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Sent: Wednesday, May 17, 2006 2:17 PM (GMT)
To: O'Meara, Chris M (NY) <comeara@lehman.com>
Subject: Fw: Morgan Stanley strategy update
Attach: ole0.bmp;ole1.bmp;ole2.bmp;MS - citi zoe mtg 11.05.pdf

Interesting point on managing thru stress scenario's something we don't do. The businesses biggest complaint about risk is that they are transactional and positional not focused on bigger stress scenario picture.

-----Original Message-----

From: Lobo, Kenneth
To: Addington, Erik R; Amat, Richard J; Bismal, Anuraj; Chopra, Neeraj; Christofi, Clare; Cohen, Jonathan; Corsalini, Enrico; Deegan, Christopher J; Essex, David; Farup, Sven; Flatman, Shane; Fox, Gary J; Geraghty, Ronald J; Grieb, Edward; Guarino, James; Kiyani, Nadeem; Lynn, Gary; Neave, Jon; Nishimura, Kayoko; O'Meara, Chris M (NY); Oommen, George; Oxenstierna, Tess; Potts, Martin; Reilly, Gerard; Rothbort, Lonnie [London]; Scicutella, Leonard; Simon, Scott A; Smith, Kristine; Smith, Paula; Stabenow, Sigrid M; Stewart, Marie; Umlauf, Erik G; Wang, Catherine

Sent: Tue May 16 17:17:27 2006
Subject: Morgan Stanley strategy update

Citi met with Zoe Cruz of Morgan Stanley. The meeting was positive and there are 2 big take-aways: Expect to see higher VaR balances and also higher Balance Sheet (they appear to be taking a leaf out of Goldman's books, remains to be seen if the results will be match).

KEY TAKEAWAYS FROM CITI's MEETING WITH ZOE CRUZ, CO-PRESIDENT OF MORGAN STANLEY

Management is focused on increasing the level of risk-taking by utilizing more leverage and we estimate that this effort could add \$1.5b to \$2b in revenue... Looking back, management is convinced that the franchise was underleveraged and as a result it left a considerable amount of money on the table.

* MS has the infrastructure to take risk already in place, implying no massive investment spend... In our view, a common misperception is that MS needs to invest heavily to build up a risk management infrastructure. Ms. Cruz made it clear that the firm already has the infrastructure in place and there is no big investment needed. If the risk management infrastructure was not in place, the linked-quarter 69% fixed income revenue growth and 39% equity trading revenue growth in 1Q06 would not have been possible.

* About 80% of the increase in risk taking is based on servicing client needs. While looking at VaR and other risk metrics are common, management is extremely focused on managing risk by stress testing to determine potential losses under various scenarios. Investing in the business based on a 3 to 5 year plan to double earnings. Ms. Cruz highlighted that the key areas of investment in the institutional business are mortgage, equity derivatives, principal risk taking, leveraged finance and prime brokerage. The management team is focused on executing the growth plan vs trying to strategize if its the right part of the cycle to enter into a particular business. Management is convinced that investing and growing the businesses mentioned above are critical for the institutional business to generate

- * higher over-the-cycle returns.
- * New leadership in retail brokerage business embarks on a 3-year fix-it plan, and we estimate that the franchise can add \$550m to \$850m in incremental pretax income. We estimate that very modest 6% revenue growth coupled with bringing the franchise to best in class full-service pretax margins (20- 25% range) could add an incremental \$550m to \$850m in pretax income by the end of 2008 (\$0.35 to \$0.55 EPS impact).
- * Asset management is core to the franchise, and in our view, selling it, spinning it off, or putting it in a minority owned joint venture are all non-starters. While back of the envelope calculations may point to a variety of options to create near-term value, Ms. Cruz was clear that asset management will continue to be core to the franchise. Morgan Stanley wants to own the business and the management team is focused on growing the business.
- * While management has been vocal about growing the alternative investment side of the business through bolt-on type acquisitions, we believe that there has been little activity to date since management is a disciplined buyer (i.e. seems unwilling to overpay).

Below is the story behind the using Leverage to grow the business:

HIGHER LEVERAGE CAN ADD \$1.5B TO \$2B IN REVENUE, OVER \$0.50 EPS, AND 170BPS TO ROE

Management is focused on a higher level of risk taking through increased leverage, to better utilize its larger equity base and more annuitized revenue stream vs. peers

In Exhibit 1, we show that although MS has a higher tangible equity base and more of an annuitized revenue stream relative to peers, it does not take a relatively higher level of risk (as defined by the amount of financial leverage utilized). While there are several measures to evaluate the level of risk taking (VaR, leverage, days with trading losses, etc.), management at MS is focused on increasing the amount of

leverage it utilizes to  generate returns.

Exhibit 1:

<<Picture (Enhanced Metafile)>>

...and assuming MS can maintain its revenue yield on adjusted assets of roughly 6%...

In Exhibit 2, we show that MS is generating about a 6% revenue yield on its adjusted asset base. While this

is a rough estimate (since the adjusted asset base is a point in time), it gives us a basis to estimate the  potential impact of increasing financial leverage.

Exhibit 2:

<<Picture (Enhanced Metafile)>>

...we estimate that increased leverage can add about \$1.5-\$2b in revenue, over \$0.50 EPS, and about 150-200bps to ROE...Based on MS's tangible equity base of \$31b at the end of 1Q06, we walk through an analysis that assumes no growth in equity, to show the impact of increased leverage. In Exhibit 3, we show that adding 1 multiple point to the leverage ratio (i.e. leveraging the existing equity base to add \$31b or 7% to the current \$481b adjusted asset base) could result in an incremental \$1.8b in revenue. Our revenue assumption is based on keeping the incremental revenue yield on adjusted assets constant vs the 2005 average yield of 5.9%. Furthermore, assuming a 45% incremental margin on this revenue yield we estimate

that the incremental EPS generation is about \$0.50 annualized and the additional leverage adds about 170bps to ROE.



Exhibit 3: Higher Leverage Can Add \$1.5b to \$2b in Rev (\$m)
<<Picture (Enhanced Metafile)>>

...and management seems convinced that the risk taking DNA is in place, implying that there is not a massive monetary investment to take more risk. In our view one of the misconceptions surrounding MS is that there needs to be a massive infrastructure build out in order to take more risk on the institutional side of the business. Management indicated that the risk management processes and systems are in place, and its more of cultural acceptance in balancing the ups & downs of risk taking. Furthermore, the higher level of risk taking is also driven by lifting capital commitment constraints on trading desks that have been restricted as part of an overall mandate to achieve the highest ROE with the lowest leverage (a restriction no longer in place). In our view, management understands that critical to the formula of successful

Here is the complete report: <<MS - citi zoe mtg 11.05.pdf>>