 could be $28.50 per share range. This represents a 6% decrease in earnings versus current consensus. Applying a 14.5x forward multiple on that lower estimate yields a price that is down 13%. We apply a 15% chance of this scenario playing out. Utilizing all three different scenarios and our various weightings, we come up with a price target for Blackrock of $551 or upside of 16%.

Hidden Gem:

As we mentioned earlier, we are FINTECH investors and love companies that can utilize technology for our advantage, as shareholders. Blackrock has a unique asset in its proprietary Aladdin operating system. The platform helps other managers (over 30,000 users) with trading, portfolio management, analytics, data insights and various risk capabilities. Quite simply, Aladdin is Blackrock's way of delivering scale, transparency and innovation to other managers, who simply choose to outsource this technology.

We like to use sum-of-the-parts analysis, when there is a chance management might consider spinning off a business. We have no idea if Blackrock would even consider spinning off Aladdin, but do not believe the market is properly reflecting this valuable asset inside of Blackrock's business.

While Aladdin represents just 5% of Blackrock's revenues, this platform would garner a much higher valuation on its own, if it was a stand-alone business. The Aladdin business used to be primarily focused on the fixed income market, but it has been diversifying towards equities and other multi-asset classes. Since 2012, Blackrock has doubled the number of countries where Aladdin is in used and outside the US now represents 30% of its revenue.

One might question why an asset manager would utilize a technology platform of a competitor. We certainly did. However, the analytics, data, information and technology of Aladdin is hard to replicate. Plus, it is cheaper to outsource these services from Blackrock than spending millions to build a proprietary platform of your own. 20% of the Top 200 global asset managers, 23% of the Top 100 US pension funds, as well as 17% of the Top 250 Insurers are Aladdin users.

While there are few direct peers for Aladdin, we liken it to dominant analytical franchises like privately-held Bloomberg, and public companies like IHS Market (INFO) and MarketAccess (MKTX). On current, 2018 earnings,

INFO is trading at 30x and MKTX is trading at 43x. These are extremely high valuations and the market believes these technology businesses have excellent prospects looking forward.

So, what is Aladdin worth? We think that Aladdin could produce nearly $750 million of revenue this year and estimate it could generate $1 billion of revenue by 2021. Over the last 5 years, it has experienced a CAGR of 12% and growth should continue in the double-digit range for the foreseeable future. The Aladdin growth profile is quite strong, as it expands its reach, fosters new relationships in various markets, enhances its service and capabilities, as well as gets network effects from developing its operating model. We believe that Aladdin has high EBITDA margins, likely in the 40% to 50% range. As a standalone franchise, we think it could be worth $7.5 billion or nearly $50 per Blackrock share. That would equate to a hidden asset worth roughly 10% of its parent's market capitalization. Is Aladdin value already embedded into Blackrock's higher than average peer multiple? We do not believe it is. We consider Aladdin to almost be a *free call option* for shareholders. Over the next few years, Aladdin should become, as their motto states, "the language of portfolio construction." If iShares is Blackrock's crown jewel, we believe Aladdin is Blackrock's hidden gem.

Cash Flow:

Good management teams look to put their cash flow to the best available options, those that generate the best future returns. Intelligent capital management is probably the most important item a financial team can be measured upon. We expect Blackrock's management team to continue to heavily invest in their Aladdin platform and other organic growth opportunities. As Blackrock's management team articulated at their Analyst Day, their first priority remains to invest back into their business.

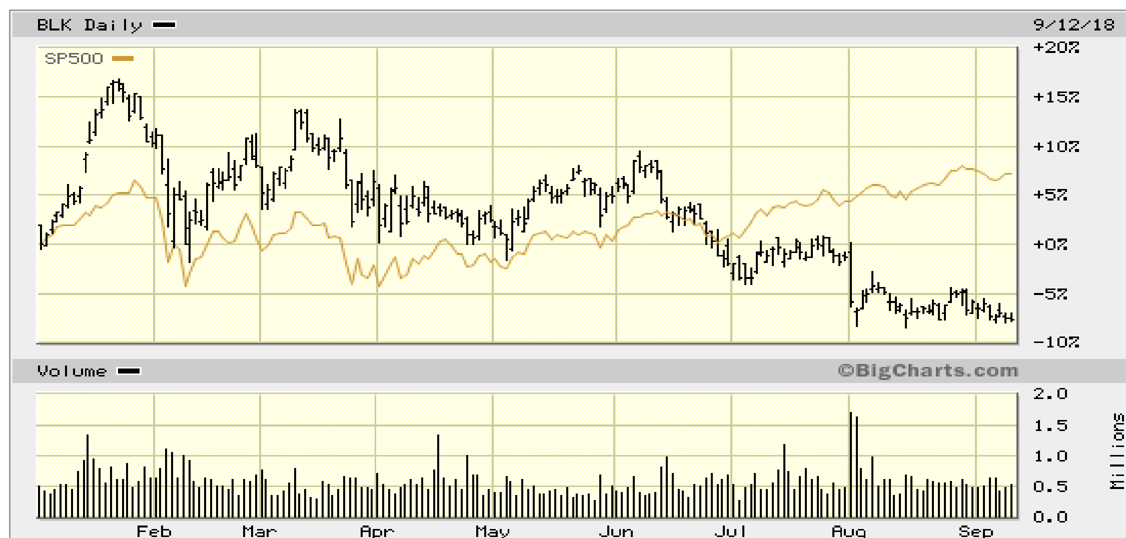
With an estimated $6.5 billion of EBITDA in 2019, the management of Blackrock is once again in an enviable position. In 2017, Blackrock returned $2.8 billion in excess cash to shareholders via dividends and stock re-purchases. We think that Blackrock is well-positioned, and that management will look to put its free cash flow to good use.

We would not anticipate that Blackrock pays down their debt. Since 2003, Blackrock has shown a 20% CAGR of its dividend. We would expect to see management steadily boost its dividend, maybe even hitting a 3.0% dividend yield. If the stock continues to languish, we would expect management and the Board of Directors to materially buyback its own stock. After re-purchasing $275 million per quarter, from 2nd quarter of 2016 to the 4th quarter of 2017, management began to raise their buyback purchases. In the 1st quarter of this year, it bought back $335 million and it just did another $300 million in the 2nd quarter. Since the end of 2012, management has reduced its share count by 6%. It has re-purchased $5.3 billion of its own stock at an average price of $337 per share. While most management teams are not wonderful buyers of their own stock, Blackrock purchased this large amount 40% lower than today's prices. If the stock price continues to underperform, we would not be surprised if the Board lifted its buybacks to the $500 million to $750 million per quarter range. With so much cash flow and such a strong balance sheet, we would like to see the Board at least consider a sizeable ASR (accelerated share repurchase). We think Blackrock could easily do a $5 billion ASR and take advantage of its year-to-date stock weakness.

Lastly, free cash flow could go towards acquisitions. As we mentioned earlier, Blackrock's management team has done an excellent job of acquiring businesses to grow assets and diversify its products. Is there an area of weakness that Blackrock should address? We do not believe so. Blackrock already is the most diversified manager and it is well-positioned in the fastest areas of growth.

Risks:

Year-to-date 2018, the market is up another 9%. With the market up, one would anticipate that the asset managers, that derive most of their profits from a rising tape, would also be performing well. Blackrock's 11-name, *Traditional Asset Manager* peer group is down an average of 15% this year.



Blackrock is down roughly 5% this year and the whole sub-segment has been an awful laggard. Wisdomtree (WETF) is down 37%, Federated Investors (FII) is down 33%, Invesco (IVZ) is down 32%, Affiliated Managers (AMG) is down 30% and Legg Mason is down 28%. Why the weakness?

We believe it is due to a few factors. On a sector level, the Financials represent 13.8% of the S&P 500 (at the end of August). The largest names in the sector are mostly traditional banks and insurance companies. We believe that some managers and investors, anticipating higher interest rates, have simply preferred to overweight the banks, instead of the asset managers. This has not been a good trade; with names like Goldman Sachs (GS) down 10%, Morgan Stanley (MS) down 9%, Wells Fargo down 6% and Citigroup (C) down 4%.

Another reason for some asset management weakness? Some of the *Traditional Assets Managers* are not terribly diversified. Many are tied to one particular client, one specific fund or even one product. For example, Federated Investors is heavily weighted towards money market assets and WisdomeTree has a large international and Japan ETF tilt. Quite simply, being diversified, from a product perspective, is good.

Flows:

If you are a diversified manager, assets can shift from money markets to fixed income to equities to alternatives, and then back again, depending on which product is hot. If you are a "one trick pony", if your product is out of favor, the outflows are painful.

In our opinion, the most watched and important metric is flows. There is a simple rule for asset managers. If a manager is experiencing outflows, the stock will fall. If a manager is bringing assets in, it will rise. The best way to calculate organic asset growth is to measure net inflows compared to prior quarter ending assets. This metric excludes market gains from asset growth, and can highlight which companies are winning in the marketplace.

From 2013 to 2017, Blackrock averaged 4% organic asset growth. However, the rate of Blackrock's organic growth is slowing. The flow story in 2018 is somewhat mixed. 2nd quarter flows represented only 1% organic growth, which dragged down the stock. While inflows were a positive $14 billion last quarter, this represented

paltry organic growth. Fixed Income showed positive flows, but the important equities group (with its higher fees) experienced $22 billion of outflows. While organic growth is low, one needs to appreciate the *law of large numbers*. If Blackrock were to generate 4% organic growth, on $6 trillion of assets, it would need to bring in $240 billion each year. That does not seem like a reasonable request.

There is no doubt that assets continue to flee active managers for passive products. The key for Blackrock will be twofold. One, can it continue to steal assets from other managers that underperform. Two, can Blackrock keep assets in-house, when clients want to move in-and-out of various products. We believe it can.

Fee Pressure:

If one analyzes Blackrock's fees by product, the trend is clearly downward. On fixed income products, Blackrock earns only 16 basis points. On equity products, it generates only 18 basis points and the blended company average is a tiny 19 basis points. That being said, 19 basis points on $6 trillion of assets can generate revenue of north of $3.5 billion per quarter. While fee pressure is not promising for any asset manager, it is a much bigger concern for smaller players.

As an asset manager ourselves, we feel some pricing pressure too. There is a trend, certainly in passive products, to lower management fees. The latest announcement had Fidelity taking certain index products to 0% fees. In the first couple of weeks, it already garnered close to $1 billion in assets. This is what we mean about asset management being a scale business. The big players, with massive asset bases, will be able to absorb pricing pressure and earn fees in other ways. Even with 0% management fees, a large asset manager can earn revenue from lending their equities out and other sources.

We believe wallet share and market share are critical issues to understand. Asset managers will struggle (as a stock and as a long-term growth business) when flows turn negative. Underperformance drives outflows, which drives the stock lower. This can be a vicious cycle. With so many managers failing to beat the overall market, it makes sense why more investors are piling into passive products. Blackrock's passive products benefit from this, but their active products are doing well too. For example, 80% of its fundamental equities are beating the benchmark over the last 5 years. 85% of BlackRock's taxable fixed income products are beating their bogey. Over the same 5-year period, 91% of their systematic equities products are beating their benchmarks. While all at Blackrock is not perfect, it is well-positioned with its diversified portfolio of products.

Conclusion:

We see upside in Blackrock shares, but this is not a company that will double or triple in value. It is a large company and there is virtually no chance it gets taken out. In a portfolio, sometimes it makes sense to own a few "steady" companies. Not every company in a diversified portfolio should be a "high flyer" or one that has tremendous volatility. We like to own companies trading at reasonable valuations, with solid dividends and a predictable and sustainable growth outlook. Getting a wonderful free cash flow yield from a company that dominates its industry is a bonus. In our opinion, Blackrock "fits the bill", for the percentage of the portfolio invested in Financials.

Blackrock is but one example of how a company can seize victory, from the jaws of defeat. It built itself into a global powerhouse, in the darkest of market conditions. Could others have followed suit? Yes, but their management teams were not ready to pounce, when the opportunity presented itself. Blackrock believes that a quiet revolution is taking place in the industry. Lucky for us as shareholders, Blackrock's management team has positioned the firm at the forefront of this trend and evolution.

There is no denying that the asset management group, as a whole, continues to underperform. The individual companies, despite this weakness, should be analyzed for their strengths and weaknesses. Some value investors are intrigued, as the group is trading at almost historical low valuations, whether on P/E, EV to EBITDA or percentage of assets managed. It is our opinion, that bottoms up, fundamental analysis can identify attractive companies at attractive valuations. We believe that Blackrock is an excellent company, led by a wonderful management team and it is well positioned for future growth. We are attracted to its valuation, which we believe is trading well below our estimate of intrinsic value. Over the next several years, we think that Blackrock will widen its moat and is poised to capture additional market share in passive and index products. With this type of growth opportunity, we do not believe it deserves to trade at a 6% to 8% discount to the S&P 500.

Some of its year-to-date weakness can be attributable to weaknesses in its peer group, the asset managers. Maybe its organic growth could be higher and equity flows could be better. To use a real estate analogy, we believe Blackrock is the best house on a crappy street. Some managers are better situated than others, in terms of asset, product, client, and diversification mix. Those that are more heavily weighted towards one particular product, especially if that product is out of favor, have been underperforming. We believe those are the asset management businesses that are in a slow and fundamental decline. However, Blackrock has a diversified product mix and its does not seem to have a material client exposure to be concerned about. We expect material stock re-purchases and continued solid revenue, free cash flow and earnings growth. The valuation is fairly cheap, and we see over 15% of upside, as we look forward over the next 12 months. This represents good upside optionality for us.

Disclaimer:

Firm: Manole Capital Management LLC is a registered investment adviser. The firm is defined to include all accounts managed by Manole Capital Management LLC. **In general:** This disclaimer applies to this document and the verbal or written comments of any person representing it. The information presented is available for client or potential client use only. This summary, which has been furnished on a confidential basis to the recipient, does not constitute an offer of any securities or investment advisory services, which may be made only by means of a private placement memorandum or similar materials which contain a description of material terms and risks. This summary is intended exclusively for the use of the person it has been delivered to by Warren Fisher and it is not to be reproduced or redistributed to any other person without the prior consent of Warren Fisher. **Past Performance:** Past performance generally is not, and should not be construed as, an indication of future results. The information provided should not be relied upon as the basis for making any investment decisions or for selecting The Firm. Past portfolio characteristics are not necessarily indicative of future portfolio characteristics and can be changed. Past strategy allocations are not necessarily indicative of future allocations. Strategy allocations are based on the capital used for the strategy mentioned. This document may contain forward-looking statements and projections that are based on current beliefs and assumptions and on information currently available. **Risk of Loss:** An investment involves a high degree of risk, including the possibility of a total loss thereof. Any investment or strategy managed by The Firm is speculative in nature and there can be no assurance that the investment objective(s) will be achieved. Investors must be prepared to bear the risk of a total loss of their investment. **Distribution:** Manole Capital expressly prohibits any reproduction, in hard copy, electronic or any other form, or any re-distribution of this presentation to any third party without the prior written consent of Manole. This presentation is not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use is contrary to local law or regulation. **Additional information:** Prospective investors are urged to carefully read the applicable memorandums in its entirety. All information is believed to be reasonable, but involve risks, uncertainties and assumptions and prospective investors may not put undue reliance on any of these statements. Information provided herein is presented as of December 2015 (unless otherwise noted) and is derived from sources Warren Fisher considers reliable, but it cannot guarantee its complete accuracy. Any information may be changed or updated without notice to the recipient. **Tax, legal or accounting advice:** This presentation is not intended to provide, and should not be relied upon for, accounting, legal or tax advice or investment recommendations. Any statements of the US federal tax consequences contained in this presentation were not intended to be used and cannot be used to avoid penalties under the US Internal Revenue Code or to promote, market or recommend to another party any tax related matters addressed herein.